COM 431

Corporate Finance and Law

Compulsory Course

M. Com (M 17) – Part I
Semester - IV

YASHWANTRAO CHAVAN MAHARASHTRA OPEN UNIVERSITY
Dnyangangotri, Near Gangapur Dam, Nashik 422 222, Maharashtra

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Dr. Surendra Patole
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School of Commerce & Management
Y.C.M.O.U., Nashik

Dr. Latika Ajitkumar Ajbani
Assistant Professor
School of Commerce & Management
Y.C.M.O.U., Nashik

Authors & Editors

Dr. Parag Prakash Saraf
Director, Institute of Management Science, Pimpri, Pune

Prof. Dr.Shubhangi Kulkarni
Sangamner College, Sangamner

Instructional Technology Editing & Programme Co-ordinator

Dr. Latika Ajitkumar Ajbani
Assistant Professor, School of Commerce & Management, Y.C.M.O.U., Nashik

Production

Shri. Anand Yadav
Manager, Print Production Centre
Y.C.M. Open University, Nashik - 422 222.

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INTRODUCTION

I am very pleased to place this edition of the study material on 'Corporate Finance and Law' to the students and practitioners of this subject.

The syllabus and content of this subject covers most of the aspects from gamut of Company Law and Finance. The objective of this subject is to give a specialized knowledge of Company Law and of Finance.

Students are also expected to take note of all the latest developments relating to the subjects covered in the syllabus by referring to ROC and MCA circulars, financial papers, economic journals, latest books and publications in the subjects concerned.

I have made a sincere attempt to make the subject easy to understand. For this purpose all the topics are written in a simple and lucid language to enable the students to grasp the essence of subject.

This book has got knowledge oriented and exam oriented approach.

I have tried to cover all the necessary acts, laws that are necessary to understand this subject.

Any suggestions will be appreciated.

With knowledge, hard work, marvelous success is just around the corner.

All the best!

- Dr.Parag Prakash Saraf

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SYLLABUS - CORPORATE FINANCE AND LAW

1) ROLE, CONSTITUTION AND POWERS OF SEBI

Composition of SEBI Board, Power and Functions of SEBI, Recognition of Stock Exchanges, Grant of Recognition to Clearing Corporations, Registration and regulation of working of intermediaries associated with securities markets, Promotion and regulation of self regulatory organisations, Fraudulent and unfair trade practices, Fraudulent and unfair trade practices, Investor education and training of intermediaries, Investor Grievance Redressal, Issuing No Objection Certificates, Information called from, inspections undertaken, inquiries and audit of stock exchanges and intermediaries, Delegated powers and functions, Investigation, Enforcement of regulations, Enquiry Proceedings, Prosecution, Cease and Desist proceedings, Prohibition of Manipulative and Deceptive Devices, Insider Trading and Substantial Acquisition of Securities or Control, Establishment of Securities Appellate Tribunal (SAT), Composition, Powers of SAT, Requirements for Appeal to the Tribunal, Powers of Central Government, Some of the other powers of the board include:

2) MERGER, AMALGAMATION AND WINDING UP OF COMPANIES

Corporate Restructuring Techniques, Merger, Takeover/ Acquisition, Joint Venture, Strategic Alliance, Merger and amalgamation of companies, Merger or amalgamation of certain companies, Steps involved in merger and amalgamation- A Flow Chart, Power to acquire shares of shareholders dissenting from scheme or contract approved by majority, Purchase of minority shareholding, Power of Central Government to provide for amalgamation of companies in public interest, Preservation of books and papers of amalgamated companies, Liability of officers in respect of offences committed prior to merger, amalgamation, etc., Winding Up

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Option to opt out in respect of any security, Depositories to indemnify loss in certain cases, SEBI (depositories and participants) regulations, 1996, Rights and obligations of depositories and its constituents, Governing Board, Disclosures and Corporate Governance, Investor Protection Fund, Audit of Depositories, Designated Depository Participant, Basic Services Demat Account (BSDA), Eligible Investor, Charges, Valuation of Holding, Statements, Charges for statements

4) INVESTMENT DECISIONS

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5) FINANCIAL ANALYSIS OF CORPORATES

Ratio Analysis, Importance of Ratio Analysis, Limitations of Ratio Analysis, Fund Flow Analysis, Meaning of Funds, Fund flow statement, Distinction between Fund Flow Statement and Balance Sheet, Objectives of Fund Flow Statement, Advantages of Fund Flow Statement, Limitations of Fund Flow Statement

6) COMPANY MEMBERS TRANSFER AND TRANSMISSION OF SHARES

Company Members, Definition of 'Member', Modes of acquiring Membership, Cessation of Membership, Rights of Members, Register of members, Register of debenture holders or any other security holders, Maintenance of the Register of members etc. under section 88, Index of names to be included in Register, Foreign register of members, debenture holders, other security holders or beneficial owners residing outside India, Authentication, Closure of register of members or debenture holders or other security holders, Return of changes in shareholding position of promoters and top ten shareholders, Inspection of registers, returns etc., Preservation of register of members etc. and annual return, Copies of the registers and annual return, Transfer of shares, Requirement for registering the transfer of securities, Power of company to register, Transmission of securities on an application of transferor alone, Transfer of security of the deceased, Nomination Facility in respect of Shares, Refusal to Register Transfer and Appeal against Refusal, Rectification of register of members on transfer of securities, Transmission of shares

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8) COMPANY MEETINGS AND RESOLUTIONS

Annual General Meeting, Power of Tribunal to call annual general meeting., Power of Tribunal to call meetings of members, etc., Calling of extraordinary general meeting, Notice of meeting, Notice through electronic means, Quorum for meetings, Proxies, Voting by show of hands., Voting through electronic means., Circulation of members' resolution, Representation of President and Governors in meetings, Resolutions, Ordinary and special resolutions, Resolutions and agreements to be filed, Postal Ballot, Items of business to be transacted through postal ballot, Minutes, Minutes of Narration, Minutes of Resolution, Minutes of proceedings of general meeting, meeting of Board of Directors and other meeting and resolutions passed by postal ballot, Inspection of minute-books of general meeting, Report on annual general meeting, Adjournment of Meeting

9) MANAGEMENT OF WORKING CAPITAL-I

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10) MANAGEMENT OF WORKING CAPITAL-II

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12) E-GOVERNANCE AND XBRL

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UNIT - 1
ROLE, CONSTITUTION AND POWERS OF SEBI

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1.3 Power and Functions of SEBI
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1.3.5 Fraudulent and unfair trade practices
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1.0 Introduction

Before 1992, the three principal Acts governing the securities markets were:

(a) the Capital Issues (Control) Act, 1947, which restricted issuer's access

to the securities market and controlled the pricing of issues; (b) the Companies Act, 1956, which sets out the code of conduct for the corporate sector in relation to issue, allotment and transfer of securities, and disclosures to be made in public issues; and (c) the Securities Contracts (Regulation) Act, 1956, which provides for regulation of transactions in securities through control over stock exchanges. The Capital Issues (Control) Act, 1947 had its origin during the war in 1943 when the objective was to channel resources to support the war effort. The Act was retained with some modifications as a means of controlling the raising of capital by companies and to ensure that national resources were channeled into proper lines, i.e., for desirable purposes to serve goals and priorities of the government, and to protect the interests of investors. Under the Act, any firm wishing to issue securities had to obtain approval from the Central Government, which also determined the amount, type and price of the issue.

Major part of the liberalisation process was the repeal of the Capital Issues (Control) Act, 1947 in May 1992. With this, Government's control over issue of capital, pricing of the issues, fixing of premia and rates of interest on debentures etc. ceased. The office which administered the Act was abolished and the market was allowed to allocate resources to competing uses. However to ensure effective regulation of the market, SEBI Act, 1992 was enacted to empower SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market. The Securities and Exchange Board of India (SEBI) was constituted as an interim administrative body under the overall administrative control of the Ministry of Finance (MoF) by a notification published in the Gazette of India: Extraordinary on April 12, 1988. Finally, SEBI was given a statutory status on January 30, 1992 by an ordinance. SEBI was enacted on April 12, 1992 in accordance with the provisions of the SEBI Act, 1992. Its regulatory jurisdiction extends over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. SEBI can specify the matters to be disclosed and the standards of disclosure required for the protection of investors in respect of issues; can issue directions to all intermediaries and other persons associated with the securities market in the interest of investors or of orderly development for securities market; and can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act.

It has been given necessary autonomy and authority to regulate and develop an orderly securities market.

SEBI's preamble describes its core functions '... to protect the interests of investors in securities and to promote the development of, and to regulate securities markets and for matters connected therewith or incidental thereto.'

1.1 Objectives

In this unit, we will introduce you to the role played by SEBI in development of securities market and protection of investors. By the end of this unit, you should be able to:

- Describe the origin of SEBI describe the composition of SEBI board
- Explain the power and functions of SEBI board

1.2 Composition of SEBI Board

Section 4(1) of SEBI Act provides that the SEBI Board shall consist of the following members, namely:

(a) A Chairman;

(b) two members from amongst the officials of the Ministry of the Central Government dealing with Finance and administration of the Companies Act, 2013;

(c) one member from amongst the officials of the Reserve Bank;

(d) five other members of whom at least three shall be the whole time members, to be appointed by the Central Government.

The Chairman and the other members shall be persons of ability, integrity and standing who have shown capacity in dealing with problems relating to securities market or have special knowledge or experience of law, finance, economics, accountancy, administration or in any other discipline which, in the opinion of the Central Government, shall be useful to SEBI.

The terms and conditions of service of Chairman and members are determined in the rules framed by Government in this regard. The general superintendence, direction and management of the affairs of SEBI vests in a Board of members, which may exercises all powers and do all acts and things which may be exercised or done by SEBI. Unless determined otherwise through regulations, the Chairman shall also have all these powers.

CHECK YOUR PROGRESS

How many members from the officials of RBI are involved in composition of SEBI?

1.3 Power and Functions of SEBI

Chapter IV of SEBI Act, 1992 deals with the powers and functions of SEBI. Section 11 of the Act lays down that it shall be the duty of SEBI to protect the interests of the investors in securities and to promote the development of, and to regulate the securities markets by such measures as it thinks fit. Section 11(2) provides that these measures would include:

(a) regulating the business in stock exchanges and any other securities markets;

(b) registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner;

(ba) registering and regulating the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as SEBI may, by notification, specify in this behalf;

(c) registering and regulating the working of venture capital funds and collective investment schemes, including mutual funds;

(d) promoting and regulating self-regulatory organisations;

(e) prohibiting fraudulent and unfair trade practices relating to securities markets;

(f) promoting investors' education and training of intermediaries of securities markets;

(g) prohibiting insider trading in securities;

(h) regulating substantial acquisition of shares and takeover of companies;

(i) calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and self regulatory organisations in the securities market;

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(ia) calling for information and records from any person including any bank or any authority or board or corporation established or constituted by or under any central or state Act, which in the opinion of SEBI, shall be relevant to any investigation or inquiry by SEBI in respect of any transaction in securities.

(ib) calling for information from or furnishing information to other authorities. Whether in India, or outside India having functions similar to those of SEBI, in the matters relating to the prevention or detection of violation in respect of securities laws, subject to the provisions of other laws for the time being in force in this regard.

However, SEBI for the purpose of furnishing any information to any authority outside India, may enter into an arrangement or agreement or understanding with such authority with approval of the Central Government.

(j) performing such functions and exercising such powers under the provisions of the Securities Contracts

(Regulation) Act, 1956, as may be delegated to it by the Central Government;

(k) levying fees or other charges for carrying out the purposes of this section;

(l) conducting research for the above purposes;

(la) calling from or furnishing to any such agencies, as may be specified by SEBI, such information as may be considered necessary by it for the efficient discharge of its functions;

(m) performing such other functions as may be prescribed.

CHECK YOUR PROGRESS

What is the full form of BSE & NSE?

Following are the powers of SEBI-

1.3.1 Recognition of Stock Exchanges

Stock exchanges are granted recognition for operations in securities markets by SEBI under Section 4 of SCRA, 1956. As on March 31, 2015 there were 13 stock exchanges in India, of which six have been granted permanent recognition, one stock exchange, the Metropolitan Stock Exchange Ltd. (earlier MCX-SX), has been granted renewal of recognition while the remaining six stock exchanges have not been granted recognition. Among the 13 stock exchanges, the Bombay Stock Exchange (BSE), the National Stock Exchange (NSE) and the Metropolitan Stock Exchange (MSEI) have been granted permission for carrying out trade in four segments - equity, equity derivatives, currency derivatives and interest rate derivatives.

1.3.2 Grant of Recognition to Clearing Corporations

SEBI has by exercising its powers granted recognition to the National Securities Clearing Corporation Ltd. (NSCCL), the Indian Clearing Corporation Ltd. (ICCL) and the MCX-SX Clearing Corporation Ltd. (MCX-SXCCL).

1.3.3 Registration and regulation of working of intermediaries associated with securities markets

Regulation of market intermediaries has three objectives: protecting client assets from insolvency of the intermediaries and guarding against defaults and sudden disruptions in the market, ensuring that the intermediaries are fair and diligent in dealing with their clients and reducing conflicts of interest. Regulation, therefore,

sets qualifying standards, prudential standards, internal controls and risk management standards and enforces a code of conduct. In order to enhance investor confidence, it is necessary that all the intermediaries maintain high standards of integrity and fairness and also act with due skill, care and diligence in the conduct of their business with high levels of compliance. Various intermediaries' regulations have been framed under the SEBI Act, 1992 and the Depositories Act, 1996 for the registration and regulation of all market intermediaries. Under these Acts, the Government and SEBI issue notifications, guidelines and circulars that the market intermediaries need to comply with. SEBI ensures the standard and quality of services to clients and investors, fair and sound conduct and compliance practices.

1.3.4 Promotion and regulation of self regulatory organisations

SEBI (Self-Regulatory Organisations), 2004 was notified on February 19, 2004 with the objective of promoting organisation of intermediaries representing a particular segment of the securities market as a self regulated entity/organisation. For recognition of an organisation of intermediaries as SROs, SEBI held discussions with various bodies like the Association of Merchant Bankers of India (AMBI), the Association of NSE Members of India (ANMI) and the Registrars Association of India (RAIN). SEBI has decided to have a single SRO for distributors of mutual fund products and a two stage procedure for granting recognition as SRO for distributors of mutual fund products, that is, grant of in-principle approval and grant of recognition.

CHECK YOUR PROGRESS

Explain the powers of SEBI related to recognition of stock exchange.

1.3.5 Fraudulent and unfair trade practices

To protect investor interests and to promote fair and orderly securities market, SEBI ensures the integrity of markets by detecting market frauds on a proactive basis, investigating abusive, manipulative or illegal trading practices in securities markets and taking punitive steps to punish the manipulators. Market surveillance helps in ensuring integrity of markets by enabling a safe and sound environment where buyers and sellers are willing to participate confidently.

1.3.6 Investor education and training of intermediaries

Section 11(2)(f) of the SEBI Act empowers SEBI to promote investors' education and foster training for intermediaries in securities markets. Along with investor education and training, SEBI has also actively pursued investor grievance redressal with a view to protecting investor interests, enhancing their confidence and increasing their participation.

1.3.7 Investor Grievance Redressal

SEBI has been taking various regulatory measures to expedite the redressal of investor grievances. The grievances lodged by investors are taken up with the respective listed company or intermediary and are continuously monitored. Grievances pertaining to stock brokers and depository participants are taken up with the concerned stock exchange and depository for redressal and monitored by the concerned department through periodic reports obtained from them. Grievances pertaining to other intermediaries are taken up with them directly for redressal and continuously monitored by the concerned department at SEBI.

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1.3.8 Issuing No Objection Certificates

Companies raising capital through public issues of securities are required to deposit one percent of the issue amount with the designated stock exchange. This deposit is released by the stock exchange only after No objection certificate is received. SEBI issues NOCs to companies after satisfactory redressal of complaints received by SEBI against the companies.

1.3.9 Information called from, inspections undertaken, inquiries and audit of stock exchanges and intermediaries

Regulation of intermediaries is an essential part of the framework for regulation of securities markets. The basic objective of prudential supervision of market intermediaries is to safeguard the stability of the financial system, protect client interests from undue risks of losses that may arise from failure, fraud or any opportunist behaviour on the part of the intermediaries, promote the efficient performance of intermediaries and markets and ensure compliance by market intermediaries. Supervision of intermediaries through on-site and off-site inspections, enquiries and adjudications in case of violations of rules and regulations and administrative and statutory actions are essential features of effective enforcement by SEBI. SEBI conducts inspections of market intermediaries directly as well as through institutions like stock exchanges and depositories. Inspections were conducted during the year to verify the compliance levels of intermediaries. Special purpose (theme based) inspections were also conducted on the basis of investor complaints, references, surveillance reports and specific concerns. Special purpose inspections of major stock exchanges as well as the depositories were also carried out in order to examine the effectiveness and quality of their audits/inspections and action taking processes.

CHECK YOUR PROGRESS

What are the powers of SEBI dealing with inspection of depositories?

I. Inspection of Stock Exchanges, Depositories and Clearing Corporations

A. Inspection of Stock Exchanges

During the inspection of stock exchanges, a review of market operations, organisational structure and administrative control of the stock exchange is conducted to ascertain as to whether:

a. It provides a fair, equitable, transparent and growing market to investors,
b. Its organisation system and practices are in accordance with the SC(R) Act, 1956 and rules framed thereunder,
c. It has implemented the directions, guidelines and instructions issued by SEBI/Government of India (GoI) from time to time, and
d. It has complied with the conditions, if any, imposed on it at the time of renewal/grant of its recognition

B. Inspection of Depositories

During the inspection of depositories, a review of market operations, organisational structure and administrative control of the depository is conducted to ascertain as to whether:

a. The procedures and practices of the depository are in compliance with the Depositories Act, 1996, SEBI (Depositories and Participants) Regulations, 1996, SEBI circulars, bye-laws etc.,
b. The books of account are being maintained by the depository in accordance with SEBI (Depositories and Participants), Regulations, 1996, and
c. Complaints received by depositories from participants, issuers, issuers' agents, beneficiary owners or any other person are redressed.

II. Inspection of Market Intermediaries

The inspection process of intermediaries has been further streamlined with a view to improving quality such as selection of themes for inspections, questionnaire for inspections and follows up action. Based on the findings of the inspections after considering the comments of intermediaries, they were specifically advised about the areas where improvements were required. They were also required to report to SEBI about the corrective steps taken and also place these before their board/ partners/ proprietor, as the case may be. These steps taken by SEBI have improved the level of compliance among the intermediaries. Administrative and quasi-judicial actions were initiated based on the deficiencies and seriousness of the violations committed by the intermediaries.

The focus of the inspections include themes such as compliance of norms regarding anti-money laundering, the investor redressal mechanism, handling funds and securities of clients, settlement of accounts of clients on a timely basis, segregation of clients and proprietary funds/ securities, KYC norms and clearing operations. Inspection of books of accounts, records and other documents pertaining to a portfolio manager are carried out to verify whether the books of accounts, records and other documents were being maintained in the specified manner including compliance with respect to AML/CFT and KYC norms. It may be noted that a pre-registration/renewal visit is conducted before granting registration/renewal of registration to a portfolio manager.

CHECK YOUR PROGRESS

What are the delegated powers and functions of SEBI?

1.3.10 Delegated powers and functions

Section 29A of SCRA, 1956 permits the central government to delegate powers exercisable by it under any provision of SCRA, 1956 to SEBI also by order published in the official Gazette except the power to make rules. The Central Government has delegated certain powers to SEBI with respect to regulation of contracts in securities and stock exchanges and clearing corporations.

The delegated powers with respect to contracts in securities include the power to notify permissible contracts in securities and the power to prohibit contract in securities in certain cases.

1.3.11 Investigation

- Timely completion of investigation cases and effective, proportionate and dissuasive action in case of violations of securities laws are important for the protection of investors' interests and ensuring fair, transparent and orderly functioning of the markets. It is also vital for improving the confidence in the integrity of securities markets. SEBI is therefore constantly striving to upgrade its investigative skills by making use of information technology (IT) and other latest investigative tools. The importance of effective and credible use of investigations has also been underscored by IOSCO in its 'Principles for the Enforcement of Securities Regulation'.
- Keeping these objectives and principles of securities regulations in view, SEBI initiates investigations to examine alleged or suspected violations of laws and regulations relating to securities markets. Possible violations may include price manipulation, creating an artificial market, insider trading, capital issue related

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irregularities, takeover related violations, non-compliance of disclosure requirements and any other misconduct in securities markets.

- The Board may, by an order in writing, direct any person to investigate the affairs of such intermediary or persons associated with the securities market and to report thereon to the Board.
- It shall be the duty of every manager, managing director, officer and other employee of the company and every intermediary to preserve and to produce to the Investigating Authority all the books, registers, other documents and record of, or relating to, the company or, as the case may be, of or relating to, the intermediary or such person, which are in their custody or power.
- The Investigating Authority may require the concerned persons to furnish such information to, or produce such books, or registers, or other documents, or record before him.
- The Investigating Authority may keep in its custody any books, registers, other documents and record for six months and thereafter shall return the same to the concerned persons by whom or on whose behalf the books, registers, other documents and record are produced. The Investigating Authority may call for any book, register, other document and record if they are needed again.
- The Investigating Authority may examine on oath, any manager, managing director, officer and other employee of any intermediary or any person associated with securities market in any manner, in relation to the affairs of his business and may administer an oath accordingly and for that purpose, may require any of those persons to appear before him personally.
- If any person fails without reasonable cause or refuses to produce to an Investigating Authority any book, register, other document and record or to furnish any information which it is his duty or to appear before the Investigating Authority personally when required to do so or to answer any question which is put to him by the Investigating Authority or to sign the notes of any examination he shall be punishable with imprisonment for a term which may extend to one year, or with fine, which may extend to one crore rupees, or with both, and also with a further fine which may extend to five lakh rupees for every day after the first during which the failure or refusal continues.
- The Investigating Authority may, pursuant to an order made on an application by the Judicial Magistrate of the first class having jurisdiction-enter the place or places where such books, registers, other documents and record are kept; search that place or those places in the manner specified in the order; and seize books, registers, other documents and record it considers necessary for the purposes of the investigation.

1.3.12 Enforcement of regulations

Effective enforcement lies at the heart of ensuring integrity, transparency and fairness in the market. It not only leads to a better compliance culture, but also underscores the point that market misconduct and abuse will not go unpunished. A credible enforcement strategy underpins the importance of consistent, timely and transparent regulatory outcomes, which are proportionate, dissuasive and effective. Under the SEBI Act, 1992, SCRA, 1956 and the Depositories Act, 1996, SEBI broadly pursues two streams of enforcement actions: administrative/civil or criminal. Administrative/civil actions include issuing directions such as remedial orders, cease and desist orders, suspension or cancellation of certificates of registration and

imposition of monetary penalty under the respective statutes. Proceedings of a criminal nature involve initiating prosecution proceedings against violators by filing criminal complaints before a competent court.

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1.3.13 Enquiry Proceedings

SEBI may suspend or cancel the certificate of registration of an intermediary through enquiry regulations on the recommendation of the enquiry officer/designated authority appointed for that purpose. It may also issue a warning to an intermediary if it considers that the violations committed by the intermediary do not warrant suspension or cancellation of registration.

1.3.14 Prosecution

Section 24 of the SEBI Act, 1992 empowers SEBI to launch prosecution against any person for contravention of any provision of the SEBI Act, 1992 or any rules or regulations made there under before a court of criminal jurisdiction.

1.3.15 Cease and Desist proceedings

CHECK YOUR PROGRESS

Explain Cease and Desist proceedings in consideration with regulation enforcement.

- If the Board finds, after causing an inquiry to be made that any person has violated, or is likely to violate, any provisions of this Act, or any rules or regulations made thereunder, the Board may pass an order requiring such person to cease and desist from committing or causing such violation.
- Board shall pass such order in respect of listed public company or a public company which intends to get its securities listed on any recognized stock exchange only if such company has indulged in insider trading or market manipulation.

1.3.16 Prohibition of Manipulative and Deceptive Devices, Insider Trading and Substantial Acquisition of Securities or Control

The following activities have been prohibited -

- use or employment of any manipulative or deceptive device or contrivance in contravention of the provisions of this Act or the rules or the regulations made there under;
- employment of any device, scheme or artifice to defraud in connection with issue or dealing in securities ;
- engaging in any act, practice, course of business which operates or would operate as fraud or deceipt upon any person, in connection with the issue, dealing in securities in contravention of the provisions of this Act or the rules and the regulations made there under;
- engaging in insider trading;
- dealing in securities while in possession of material or non-public information or communicating such material or non-public information to any other person, in a manner which is in contravention of the provisions of this Act or the rules and the regulations made there under;
- acquiring control of any company or securities more than the percentage of equity share capital of a listed company in contravention of the provisions of this Act or the rules and the regulations made there under.

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1.4 Establishment of Securities Appellate Tribunal (SAT)

1.4.1 Composition

- The Securities Appellate Tribunal shall consist of a Presiding Officer and two other members.
- A person, who is a sitting or retired Judge of the Supreme Court or a sitting or retired Chief Justice of a High Court, may be appointed as Presiding Officer in consultation with the Chief Justice of India or his nominee.
- A person who is a person of ability, integrity and standing who has shown capacity in dealing with problems relating to securities market and has qualification and experience of corporate law, securities laws, finance, economics or accountancy shall be qualified for appointment as Member
- A member of the Board or any person holding a post at level equivalent to Executive Director in the Board shall not be appointed as Presiding Officer or Member of a Securities Appellate Tribunal during his service or tenure as such with the Board or within two years from the date on which he ceases to hold office as such in the Board.
- The Presiding Officer, Members and other officers and employees of the Securities Appellate Tribunal shall be deemed to be public servants.
- Appeal to Supreme Court- Against any decision or order of the Securities Appellate Tribunal an appeal shall to the Supreme Court.
- Such appeal may be filed by the aggrieved party within sixty days from the date of communication of the decision or order on any question of law arising out of such order.

CHECK YOUR PROGRESS
How many number of members composite the Securities Appellate Tribunal (SAT)

1.4.2 Powers of SAT

The Securities Appellate Tribunals shall have, for the purposes of discharging their functions under this Act, the same powers as are vested in a Civil Court under the Code of Civil Procedure, 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) reviewing its decisions;

(f) dismissing an application for default or deciding it ex parte;

(g) setting aside any order of dismissal of any application for default or any order passed by it ex parte;

(h) any other matter which may be prescribed.

1.4.3 Requirements for Appeal to the Tribunal-

Section 15T lays down that any person aggrieved:

1) (a) by an order of SEBI made, under this Act, or the rules or regulations made thereunder; or (b) by an order made by an adjudicating officer under this Act may prefer an appeal to a Securities Appellate Tribunal having jurisdiction in the matter.

2) Every appeal shall be filed within a period of 45 days from the date on which a copy of the order made by SEBI or the Adjudicating Officer, as the case may be, is received by him and it shall be in such form and be accompanied by prescribed fee.

   However, the Securities Appellate Tribunal may entertain an appeal after the expiry of the said period of 45 days if it is satisfied that there was sufficient cause for not filing it within that period.

3) On receipt of an appeal, the Securities Appellate Tribunal may, after giving the parties to the appeal, an opportunity of being heard, pass such orders thereon as it thinks fit, confirming, modifying or setting aside the order appealed against.

4) The Securities Appellate Tribunal shall send a copy of every order made by it to SEBI and the parties to the appeal and to the concerned Adjudicating Officer.

5) The appeal filed before the Securities Appellate Tribunal shall be dealt with by it as expeditiously as possible and endeavour shall be made by it to dispose of the appeal finally within six months from the date of receipt of the appeal.

CHECK YOUR PROGRESS

How can central govt. Supercede SEBI?

1.4.4 Powers of Central Government

(a) To issue directions

Section 16 empowers Central Government to issue directions in writing to SEBI on questions of policy as it may deem fit from time to time. However the Central Government shall as far as practicable, give an opportunity to SEBI to express its views before any such directions is given by the Central Government. The decision of the Central Government as to whether a question is one of policy or not shall be final.

(b) To Supercede SEBI

Section 17 lays down that if at any time the Central Government is of opinion that:

(a) on account of grave emergency, SEBI is unable to discharge the functions and duties imposed on it by or under the provisions of this Act; or

(b) SEBI has persistently made default in complying with any direction issued by the Central Government under this Act or in the discharge of the functions and duties imposed on it by or under the provisions of this Act and as a result of such default the financial position of SEBI or the administration of SEBI has deteriorated; or

(c) circumstances exist which render it necessary in the public interest so to do, it may, by notification, supersede SEBI for such period, not exceeding six months, as may be specified in the notification.

Upon the publication of the notification, it will have the following effects:

(a) all the 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 by or on behalf of SEBI, shall until SEBI is reconstituted under sub-section (3), be exercised and discharged by such person or persons as the Central Government may direct; and

(c) all property owned or controlled by SEBI shall, until SEBI is reconstituted,

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vest in the Central Government. On the expiration of the period of supersession specified in the notification, the Central Government may reconstitute SEBI by a fresh appointment and in such case any person or persons who vacated their offices because of supersession shall not be deemed disqualified for appointment.

However, the Central Government may, at any time, before the expiration of the period of supersession, take action. The Central Government shall cause a notification issued and a full report of any action taken under this section and the circumstances to such action to be laid before each House of Parliament at the earliest.

(c) Power to Grant Immunity

(a) If on recommendation by the Board, the Central Government is satisfied that any person, who is alleged to have violated any of the provisions of this Act or the rules or the regulations made thereunder, has made a full and true disclosure in respect of the alleged violation, it may grant to such person, subject to such conditions as it may think fit to impose, immunity from prosecution for any offence under this Act, or the rules or the regulations made thereunder or also from the imposition of any penalty under this Act with respect to the alleged violation.

(b) No such immunity can be granted in cases where the proceedings for the prosecution for any such offence have been instituted before the date of receipt of application for grant of such immunity.

(c) An immunity granted to a person may, at any time, be withdrawn by the Central Government, if it is satisfied that such person had, in the course of the proceedings, not complied with the condition on which the immunity was granted or had given false evidence.

CHECK YOUR PROGRESS
List out the powers of SEBI?

1.5 Some of the Other Powers of the Board Include

1. The Board has been conferred powers for passing an order for reasons to be recorded in writing, in the interest of investors or securities market, either pending investigation or enquiry or on completion of such investigation or enquiry for taking any of the following :

- Suspend the trading of any security in any recognised stock exchange.
- Restrain persons from accessing the securities market and prohibit any person associated with the securities market to buy, sell or deal in securities.
- Suspend any office bearer of any stock exchange or self regulatory organization from holding such position.
- Impound and retain the proceeds or securities in respect of any transaction which is under investigation.
- Attach one or more bank account of any intermediary or person associated with the securities market in any manner involved in violation of any of the provisions of the Act, Rules or Regulations. However, such order of attachment can be made by the Board only after passing of an order by a Judicial Magistrate of the First Class on an application made for the approval. Further, such order of attachment can be made only for a period not exceeding one month and that only the bank account so far as it relates to the proceeds actually involved in violation of the provisions of the Act, Rules, or Regulations shall

be allowed to be attached.

- Direct any intermediary or any person associated with the securities market in any manner not to dispose off or alienate an asset forming part of the transaction which is under investigation.

2. The Board may, for the protection of investors, by general or special orders -

- Prohibit any company from issuing prospectus, any offer document, or advertisement soliciting money from the public by the issue of securities;
- Specify the conditions subject to which the prospectus, such offer document or advertisement, if not prohibited, may be issued.
- The Board may specify the requirements for listing and transfer of securities.

1.6 Key Concepts

- **BSE :** Bombay Stock Exchange
- **NSE :** National Stock Exchange
- **SEBI :** Securities Exchange Board of India

1.7 Summary

- Before 1992, the three principal Acts governing the securities markets were the Capital Issues (Control) Act, 1947, the Companies Act, 1956 & the Securities Contracts (Regulation) Act, 1956.
- To ensure effective regulation of the market, SEBI Act, 1992 was enacted to empower SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market.
- SEBI was enacted on April 12, 1992 in accordance with the provisions of the SEBI Act, 1992.
- The SEBI Board shall consist of the following members, namely:
  (a) a Chairman;
  (b) two members from amongst the officials of the Ministry of the Central Government dealing with Finance and administration of the Companies Act, 2013;
  (c) one member from amongst the officials of the Reserve Bank;
  (d) five other members of whom at least three shall be the whole time members, to be appointed by the Central Government.
- The powers and functions of SEBI are as follows:
  (a) Recognition of Stock Exchanges
  (b) Grant of Recognition to Clearing Corporations
  (c) Registration and regulation of working of intermediaries associated with securities markets
  (d) Promotion and regulation of self regulatory organisations
  (e) Fraudulent and unfair trade practices
  (f) Investor education and training of intermediaries
  (g) Investor Grievance Redressal
  (h) Issuing No Objection Certificates

(i) Information called from, inspections undertaken, inquiries and audit of stock exchanges and intermediaries

(j) Investigation

(k) Enforcement of regulations

(l) Enquiry Proceedings

(m) Prosecution

(n) Cease and Desist proceedings

(o) Prohibition of Manipulative and Deceptive Devices, Insider Trading and Substantial Acquisition of Securities or Control

(p) Establishment of Securities Appellate Tribunal (SAT)

Composition, Powers of SAT, Requirements for appeal to the tribunal, Powers of Central Government.

1.8 Questions and Exercise

1. What are the measures that SEBI shall take to protect the interest of the investors in securities?
2. Explain the power of SEBI board with respect to grant of immunity?
3. Explain the investigative powers of SEBI board.
4. What is the time period for filling an appeal with SAT and Supreme Court?

● **Fill in the blanks**

1. SEBI consists of one member from the _____.

   (Department of Defence, Reserve Bank of India, Ministry of Corporate Affairs,)

2. _____is not the function of SEBI.

   (regulating the businesss of stock exchanges, regulating the working of stock brokers, registering the business of Depositories, changing the name of the company)

3. Companies raising capital through public issues of securities are required to deposit _____ of the issue amount with the designated stock exchange.

   (fifty percent, one percent, five percent, twenty percent)

4. During the _____ of stock exchanges and market intermediaries a review of market operations, organisational structure and administrative control of the stock exchange is conducted.

   (inspection, regulation, calculation, management)

5. The _____ may call for any book, register, other document and record if they are needed.

   (investigating authority, higher authority, checking authority, ruling authority)

6. If any person fails without reasonable cause or refuses to produce to an Investigating Authority any book, register, other document and record he shall be punishable with imprisonment for a term which may extend to one year, or with fine, which may extend to _____ rupees, or with both.

   (one lakh, one crore, one thousand, one hundred)

7. A credible _____ underpins the importance of consistent, timely and transparent regulatory outcomes, which are proportionate, dissuasive and effective.

   (regulation strategy, imposition strategy, enforcement strategy, conducting

strategy)

8. Board shall pass _____ order in respect of listed public company or a public company which intends to get its securities listed on any recognized stock exchange only if such company has indulged in insider trading or market manipulation.

   (cease and desist, lock and prohibit, check and break, stop and discard)

9. While constituting Securities Appellate Tribunal, a person, who is a sitting or retired Judge of the Supreme Court or a sitting or retired Chief Justice of a High Court, may be appointed as _____ in consultation with the Chief Justice of India or his nominee.

   (Presiding Officer, Member, Secretary, Director)

10. Appeal to Supreme Court against any decision or order of the Securities Appellate Tribunal shall be made within _____ from the date of communication of the decision or order by SAT.

    (15 days, 30 days, 40 days, 60 days)

Answers: 1) Reserve Bank of India, 2) changing the name of the company, 3) one percent, 4) inspection, 5)investigating authority, 6)one crore, 7) enforcement strategy, 8)cease and desist order, 9)Presiding Officer, 10)60 days

1.9 Further Reading and References

V.L. Iyer : SEBI Practice Manual; Taxman Allied Service (P) Ltd., 59/32, New Rohtak Road, New Delhi 110005.

Sanjeev Aggarwal: Guide to Indian Capital Market; Bharat Law House, 22, Tarun Enclave, Pitampura, New Delhi - 110 034.

S. Suryanarayanan & V. Varadarajan : SEBI - Law, Practice & Procedure; Commercial Law Publishers (India) Pvt. Ltd., 151, Rajindra Market, Opp. Tis Hazari Court, Delhi - 110054

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UNIT - 2
MERGER, AMALGAMATION AND WINDING UP OF COMPANIES

2.0 Introduction
2.1 Objectives
2.2 Corporate Restructuring Techniques
2.2.1 Merger
2.2.2 Takeover/ Acquisition
2.2.3 Joint Venture
2.2.4 Strategic Alliance
2.3 Merger and amalgamation of companies
2.4 Merger or amalgamation of certain companies
2.5 Steps involved in merger and amalgamation- A Flow Chart
2.6 Power to acquire shares of shareholders dissenting from scheme or contract approved by majority
2.7 Purchase of minority shareholding
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2.9 Preservation of books and papers of amalgamated companies
2.10 Liability of officers in respect of offences committed prior to merger, amalgamation, etc.
2.11 Winding Up
2.12 Key Concepts
2.13 Summary
2.14 Questions and Exercises
2.15 Further Reading and References

CHECK YOUR PROGRESS

Why there is a need to change the organizational structure

2.0 Introduction

Corporate restructuring is defined as the process involved in changing the organization of a business.

Corporate restructuring can involve making dramatic changes to a business by cutting out or merging departments. It implies rearranging the business for increased efficiency and profitability. In other words, it is a comprehensive process, by which a company can consolidate its business operations and strengthen its position for achieving corporate objectives-synergies and continuing as competitive and successful entity.

The various needs for undertaking a Corporate Restructuring exercise are as follows:

(i) to focus on core strengths, operational synergy and efficient allocation of managerial capabilities and infrastructure.

(ii) consolidation and economies of scale by expansion and diversion to exploit extended domestic and global markets.

(iii) revival and rehabilitation of a sick unit by adjusting losses of the sick unit with profits of a healthy company.

(iv) acquiring constant supply of raw materials and access to scientific research and technological developments.

(v) capital restructuring by appropriate mix of loan and equity funds to reduce the cost of servicing and improve return on capital employed.

(vi) Improve corporate performance to bring it at par with competitors by adopting the radical changes brought out by information technology.

2.2 Objectives

In this unit, you will be introduced to the rules and regulations dealing with mergers, amalgamations and winding up. By the end of this unit, you should be able to:

- explain the rules dealing with mergers and amalgamations
- describe the process of mergers and amalgamations of certain companies
- discuss the power of Central Government to provide for amalgamation of companies in public interest
- discuss the circumstances in which company may be wound up by Tribunal
- describe the procedure dealing with petition for winding up

CHECK YOUR PROGRESS

What are the Corporate Restructuring Techniques?

2.2 Corporate Restructuring Techniques

2.2.1 Merger

Merger is the combination of two or more companies which can be merged together either by way of amalgamation or absorption. The combining of two or more companies, is generally by offering the stockholders of one company securities in the acquiring company in exchange for the surrender of their stock.

Mergers may be

(i) Horizontal Merger: It is a merger of two or more companies that compete in the same industry. It is a merger with a direct competitor and hence expands as the firm's operations in the same industry. Horizontal mergers are designed to achieve economies of scale and result in reduce the number of competitors in the industry.

(ii) Vertical Merger: It is a merger which takes place upon the combination of two companies which are operating in the same industry but at different stages of production or distribution system. If a company takes over its supplier/ producers of raw material, then it may result in backward integration of its activities. On the other hand, Forward integration may result if a company decides to take over the retailer or Customer Company. Vertical merger provides a way for total integration to those firms which are striving for owning of all phases of the production schedule together with the marketing network

(iii) Co generic Merger: It is the type of merger, where two companies are in the same correlated industries but do not offer the same products, but related products and may share similar distribution channels, providing synergies for the merger. The potential benefit from these mergers is high because these transactions offer opportunities to diversify around a common case of strategic resources.

(iv) Conglomerate Merger: These mergers involve firms engaged in unrelated type of activities i.e. the business of two companies are not related to each other horizontally or vertically. In a pure conglomerate, there are no important

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common factors between the companies in production, marketing, research and development and technology. Conglomerate mergers are merger of different kinds of businesses under one flagship company. The purpose of merger remains utilization of financial resources enlarged debt capacity and also synergy of managerial functions. It does not have direct impact on acquisition of monopoly power and is thus favoured throughout the world as a means of diversification.

2.2.2 Takeover/ Acquisition

Takeover means an acquirer takes over the control of the target company. It is also known as acquisition.

Normally this type of acquisition is undertaken to achieve market supremacy. It may be friendly or hostile takeover.

Friendly takeover: In this type, one company takes over the management of the target company with the permission of the board.

CHECK YOUR PROGRESS
What is Strategic Alliance?

Hostile takeover: In this type, one company takes over the management of the target company without its knowledge and against the wish of their management.

2.2.3 Joint Venture

A joint venture is an entity formed by two or more companies to undertake financial activity together. The parties agree to contribute equity to form a new entity and share the revenues, expenses, and control of the company. It may be Project based joint venture or Functional based joint venture.

Project based Joint venture: The joint venture entered into by the companies in order to achieve a specific task is known as project based JV.

Functional based Joint venture: The joint venture entered into by the companies in order to achieve mutual benefit is known as functional based JV.

2.2.4 Strategic Alliance

Any agreement between two or more parties to collaborate with each other, in order to achieve certain objectives while continuing to remain independent organizations is called strategic alliance.

2.3 Merger and Amalgamation of Companies

(1) Where an application is made to the Tribunal under section 230 for the sanctioning of a compromise or an arrangement proposed between a company and any such persons as are mentioned in that section, and it is shown to the Tribunal that under the scheme, the whole or any part of the undertaking, property or liabilities of any company (hereinafter referred to as the transferor company) is required to be transferred to another company (hereinafter referred to as the transferee company), or is proposed to be divided among and transferred to two or more companies, the Tribunal may on such application, order a meeting of the creditors or class of creditors or the members or class of members, as the case may be.

(2) Merging companies or the companies in respect of which a division is proposed, shall also be required to circulate the following for the meeting so ordered by the Tribunal, namely:-

(a) the draft of the proposed terms of the scheme drawn up and adopted by

the directors of the merging company;

(b) confirmation that a copy of the draft scheme has been filed with the Registrar;

(c) a report adopted by the directors of the merging companies explaining effect of compromise on each class of shareholders, key managerial personnel, promotors and non-promoter shareholders laying out in particular the share exchange ratio, specifying any special valuation difficulties;

(d) the report of the expert with regard to valuation, if any;

(e) a supplementary accounting statement if the last annual accounts of any of the merging company relate to a financial year ending more than six months before the first meeting of the company summoned for the purposes of approving the scheme.

(3) The Tribunal, after satisfying itself that the procedure specified has been complied with, may, by order, sanction the compromise or arrangement.

(4) Where an order under this section provides for the transfer of any property or liabilities, then, by virtue of the order, that property shall be transferred to the transferee company and the liabilities shall be transferred to and become the liabilities of the transferee company and any property may, if the order so directs, be freed from any charge which shall by virtue of the compromise or arrangement, cease to have effect.

(5) Every company in relation to which the order is made shall cause a certified copy of the order to be filed with the Registrar for registration within thirty days of the receipt of certified copy of the order.

(6) The scheme under this section shall clearly indicate an appointed date from which it shall be effective and the scheme shall be deemed to be effective from such date and not at a date subsequent to the appointed date.

(7) Every company in relation to which the order is made shall, until the completion of the scheme, file a statement in such form and within such time as may be prescribed with the Registrar every year duly certified by a chartered accountant or a cost accountant or a company secretary in practice indicating whether the scheme is being complied with in accordance with the orders of the Tribunal or not.

(8) If a transferor company or a transferee company contravenes the provisions of this section, the transferor company or the transferee company, as the case may be, shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees and every officer of such transferor or transferee company who is in default, shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

CHECK YOUR PROGRESS

Discuss the regulations associated with merger and amalgamation of companies.

Discuss the regulations associated with merger and amalgamation of companies.

2.4 Merger or Amalgamation of Certain Companies

1) A scheme of merger or amalgamation may be entered into between two or more small companies or between a holding company and its wholly-owned subsidiary company or such other class or classes of companies as may be

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prescribed, subject to the following, namely:-

(a) a notice of the proposed scheme inviting objections or suggestions, if any, from the Registrar and Official Liquidators where registered office of the respective companies are situated or persons affected by the scheme within thirty days is issued by the transfer or company or companies and the transferee company;

(b) the objections and suggestions received are considered by the companies in their respective general meetings and the scheme is approved by the respective members or class of members at a general meeting holding at least ninety per cent of the total number of shares;

(c) each of the companies involved in the merger files a declaration of solvency, in the prescribed form, with the Registrar of the place where the registered office of the company is situated; and

(d) the scheme is approved by majority representing nine-tenths in value of the creditors or class of creditors of respective companies indicated in a meeting convened by the company by giving a notice of twenty-one days along with the scheme to its creditors for the purpose or otherwise approved in writing.

CHECK YOUR PROGRESS

Explain the procedure for merger and amalgamation.

2) The transferee company shall file a copy of the scheme so approved in the manner as may be prescribed, with the Central Government, Registrar and the Official Liquidator where the registered office of the company is situated.

3) On the receipt of the scheme, if the Registrar or the Official Liquidator has no objections or suggestions to the scheme, the Central Government shall register the same and issue a confirmation thereof to the companies.

4) If the Registrar or Official Liquidator has any objections or suggestions, he may communicate the same in writing to the Central Government within a period of thirty days:

Provided that if no such communication is made, it shall be presumed that he has no objection to the scheme.

5) If the Central Government after receiving the objections or suggestions or for any reason is of the opinion that such a scheme is not in public interest or in the interest of the creditors, it may file an application before the Tribunal within a period of sixty days of the receipt of the scheme stating its objections.

6) On receipt of an application from the Central Government or from any person, if the Tribunal, for reasons to be recorded in writing, is of the opinion that the scheme should not be given a go ahead, the Tribunal may direct accordingly or it may confirm the scheme by passing such order as it deems fit.

7) A copy of the order confirming the scheme shall be communicated to the Registrar having jurisdiction over the transferee company and the persons concerned and the Registrar shall register the scheme and issue a confirmation thereof to the companies and such confirmation shall be communicated to the Registrars where Transferor Company or companies were situated.

8) The registration of the scheme shall have the following effects, namely:-

(a) transfer of property or liabilities of the transferor company to the transferee company so that the property becomes the property of the transferee company and the liabilities become the liabilities of the transferee company;

(b) the charges, if any, on the property of the transferor company shall be applicable and enforceable as if the charges were on the property of the transferee company;

(c) legal proceedings by or against the transferor company pending before

any court of law shall be continued by or against the transferee company; and

(d) where the scheme provides for purchase of shares held by the dissenting shareholders

or settlement of debt due to dissenting creditors, such amount, to the extent it is unpaid, shall become the liability of the transferee company.

9) The transferee company shall file an application with the Registrar along with the scheme

registered, indicating the revised authorised capital and pay the prescribed fees due on revised capital.

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2.5 Steps Involved in Merger and Amalgamation A Flow Chart

Check memorandum whether it authorizes Merger	----If No----	Amend the Object Clause
Convene a preliminary Board Meeting		
Prepare Valuation Report & Swap Ratio		
Preparation of scheme of Amalgamation		
Convene Board meeting to approve the scheme, valuation report & swap ratio	----------	Inform stock exchange before meeting & the outcome of the meeting
Application under clause 24 of Listing Agreement filing the proposed Scheme of Amalgamation		
Application to the court seeking direction to call general meeting or creditors' meeting		
Convene general meeting	----------	Inform Stock Exchanges as and when required
Reporting the results of meeting to the concerned High Court		
Petition to the court for the confirmation of the scheme		
Obtaining the court order sanctioning the scheme		

CHECK YOUR PROGRESS

What are the steps involved in merger and amalgamation?

NOTES

Filing copy of court order to the concerned ROC

Transfer of assets and liabilities

Allotment of shares to the shareholders of Transfer or company

Listing of shares at Stock Exchanges

Post Merger Integration

CHECK YOUR PROGRESS
Who are the dissenting shareholders?

2.6 Power to acquire shares of shareholders dissenting from scheme or contract approved by majority

(1) Where a scheme or contract involving the transfer of shares or any class of shares in a company (the transferor company) to another company (the transferee company) has, within four months after making of an offer in that behalf by the transferee company, been approved by the holders of not less than nine-tenths in value of the shares whose transfer is involved, other than shares already held at the date of the offer by, or by a nominee of the transferee company or its subsidiary companies, the transferee company may, at any time within two months after the expiry of the said four months, give notice in the prescribed manner to any dissenting shareholder that it desires to acquire his shares.

(2) Where a notice under sub-section (1) is given, the transferee company shall, unless on an application made by the dissenting shareholder to the Tribunal, within one month from the date on which the notice was given and the Tribunal thinks fit to order otherwise, be entitled to and bound to acquire those shares on the terms on which, under the scheme or contract, the shares of the approving shareholders are to be transferred to the transferee company.

(3) Any sum received by the transferor company under this section shall be paid into a separate bank account, and any such sum and any other consideration so received shall be held by that company in trust for the several persons entitled to the shares in respect of which the said sum or other consideration were respectively received and shall be disbursed to the entitled shareholders within sixty days.

2.7 Purchase of Minority Shareholding

(1) In the event of an acquirer, or a person acting in concert with such acquirer, becoming registered holder of ninety per cent. or more of the issued equity share capital of a company, or in the event of any person or group of persons becoming ninety per cent majority or holding ninety per cent of the issued equity share capital of a company, by virtue of an amalgamation, share

exchange, conversion of securities or for any other reason, such acquirer, person or group of persons, as the case may be, shall notify the company of their intention to buy the remaining equity shares.

(2) The acquirer, person or group of persons under sub-section (1) shall offer to the minority shareholders of the company for buying the equity shares held by such shareholders at a price determined on the basis of valuation by a registered valuer in accordance with such rules as may be prescribed.

(3) The minority shareholders of the company may offer to the majority shareholders to purchase the minority equity shareholding of the company at the price determined in accordance with such rules as may be prescribed.

(4) The majority shareholders shall deposit an amount equal to the value of shares to be acquired by them in a separate bank account to be operated by the transferor company for at least one year for payment to the minority shareholders and such amount shall be disbursed to the entitled shareholders within sixty days.

(5) In the absence of a physical delivery of shares by the shareholders within the time specified by the company, the share certificates shall be deemed to be cancelled, and the transferor company shall be authorised to issue shares in lieu of the cancelled shares and complete the transfer in accordance with law and make payment of the price out of deposit made by the majority in advance to the minority by despatch of such payment.

2.8 Power of Central Government to provide for amalgamation of companies in public interest

(1) Where the Central Government is satisfied that it is essential in the public interest that two or more companies should amalgamate, the Central Government may, by order notified in the Official Gazette, provide for the amalgamation of those companies into a single company with such constitution, with such property, powers, rights, interests, authorities and privileges, and with such liabilities, duties and obligations, as may be specified in the order.

(2) The order may also provide for the continuation by or against the transferee company of any legal proceedings pending by or against any transferor company.

(3) Every member or creditor, including a debenture holder, of each of the transferor companies before the amalgamation shall have, as nearly as may be, the same interest in or rights against the transferee company as he had in the company of which he was originally a member or creditor, and in case the interest or rights of such member or creditor in or against the transferee company are less than his interest in or rights against the original company, he shall be entitled to compensation to that extent, which shall be assessed by such authority as may be prescribed and every such assessment shall be published in the Official Gazette, and the compensation so assessed shall be paid to the member or creditor concerned by the transferee company.

(4) Any person aggrieved by any assessment of compensation made by the prescribed authority may, within a period of thirty days from the date of publication of such assessment in the Official Gazette, prefer an appeal to the Tribunal and thereupon the assessment of the compensation shall be made by the Tribunal.

(5) No order shall be made under this section unless-

(a) a copy of the proposed order has been sent in draft to each of the

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companies concerned;

(b) the time for preferring an appeal under sub-section (4) has expired, or where any such appeal has been preferred, the appeal has been finally disposed off; and

(c) the Central Government has considered, and made such modifications, if any, in the draft order as it may deem fit in the light of suggestions and objections which may be received by it from any such company within such period as the Central Government may fix in that behalf, not being less than two months from the date on which the copy aforesaid is received by that company, or from any class of shareholders therein, or from any creditors or any class of creditors thereof.

(6) The copies of every order made under this section shall, as soon as may be after it has been made, be laid before each House of Parliament.

CHECK YOUR PROGRESS

Discuss the regulations related to purchase of minority shareholding of a company.

2.9 Preservation of books and papers of amalgamated companies

The books and papers of a company which has been amalgamated with, or whose shares have been acquired by, another company under this Chapter shall not be disposed of without the prior permission of the Central Government and before granting such permission, that Government may appoint a person to examine the books and papers or any of them for the purpose of ascertaining whether they contain any evidence of the commission of an offence in connection with the promotion or formation, or the management of the affairs, of the transferor company or its amalgamation or the acquisition of its shares.

2.10 Liability of officers in respect of offences committed prior to merger, amalgamation, etc.

The liability in respect of offences committed under this Act by the officers in default, of the transferor company prior to its merger, amalgamation or acquisition shall continue after such merger, amalgamation or acquisition.

2.11 Winding Up

Winding-up of a company is a process of putting an end to the life of a company. It is a proceeding by means of which a company is dissolved and in the course of such dissolution its assets are collected, its debts are paid off out of the assets of the company or from contributions by its members, if necessary. If any surplus is left, it is distributed among the members in accordance with their rights.

Winding-up is the process by which management of a company's affairs is taken out of its directors' hands, its assets are realized by a liquidator and its debts are realized and liabilities are discharged out of proceeds of realization and any surplus of assets remaining is returned to its members or shareholders. At the end of the winding up the company will have no assets or liabilities and it will, therefore, be simply a formal step for it to be dissolved, that is, for its legal personality as a corporation to be brought to an end.

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1. Modes of winding up.

(1) The winding up of a company may be either-

(a) by the Tribunal; or

(b) voluntary.

(A) Winding up by the Tribunal

1. Circumstances in which company may be wound up by Tribunal

(1) A company may, on a petition under section 272, be wound up by the Tribunal,-

(a) if the company is unable to pay its debts;

(b) if the company has, by special resolution, resolved that the company be wound up by the Tribunal;

(c) if the company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality;

(d) if the Tribunal has ordered the winding up of the company under Chapter XIX;

(e) if on an application made by the Registrar or any other person authorised by the Central Government by notification under this Act, the Tribunal is of the opinion that the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose or the persons concerned in the formation or management of its affairs have been guilty of fraud, misfeasance or misconduct in connection therewith and that it is proper that the company be wound up;

(f) if the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding five consecutive financial years; or

(g) if the Tribunal is of the opinion that it is just and equitable that the company should be wound up.

CHECK YOUR PROGRESS

Explain the modes of winding up of companies.

(2) A company shall be deemed to be unable to pay its debts,-

(a) if a creditor, by assignment or otherwise, to whom the company is indebted for an amount exceeding one lakh rupees then due, has served on the company, by causing it to be delivered at its registered office, by registered post or otherwise, a demand requiring the company to pay the amount so due and the company has failed to pay the sum within twenty-one days after the receipt of such demand or to provide adequate security or re-structure or compound the debt to the reasonable satisfaction of the creditor;

(b) if any execution or other process issued on a decree or order of any court or tribunal in favour of a creditor of the company is returned unsatisfied in whole or in part; or

(c) if it is proved to the satisfaction of the Tribunal that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the Tribunal shall take into account the contingent and prospective liabilities of the company.

Petition for winding up

(1) petition to the Tribunal for the winding up of a company shall be presented by-

(a) the company;

(b) any creditor or creditors, including any contingent or prospective creditor or creditors;

(c) any contributory or contributories;

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(d) all or any of the persons specified in clauses (a), (b) and (c) together;
(e) the Registrar;
(f) any person authorised by the Central Government in that behalf; or

(2) A secured creditor, the holder of any debentures, whether or not any trustee or trustees have been appointed in respect of such and other like debentures, and the trustee for the holders of debentures shall be deemed to be creditors.

(3) A contributory shall be entitled to present a petition for the winding up of a company, notwithstanding that 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.

(4) A petition presented by the company for winding up before the Tribunal shall be admitted only if accompanied by a statement of affairs in such form and in such manner as may be prescribed.

(5) Before a petition for winding up of a company presented by a contingent or prospective creditor is admitted, the leave of the Tribunal shall be obtained for the admission of the petition and such leave shall not be granted, unless in the opinion of the Tribunal there is a prima facie case for the winding up of the company and until such security for costs has been given as the Tribunal thinks reasonable.

CHECK YOUR PROGRESS

What are the powers of Tribunal regarding winding up of a company.

Powers of Tribunal

(1) The Tribunal may, on receipt of a petition for winding up pass any of the following orders, namely:-

(a) dismiss it, with or without costs;
(b) make any interim order as it thinks fit;
(c) appoint a provisional liquidator of the company till the making of a winding up order;
(d) make an order for the winding up of the company with or without costs; or
(e) any other order as it thinks fit:

Provided that an order under this sub-section shall be made within ninety days from the date of presentation of the petition.

(2) Where a petition is presented on the ground that it is just and equitable that the company should be wound up, the Tribunal may refuse to make an order of winding up, if it is of the opinion that some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing the other remedy.

Directions for filing statement of affairs

(1) Where a petition for winding up is filed before the Tribunal by any person other than the company, the Tribunal shall, if satisfied that a prima facie case for winding up of the company is made out, by an order direct the company to file its objections along with a statement of its affairs within thirty days of the order in such form and in such manner as may be prescribed:

Provided that the Tribunal may allow a further period of thirty days in a situation of contingency or special circumstances:

Provided further that the Tribunal may direct the petitioner to deposit such security for costs as it may consider reasonable as a precondition to issue directions to the company.

(2) A company, which fails to file the statement of affairs shall forfeit the right to

oppose the petition and such directors and officers of the company as found responsible for such non-compliance, shall be liable for punishment.

(3) The directors and other officers of the company, in respect of which an order for winding up is passed by the Tribunal shall, within a period of thirty days of such order, submit, at the cost of the company, the books of account of the company completed and audited up to the date of the order, to such liquidator and in the manner specified by the Tribunal.

(4) If any director or officer of the company contravenes the provisions of this section, the director or the officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months or with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees, or with both.

Effect of winding up order.

The order for the winding up of a company shall operate in favour of all the creditors and all contributories of the company as if it had been made out on the joint petition of creditors and contributories

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CHECK YOUR PROGRESS

Effects of winding up order, explain.

Stay of suits, etc., on winding up order.

(1) When a winding up order has been passed or a provisional liquidator has been appointed, no suit or other legal proceeding shall be commenced, or if pending at the date of the winding up order, shall be proceeded with, by or against the company, except with the leave of the Tribunal and subject to such terms as the Tribunal may impose:

Provided that any application to the Tribunal seeking leave under this section shall be disposed of by the Tribunal within sixty days.

(2) Nothing in sub-section (1) shall apply to any proceeding pending in appeal before the Supreme Court or a High Court.

Custody of company's properties

(1) Where a winding up order has been made or where a provisional liquidator has been appointed, the Company Liquidator or the provisional liquidator, as the case may be, shall, on the order of the Tribunal, forthwith take into his or its custody or control all the property, effects and actionable claims to which the company is or appears to be entitled to and take such steps and measures, as may be necessary, to protect and preserve the properties of the company.

(2) All the property and effects of the company shall be deemed to be in the custody of the Tribunal from the date of the order for the winding up of the company.

Promoters, directors, etc., to co-operate with Company Liquidator

(1) The promoters, directors, officers and employees, who are or have been in employment of the company or acting or associated with the company shall extend full cooperation to the Company Liquidator in discharge of his functions and duties.

(2) Where any person, without reasonable cause, fails to discharge his obligations under subsection (1), he shall be punishable with imprisonment which may extend to six months or with fine which may extend to fifty thousand rupees, or with both.

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2.12 Key Concepts

- **Corporate restructuring** is defined as the process involved in changing the organization of a business.

- **Merger** is the combination of two or more companies which can be merged together either by way of amalgamation or absorption.

- **A joint venture** is an entity formed by two or more companies to undertake financial activity together.

2.13 Summary

- An application is made to the Tribunal for the sanctioning of a compromise or an arrangement proposed between a company and any such persons.
- The Tribunal, after satisfying itself that the procedure specified has been complied with, may, by order, sanction the compromise or arrangement.
- Where an order under this section provides for the transfer of any property or liabilities, then, by virtue of the order, that property shall be transferred to the transferee company and the liabilities shall be transferred to and become the liabilities of the transferee company.
- If a transferor company or a transferee company contravenes the provisions of this section, the transferor company or the transferee company, as the case may be, shall be punishable with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees.
- Every officer of such transferor or transferee company who is in default, shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.
- A scheme of merger or amalgamation may be entered into between two or more small companies or between a holding company and its wholly-owned subsidiary company or such other class or classes of companies.
- Where the Central Government is satisfied that it is essential in the public interest that two or more companies should amalgamate, the Central Government may, by order notified in the Official Gazette, provide for the amalgamation of those companies into a single company.
- The books and papers of a company which has been amalgamated with, or whose shares have been acquired by, another company under this Chapter shall not be disposed of without the prior permission of the Central Government.
- The liability in respect of offences committed under this Act by the officers in default, of the transferor company prior to its merger, amalgamation or acquisition shall continue after such merger, amalgamation or acquisition.

2.14 Questions and Exercises

1. Discuss in Brief steps involved in process of Merger.
2. Explain the powers of tribunal with respect to winding up of companies.
3. What are the various modes of winding up of companies?

- **Fill in the blanks**

1. Improve corporate performance to bring it at par with competitors by adopting the radical changes brought out by information technology is one of the objective of Corporate _____.
(restructuring, adjustment, arrangement, strategy)
2. The _____ mergers involve firms engaged in unrelated type of businesses.

(horizontal, vertical, co-generic, conglomerate)

3. In _____takeover, one company takes over the management of the target company without its knowledge and against the wish of their management.
(strategic, hostile, friendly, consenting)
4. Any agreement between two or more parties to collaborate with each other, in order to achieve certain objectives while continuing to remain independent organizations is called _____.
(strategic alliance, combination, merger, joint venture)
5. In the process of merger and amalgamation the draft of the proposed terms of the scheme drawn up and adopted by the _____of the merging company.
(directors, secretary, chairman, members)
6. a scheme involving the transfer of shares or any class of shares in a company (the transferor company) to another company (the transferee company) shall, within four months after making of an offer in that behalf by the transferee company, be approved by the holders of not less than _____ in value of the shares whose transfer is involved.
(one tenths, nine tenths, two tenths, one ninths)
7. Where shares of dissenting shareholders are to be acquired, notice in the prescribed manner shall be given to any dissenting shareholder that it desires to acquire his shares within _____ months.
(three, four, five, two)
8. Where the _____ is satisfied that it is essential in the public interest that two or more companies should amalgamate, it may, by order notified in the Official Gazette, provide for the amalgamation of those companies into a single company.
(High Court, Supreme court, Central Government, SEBI))
9. The books and papers of a company which has been amalgamated with, or whose shares have been acquired by, another company under this Chapter shall not be disposed of without the prior permission of the _____.
(High Court, Supreme court, Central Government, SEBI)
10. _____is a proceeding by means of which a company is dissolved and in the course of such dissolution its assets are collected, its debts are paid off out of the assets of the company or from contributions by its members, if necessary.
(merger, amalgamation, takeover, winding up)
11. There are two modes of winding up of a company. One is voluntary winding up and the other is winding up by _____.
(chairman, directors, tribunal, members)
12. The order for the winding up of a company shall operate in favour of all the creditors and all _____ of the company as if it had been made out on the joint petition of both of them.
(contributaries, directors, chairman, vendors)

Answers: 1) Corporate restructuring, 2) conglomerate, 3) Hostile, 4) strategic alliance, 5)directors, 6)nine tenths, 7)two, 8) Central Government, 9) central Government, 10) winding up, 11) tribunal, 12) contributaries

2.15 Further Reading and References

Dr. Avtar Singh : Company Law; Eastern Book Company, 34, Lalbagh, Lucknow -226 001

A. Ramaiya : Guide to the Companies Act; Lexis Nexis, Butterworths Wadhwa, Nagpur

UNIT - 3
DEPOSITORIES ACT

NOTES

3.0 Introduction
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3.0 Introduction

The earlier settlement system on Indian stock exchanges was very inefficient as it was unable to take care of the transfer of securities in a quick/ speedy manner. Since, the securities were in the form of physical certificates; their quick movement was difficult. This led to settlement delays, theft, forgery, mutilation and bad deliveries and also to added costs.

To wipeout these problems, the Depositories Act 1996 was passed. It was formed with the purpose of ensuring free transferability of securities with speed, accuracy & security. It has been able to do so by:

a) Making securities of public limited companies freely transferable, subject to certain exceptions;

b) Dematerialising the securities in the depository mode; and

c) Providing for maintenance of ownership records in a book entry form.

For performing the above tasks, two depositories viz. **NSDL & CDSL** have come up.

National Securities Depository Limited (NSDL) does the above tasks for the trades done on NSE. It is a joint venture of:

- IDBI (Industrial Development Bank of India Limited);
- NSE (National Stock Exchange); and
- UTI (Unit Trust of India).

NSDL is the first depository to be set up in India. It was registered by SEBI on June 7,1996.

The second depository **Central Depository Services Limited (CDSL)** has been promoted by Bombay Stock Exchange and Bank of India. It was formed in February1999. Both depositories have a network of Depository participants (DPs) which are further electronically connected to their clients. So, DPs act as a link between the depositories and the clients.

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CHECK YOUR PROGRESS

NSDL & CDSL stands for -

3.1 Objectives

In this unit, we will introduce you to the depositories act and its associated concepts. By the end of this unit, you should be able to:

- explain the concepts of dematerialization and depository participant
- describe benefits of depository system
- discuss the Depositories Act, 1996
- discuss the rights and obligations of depositories and its constituents
- explain the SEBI (depositories and participants) regulations, 1996
- describe the features of Basic Services Demat Account

3.2 An overview of Depository System

The Depository System functions very much like the banking system. A bank holds funds in accounts whereas a Depository holds securities in accounts for its clients. A Bank transfers funds between accounts whereas a Depository transfers securities between accounts. In both systems, the transfer of funds or securities happens without the actual handling of funds or securities. Both the Banks and the Depository are accountable for the safe keeping of funds and securities respectively.

In the depository system, share certificates belonging to the investors are to be dematerialized and their names are required to be entered in the records of depository as beneficial owners. Consequent to these changes, the investors' names in the companies' register are replaced by the name of depository as the registered owner of the securities. The depository, however, does not have any voting rights or other economic rights in respect of the shares as a registered owner. The beneficial owner continues to enjoy all the rights and benefits and is subject to all

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the liabilities in respect of the securities held by a depository. Shares in the depository mode are fungible and cease to have distinctive numbers. The transfer of ownership changes in the depository is done automatically on the basis of delivery v. payment.

In the Depository mode, corporate actions such as IPOs, rights, conversions, bonus, mergers/amalgamations, subdivisions & consolidations are carried out without the movement of papers, saving both cost & time. Information of beneficiary owners is readily available. The issuer gets information on changes in shareholding pattern on a regular basis, which enables the issuer to efficiently monitor the changes in shareholdings. The Depository system links the issuing corporates, Depository Participants (DPs), the Depositories and clearing corporation/ clearing house of stock exchanges. This network facilitates holding of securities in the soft form and effects transfers by means of account transfers.

As a broker represents their investors, and can trade on their behalf either on the stock exchange or off-market. Similarly, a Depository Participant (DP) is the representative (agent) of the investor in the depository system providing the link between the Company and the client through the Depository. The client's Depository Participant will maintain his securities account balances and intimate the status of the holding from time to time. According to SEBI guidelines, Financial Institutions like banks, custodians, stockbrokers etc. can become participants in the depository. A DP is one with whom a client needs to open an account to deal in electronic form.

CHECK YOUR PROGRESS

What do you understand by the meaning of the term "fungibility"?

While the Depository can be compared to a Bank, DP is like a branch of a bank with which one can have an account. Therefore, DPs are authorized to maintain accounts of dematerialized shares. They help in instantaneous electronic transfer of shares held in Demat form through **electronic book entry system.**

Book entry system is a system under which no physical transfer of securities takes place. In case of change of ownership rights, securities do not change hands physically. To facilitate the change of name/ownership rights, merely a book entry is passed. Since, the securities are fungible; transfer becomes easier. **Fungibility** means that all the holdings of a particular security are identical & inter-changeable & they have no unique characteristic such as distinctive number, certificate no., folio no. etc. To have a better understanding of the concept of fungibility, we can take an example of a currency note. Just as an Rs.100 note can be interchangeable with any other note of Rs.100, similarly securities of a company can be interchanged with any other security of the same company, as the distinctive number of the security does not matter.

Whenever securities are bought and sold, transfer of name has to take place. Earlier, when the securities were in the physical form, it used to take a lot of time as it was a cumbersome process. The physical securities were send to the R&TA (Registrar and Transfer Agents) appointed by the company along with the required form for change of name/transfer of securities. The R&TA (Registrar and Transfer Agents) used to make the due changes as required and send them back. This whole process was time consuming and sometimes the securities never reached its destination, thus creating lot of inconvenience to the investors. To get away with such problems, securities were changed into demat form which helped in quick transfer of securities and also eliminate the fear of theft, mutilation etc. Apart from getting the current holdings changed into demat form, one can also receive their shares in demat form when offered during an initial public issue by giving the appropriate instructions in the application itself. If one is adopting this approach, then he has to also furnish the details of his bank account number, name of the DP, DP ID and client ID to facilitate the transfer of securities.

3.3 Benefits of depository system

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In the depository system, the ownership and transfer of securities takes place by means of electronic book entries. At the outset, this system rids the capital market of the dangers related to handling of paper. The system provides numerous direct and indirect benefits, like:

Elimination of bad deliveries

In the depository environment, once holdings of an investor are dematerialised, the question of bad delivery does not arise i.e. they cannot be held "under objection". In the physical environment, buyer of shares was required to take the risk of transfer and face uncertainty of the quality of assets purchased. In a depository environment good money certainly begets good quality of assets.

Elimination of all risks associated with physical certificates

Dealing in physical securities have associated security risks of theft of stocks, mutilation of certificates, loss of certificates during movements through and from the registrars, thus exposing the investor to the cost of obtaining duplicate certificates and advertisements, etc. This problem does not arise in the depository environment.

Immediate transfer and registration of securities

In the depository environment, once the securities are credited to the investors account on pay out, he becomes the legal owner of the securities. There is no further need to send it to the company's registrar for registration. Having purchased securities in the physical environment, the investor has to send it to the company's registrar so that the change of ownership can be registered. This process usually takes around three to four months and is rarely completed within the statutory framework of two months thus exposing the investor to opportunity cost of delay in transfer and to risk of loss in transit. To overcome this, the normally accepted practice is to hold the securities in street names i.e. not to register the change of ownership. However, if the investors miss a book closure the securities are not good for delivery and the investor would also stand to lose his corporate entitlements.

Faster disbursement of non cash corporate benefits like rights, bonus, etc.

Depository system provides for direct credit of non cash corporate entitlements to an investors account, thereby ensuring faster disbursement and avoiding risk of loss of certificates in transit.

Reduction in brokerage by many brokers for trading in dematerialized securities

Brokers provide this benefit to investors as dealing in dematerialized securities reduces their back office cost of handling paper and also eliminates the risk of being the introducing broker. Reduction in handling of huge volumes of paper and periodic status reports to investors on their holdings and transactions, leading to better controls.

Elimination of problems related to change of address of investor, transmission, etc.

In case of change of address or transmission of demat shares, investors are saved from undergoing the entire change procedure with each company or registrar. Investors have to only inform their DP with all relevant documents and the required changes are effected in the database of all the companies, where the

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investor is a registered holder of securities.

Elimination of problems related to selling securities on behalf of a minor

A natural guardian is not required to take court approval for selling demat securities on behalf of a minor.

3.4 Dematerialization

Dematerialization is a process by which the physical share certificates of an investor are taken back by the Company and an equivalent number of securities are credited his account in electronic form at the request of the investor. An investor will have to first open an account with a Depository Participant and then request for the dematerialization of his share certificates through the Depository Participant so that the dematerialized holdings can be credited into that account. This is very similar to opening a Bank Account.

Dematerialization of shares is optional and an investor can still hold shares in physical form. However, he/she has to demat the shares if he/she wishes to sell the same through the Stock Exchanges. Similarly, if an investor purchases shares from the Stock Exchange, he/she will get delivery of the shares in demat form.

CHECK YOUR PROGRESS
What is Dematerialization?

3.5 Depository participant

Just as a brokers act an agent of the investor at the Stock Exchange; a Depository Participant (DP) is the representative (agent) of the investor in the depository system providing the link between the Company and investor through the Depository. The Depository Participant maintains securities account balances and intimate the status of holding to the account holder from time to time. According to SEBI guidelines, Financial Institutions like banks, custodians, stockbrokers etc. can become participants in the depository. A DP is one with whom an investor needs to open an account to deal in shares in electronic form. While the Depository can be compared to a Bank, DP is like a branch of that bank with which an account can be opened. The main characteristics of a depository participant are as under:

- Acts as an Agent of Depository
- Customer interface of Depository
- Functions like Securities Bank
- Account opening
- Facilitates dematerialisation
- Instant transfer on pay-out
- Credits to investor in IPO, rights, bonus
- Settles trades in electronic segment

3.6 Registered owner and Beneficiary owner

All the public limited companies are required by the Companies Act 1956 to maintain an index of members, wherein they are required to keep a record or the owners of the company. With the concept of dematerialization of securities and transfer of shares through book entry system coming up, registered owners are NSDL and CDSL only.

So, in the index of members of any company, there are only two registered owners, i.e. the two depositories. The depositories keep a track of all the clients through the depository participants. Therefore, the registered owners are the depositories whereas the beneficiary owners are the people who are holding the

securities at any given point of time. Whenever a company declares a bonus issue, the securities are transferred in the name of the two depositories and they further transfer it to the clients through their participants. Therefore, the depositories are known as the registered owners and the investors are known as the beneficiary owners as they get the benefits of all the corporate actions.

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Further, if a company declares a cash dividend, then the details of the holdings by the investors is given by the respective depository participants to the depository so that the details can further be given to the RTA (Registrar and Transfer Agents) which would facilitate them to directly transfer the amount to the bank account of the investor/holder through the ECS (Electronic Clearing System) system.

For having a security of a company in demat form, first a company has to opt for the same. A company can do so by getting itself registered with at least one of the depositories. For this, the company has to transfer all its shares to the depository. For differentiating among all the companies, International Securities Identification Number (ISIN) is assigned to them which are unique in nature.

3.7 International Securities Identification Number

CHECK YOUR PROGRESS

What are the benefits of depository system?

Each security issued bears a unique ISIN issued by the International Standards Organisation (ISO). In India, the task of issuing ISIN of various securities has been assigned by SEBI to NSDL. For Government securities, allotment of ISIN is done by Reserve Bank of India. Each member country has a different code according to the ISIN Standard (ISO 6166).

ISIN is a twelve-character long identification mark. It has three components - a pre-fix, a basic number and a check digit.

- The pre-fix is a two digit country code as stated under ISO 3166 (IN for India).
- The basic number is made up of nine alphanumeric characters (digits and/or alphabets).
- The check digit at the end of the ISIN is computed to check the validity of the ISIN.

Distinct ISINs are allotted to securities issued by the same company, issued at different times or carrying different rights of different terms and conditions. Different ISINs are issued to physical and dematerialized securities of the same issue.

3.8 The Depositories Act, 1996

3.8.1 Objectives

The depositories legislation as per the Statement of Objects and Reasons appended to the Depositories Act, 1996 aims at providing for:

- A legal basis for establishment of depositories to conduct the task of maintenance of ownership records of securities and effect changes in ownership records through book entry;
- Dematerilisation of securities in the depositories mode as well as giving option to an investor to choose between holding securities in physical mode and holding securities in a dematerialized form in a depository;
- Making the securities fungible;
- Making the shares, debentures and any interest thereon of a public limited company freely transferable; and

- Exempting all transfers of shares within a depository from stamp duty.

3.8.2 Eligibility condition for depository services

NOTES

Any company or other institution to be eligible to provide depository services must:

- be formed and registered as a company under the Companies Act, 2013.
- be registered with SEBI as a depository under SEBI Act, 1992.
- has framed bye-laws with the previous approval of SEBI.
- has one or more participants to render depository services on its behalf.
- has adequate systems and safeguards to prevent manipulation of records and transactions to the satisfaction of SEBI.
- complies with Depositories Act, 1996 and SEBI (Depositories and Participants) Regulations, 1996.
- meets eligibility criteria in terms of constitution, network, etc.

3.8.3 Eligible securities required to be in the depository mode

Section 8 of the Depositories Act gives the option to the investors to receive securities in physical form or in depository mode.

It is not necessary that all eligible securities must be in the depository mode. In the scheme of the Depositories legislation, the investor has been given supremacy. The investors have the choice of holding physical securities or opt for a depository based ownership record.

However in case of fresh issue of securities all securities issued have to be in dematerialized form. However after that investor will also have the freedom to switch from depository mode to non-depository mode and vice versa. The decision as to whether or not to hold securities within the depository mode and if in depository mode, which depository or participant, would be entirely with the investor.

Fungibility

Section 9 states that securities in depositories shall be in fungible form.

The Act envisages that all securities held in depository shall be fungible i.e. all certificates of the same security shall become interchangeable in the sense that investor loses the right to obtain the exact certificate he surrenders at the time of entry into depository. It is like withdrawing money from the bank without bothering about the distinctive numbers of the currencies.

Immobilisation of securities in a depository mode refers to a situation where the depository holds securities in the form of physical paper side by side with electronic evidence of ownership. In such a case the transfers are not accompanied by physical movement of securities but securities are in existence in the custody of the depository.

However, the Depositories Act, envisages dematerialisation in the depository mode. In such a case the securities held in a depository shall be dematerialized and the ownership of the securities shall be reflected through book entry only. The securities outside the depository shall be represented by physical scrips. Hence, the depository legislation envisages partial dematerialisation, i.e. a portion of the securities in dematerialized form and the other portion in physical form. (Sections 89 and 186 of Companies Act, 2013 shall not apply to a depository in respect of shares held on behalf of beneficial owners in depositories).

3.8.4 Rights of depositories and beneficial owner

A depository should be deemed to be the registered owner for the purposes of effecting transfer of ownership of security on behalf of a beneficial owner. The depository as a registered owner should not have any voting rights or any other rights in respect of securities held by it. The beneficial owner is entitled to all the rights and benefits and be subjected to all the liabilities in respect of his securities held by a depository.

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3.8.5 Register of beneficial owner

Every depository is required to maintain a register and an index of beneficial owners in the manner provided in the Companies Act, 2013.

3.8.6 Pledge or hypothecation of securities held in a depository

A beneficial owner may with the previous approval of the depository create a pledge or hypothecation in respect of a security owned by him through a depository. Every beneficial owner should give intimation of such pledge or hypothecation to the depository participant and such depository is required to make entries in its records accordingly. Any entry in the records of a depository should be evidence of a pledge or hypothecation.

CHECK YOUR PROGRESS

What is the Eligibility condition for depository services?

3.8.7 Furnishing of information and records by depository and issuer

Every depository shall furnish to the issuer information about the transfer of securities in the name of beneficial owners at such intervals and in such manner as may be specified by the bye-laws. Every issuer shall make available to the depository copies of the relevant records in respect of securities held by such depository.

3.8.8 Option to opt out in respect of any security

Section 14 of the Act provides that if a beneficial owner seeks to opt out of a depository in respect of any security he should inform the depository accordingly. After the receipt of intimation the depository should make appropriate entries in its records and also inform the issuer. Every issuer may, within thirty days of the receipt of intimation from the depository and on fulfillment of such conditions and on payment of such fees as may be specified by the regulations, issue the certificate of securities to the beneficial owner or the transferee, as the case may be.

3.8.9 Depositories to indemnify loss in certain cases

Any loss caused to the beneficial owner due to the negligence of the depository or the participant, would be indemnified by the depository to such beneficial owner. Where the loss due to the negligence of the participant is indemnified by the depository, the depository has the right to recover the same from such participant.

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3.9 SEBI (depositories and participants) regulations, 1996

The Depositories Act requires that the registration of the depository, depository participant and the custodian, is mandatory with the SEBI. These market intermediaries can function or commence business only after registration from SEBI has been obtained and requisite fee paid to SEBI. The requirement of registration is a continuing one and the moment the registration is cancelled or revoked or surrendered, the person shall cease to act as such.

SEBI had issued SEBI (Depositories and Participants) Regulations, 1996 on 16th May, 1996 which apply to depositories and its participants.

These regulations also contain provisions for operations and functioning of depositories, form for application and certificates used and schedule of fees for participants, etc. It also contains provisions for registration of depository and depository participants, rights and obligations of various users and constituents, inspection and procedure for action in case of default.

Entities desiring to become depository participants must apply to the depository and are required to be recommended to SEBI by the depository. If approved and registered by SEBI, the depository participant can be admitted on the depository. The depository has to formulate its own set of criteria for selection of participants. Every participant holding a certificate is required at all times to abide by the specified Code of Conduct.

The regulations require the depository to list out, through its Bye-laws, the securities which are eligible to be admitted to the depository for dematerialization. Equity shares, debentures, warrants, bonds, units of mutual funds, etc. are part of the list of eligible securities. The depository is empowered to set its own criteria for selection of securities and make securities eligible to be maintained in the form of electronic holdings on the depository.

Further, the regulations stipulate that agreements should be entered into by the following entities:

- depository and every participant
- participant and every client
- depository, issuer company and the Registrar

The draft of these agreements are to be included in the Bye-laws and to be approved by SEBI.

The depository is required to ensure that sufficient safeguards are in place to protect the data available with it and with the participants. To reduce risk in operations, the regulations stipulate that adequate insurance cover be provided by the depository and by the depository participants as well.

The regulations also require for reconciliation to be carried out on a daily basis. Further, the depository and the registrar will also reconcile balances on a daily and a periodic basis.

3.9.1 Rights and obligations of depositories and its constituents

This Regulations deal with rights and obligations of depositories and every depository has to state in its byelaws the eligible securities for dematerialisation which include shares, scrips, stock, bonds, debentures stock, Indian Depository

Receipts or other marketable securities of a like nature, etc., and include units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificate of deposit, securitised debt, money market instruments Government Securities and even unlisted securities.

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Every depository is required to enter into an agreement with the issuer in respect of securities disclosed as eligible to be held in demat form. No agreement is required to be entered into where the depository itself is an issuer of securities.

The depository is also required to enter into a tripartite agreement with the issuer, its transfer agent and itself where company has appointed a transfer agent. Every depository is required to maintain continuous connectivity with issuers, registrars and transfer agents, participants and clearing house or clearing corporations. Depositories should take adequate measures including insurance to protect the interest of the beneficial owners.

Every depository is required to maintain the following records and documents namely:

- records of securities dematerialised and rematerialised;
- the names of the transferor, transferee, and the dates of transfer of securities;,
- a register and an index of beneficial owners;
- details of holding of the securities of the beneficial owners as at the end of the each day;
- records of instruction(s) received from and sent to participants, issuers' agents and beneficial owners;
- records of approval, notice, entry and cancellation of pledge or hypothecation, as the case may be;
- details of participants;
- details of securities declared to be eligible for dematerialisation in the depository; and
- such other records as may be specified by SEBI for carrying on the activities as a depository.

CHECK YOUR PROGRESS

Explain Rights and obligations of depositories.

Every depository has to intimate SEBI the place where the records and documents are maintained. Subject to the provisions of any other law, the depository shall preserve records and documents for a minimum period of five years.

Participants are required to enter into an agreement with beneficial owners. It is required that separate accounts are to be opened by every participant in the name of each of the beneficial owner and the securities of each beneficial owners are to be segregated and shall not be mixed up with the securities of other beneficial owners or with the participant's own securities. The participants are obliged to reconcile the records with every depository on a daily basis. Participants are required to maintain the following records for a period of five years-

- records of all the transactions entered into with a depository and with a beneficial owner;
- details of security dematerialised, rematerialised on behalf of beneficial owners with whom it has entered into an agreement;
- records of instructions received from beneficial owners
- and statements of account provided to beneficial owners; and
- records of approval, notice, entry and cancellation of pledge or hypothecation as the case may be.

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3.9.2 Governing Board, Disclosures and Corporate Governance

This regulations deal with the composition of Governing board of a Depository.

The governing board of every depository is required to include:

(a) shareholder directors;

(b) public interest directors; and

(c) managing director.

Any employee of a depository may be appointed on the governing board in addition to the managing director, and such director shall be deemed to be a shareholder director.

The chairperson shall be elected by the governing board from amongst the public interest directors subject to prior approval of SEBI.

The number of public interest directors shall not be less than the number of shareholder directors in a depository.

The managing director shall be an ex-officio director on the governing board and shall not be included in either the category of public interest directors or shareholder directors.

The disclosure requirements and corporate governance norms as specified for listed companies shall mutatis mutandis apply to a depository.

3.9.3 Investor Protection Fund

Every depository is required to establish and maintain an Investor Protection Fund for the protection of interest of beneficial owners. However, this fund shall not be used by the depository for the purpose of indemnifying the beneficial owner under section 16 of the Depository Act, 1996. Every depository should credit twenty five per cent of its profits every year to the Investor Protection Fund.

(a) Utilization of the IPF

The IPF may be utilized for the following purposes with a focus on depository related services:

Promotion of investor education and investor awareness programmes through seminars, lectures, workshops, publications (print and electronic media), training programmes etc. aimed at enhancing securities market literacy and promoting retail participation in securities market.

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To aid, assist, subsidise, support, promote and foster research activities for promotion/ development of the securities market.

To utilize the fund for supporting initiatives of Depository Participants for promotion of investor education and investor awareness programmes.

To utilize the fund in any other manner as may be prescribed/ permitted by SEBI in the interest of investors.

Depositories shall frame their internal guidelines on utilisation of the funds in accordance with the aforementioned objectives and post approval of their board of directors, submit the same within 30 days to SEBI. Depositories shall also keep SEBI informed of any subsequent changes in internal guidelines with regard to utilization of IPF.

(b) Contribution to the IPF

The following contributions shall be made by the depository to the IPF:

- 5% of their profits from depository operations every year.
- All fines and penalties recovered from DPs and other users including clearing member pool account penalty as specified in SEBI circular no. SMDRP/Policy/Cir-05/2001 dated February 01, 2001.
- Interest or Income received out of any investments made from the IPF.
- Funds lying to the credit of IPR (Investor Protection Reserve) / BOPF (Beneficial Owners Protection Fund) of the depository or any other such fund / reserve of the depository shall be transferred to IPF.
- Any other sums as may be prescribed by SEBI from time to time.

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3.9.4 Audit of Depositories

Regulation 55A of SEBI (Depositories and Participants) Regulations, 1996 provides that every issuer shall submit audit report on a quarterly basis to the concerned stock exchanges audited by a practicing Company Secretary or a qualified Chartered Accountant, for the purposes of reconciliation of the total issued capital, listed capital and capital held by depositories in dematerialized form, the details of changes in share capital during the quarter and the in-principle approval obtained by the issuer from all the stock exchanges where it is listed in respect of such further issued capital.

CHECK YOUR PROGRESS

What is the function of Investor Protection Fund?

The audit report is required to give the updated status of the register of members of the issuer and confirm that securities have been dematerialized as per requests within 21 days from the date of receipt of requests by the issuer and where the dematerialization has not been effected within the said stipulated period, the report would disclose the reasons for such delay.

The issuer is under an obligation to immediately bring to the notice of the depositories and the stock exchanges, any difference observed in its issued, listed, and the capital held by depositories in dematerialized form.

The two Depository service providers in India, viz., National Securities Depository Ltd. (NSDL) and Central Depository Services (India) Limited (CDS) have allowed Company Secretaries in Whole-time Practice to undertake internal audit of the operations of Depository Participants (DPs).

3.10 Designated Depository Participant

"Designated depository participant" means a person who has been approved by SEBI under Chapter III of SEBI (Foreign Portfolio Investors) Regulations, 2014. A person shall not act as designated depository participant unless it has obtained the approval of SEBI.

Eligibility criteria for DDP

SEBI shall grant an approval to a person to act as DDP subject to satisfaction of, inter alia, the following conditions:

(a) The applicant is a participant and custodian registered with the SEBI;

(b) The applicant is an Authorized Dealer Category-1 bank authorized by the Reserve Bank of India;

(c) The applicant has multinational presence either through its branches or through agency relationships with intermediaries regulated in their respective home jurisdictions;

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(d) The applicant has systems and procedures to comply with the requirements of FATF Standards, Prevention of Money Laundering Act, 2002, and the rules and circulars prescribed thereunder.

(e) A Certificate of Registration granted to a DDP shall be permanent unless suspended or cancelled by SEBI or surrendered by the DDP.

On 7 January 2014, SEBI notified the SEBI (Foreign Portfolio Investors) Regulations, 2014 (FPI Regulations).

Subsequently, the SEBI has also vide a Circular dated 8 January 2013 issued operating guidelines for Designated Depository Participants (DDP) who would grant registration to Foreign Portfolio Investors (FPI). Designated Depository Participants (DDPs) are authorised to grant registration to FPIs on behalf of the SEBI. The application for grant of registration is to be made to the DDP in a prescribed form alongwith the specified fees.

CHECK YOUR PROGRESS
What do you mean by Designated Depository Participant?

3.11 Basic Services Demat Account (BSDA)

With a view to achieve wider financial inclusion, encourage holding of demat accounts and to reduce the cost of maintaining securities in demat accounts for retail individual investors, SEBI introduced the concept of basic services demat account (BSDA). All depository participants (DPs) shall make available a "Basic Services Demat Account" (BSDA) with limited services and reduced costs compared to conventional demat accounts. These BSDA will also offer SMS alert facility for debit transactions.

3.11.1 Eligible Investor

The "Basic Services Demat Account" (BSDA) promises to provide limited services at reduced costs to retail investors. All individual who currently have one account or plan to open an demat account where they are the sole first holder will be allowed to open the BSDA, provided that the value of securities held will not be more than Rs.2 lakh at any given point of time. However, Investors can open only one BSDA across all DPs. An existing eligible individual who holds a demat account with a DP can convert demat account into BSDA on the date of the next billing cycle based on value of holding of securities as on the last day of previous billing cycle.

3.11.2 Charges

The Annual Maintenance Charges (AMC) to be payed for BSDA will be as per pre-determined slabs. If the value of holdings is up to Rs. 50,000 there won't be any annual maintenance charge. However, if the value of holding is in between Rs.50,001 to Rs.200,000, a fee of Rs.100 as AMC may be charged. If the value of holdings exceeds, DPs are permitted to charge the same as they charge non-BSDA regular demat accounts.

3.11.3 Valuation of Holding

The value of holding shall be determined on the basis of the daily closing price or Net Asset Value of the securities or units of mutual funds. Where such price is not available the last traded price may be taken into account and for unlisted securities other than units of mutual funds, face value may be taken in to account.

NOTES

3.11.4 Statements

(a) Transaction statements:

(a) Transaction statements shall be sent to the beneficial owner (BO) at the end of each quarter. If there are no transactions in any quarter, no transaction statement may be sent for that quarter.

(b) If there are no transactions and no security balance in an account, then no further transaction statement needs to be provided.

(c) Transaction statement shall be required to be provided for the quarter in which the account became a zero balance account.

(b) Holding Statement:

(a) One annual physical statement of holding shall be sent to the stated address of the BO in respect of accounts with no transaction and nil balance.

(b) One annual statement of holding shall be sent in respect of remaining accounts in physical or electronic form as opted for by the BO.

3.11.5 Charges for statements

Electronic statements shall be provided free of cost. However, for physical statements, DPs have to provide two statements free of cost to the account holder during the billing cycle. But additional statements will be charged a fee, which cannot be more than ` 25. Holder will get a transaction statement at the end of every quarter, provided there has been at least a single transaction in the quarter. For accounts where there are transactions, account holder will get an annual statement of holding, as per his/her choice, that is electronically or physical. If there are no transactions in any quarter, no transaction statement may be sent for that quarter.

However, in order to reduce the cost of compliance of DPs, the following rationalization measures have been prescribed for regular accounts:

(a) Accounts with zero balance and nil transactions during the year: The DPs shall send one physical statement of holding annually to such BOs and shall resume sending the transaction statement as and when there is a transaction in the account.

(b) Accounts which become zero balance during the year: For such accounts, no transaction statement may be sent for the duration when the balance remains nil. However, an annual statement of holding shall be sent to the beneficiary owner.

(c) Accounts with credit balance: For accounts with credit balance but no transactions during the year, one statement of holding for the year shall be sent to the BO.

3.12 Key Concepts

- **Dematerialization** is a process by which the physical share certificates of an investor are taken back by the Company and an equivalent number of securities are credited his account in electronic form at the request of the investor.
- **NSDL :** National Securities Depository Limited
- **IPF :** Investor Protection Fund
- **CDSL :** Central Depository Services Limited

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3.13 Summary

- The legal framework for depository system in the Depositories Act, 1996 provides for the establishment of single or multiple depositories.
- There are two Depositories functioning in India, namely the National Securities Depository Limited (NSDL) and the Central Depository Services (India) Limited (CDSL).
- All the securities held by a depository are dematerialized and are in a fungible form.
- In the depository system, the ownership and transfer of securities takes place by means of electronic book entries.
- A Depository Participant (DP) is the representative (agent) of the investor in the depository system providing the link between the Company and investor through the Depository.
- The Depository Act, 1996 and SEBI (Depositories and Participants) Regulations, 1996 regulates the function of Depositories and participants.
- Both the Depositories in India have allowed Practising Company Secretaries to undertake internal audit of the operations of Depository Participants (DPs).

3.14 Questions and Exercises

1. Briefly outline the concept of Depository system in India.
2. Enumerate the enquiry, inspection and penalties under the Depositories Act, 1996.
3. Give an overview of the rights and obligations of Depositories, Participants and issuers under SEBI
   (Depositories and Participants) Regulations, 1996.
4. Explain in detail the Statement required to be sent to the beneficial owner by a DP under BSDA facility?

- **Fill in the Blanks**

1. National Securities Depository Limited (NSDL) is a joint venture of IDBI Industries Development Bank of India), _____ and UTI (Unit Trust of India).
   (BSE (Bombay Stock Exchange), NSE (National Stock Exchange), RBI (Reserve Bank of India), SBI State bank of india)
2. In the depository system, share certificates belonging to the investors are to be dematerialized and their names are required to be entered in the records of depository as _____.
   (beneficial owners, registered owners, real owners, certified owners)
3. _____means that all the holdings of a particular security are identical & inter-changeable & they have no unique characteristic such as distinctive number, certificate no., folio no. etc.
   (classification, categarisation, fungibility, distinction)
4. Conversion of physical share certificates into electronic form is called _____.
   (electrification, dematerialization, rematerialisation, conversion)
5. A _____ is the representative (agent) of the investor in the depository system providing the link between the Company and investor through the Depository.
   (share broker, secretary, depository broker, depository participant)

6. A _____should be deemed to be the registered owner for the purposes of effecting transfer of ownership of security on behalf of a beneficial owner.
(share broker, secretary, depository , depository participant)
7. A beneficial owner may with the previous approval of the _____ create a pledge or hypothecation in respect of a security owned by him through a depository.
(share broker, secretary, depository , depository participant)
8. Entities desiring to become depository participants must apply to the depository and are required to be recommended to_____ by the depository.
(SEBI, RBI, MCA, SBI)
9. The depository shall preserve records and documents for a minimum period of _____.
(four years, five years, fifteen years, eight years)
10. The managing director shall be an/a _____ director on the governing board and shall not be included in either the category of public interest directors or shareholder directors.
(ex-officio, current, permanent, managing)
11. Every depository is required to establish and maintain an _____ for the protection of interest of beneficial owners.
(investor protection fund, providend fund, dividend, interest fund)
12. ____of their profits from depository operations shall be contributed to the investor protection fund.
(2%, 1%, 10%, 5%)

Answers: 1) NSE (national Stock Exchange), 2) beneficial owners, 3) fungibility, 4) dematerialization, 5) depository participant, 6) depository, 7) depository, 8) SEBI, 9) five years, 10) ex-officio, 11) investor protection fund, 12) 5%

3.15 Further Reading and References

E. Gordon & K. Natarajan : Capital Market in India; Himalaya Publishing House, Ramdoot, Dr. Bhalerao Marg, Girgaon, Mumbai - 400004.

Sanjeev Aggarwal : Guide to Indian Capital Market; Bharat Law House, 22, Tarun Enclave, Pitampura, New Delhi - 110 034.

UNIT - 4
INVESTMENT DECISIONS

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4.0 Introduction

The purpose of financial management is not just to ensure that funds are available at the right time for the organisation but also to take care that they are utilized in the most efficient manner to achieve organisational objectives and maximize shareholder's wealth. Therefore an important decision for any firm is the allocation of wealth. This is however not an easy decision to make due to multiple objectives and needs that an organisation faces both in the short term as well as in the long term. Thus, allocation of wealth becomes actually a question of allocation of funds among different assets and organizational activities. This is known as Investment decision. Investment decisions can be categorised into two types: one is the short term investment decision which is also known as working capital management while the other is the long term investment decision commonly known as capital budgeting. The topic of working capital management has been dealt in detail in the subsequent units while this unit deals with capital budgeting.

4.1 Objectives

In this unit, we will introduce you to the concept of capital budgeting and the methods of evaluating capital expenditure projects. You will also be introduced to the concept of time value of money in this unit.

By the end of this unit, you should be able to:

- Explain the concept of capital budgeting
- Explain the importance and process of capital budgeting
- Discuss the concepts of compounding and discounting
- Describe the different types of methods like Payback, NPV, IRR, PI that are used to evaluate proposals of capital investment
- Discuss the importance and limitations of Payback, NPV and IRR

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4.2 Capital Budgeting

4.2.1 Meaning of Capital Budgeting

Capital budgeting can be defined as a process of finding investment opportunities wherein the return from investments exceeds the cost of making those investments to maximize the wealth of the shareholders. An important feature of capital budgeting is that it is an expenditure which is largely irreversible and involves a significant degree of risk since it is based on future estimates of returns. Thus, it is a commitment of resources now in anticipation of relatively large returns sometimes in the future. Due care is to be taken before any such proposals are acted upon as it might lead to huge losses for the company if they are not properly planned and executed.

Capital budgeting refers to long-term planning for proposed capital outlays and their financing. Thus, it includes both raising of long-term funds as well as their utilisation. It may, thus, be defined as the "firm's formal process for acquisition and investment of capital." To be more precise, capital budgeting decision may be defined as "the firms' decision to invest its current fund more efficiently in long-term activities in anticipation of an expected flow of future benefit over a series of years." The long-term activities are those activities which affect firms operation beyond the one year period. Capital budgeting is a many sided activity. It contains searching for new and more profitable investment proposals, investigating, engineering and marketing considerations to predict the consequences of accepting the investment and making economic analysis to determine the profit potential of investment proposal.

The basic features of capital budgeting decisions are:

(1) current funds are exchanged for future benefits;

(2) there is an investment in long-term activities; and

(3) the future benefits will occur to the firm over series of years.

4.2.2 Need for Capital investment

The following factors give rise to the need for capital investments:

(a) Wear and tear of old equipments.

(b) Obsolescence.

(c) Variation in product demand necessitating change in volume of production.

(d) Product improvement requiring capital additions.

(e) Learning-curve effect.

(f) Expansion.

(g) Change of plant site.

(h) Diversification.

(i) Productivity improvement.

4.2.3 Importance of Capital Budgeting

(1) Long-term Implications: A capital budgeting decision has its effect over a long time span and inevitably affects the company's future cost structure and growth. A wrong decision can prove disastrous for the long-term survival of firm. It leads unwanted expansion of assets, which results in heavy operating cost to the firm. On the other hand, lack of investment in asset would influence

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the competitive position of the firm. So the capital budgeting decisions determine the future destiny of the company.

(2) **Involvement of large amount of funds:** Capital budgeting decisions need substantial amount of capital outlay. This underlines the need for thoughtful, wise and correct decisions as an incorrect decision would not only result in losses but also prevent the firm from earning profit from other investments which could not be undertaken.

(3) **Irreversible decisions:** Capital budgeting decisions in most of the cases are irreversible because it is difficult to find a market for such assets. The only way out will be to scrap the capital assets so acquired and incur heavy losses.

(4) **Risk and uncertainty:** Capital budgeting decision is surrounded by great number of uncertainties. Investment is present and investment is future. The future is uncertain and full of risks. Longer the period of project, greater may be the risk and uncertainty. The estimates about cost, revenues and profits may not come true.

CHECK YOUR PROGRESS
What is the Need for Capital investment?

(5) **Difficult to make:** Capital budgeting decision making is a difficult and complicated exercise for the management. These decisions require an overall assessment of future events which are uncertain. It is really a marathon job to estimate the future benefits and cost correctly in quantitative terms subject to the uncertainties caused by economic-political social and technological factors.

4.2.4 Process of Capital Budgeting

The process of capital budgeting involves the following steps:

Identification of investment opportunities

Devising investment proposals

Decision making

Implementation of proposals

Post-completion follow-up

Identification of potential investment opportunities

The process of capital budgeting starts with the identification of investment opportunities. These investments may be necessitated due to rising sale of the company which requires an expansion in the production capacity or it may be required because the firm wants to expand on its own looking at future growth prospects. The investment opportunities or the proposals that to be considered shall be accompanied by details relating to following matters-

(a) Market potential for the product and yearly sales forecasts for different years.

(b) Raw material requirements and their supply position.

(c) Technical details relating to physical facilities and flow diagrams.

(d) Financial implications.

Devising investment proposals

Any investment proposal identified by the various departments of the firm is submitted in a standardised format for further processing. These proposals before its final drafting is done are sent to number of people for their opinion so that the proposal can be viewed from different perspectives. It also helps in creating a culture of collaboration within an organisation.

Decision making and Co-ordination

At this stage, all those proposals which are conflicting and do not deserve further consideration are rejected so that only useful alternatives are analysed in detail. Economic evaluation generally plays an important role in the screening process. Along with screening, there is also the need for blending together and unifying different capital projects under the total capital expenditure programme. In this way, conflicting and duplicate proposals would be eliminated and taken together all of them contribute to the accomplishment of some higher objectives. Co-ordination will be greatly facilitated in different proposals for capital outlays are related to each other.

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Implementation of proposals

Practical implementation of an investment proposal requires lot of time and energy due to the complexity involved. Implementation process has to be chalked out well in advance with clear deadlines to complete each stage of the proposal. This is necessary since any delays typically lead to huge cost overruns and jeopardize the feasibility of the proposal.

CHECK YOUR PROGRESS

Explain the meaning and importance of capital budgeting.

Post-completion follow-up

This step acts as a means to check whether the targeted performance objectives have been met or not. Thus it acts as a feedback mechanism in any investment proposal. If difference is found between the actual and the targeted performance, then the cause for this gap needs to be found out and remedial measures should be adopted at the earliest. Follow up implies comparing and reporting actual results with the projected result of investment proposal so as to evaluate the performance and outcome in proper perspective. It is required; however, that procedures and format of follow-up should be clearly defined and communicated.

The post completion audit helps management in a number of ways:

(a) to validate the existing capital expenditure, planning and control procedures and methods;

(b) to evaluate results;

(c) to highlight reasons for projects failure; and

(d) to judge soundness of proposals originating at different levels in the organisaiton.

4.3 Capital Rationing

The firm may put a limit to the maximum amount that can be invested during a given period of time, such as a year. Such a firm is then said to be resorting to capital rationing. A firm with capital rationing constraint attempts to select the combination of investment projects that will be within the specified limits of investments to be made during a given period of time and at the same time provide greatest profitability.

Capital rationing may be effected through budget ceiling. A firm may resort to capital rationing when it follows the policy of financing investment proposals only by ploughing back its retained earnings. In that case, capital expenditure in a given period cannot exceed the amount of retained earnings available for reinvestment.

Management may also introduce capital rationing when a department is

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authorised to make investments upto a limit beyond which investment decisions will be made by higher level management.

Capital rationing may result in accepting several small investment proposals then accepting a few large investment proposals so that there may be full utilisation of budget ceiling. This may result in accepting relatively less profitable investment proposals if full utilization of budget is a primary consideration. Similarly, capital rationing also means that the firm foregoes the next most profitable investment falling after the budget ceiling even though it is estimated to yield a rate of return much higher than the required rate of return. Thus, capital rationing does not lead optimum results.

4.4 Time Value of Money

4.4.1 Concept

One of the most fundamental concepts in finance is that money has a "time value." That is to say that money in hand today is worth more than money that is expected to be received in the future. If given a choice than we can receive Rs.100 now or after a year, anybody will choose to have Rs. 100 now rather than waiting for a year. However, if he is given a choice of Rs.100 now and Rs. 115 after one year, then you will find that people would be willing to forego receipt of Rs.100 now in order to get something extra than what they are getting right now. This additional payment (Rs. 15 here) is called as the "Time value of money". So at the most basic level, the time value of money demonstrates the concept of time value:

"A rupee today is worth more than a rupee tomorrow."

4.4.2 Methods

There are namely two methods for calculating the time value of money.

(i) Compounding: Here the future value of all the cash flows at the end of a specific time period is found at a predetermined interest rate.

(ii) Discounting: Present value of future cash flows are determined at a given interest rate.

1. Compounding

The future value of a single cash flow invested at a particular point of time can be calculated as:

$FVn = PV (1+r)n$

Where,

FVn = Future value of present cash flow after n years

PV= Initial cash flow invested

r= rate of interest

n= time period of investment

Example: Let's say that you invested Rs.10000 in a government scheme for a period of 5 years which is offering an interest rate of 10%, then the amount you will receive after 5 yrs can be calculated as:

$FVn = PV (1+r)n$

= 10000 (1+0.10)5 [Remember r=10%=0.10]

=10000 (1.10)5

=10000 (1.610)

= Rs. 16100

NOTES

Future value of multiple cash flows can also be computed in the same manner. Let us look at an example of how to calculate future value of multiple cash flows.

Example: Calculate the future value of the cash flows given in the table below after 2 years. Assume rate of interest to be 5%.

Beginning of the Year	**Investment (Rs.)**
0	5,000
1	10,000
2	15,000
Total	**30,000**

CHECK YOUR PROGRESS

Explain the concept of Time Value of Money.

The future value of this type of cash flow is nothing but a simple addition of future value of individual cash flows. That is:

FV^{Total} = (FV of cash flow at time t=0) + (FV of cash flow at time t=1) + (FV of cash flow at time t=2)

= 5000 (1+0.05)3 + 10000 (1+0.05)2 + 15000 (1+0.05)1

= 5000 (1.05)3 + 10000 (1.05)2 + 15000 (1.05)1

= 5000 (1.157) + 10000 (1.102) + 15000 (1.05)

= 5785+11020+15750

=32555

Thus, the total compounded value is Rs.32555

2. Discounting

The present value of a single cash flow can be calculated as follows:

PV= (FVn)/?(1+r)?^n

PV= Present value

FVn = Future value receivable after n years

r= rate of interest

n= time period

Let us understand this through an illustration given below.

Example: What is the present value of Rs.500 to be received after 2 years if the interest rate is 10% p.a.

We know that:

PV = (FVn) / (1+r)?^n

= (500) / (1+0.10)?^2

= (500) / (1.10)?^2

= (500) / 1.21

= 413.22

Therefore, the present value of Rs.500 to be received after 2 years is

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Rs.413.22.

The present value of multiple cash flows is a simple summation of present values of individual cash flows. Thus for three cash flows, the present value can be represented as:

$$PV= (FV_1) / (1+r)^1 + (FV_2) / (1+r)^2 + (FV_3) / (1+r)^3$$

This can be illustrated from the following example.

Example: Calculate the present value of the future cash flows given in the table below. Assume rate of interest to be 5%.

Year	**Investment (Rs.)**
1	5,000
2	10,000
3	15,000
Total	**30,000**

The present value can be calculated as:

$PV = (5000) / (1+0.05)^1 + 10000 / (1+0.05)^2 + (15000) / (1+0.05)^3$

$= (5000) / (1.05)^1 + 10000 / (1.05)^2 + (15000) / (1.05)^3$

$= (5000) / 1.05 + 10000 / 1.10 + (15000) / 1.15$

$= 4761.9 + 9090.90 + 13043.47$

= Rs. 26896.27 = Rs.26896

Thus the present value of Rs.30000 is Rs. 26896

4.5 Evaluation techniques

This section of the unit discusses the commonly used techniques for evaluating investment decisions. They include (i) Pay back (PB) method (ii) Net Present Value (NPV) (iii) Internal Rate of Return (IRR) (iv) Profitability Index (P.I)

(A) Pay Back Method

This method helps in calculating the time required to recover the initial investment in a project based on the expected cash inflows. The time taken to recover the original investment is called as "payback period". The shorter the payback period, the higher the desirability of that project.

There are two ways to calculate payback period. The first method is applied when there is uniform cash inflow in each year of the project's life. The payback period can be calculated as:

Payback period (PB) = (Initial Investment) / (Annual Cash Flow)

For instance, if the initial investment in a project is Rs.50,000 and cash inflow in each year is Rs. 5000, then the payback period will be:

PB= (50000) / 5000 = 10 years

However, practically it is very rare that there will be uniform cash flows across the life of the project. The method to calculate payback period requires a bit of modification in these cases. Let us see how the payback period is calculated when the cash flows are not constant.

Example: Let us say that the initial investment in the project is Rs.50,000. The cash flows for each successive year are given below:

Year	Cash Flow	Cumulative cash flow
1	10,000	10,000
2	20,000	30,000
3	30,000	60,000

We can observe from the cash flows that initial investment of Rs.50,000 is recovered between the years 2 & 3. A sum of Rs.30,000 is recovered by the second year. Therefore, the payback period will be a fraction more than 2 years. After 2 years, the amount remaining to be recovered out of initial investment is Rs.20,000 (Rs.50000-Rs.30000). This remaining amount is recovered in the third year out of the cash flow of Rs.30000. The payback fraction is therefore 0.67 (Rs.20000/Rs.30000). The payback period is therefore 2.67 years.

Decision Rule for Payback Method:

Accept the project if the payback period calculated for it is less than the maximum set by the management. Reject the project if it is otherwise. In case of multiple projects, the project with shorter payback period will be selected. In essence, payback period shows break-even point where cash inflows are equal to cash out flows. Any inflows beyond this period are surplus inflows.

Merits of Payback period

1. No assumptions about future interest rates have to be made.
2. It is simple to understand and easy to compute.
3. The company gets forced to invest in projects with the shortest payback period whenever there is constraint of capital.
4. Any investor willing to invest his money in the project gets a fair idea about when he will be able to get back his investments.
5. Investment proposals can be ranked quickly.

Demerits of Payback period

1. A major drawback of this method is that any cash flow generated post the payback period is completely ignored which may be misleading in any capital expenditure decision.
2. The pattern of cash flows is not considered in this method. A rupee that comes back in the second year (say) is treated at par with a rupee that comes in the fourth year (say). This idea is though flawed because of the concept of time value of money as discussed earlier.
3. The cost of capital is not taken into consideration in this method.

Suitability of Pay Back period method-

Payback period method may be successfully applied in the following circumstances:

(i) where the firms suffers from liquidity problem and is interested in quick recovery of fund than profitability;

(ii) high external financing cost of the project;

(iii) for projects involving very uncertain return; and

(iv) political and economic pressures.

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It may, therefore, be said that payback period is defined as the measure of projects liquidity and capital recovery rather than its profitability.

(B) Net Present Value (NPV)

NPV is calculated as the difference of the present value of cash inflows and present value of cash outflows. The rate of interest used for discounting the cash flows is the weighted average cost of capital.

Projects with positive NPV are selected for investment while those with negative NPV are rejected. If the value of NPV is zero, then it means that the firm is indifferent to either accepting or rejecting the proposal. In practice however, it makes no sense to accept a proposal with zero NPV as it would mean that a firm is able to get returns equal to just its initial investment. A firm will have no reason to invest in such a case where there are no profits.

CHECK YOUR PROGRESS

What is the benefit of Payback Period method?

Example: A firm is faced with an investment proposal of Rs.50,000 for installing a new machine. The machine has a life of 5 years. The average cost of capital for the company is 10%. The cash flows after tax are given in the table below. Calculate the NPV of the proposal.

Year	Cash Flow after Tax (CFAT)
1	10,000
2	15,000
3	18,000
4	25,000
5	28,000

Solution:

Computation of PV of cash inflows

PV= $(10000) / (1+0.10)^1 + 15000 / (1+0.10)^2 + (18000) / (1+0.10)^3 + (25000) / (1+0.10)^4 + (28000) / (1+0.10)^5$

$= (10000) / (1.10)^1 + 15000 / (1.10)^2 + (18000) / (1.10)^3 + (25000) / (1.10)^4 + (28000) / (1.10)^5$

= (10000) / 1.10 + 15000/1.21 + (18000) / 1.331 + (25000) / 1.464+(28000) /1.61

= 9090 + 12396 + 13523 + 17076 +17391

= 69476

NPV= PV of cash inflows- Initial investment

= 69476-50000

= Rs.19476

Since the NPV is positive, the proposal can be accepted.

Decision Rule of using DCF Method:

If NPV > Zero : Accept the project

NPV < Zero : Reject the project

NPV = Zero : Firm is indifferent to accept or reject the project.

Merits of NPV

1. It recognises the time value of money.
2. The benefits accruing over the complete lifetime of the project are

considered.

3. If the cost of capital changes during the course of the project, then it can be incorporated in the calculations.
4. It is helpful in selection of mutually exclusive projects.

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Demerits of NPV

1. Calculation of the required rate of return or the cost of capital is a complicated task.
2. This method is not suitable in case of comparison of projects which have different effective lives.

Suitability of NPV Method:

Net present value is the most suitable method in those circumstances where availability of resources is not a constraint. The management authority can accept all those projects having Net Present Value either Zero or positive. This method shall maximise shareholders wealth and market value of share which is the sole aim of any business enterprise.

CHECK YOUR PROGRESS

What do you mean by Net Present Value?

(C) Internal Rate of Return (IRR)

The internal rate of return refers to the rate which equates the present value of cash inflows and present value of cash outflows. In other words, it is the rate at which net present value of the investment is zero. If the Net Present Value is positive, a higher discount rate may be used to bring it down to equalise the discount cash inflows and vice versa. That is why Internal Rate of Return is defined as the break even financing rate for the project.

The necessary steps to be followed in applying this method are:

(i) Project the net cash benefit of an investment during the whole of its economic life. Future cash flows should be estimated after taxes, but before depreciation and interest.

(ii) Determine the rate of discount that equates the present value of its future cash benefits to its present investment. The rate of discount is determined by the method of trial and error.

(iii) Compare the rate of discount as determined above with the cost of capital or any other cut-off rate, and select proposals with the highest rate of return as long as the rate is higher than the cost of capital or cut off rate.

Decision Rule

A project is accepted only if the IRR is greater than the cost of capital. In case both of them are equal, then the management is indifferent between accepting or rejecting the proposal.

Merits of IRR

1. Time value of money is taken into consideration.
2. All the future cash flows are taken into account while making calculations.
3. There is no need to a priori define the cost of capital. It provides the value of the cost of capital or the required rate of return by itself.

Demerits of IRR

1. The calculations are tedious and complicated.
2. Multiple rates of return are produced which can be confusing.

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(D) Profitability Index (PI) or Benefit Cost Ratio (B/C) ratio

Profitability Index measures the present value of cash inflows per unit of capital invested. It can be calculated as:

PI = (Present value of cash inflows) / (Present value ofcash outflows)

Both NPV and IRR utilize the same measures i.e. present value of cash inflows and outflows to evaluate proposals. However, a basic difference between the two is that while NPV is an absolute measure of returns, IRR is a relative measure. This means that if projects have different initial investments, then NPV is not a reliable method to evaluate projects. This shortcoming is overcome by Profitability Index.

This measure is also known as Benefit cost ratio because the numerator provides a measure of the benefits while the denominator provides a measure of the costs.

Decision Rule

A project will be accepted only if its PI is greater than 1. If it is equal to 1, then the firm is indifferent to the project.

Example: If the present value of cash inflows of a project Y is Rs. 30000 while the present value of cash outflows is Rs. 40000, then:

PI = 30000 / 40000

PI = 0.75

Since the value of PI<1, project Y is rejected.

Merits of PI Method:

(1) Profitability Index method gives due consideration to the time value of money.

(2) Profitability Index method satisfies almost all the requirements of a sound investment criterion.

(3) This method can be successfully employed to rank projects of varying cash and benefits in order of their profitability.

Demerits of PI Method:

(1) This method is more difficult to understand and compute.

(2) This method does not take into account the size of investment.

(3) When cash outflows occur beyond the cement period Profitability Index Ratio criterion is unsuitable as a selection criterion.

4.6 Key Concepts

- **"time value"** That is to say that money in hand today is worth more than money that is expected to be received in the future.
- **NPV :** Net Present Value
- **IRR :** Internal Rate of Return

4.7 Summary

Capital budgeting decisions involve current outlay of funds with an anticipation of flow of benefits extending far into the future.

Capital budgeting process involves the following steps: (i) Identification of

investment opportunities (ii) Devising investment proposals (iii) Decision making and co-ordination (iv) Implementation of proposals (v) Post-completion follow-up

Capital budgeting techniques include (i) Payback period (ii) NPV (iii) IRR (iv) Profitability Index

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Payback period measures the time required to recover the initial capital outlay in the project. Shorter the payback period, the higher is the desirability of the project.

NPV is the difference between the present value of cash inflows and present value of cash outflows. Projects with NPV greater than zero are chosen for investment.

IRR is the rate of return which makes the present value of cash inflows equal to the present value of cash outflows. A project is accepted when the IRR is greater than the required rate of return.

PI index measures the present value of returns per unit of capital invested. A project with PI greater than one is selected for investment.

4.8 Questions and Exercises

1. Explain the Capital Budgeting process.
2. What you understand by IRR? Explain its merits and demerits.
3. How is Profitability Index calculated?

● **Fill in the blanks**

1) Short term investment decision are also known as working capital management while the long term investment decisions are known as _____.
(capital budgeting, capital saving, capital rationing)
2) _____ is defined as "The firms' decision to invest its current fund more efficiently in long-term activities in anticipation of an expected flow of future benefit over a series of years".
(capital budgeting, capital saving, capital rationing)
3) The process of capital budgeting starts with the _____of investment opportunities.
(devising, analysis, identification)
4) The firm may put a limit to the maximum amount that can be invested during a given period of time, such as a year. Such a firm is then said to be resorting to_____.
(capital budgeting, capital saving, capital rationing)
5) In _____method , the future value of all the cash flows at the end of a specific time period is found at a predetermined interest rate.
(discounting, compounding, IRR)
6) In _____method, Present value of future cash flows are determined at a given interest rate.
(discounting, compounding, IRR)
7) Pay back (PB) method, Net Present Value (NPV), Internal Rate of Return (IRR) & Profitability Index (P.I) are the techniques of evaluating the _____.
(financial decisions, investment decisions, business decisions)
8) In payback period method, the _____the payback period, the higher the desirability of that project.
(longer, shorter, lesser)
9) Payback period is calculated by dividing _____with annual cash flow.
(profit, total investment, initial investment)
10) The_____ method recognizes the time value of money.
(IRR, PI, NPV)

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11) _____is calculated as the difference of the present value of cash inflows and present value of cash outflows.
(IRR, PI, NPV,)

12) If NPV is greater than_____, then the project shall be accepted.
(two, zero, one)

13) The _____to the rate which equates the present value of cash inflows and present value of cash outflows i. e. it is the rate at which net present value of the investment is zero.
(profitability index, net present value, internal rate of return)

14) A project will be _____ if its profitability index is greater than 1.
(accepted, rejected, indifferent)

Answers: 1)capital budgeting, 2) capital budgeting, 3) identification, 4) capital rationing, 5) Compounding, 6) Discounting, 7)investment decisions, 8) shorter, 9) initial investment, 10) initial investment, 11) NPV, 12) zero, 13) internal rate of return refers, 14) accepted

4.9 Further Reading and References

Brigham & Ehrhardt: Financial Management-Theory and Practice, Cengage Learning

I.M.Pandey: Financial Management, S.Chand & Company Ltd.

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UNIT - 5
FINANCIAL ANALYSIS OF CORPORATES

5.0 Introduction
5.1 Objectives
5.2 Ratio Analysis
5.2.1 Importance of Ratio Analysis
5.2.2 Limitations of Ratio Analysis
5.3 Fund Flow Analysis
5.3.1 Meaning of Funds
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5.3.4 Objectives of Fund Flow Statement
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5.5 Summary
5.6 Questions and Exercises
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5.0 Introduction

Traditional financial statements like balance sheet and profit and loss account provide an overview of the composition of asset and liabilities on a specific date as well as revenues and costs during a period of time respectively. However, they suffer from a basic limitation that they are not able to provide complete information about the financial operations of the firm just by glossing over them, for example, ability of the firm to meet its interest obligations or the time required to collect payment. Therefore there is a need for analyzing the data to be able to better understand a firm's operations and its performance. This analysis is useful for various stakeholders of the firm like investors, managers, lenders and others. It helps in evaluating the creditworthiness of the firm, valuation of shares and assessment of market risk.

This unit is focused on understanding the conceptual framework of financial analysis and its utility in decision making by different affiliates of a corporate. The unit discusses two important tools of financial analysis: Ratio Analysis and Fund Flow Analysis. In section 1 of this unit, an in-depth study on ratio analysis has been presented. Section 2 outlines the importance of ratio analysis as well as its limitations. Section 3 of this unit discusses Fund Flow analysis as a tool for analyzing financial statements.

5.1 Objectives

In this unit, we will introduce you to the concept of ratio analysis and the different types of ratios that are used in financial analysis. You will also be introduced to the concept of fund flow statement in this unit.

By the end of this unit, you should be able to:

- Explain the concept of ratio analysis
- Describe the different types of ratios that are used to evaluate the financial

strength of the firm

- Discuss the importance and limitations of ratio analysis
- Explain the concept of fund flow analysis
- Describe the advantages and limitations of fund flow analysis

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5.2 Ratio Analysis

A ratio refers to an arithmetical relationship between two variables. Thus financial ratios are nothing but arithmetical relationship between two or more items in a financial statement. Ratio analysis refers to the study of various financial ratios to evaluate the performance of the firm. The utility of ratio analysis lies in the fact that a single financial figure in itself does not hold much meaning by itself but when expressed in terms of other figures, it provides significant information for decision making purpose. For example, let's say that net profit in year 1 was Rs.20 crore while in year 2 was Rs.30 crore. Looking at these numbers, one would tend to believe that the performance in year 2 was better than year 1. Let's say that the sale in year 1 was Rs.50 crore while it was Rs.100 crore in year 2. Now, if we calculate the profit margin, we find that the margin was 40% in year 1 while it was just 30% in year 2. So, on the basis of profit margin, we find that year 1 was better than year 2 which is opposite to what we obtained when we compared just net profit numbers. Thus, ratio analysis helps in making informed judgment about the performance of the company.

Although the ratios have been classified in different ways, for our purpose, we have divided them into four broad categories:

(i) Liquidity ratios

(ii) Leverage ratios

(iii) Profitability ratios

(iv) Activity ratios

Liquidity Ratios

The importance of liquidity lies in the fact that it helps in evaluating the ability of the firm to meet its short term obligations. Liquidity ratios measure the short term solvency of the firm. The important liquidity ratios are: (i) Current ratio (ii) Quick ratio (iii) Super-quick ratio

(i) Current Ratio:

It is the ratio of current assets and current liabilities. It is represented as:

Current Ratio = Current Assets / Current Liabilities

Current Assets are those which can be converted into cash in a time period not exceeding one year. They include cash, bank balance, inventory (raw material, work in progress & finished goods), prepaid expenses, bills receivable & debtors. Current liabilities represent those liabilities which have to be paid in the next one year and include bills payable, bank loan, dividend payable, outstanding expenses, creditors and provision for taxation.

Although there are no hard and fast rules, an ideal current ratio should be 2:1. This implies that current assets should be twice the current liabilities. The higher the current ratio of the firm, the better is its short term solvency. When comparing two firms, the firm having higher current ratio is considered to be better than the other in meeting its short term liquidity requirements. However, it is important to be cautious while interpreting the current ratio as not only its value, but also the composition of current assets or liabilities is to be carefully observed. For instance,

a firm having higher proportion of its current assets in the form of cash and bank balances would be in a better position than the firm with higher proportion in inventory and debtors even though their current ratios might be the same.

(ii) Quick Ratio:

It is the ratio of quick assets and current liabilities.

Quick Ratio= Quick Assets / Current Liabilities = Current Assets - Inventory - prepaid Expenses / Current Liabilities

Quick assets are those assets which can be converted into cash in a very short period of time without loss of value. These include: (i) Short term marketable securities (ii) Cash and Bank balances (iii) Debtors/receivables

Quick ratio is a stringent measure of the liquidity position of the company. A ratio of 1:1 is considered to be satisfactory.

(iii) Super-quick ratio: It is the ratio of super-quick assets and current liabilities. Quick Ratio = Super Quick Assets / Current Liabilities = Cash Balance+Bank Balance+Marketable securities / Current Liabilities

Out of the three solvency ratios, super-quick or cash ratio is considered to be the most rigorous is measuring the short term solvency position of the company. This ratio is essentially used as a conservation test and is not widely used in practice.

CHECK YOUR PROGRESS

What do you understand by ratio analysis?

Leverage Ratios

Financial leverage refers to usage of debt to finance business activities. These ratios are used to assess the long term solvency as they measure the ability of the firm to service the interest payments regularly and pay back the principal on due date. The following are the important types of leverage ratios : (i) debt-equity ratio (ii) debt-assets ratio (iii) interest coverage ratio (iv) fixed charges coverage ratio (v) debt service coverage ratio

(i) Debt-Equity ratio: This ratio shows the relative proportion of borrowed funds and shareholders capital in the capital structure of the firm. Alternatively, this ratio indicates the contribution of debt and equity in financing the assets of the firm. The term "borrowed funds" generally refers to long term debt of the company.

Debt-Equity Ratio = Long- term debt / Shareholder's Equity

Sometimes, a different approach to calculate debt-equity ratio is employed where instead of only long-term debt, total debt (i.e. both short term and long term debt) is used. That is:

Debt-Equity Ratio = Total debt / Shareholder's Equity

This ratio indicates the margin of safety for the creditors. If the debt to equity ratio is high, it means that the owners are putting up less of their capital as compared to their creditors. This in case of any project failures, the creditors will lose more money than the owners. Also, a high D/E ratio may lead the owners to behave recklessly while planning and implementing projects as they have fewer stake involved.

(ii) Debt-assets ratio: This ratio denotes the proportion of total assets which have been financed by borrowed funds.

Debt-assets Ratio = Total debt / Total assets

Total debt includes both short term as well as long term debt.

(iii) Interest Coverage ratio: This ratio measures the interest servicing capacity of the firm in so far as interest on long term debt is concerned.

Interest coverage Ratio = PBIT / Interest

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PBIT denotes Profit before Interest and Tax. Profit before tax is used in the calculation because interest payments are not affected by tax considerations. In fact, interest is a tax-deductible expense and the tax is calculated only after deducting the interest payments. A high interest coverage ratio indicates that the firm will be able to meet its interest obligations even after substantial decline in its profits. For example, if the value of the interest coverage ratio is 5, it means that even if the PBIT declines by 5 times, then also the firm will be able to meet its interest obligations. It is used by lenders to evaluate the debt capacity of the firm. It is also an important determinant of bond rating.

(iv) Fixed charges coverage ratio: This ratio looks at the ability of the firm to meet all its fixed obligations. These obligations may include: (i) preference dividend (ii) lease payments (iii) interest on loan (iv) repayment of principal.

Fixed charges coverage Ratio = PBIT+Lease payments / Interest+Lease payments + Preference dividend + loan instalment / (1-tax rate)

This ratio is a more comprehensive measure of the debt repaying capacity of the firm as it includes both interest as well as principal repayment.

(v) Debt service coverage ratio: It is widely used by financial institutions to evaluate the ability of the firm to meet all its debt service obligations. It can be defined as:

DSCR = Profit after Tax + Depreciation + Interest + Other non-cash expenses / Interest + Repayment of Principal

Profitability Ratios

These ratios help in measuring the efficiency with which the operations of the firm are carried out. Profitability ratios help in calculating the profitability of an organisation. Some of the important profitability ratios are: (i) Gross Profit ratio (ii) Net Profit ratio (iii) Return on Investment (iv) Earnings Per Share (EPS) (iv) Price- earnings ratio

(i)Gross Profit Ratio: Also known as gross margin, this ratio describes the relationship between gross profit and sales. It can be calculated as:

Gross profit Ratio = Gross Profit/ Sales x 100

This ratio helps in calculating the margin left after meeting all manufacturing costs. Higher gross profit ratio indicates efficient production and pricing.

(ii) Net Profit ratio: It measures the relationship between net profit and sales of a firm.

Net profit Ratio = Net Profit/ Net Sales) x 100

This ratio enables determination of efficiency with which the business affairs are being carried out. An increasing trend in this ratio clearly illustrates improvement in conditions of the business. High net profit ratio ensures sufficient returns for the shareholders as well as provides a cushion for the firm to bear any adverse economic shocks.

(iii) Return on Investment: This ratio helps in determining the overall returns generated by the management with the assets possessed by the company. It can be calculated as:

Return on Investment = Operating Profit / Capital Employed

ROI measures the returns generated per unit of capital invested by the company.

(iv) Earnings Per Share (EPS): It measures the per share profit available to the equity shareholders.

Earnings Per Share (EPS) = Net Profit available to equity shareholders / Number of oustanding ordinary shares

(v) Price-earnings (P/E) Ratio: It reflects the price which the market is willing to pay for each unit of earnings of the firm.

Price-earnings (P/E) ratio = Market price of share / EPS

This ratio is widely used by stock market participants to determine whether to buy a particular stock or not at a particular price.

Activity Ratios

These ratios indicate the efficiency with which outstanding accounts or assets are converted into cash or sales. That is why these ratios are also called as turnover ratios. Higher the activity ratio, the better is the efficiency in utilisation of assets. Some of the common activity ratios are: (i) Inventory turnover ratio (ii) Debtors Turnover ratio (iii) Creditors Turnover ratio (iv) Assets Turnover ratio

(i) Inventory turnover ratio: This ratio measures the speed with which the inventory is getting converted into sales.

Inventory turnover ratio = Cost of goods sold / Average inventory

Average Inventory = Opening stock + (Closing stock)^2

The higher the inventory turnover ratio, the better is the inventory management. A very low inventory turnover ratio indicates the opposite signifying excessive inventory. Carrying too much inventory is not a financially viable proposition for the company as it represents cost in terms of storage, locking up of funds, interest and opportunity cost of blocked funds.

CHECK YOUR PROGRESS

Explain the different types of profitability ratios.

(ii) Debtors turnover ratio: This ratio indicates the pace with which receivables is collected from the debtors.

Debtors turnover ratio = Net credit sales / Average sundry debtors

Higher the debtors turnover ratio, the better is the credit management of the firm.

(iii) Creditors turnover ratio: It measures the speed with which payment is made to creditors.

Creditors turnover ratio = Net credit purchase / Average accounts payable

This ratio is a reflection of the promptness in payment to creditors. A high creditors turnover ratio indicates that the creditors are being paid quickly which enhances the credit worthiness of the firm. However, too high a ratio indicates that the credit facilities are not being taken full advantage of.

(iv) Assets turnover ratio: It indicates the efficiency of utilisation of assets to generate sales. It can be defined as:

Assets turnover ratio = Cost of goods sold / Average total assets

The higher the assets turnover ratio, the better the utilisation of assets while low ratio indicates suboptimal utilisation of available resources.

5.2.1 Importance of Ratio Analysis

Measuring liquidity position

An important use of ratio analysis is to judge the liquidity position of the firm. A firm is said to have a satisfactory liquidity position if it is able to meet its

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short term liabilities. Meeting short term liabilities will mean that the firm is able to repay back the interest as well as principal arising out of short term debt mostly within a year. Liquidity ratios are used by banks and other lending institutions to evaluate the short term repaying capability of any company.

Comparison of firms - Ratio analysis helps a company in conducting a reality check of its performance. An inter-firm comparison helps the company measure its performance vis-à-vis its competitors as well as overall industry. Any large differences found between the firm and its competitors and industry call for a self-appraisal and adoption of appropriate remedial measures.

Assessing profitability - The management of any firm is constantly worries about the profitability of the firm as higher profits would mean that the firm will be able to meet its short term and long term obligations, generate sufficient returns for all stakeholders in the firm as well as help the firm build sufficient reserves to meet any eventuality. Ratios help in measuring the profitability of the firm.

CHECK YOUR PROGRESS
State the limitations of ratio analysis.

Analysis of Trends - Evaluating the long term performance of the firm requires that its performance be tracked consistently over a period of time. Ratio analysis aids a company to check whether its performance is improving or declining over the years. Trend analysis is significant because of the fact that one can know the movements in the performance of the firm i.e. whether they are in the direction desired by the firm or are they moving in an unfavourable direction.

Measuring operating efficiency or turnover of the firm - The ratios are useful in calculating the operating efficiency of the firm. Higher the operating efficiency of the firm better is the utilisation of the assets. Any management would like to have as high operating efficiency as possible as it represents best possible utilisation of the assets of the firm.

5.2.2 Limitations of Ratio Analysis

Although ratio analysis is a widely used tool in financial analysis, yet it suffers from various difficulties. Some of them are as follows:

Requirement of Comparative Study - Ratios make sense only if they are compared with their past performance or compared with other firms in the same industry. The problem that arises however in this is that comparison will be relevant only if same methodology for computing assets and liabilities has been used by the firm in the past as well and also by other firms in the industry.

Limitations of financial statements - Any calculation of ratios is based on the information contained in the financial statements. However, we know that financial statements themselves suffer from certain limitations and correspondingly ratio analysis as a tool also suffers from the same drawbacks. For example, if there is change in the management of the company, then it might lead to change in the financial performance of the firm and hence the present and past performance becomes incomparable.

Changes in Price levels - The practice of financial accounting in India suffers from a major disadvantage that it does not into account changes in price level. This leads to distorted and misreported profits and incomparable financial statements. Hence, ratios calculated on the basis of these financial statements would provide false picture of the status of the firm.

5.3 Fund Flow Analysis

Two types of financial statements are prepared at the end of each financial year by business organisations: Profit and Loss (P& L) account and Balance sheet. Profit and Loss account reveals the profit or loss sustained by the firm during the accounting year while Balance sheet describes the status of the company at a particular point of time. Balance sheet is composed of two sides. One side, called the assets side indicates how the resources of a firm have been deployed while the second side called as the liabilities side describes its obligations.

However, both Profit and Loss account and Balance sheet suffer from a disadvantage that they both provide only a static picture of the accounts of the firm. But in a business enterprise, there is continuous flow of funds into a firm as well as out of the firm. Hence arises a need of creating an additional statement which can show the changes in assets, liabilities and owner's equity between two balance sheet dates. Such a statement is called as Fund Flow statement or Statement of Sources and uses of funds.

5.3.1 Meaning of Funds

The term "Fund" has acquired number of meanings depending on the broadness or narrowness of the context in which it is used. One of the meanings of fund is cash and statement prepared to take only this meaning of fund into account is called as cash flow statement. In cash flow statement, only inflow and outflow of cash is taken into account. In a broader context, fund means all financial resources be it in the form of money, men, materials etc. However, the most widely used meaning of the term funds is working capital. Working capital means the difference between current assets and current liabilities.

5.3.2 Fund flow statement

The funds-flow-statement is a report on financial operations changes, flow or movements during the period. It is a statement which shows the sources an application of funds or it shows how the activities of a business is financed in a particulate period. In other words, such a statement shows how the financial resources have been used during a particular period of time. It is, thus, a historical statement showing sources and application of funds between the two dates designed especially to analyse the changes in the financial conditions of an enterprise. In the words of Foulke, it is-

"A statement of Sources and Application of Funds is a technical device designed to analyse the changes in the financial condition of a business enterprises between two dates."

Funds Flow Statement is not an income statement. Income statement shows the items of income and expenditure of a particular period, but the Funds flow statement is an operating statement as it summaries the financial activities for a period of time. It covers all movements that involve an actual exchange of assets.

Various titles are used for this statement such as 'Statement of sources and Application of Funds', 'Summary of Financial operations,' 'Changes in Financial Position', 'Fund received and Disbursed', 'Funds Generated and Expended', Changes in Working Capital", "Statement of Fund' etc. Title of Funds Flow Statement has been modified from time to time. Really it is very difficult to find a short time for such statement which carries much to the readers regarding its contents and functions.

A new interpretation of the term 'funds, has now been adopted as to include assets or financial resourceful which do not flow through the working capital accounts. It seems to be the most suitable meaning fort the term 'funds' but the most commonly used interpretation of the term 'funds' is 'working capital'

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5.3.3 Distinction between Fund Flow Statement and Balance Sheet

(i) Balance sheet is a statement showing the financial position of the concern on a particular date. The asset side portrays the development of resources in various type of properties an liabilities side indicates the manner in which these resources are obtained. It shows all assets and liabilities whether current or fixed, tangible or intangible etc., while Funds Flow Statement shows the changes in current assets an current liabilities during a particular period of time.

(ii) Balance Sheet shows the total financial position on a particular date and in this way, it is of a historical nature and therefore, its utility is very limited for the management. On the other hand, Funds Flow Statement is a comparative statement of assets and liabilities and depicts the changes in working capital during the period of two Balance sheets.

(iii) Funds Flow Statement is an analysis and control device for the management. Management can ensure the long term and the short term solvency of the firm by studying the internal funds flow cycles. It is a modern technique of knowing the inflows and outflows of funds during a particular period. Balance Sheet represents the balance of various assets and liabilities and does not present analysis of any kind.

(iv) There are two views of h financial position of the firm-long term and short-term. Short-term financial position means the technical solvency of the firm in the near future while on the other hand, long-term financial position means future financial structure of the firm. Both are inter-relate but there is a differences in their analysis. The short-term view of the financial position of the firm ca not be had from the Balance Sheet.

CHECK YOUR PROGRESS

Explain the concept of Fund Flow Analysis.

5.3.4 Objectives of Fund Flow Statement

It help in identifying the sources from where funds have been obtained as well as where have they been utilized.

It highlights the financing pattern of the expansion of the firm.

It pinpoints the use of debt finance in the financing structure.

It describes the relationship between liquidity, financing, investment and dividend decision of a firm.

5.3.5 Advantages of Fund Flow Statement

1. Fund flow statement helps in understanding the effectiveness of use of working capital
2. It helps the management of a company to define its investment policy by highlighting the changes in working capital.
3. It enables the firm to evaluate its current financing pattern and take suitable corrective measures in case it finds any inadequacies.
4. It assists the creditors, financial institutions and banks in understanding the financial soundness of the firm.
5. Financial policies like dividend etc. are guided by fund flow statement.
6. It helps one understand the effects of business operations on the financial and operational position of the firm.
7. It acts as a guide to the management to maintain the working capital at optimum level through either purchase or sale of marketable securities during the periods of adequate and inadequate working capital respectively.

5.3.6 Limitations of Fund Flow Statement

1. Fund flow statement lacks originality. It simply rearranges the data which

exists in the financial statements in a systematic way.

2. It is historic in nature and indicates what has happened in the past and provides no estimate of the future.
3. It cannot be used on standalone basis as it gives idea only about change in working capital and hence has to be used with balance sheet and profit and loss account.
4. It cannot reveal continuous changes that are happening in the financial activities of the company as it takes into consideration two particular time periods.

5.4 Key Concepts

- **Ratio** refers to an arithmetical relationship between two variables.
- **Funds-flow-statement** is a report on financial operations changes, flow or movements during the period.

5.5 Summary

A ratio refers to an arithmetical relationship between two variables.

The utility of ratio analysis lies in the fact that a single financial figure in itself does not hold much meaning by itself but when expressed in terms of other figures, it provides significant information for decision making purpose.

Although the ratios have been classified in different ways, for our purpose, we have divided them into four broad categories: (i)Liquidity ratios (ii) Leverage ratios(iii) Profitability ratios
(iv) Activity ratios.

Liquidity ratios measure the short term solvency of the firm. The important liquidity ratios are: (i) Current ratio (ii) Quick ratio (iii) Super-quick ratio.

Leverage Ratios are used to assess the long term solvency as they measure the ability of the firm to service the interest payments regularly and pay back the principal on due date. The following are the important types of leverage ratios: (i) debt-equity ratio (ii) debt-assets ratio (iii) interest coverage ratio (iv) fixed charges coverage ratio (v) debt service coverage ratio

Profitability Ratios help in measuring the efficiency with which the operations of the firm are carried out. Some of the important profitability ratios are: (i) Gross Profit ratio (ii) Net Profit ratio (iii) Return on Investment (iv) Earnings Per Share (EPS) (iv) Price- earnings ratio

Activity Ratios indicate the efficiency with which outstanding accounts or assets are converted into cash or sales. Higher the activity ratio, the better is the efficiency in utilisation of assets. Some of the common activity ratios are: (i) Inventory turnover ratio (ii) Debtors Turnover ratio (iii) Creditors Turnover ratio (iv) Assets Turnover ratio.

The funds-flow-statement is a report on financial operations changes, flow or movements during the period.

5.6 Questions and Exercises

1. Explain the importance and limitations of ratio analysis.
2. State the advantages and limitations of fund flow statement.
3. How fund flow statement is different from balance sheet?

● **Fill in the blanks**

1) _____ provides significant information for decision making

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purpose.
(financial analysis, business analysis, capital analysis)

2) Current ratio and quick ratio are the types of _____ ratio.
(profitability, activity, liquidity)

3) Current Assets are those which can be converted into cash in a time period not exceeding _____. And Current liabilities represent those liabilities which have to be paid in the next one year.
(two year, half year, one year)

4) When inventory and prepaid expenses are subtracted from current assets we get,_____.
(total assets, quick assets, fixed assets)

5) _____ are those assets which can be converted into cash in a very short period of time.
(current assets, quick assets, fixed assets)

6) Debt-equity ratio, debt-assets ratio, interest coverage ratio, fixed charges coverage ratio & debt service coverage ratio are the types of _____.
(liquidity ratios, turnover ratios, leverage ratios)

7) If the debt to equity ratio is high, it means that the owners are putting up less of their capital as compared to their_____.
(creditors, debtors, directors)

8) A _____ interest coverage ratio indicates that the firm will be able to meet its interest obligations even after substantial decline in its profits.
(high, low, at par)

9) Gross Profit ratio describes the relationship between gross profit and _____.
(capital, purchase, sales)

10) To ensure sufficient returns for the shareholders as well as to provide a cushion for the firm to bear any adverse economic shocks, the net profit ratio should be_____.
(high, low, at par)

11) _____ measures the returns generated per unit of capital invested by the company.
(return on investment, return on capital, return on fund)

12) Activity ratios are also called as _____ratios.
(leverage, debt, turnover)

13) Requirement of Comparative Study, Changes in Price levels, dependency on financial statements, all these are the _____of ratio analysis.
(limitations, benefits, importance)

14) A statement of Sources and Application of Funds is a technical device designed to analyse the changes in the financial condition of a business enterprises between two dates is called as _____.
(financial statement, fund flow statement, profit & loss statement)

Answers: 1)financial analysis, 2)liquidity, 3)one year, 4)quick assets, 5) quick assets, 6) leverage ratio, 7) creditors, 8) high, 9)sales, 10) high, 11) return on investment, 12) turnover, 13) limitations, 14) fund flow statement

5.7 Further Reading and References

Brigham & Ehrhardt: Financial Management-Theory and Practice, Cengage Learning

I.M.Pandey: Financial Management, S.Chand & Company Ltd.

Prasanna Chandra: Financial Management-Theory and Practice, McGraw Hill Education India Private Limited

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UNIT - 6
COMPANY MEMBERS TRANSFER AND TRANSMISSION OF SHARES

6.0 Introduction
6.1 Objectives
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6.0 Introduction

The membership in a company is obtained through subscribing to the memorandum, through allotment/transfer/transmission etc. The membership rights enable the member to participate into the affairs of the company through general

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meeting.

The Companies Act 2013 prescribes aspects as to the mode of acquisition of membership, eligibility criteria, minimum number of members, rights and liabilities of members.

6.1 Objectives

In this unit, you will be introduced to the rules and regulations associated with membership of a company. By the end of this unit, you should be able to:

- Understand the concept of a Member Of A Company.
- explain the rules dealing with registration of members of a company
- discuss the rules dealing with transfer of shares
- discuss the regulations dealing with transmission of shares

6.2 Company Members

A company is composed of members, though it has its own entity distinct from the members. The members of a company are the persons who, for the time being, constitute the company, as a corporate entity.

In the case of a company limited by shares, the shareholders are the members. The terms "members" and "shareholders" are usually used interchangeably. Generally speaking, every shareholder is a member and every member is a shareholder. However, there may be exceptions to this statement, e.g., a person may be a holder of share by transfer but would not become member until the transfer is registered in the books of company in his favor and his name is entered in the register of members. Similarly, a member who has transferred his shares, though he does not hold any shares continues to be member of the company until the transfer is registered and his name is removed from the register of members maintained by the company under section 88 of the Companies Act, 2013.

In a company limited by guarantee, the persons who are liable under the guarantee clause in its memorandum of association are members of the company.

In an unlimited company, the members are the persons who are liable each in proportion to the extent of the their interests in the company, to contribute the sums necessary to discharge in full, the debts and liabilities of the company, in the event of its being wound up.

The terms 'contributory' and 'member' are not interchangeable; while every member would become a contributory the converse would not be true, unless the name of the contributory is entered in the register of members.

6.2.1 Definition of 'Member'

According to Section 2 (55) of the Companies Act, 2013, 'member' in relation to a company, means -

(i) Those who deemed to have agreed to become member: The subscribers of the memorandum of a company shall be deemed to have agreed to become members of the company, and on registration, shall be entered as members in its register of members;

(ii) Those who agrees in writing to become member: Every other person who agrees in writing to become a member of a company and

whose name is entered in its register of members shall, be a member of the company;

(iii) Those who are beneficial owner: Every person holding shares of the company and whose name is entered as a beneficial owner in the records of a depository.

Thus, there are two important elements which must be present before a person can acquire membership of a company viz.,

(i) agreement in writing to become a member; and

(ii) entry of the name of the person, in the register of members of the company.

6.3 Modes of acquiring Membership-MODES OF ACQUIRING MEMBERSHIP

CHECK YOUR PROGRESS

Who can be a Member of a company?

As per section 2(55) of the Companies Act, 2013, a person may acquire the membership of a company:

(a) by subscribing to the memorandum of association; or

(b) by agreeing to become a member:

(i) by making an application to the company for allotment of shares, or

(ii) by executing an instrument of transfer of shares as transferee, or

(iii) by consenting to the transmission of shares of a deceased member in his name; or

(iv) by acquiescence or estoppel and on his name being entered in the register of the members of the company,

(c) by holding equity share capital of the company and on his name being entered as beneficial owner in the records of the depository under the Depository Act,1996.

6.4 Cessation of Membership-CESSATION OF MEMBERSHIP

A member ceases to be a member of a company when his name is removed from the register of members or register of beneficial owners. Cessation of membership may occur in following ways:

(i) Transfer of shares by sale or otherwise:

When the member signs the instrument of transfer and delivers it together with relevant share certificate(s) to the person to whom he intends to transfer the shares or broker as the case may be. In case of the shares held in the demat form, the members issue Delivery Instruction on the prescribed form to the Depository Participant (DP) with whom he has his Account for such shares. In the case of demat form, the name of the member shall be removed from the Register of beneficial owners. In the case of Physical Form, the name of the member shall be removed from the register of members only on registration of the shares in the name of the transferee.

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(ii) Forfeiture of shares:

If a member does not pay the allotment/call money on the shares held by him in the company, the company is empowered to forfeit such shares for nonpayment of the due amount by the member after complying with the relevant procedure in this regard.

(iii) Sale of shares under lien:

If company has exercised lien on the shares of a member in accordance with its Articles of Association, the member ceases to be a member on removal of his name from the register of members/beneficial owners if the company enforces its lien by way of sale of such shares.

(iv) Death/Insolvency :

A member ceases to be a member of the company on removal of his name from the register of members/ beneficial owners and entering the name of the nominee/ successor or creditor in the register of member/ beneficial owners in his place. The nominee/successor or creditor shall follow the same procedure as stated in case of transmission of shares.

(v) Conversion of shares into share warrants/stocks:

If a company subject to its Articles of Association converts its fully paid equity shares into share warrants or stock, the names of the members are struck from the register of members/beneficial owners. Consequently, the members cease to be members of the company on and from the date of such conversion.

(vi) Buy back of shares:

If a company, subject to its Articles of Association and the provisions of section 68 of the Companies Act, 2013, buys back its own shares from its existing members, then such members who offer all their shares in the company for sale cease to be members of the company on cancellation of such bought out shares.

(vii) Purchase of Shares under the Court order:

If the shares of a member are purchased by another member or the Company, itself under the order of the Court under Section 242 of the Companies Act, 2013, such member ceases to be a member of such company on removal of his name and placing of the other person's name in the register of members/beneficial owners.

(viii) Dissolution/Winding up/Striking off the name of the Company:

If a company is dissolved, wound up or its name has been stuck off from the register of the Companies by the Registrar of Companies; the members cease to be the members of such a company. In the case of winding up of a company, the members cease to be members of such company but they remain liable as contributory and/or entitled to claim share in the surplus, if any.

A member does not cease to be a member merely because winding up of the company has commenced.

He continues to be a member of the company so long as the requirements of prescribed sections of Companies Act, 1956.

(ix) Cancellation of Contract of membership:

If a member rescinds the contract of membership on the ground of fraud, misrepresentation, genuine mistake or irregular allotment, such member ceases to be a member of the company on removal of his name from the register of members/ beneficial owners.

6.5 Rights of Members

According to section 47(1), subject to the provisions of section 43 and sub-section (2) of section 50,-

(a) every member of a company limited by shares and holding equity share capital therein, shall have a right to vote on every resolution placed before the company; and

(b) his voting right on a poll shall be in proportion to his share in the paid-up equity share capital of the company.

6.6 Register of Members

CHECK YOUR PROGRESS
What are the rights of members of a company?

(1) Every company limited by shares shall, from the date of its registration, maintain a register of its members in Form No. MGT.1

(2) In the case of a company not having share capital, the register of members shall contain the following particulars, in respect of each member, namely:-

(a) name of the member; address (registered office address in case the member is a body corporate); e-mail address; Permanent Account Number or CIN; Unique Identification Number, if any; Father's/Mother's/ Spouse's name; Occupation; Status; Nationality; in case member is a minor, name of the guardian and the date of birth of the member; name and address of nominee;

(b) date of becoming member;

(c) date of cessation;

(d) amount of guarantee, if any;

(e) any other interest if any; and

(f) instructions, if any, given by the member with regard to sending of notices etc:

6.6.1 Register of debenture holders or any other security holders

Every company which issues or allots debentures or any other security shall maintain a separate register of debenture holders or security holders, as the case may be, for each type of debentures or other securities in Form No.MGT.2.

6.6.2 Maintenance of the Register of members etc. under section 88

Every company shall maintain the registers under section 88 in the following manner namely:-

(1) The entries in the registers maintained under section 88 shall be made within seven days after the Board of Directors or its duly constituted committee

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approves the allotment or transfer of shares, debentures or any other securities, as the case may be.

(2) The registers shall be maintained at the registered office of the company unless a special resolution is passed in a general meeting authorising the keeping of the register at any other place within the city, town or village in which the registered office is situated or any other place in India in which more than one-tenth of the total members entered in the register of members reside.

(3) Consequent upon any forfeiture, buy-back, reduction, sub-division, consolidation or cancellation of shares, issue of sweat equity shares, transmission of shares, shares issued under any scheme of arrangements, mergers, reconstitution or employees stock option scheme or any of such scheme provided under this Act or by issue of duplicate or new share certificates or new debenture or other security certificates, entry shall be made within seven days after approval by the Board or committee, in the register of members or in the respective registers, as the case may be.

CHECK YOUR PROGRESS

What are the laws related to maintenance of register of members of a company?

(4) If any change occurs in the status of a member or debenture holder or any other security holder whether due to death or insolvency or change of name or due to transfer to Investor Education Protection Fund or due to any other reason, entries thereof explaining the change shall be made in the respective register.

(5) If any rectification is made in the register maintained under section 88 by the company pursuant to any order passed by the competent authority under the Act, the necessary reference of such order shall be indicated in the respective register.

(6) If any order is passed by any judicial or revenue authority or by Security and Exchange Board of India (SEBI) or Tribunal attaching the shares, debentures or other securities and giving directions for remittance of dividend or interest, the necessary reference of such order shall be indicated in the respective register.

(7) In case of companies whose securities are listed on a stock exchange in or outside India, the particulars of any pledge, charge, lien or hypothecation created by the promoters in respect of any securities of the company held by the promoter including the names of pledgee/pawnee and any revocation therein shall be entered in the register within fifteen days from such an event.

(8) If promoters of any listed company, which has formed a joint venture company with another company have pledged or hypothecated or created charge or lien in respect of any security of the listed company in connection with such joint venture company, the particulars of such pledge, hypothecation, charge and lien shall be entered in the register members of the listed company within fifteen days from such an event.

6.6.3 Index of names to be included in Register

(1) Every register maintained under sub-section (1) of section 88 shall include an index of the names entered in the respective registers and the index shall, in respect of each folio, contain sufficient indication to enable the entries relating to that folio in the register to be readily found:

Provided that the maintenance of index is not necessary in case the number of members is less than fifty.

(2) The company shall make the necessary entries in the index simultaneously with the entry for allotment or transfer of any security in such Register.

6.6.4 Foreign register of members, debenture holders, other security holders or beneficial owners residing outside India

(1) A company which has share capital or which has issued debentures or any other security may, if so authorised by its articles, keep in any country outside India, a part of the register of members or as the case may be, of debenture holders or of any other security holders or of beneficial owners, resident in that country.

(2) 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 in Form No.MGT.3 along with the fee where such register is kept; and in the event of any change in the situation of such office or of its discontinuance, shall, within thirty days from the date of such change or discontinuance, as the case may be, file notice in Form No.MGT.3 with the Registrar of such change or discontinuance.

(3) A foreign register shall be deemed to be part of the company's register (hereafter in this rule referred to as the "principal register") of members or of debenture holders or of any other security holders or beneficial owners, as the case may be.

(4) The foreign register shall be maintained in the same format as the principal register.

(5) A foreign register shall be open to inspection and may be closed, and extracts may be taken there from and copies thereof may be required, in the same manner as is applicable to the principal register, except that the advertisement before closing the register shall be inserted in at least two newspapers circulating in the place wherein the foreign register is kept.

(6) If a foreign register is kept by a company in any country outside India, the decision of the appropriate competent authority in regard to the rectification of the register shall be binding.

(7) Entries in the foreign register maintained under sub-section (4) of section 88 shall be made simultaneously after the Board of Directors or its duly constituted committee approves the allotment or transfer of shares, debentures or any other securities, as the case may be.

(8) The company shall-

(a) transmit to its registered office in India a copy of every entry in any foreign register within fifteen days after the entry is made; and

(b) keep at such office a duplicate register of every foreign register duly entered up from time to time.

(9) Every such duplicate register shall, for all the purposes of this Act, be deemed to be part of the principal register.

(10) The company may discontinue the keeping of any foreign register; and thereupon all entries in that register shall be transferred to some other foreign register kept by the company outside India or to the principal register.

6.6.5 Authentication

(1) The entries in the registers maintained under section 88 and index included therein shall be authenticated by the company secretary of the company or by any other person authorised by the Board for the purpose, and the date of the board resolution authorizing the same shall be mentioned.

(2) The entries in the foreign register shall be authenticated by the company secretary of the company or person authorised by the Board by appending

his signature to each entry.

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6.6.6 Closure of register of members or debenture holders or other security holders

(1) A company closing the register of members or the register of debenture holders or the register of other security holders shall give at least seven days previous notice and in such manner, as may be specified by Securities and Exchange Board of India, if such company is a listed company or intends to get its securities listed, by advertisement at least once in a vernacular newspaper in the principal vernacular language of the district and having a wide circulation in the place where the registered office of the company is situated, and at least once in English language in an English newspaper circulating in that district and having wide circulation in the place where the registered office of the company is situated and publish the notice on the website as may be notified by the Central Government and on the website, if any, of the Company.

(2) The provisions contained in sub-rule (1) shall not be applicable to a private company provided that the notice has been served on all members of the private company not less than seven days prior to closure of the register of members or debenture holders or other security holders.

6.6.7 Return of changes in shareholding position of promoters and top ten shareholders

Every listed company shall file with the Registrar, a return in Form No.MGT.10 along with the fee with respect to changes relating to either increase or decrease of two percent, or more in the shareholding position of promoters and top ten shareholders of the company in each case, either value or volume of the shares, within fifteen days of such change.

6.6.8 Inspection of registers, returns etc.

(1) The registers and indices maintained pursuant to section 88 and copies of returns prepared pursuant to section 92, shall be open for inspection during business hours, at such reasonable time on every working day as the board may decide, by any member, debenture holder, other security holder or beneficial owner without payment of fee and by any other person on payment of such fee as may be specified in the articles of association of the company but not exceeding fifty rupees for each inspection.

(2) Any such member, debenture holder, security holder or beneficial owner or any other person may require a copy of any such register or entries therein or return on payment of such fee as may be specified in the articles of association of the company but not exceeding ten rupees for each page. Such copy or entries or return shall be supplied within seven days of deposit of such fee.

6.6.9 Preservation of register of members etc. and annual return

(1) The register of members along with the index shall be preserved permanently and shall be kept in the custody of the company secretary of the company or any other person authorized by the Board for such purpose; and

(2) The register of debenture holders or any other security holders along with the index shall be preserved for a period of eight years from the date of redemption of debentures or securities, as the case may be, and shall be kept in the custody of the company secretary of the company or any other person authorized by the Board for such purpose.

(3) Copies of all annual returns prepared under section 92 and copies of all certificates and documents required to be annexed thereto shall be preserved for a period of eight years from the date of filing with the Registrar.

(4) The foreign register of members shall be preserved permanently, unless it is discontinued and all the entries are transferred to any other foreign register or to the principal register.

Foreign register of debenture holders or any other security holders shall be preserved for a period of eight years from the date of redemption of such debentures or securities.

(5) The foreign register shall be kept in the custody of the company secretary or person authorised by the Board.

(6) A copy of the proposed special resolution in advance to be filed with the registrar as required in accordance with first proviso of sub-section (1) of section 94, shall be filed with the Registrar, at least one day before the date of general meeting of the company in Form No.MGT.14.

CHECK YOUR PROGRESS

Explain the regulations related with inspection of register.

6.6.10 Copies of the registers and annual return

Copies of the registers maintained under section 88 or entries therein and annual return filed under section 92 shall be furnished to any member, debenture-holder, other security holder or beneficial owner of the company or any other person on payment of such fee as may be specified in the Articles of Association of the company but not exceeding rupees ten for each page and such copy shall be supplied by the company within a period of seven days from the date of deposit of fee to the company.

6.7 Transfer of Shares

Transfer of shares means the voluntary conveyance of the rights and possibly, the duties of a member (as represented in a share in the company) from a shareholder who wishes to cease to be a member to a person desirous of becoming a member. Thus, shares in a company are transferable like any other moveable property in the absence of express restrictions under the articles.

Section 56 of the Companies Act, 2013 deals with the transfer and transmission of securities or interest of a member in the company.

(1) INSTRUMENT OF TRANSFER :

Section 56 of the Companies Act, 2013 provides that transfer of securities or interest of a member shall not be registered except on production of instrument of transfer duly stamped, dated and executed and has been delivered to the company by the transferor or the transferee within a period of sixty days (irrespective of the nature of the company, whether listed or unlisted) from the date of execution, along with the certificate relating to the securities, or if no such certificate is in existence, along with the letter of allotment of securities.

Proviso to sub-section (1) of section 56 provides that the provisions of this sub - section in so far as it requires a proper instrument of transfer, to be duly

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stamped and executed by or on behalf of the transfer or an by or on behalf of the transferee, shall not apply with respect to bonds issued by a Government company. This is subject to condition that an intimation by the transferee specifying his name, address and occupation, if any, has been delivered to the company along with the certificate relating to the bond ; and if no such certificate is in existence, along with the letter of allotment of the bond.

The provisions of section 56(1) shall not apply to a Government Company in respect of securities held by nominees of the Government.

(2) IN CASE OF LOSS OF TRANSFER DEED:

In case of loss of the instrument, the company may register the transfer in terms of indemnity. It has been provided in section 56(2) of the Act that where, on an application in writing made to the company bearing adequate stamp value for an instrument of transfer, it is proved to the satisfaction of the Board of directors that the transfer deed signed by or on behalf of the transferor and by or on behalf of the transferee has been lost, the company may register the transfer on such terms as to indemnify as the Board may think fit.

(3) TRANSFER OF PARTLY PAID UP SHARES:

Section 56(3) of the Act provides that where an application is made by the transferor alone and relates to partly paid shares, the transfer shall not be registered unless a notice in Form SH-5 is issued to the transferee and transferee gives "No objection" to the transfer within two weeks from the receipt of the notice. The notice to the transferee shall be deemed to have been duly given if it is dispatched by prepaid registered post to the transferee at the address given in the instrument of transfer, and shall be deemed to have been duly delivered at the time at which it would have been delivered in the ordinary course of post.

(4) TIME LIMIT REGISTRATION OF TRANSFER FOR UNLISTED PUBLIC COMPANY:

Section 56(4) of the Act provides that every company unless prohibited by any provisions of law or of any order of any court, Tribunal* or other authority, shall deliver the certificates of all securities allotted, transferred or transmitted-

(i) Within a period of two months from the date of incorporation, in the case of subscribers to the memorandum;

(ii) Within a period of two months from the date of allotment, in the case of any allotment of any of its shares;

(iii) Within a period of one month from the date of receipt by the company of the instrument of transfer or the intimation of transmission, in the case of a transfer or transmission of securities.

(iv) Within a period of six months from the date of allotment in the case of any allotment of debenture.

Where the securities are dealt with in a depository, the company shall intimate the details of allotment of securities to depository immediately on allotment of such securities. [In case of a listed company, the listing Regulation requires that the registration of transfers and issuance of certificates will be made within fifteen days from the date of receipt of request of transfer. [Regulation 40(3) of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015].

(5) TRANSFER BY LEGAL REPRESENTATIVE:

According to Section 56(5) of the Act, the transfer of any security or other instrument of a deceased person in a company made by his legal representative shall, even if the legal representative is not a holder thereof, be valid as if he had been the holder at the time of execution of the instrument of transfer.

(6) OFFENCE & PENALTY:

Where a company registers transfer or transmission of security not in accordance with the provisions of section 56 of the Act, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees.

(7) VALUATION OF SHARES:

If the shares are listed in stock exchange, the valuation will be determined on the basis of quotations available on the stock exchange on the date of execution of transfer deed or the consideration paid whichever is higher.

On the contrary, if shares are not listed on stock exchange, the value of the shares for the purpose of stamp means the price that the shares would fetch at the time of transfer of shares or consideration agreed, whichever is higher.

It is to be noted that no transfer duty is applicable for transfer of shares if shares are in dematerialized form.

CHECK YOUR PROGRESS

Explain the procedure of Transfer of Shares.

(8) STAMP DUTY:

At present, stamp duty applicable for transfer of shares is 25 paise for every one hundred rupees or part thereof of the value of share. Section 56 of the Companies Act requires that where share transfer form is delivered to the company should be adequately stamped. It means stamp of adequate value should be affixed and cancelled on transfer deed. Unless a transfer form is duly stamped when it was delivered to the company for registration of transfer, it could not say that mandatory requirement of section 56 is complied with and the company is justified to refuse the transfer.

- The share transfer stamps so affixed on a share transfer form are required to be cancelled either at the time of affixing them or at the time of execution of the deed by the transferee. The transferee must make sure that before lodgment of the transfer with the company, he must cancel the stamps by crossing them on their face. No such cancellation of stamps is required in case shares are in dematerialized form.
- If adhesive stamp on transfer deed is not defaced, a fresh deed is to be submitted; company is not obliged to cancel stamp.
- Unless a particular mode of cancellation is prescribed in any state, crossing of stamps is sufficient.
- When the number of share transfer stamps to be affixed on a share transfer form is large it is practically impossible to affix all the stamps on the share transfer form. In such a situation, the share transfer form, with which a separate sheet of paper with share transfer stamps of appropriate value having been affixed is permanently attached, should be treated as duly stamped under the Stamp Act
- It is not necessary that stamps be affixed before transfer deed is executed, they are to be affixed before delivery.

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(9) EXEMPTION FROM PAYMENT OF STAMP DUTY:

No duty shall be chargeable in respect of any instrument executed by or on behalf of or in favor of the Government in cases where but for this exemption, the Government would be liable to pay to pay the duty chargeable in respect of such instrument.

(10) NON-APPLICABILITY OF ABOVE CONDITIONS:

The instrument of transfer and the concerned formalities in section 56 do not apply to the transfer of securities held under the system of depositories. Mere delivery of transfer instruction in the prescribed form to the depository participant by the transferor shall be sufficient.

6.7.1 Requirement for registering the transfer of securities

According to the law, a company shall not register a transfer of securities of the company, or the interest of a member in the company in the case of a company having no share capital, unless a proper instrument of transfer, in such form as may be prescribed, duly stamped, dated and executed by or on behalf of the transferor and the transferee (except where the transfer is between persons both of whose names are entered as holders of beneficial interest in the records of a depository), specifying the name, address and occupation, if any, of the transferee, has been delivered to the company by the transferor or the transferee within a period of 60 days from the date of execution, along with the certificate relating to the securities, or if no such certificate is in existence, along with the letter of allotment of securities.

6.7.2 Power of company to register

Power of company to register shall not be effected by above provision (given under sub- section 1) on receipt of an intimation of transmission of any right to securities by operation of law from any person to whom such right has been transmitted.

6.7.3 Transmission of securities on an application of transferor alone

Where an application is made by the transferor alone and relates to partly paid shares, the transfer shall not be registered, unless the company gives the notice of the application, in such manner as may be prescribed, to the transferee and the transferee gives no objection to the transfer within two weeks from the receipt of notice.

6.7.4 Transfer of security of the deceased

The transfer of any security or other interest of a deceased person in a company made by his legal representative shall, even if the legal representative is not a holder thereof, be valid as if he had been the holder at the time of the execution of the instrument of transfer.

6.7.5 Nomination Facility in respect of Shares

As per the provision given under the section 72 of the Companies Act,

2013, every holder of securities of a company may, at any time, nominate, in the prescribed manner, any person to whom his securities shall vest in the event of his death.

Where the securities of a company are held by more than one person jointly, the joint holders may together nominate, in the prescribed manner, any person to whom all the rights in the securities shall vest in the event of death of all the joint holders.

Nominees to be the holder of the securities: Where a nomination made in the prescribed manner purports to confer on any person the right to vest the securities of the company, the nominee shall, on the death of the holder of securities or, as the case may be, on the death of the joint holders, become entitled to all the rights in the securities, of the holder or, as the case may be, of all the joint holders, in relation to such securities, to the exclusion of all other persons, unless the nomination is varied or cancelled in the prescribed manner.

Where the nominee is a minor, it shall be lawful for the holder of the securities, making the nomination to appoint, in the prescribed manner, any person to become entitled to the securities of the company, in the event of the death of the nominee during his minority.

CHECK YOUR PROGRESS

What is the Requirement for registering the transfer of securities?

6.7.6 Refusal to Register Transfer and Appeal against Refusal

Section 58 of the Companies Act, 2013, deals with process of the company to be followed by on refusal to register the transfer of securities.

(i) If a private company limited by shares refuses, to register the transfer of, or the transmission of the right to any securities or interest of a member in the company, then the company shall send notice of the refusal to the transferor and the transferee or to the person giving intimation of such transmission, within a period of thirty days from the date on which the instrument of transfer, or the intimation of such transmission, was delivered to the company.

The securities or other interest of any member in a public company are freely transferable, subject to the contract/arrangement.

(ii) The transferee may appeal to the Tribunal against the refusal within a period of thirty days from the date of receipt of the notice or in case no notice has been sent by the company, within a period of sixty days from the date on which the instrument of transfer or the intimation of transmission, was delivered to the company.

(iii) If a public company without sufficient cause refuses to register the transfer of securities within a period of thirty days from the date on which the instrument of transfer or the intimation of transmission, is delivered to the company, the transferee may, within a period of sixty days of such refusal or where no intimation has been received from the company, within ninety days of the delivery of the instrument of transfer or intimation of transmission, appeal to the Tribunal.

(iv) The Tribunal, while dealing with an appeal may, after hearing the parties, either dismiss the appeal, or by order-

(a) direct that the transfer or transmission shall be registered by the company and the company shall comply with such order within a period of ten days of the receipt of the order; or

(b) direct rectification of the register and also direct the company to pay

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damages, if any, sustained by any party aggrieved.

(v) If a person contravenes the order of the Tribunal he shall be punishable with imprisonment for a term not less than one year but may extend to three years and with fine not less than one lakh rupees which may extend to five lakh rupees.

6.7.7 Rectification of register of members on transfer of securities

Section 59 of the Companies Act, 2013 provides the procedure for the rectification of register of members after the transfer of securities. The provision states that-

(i) Remedy to the aggrieved for not carrying the changes in the register of members: If the name of any person is, without sufficient cause, entered in the register of members of a company, or after having been entered in the register, is, omitted there from, or if a default is made, or unnecessary delay takes place in entering in the register, the fact of any person having become or ceased to be a member, the person aggrieved, or any member of the company, or the company may appeal in such form as may be prescribed, to the Tribunal, or to a competent court outside India, specified by the Central Government by notification, in respect of foreign members or debenture holders residing outside India, for rectification of the register.

(ii) Order of the Tribunal: The Tribunal may, after hearing the parties to the appeal by order, either dismiss the appeal or direct that the transfer or transmission shall be registered by the company within a period of ten days of the receipt of the order, or direct rectification of the records of the depository or the register and in the latter case, direct the company to pay damages, if any, sustained by the party aggrieved.

(iii) The provisions of this section shall not restrict the right of a holder of securities, to transfer such securities and any person acquiring such securities shall be entitled to voting rights unless the voting rights have been suspended by an order of the Tribunal.

(iv) Where the transfer of securities is in contravention of any of the provisions of the Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India Act, 1992 or this Act or any other law for the time being in force, there the Tribunal may, on an application made by the depository, company, depository participant, the holder of the securities or the Securities and Exchange Board, direct any company or a depository to set right the contravention and rectify its register or records concerned.

(v) Default in complying with the order: If any default is made in complying with the order of the Tribunal under this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

6.8 Transmission of Shares

It takes place when shares are transferred under the operation of law, either on the death of the registered shareholder or on his being adjudged as insolvent. It also takes place where the holder is a company if it goes into liquidation. Upon the death, the shares of the deceased vest in his executors or administrators and the estate becomes liable for calls if the shares are not fully paid up. In the like manner the official assignee or the receiver, as the case may be, is also entitled to be registered as a member in the place of shareholder who has been adjudged an insolvent [R.W. Key and Sons (1902) I C, 467]. However, the executors or administrators may decline to be registered as members for various reasons. In that event the legal representatives, by virtue of Section 56 of the Companies Act, 2013, shall be entitled to transfer the shares of the deceased irrespective of whether they are partly paid or fully paid.

In case legal representative elects to become a member, he must send a written and signed notice called "Letter of Request" to the company notifying his decision. If he elects to transfer, he shall notify the election after executing a transfer of the shares. All rules relating to the right of transfer and registration of transfer will apply to such notice and transfer.

CHECK YOUR PROGRESS
Difference between transfer and transmission of shares.

The distinction between transfer and transmission, thus, is that the former is the effect of deliberate act of a member whereas the latter is the result of operation of law on the death or insolvency of a member. Again unlike a transfer in the case of the transmission of shares, an execution of any instrument of transfer is not required. Transmission is recorded by the company on the basis of evidence showing the entitlement of the transferee the shares. No stamp duty is payable on transmission of shares.

The regulations associated with transmission of shares under Company Act 2013 are as under:

1. (i) On the death of a member, the survivor or survivors where the member was a joint holder, and his nominee or nominees or legal representatives where he was a sole holder, shall be the only persons recognised by the company as having any title to his interest in the shares.

2. (i) Any person becoming entitled to a share in consequence of the death or insolvency of a member may, upon such evidence being produced as may from time to time properly be required by the Board and subject as hereinafter provided, elect, either-

   (a) to be registered himself as holder of the share; or

   (b) to make such transfer of the share as the deceased or insolvent member could have made.

   (ii) The Board shall, in either case, have the same right to decline or suspend registration as it would have had, if the deceased or insolvent member had transferred the share before his death or insolvency.

3. (i) If the person so becoming entitled shall elect to be registered as holder of the share himself, he shall deliver or send to the company a notice in writing signed by him stating that he so elects.

   (ii) If the person aforesaid shall elect to transfer the share, he shall testify his election by executing a transfer of the share.

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(iii) All the limitations, restrictions and provisions of these regulations relating to the right to transfer and the registration of transfers of shares shall be applicable to any such notice or transfer as aforesaid as if the death or insolvency of the member had not occurred and the notice or transfer were a transfer signed by that member.

4. A person becoming entitled to a share by reason of the death or insolvency of the holder shall be entitled to the same dividends and other advantages to which he would be entitled if he were the registered holder of the share, except that he shall not, before being registered as a member in respect of the share, be entitled in respect of it to exercise any right conferred by membership in relation to meetings of the company:

   Provided that the Board may, at any time, give notice requiring any such person to elect either to be registered himself or to transfer the share, and if the notice is not complied with within ninety days, the Board may thereafter withhold payment of all dividends, bonuses or other monies payable in respect of the share, until the requirements of the notice have been complied with.

5. In case of a One Person Company-

   (i) on the death of the sole member, the person nominated by such member shall be the person recognised by the company as having title to all the shares of the member;

   (ii) the nominee on becoming entitled to such shares in case of the member's death shall be informed of such event by the Board of the company;

   (iii) such nominee shall be entitled to the same dividends and other rights and liabilities to which such sole member of the company was entitled or liable;

   (iv) on becoming member, such nominee shall nominate any other person with the prior written consent of such person who, shall in the event of the death of the member, become the member of the company.

6.9 Key Concepts

- **Transfer of shares** means the voluntary conveyance of the rights and possibly, the duties of a member (as represented in a share in the company) from a shareholder who wishes to cease to be a member to a person desirous of becoming a member.

- **Transmission of Shares** It takes place when shares are transferred under the operation of law, either on the death of the registered shareholder or on his being adjudged as insolvent.

6.10 Summary

- Every company limited by shares shall, from the date of its registration, maintain a register of its members.
- A member ceases to be a member of a company when his name is removed from the register of members or register of beneficial owners.
- The entries in the registers shall be made within seven days after the Board of Directors or its duly constituted committee approves the allotment or transfer of shares, debentures or any other securities.

- The register of members along with the index shall be preserved permanently and shall be kept in the custody of the company secretary of the company or any other person authorized by the Board.
- Transfer of shares means the voluntary conveyance of the rights and possibly, the duties of a member from a shareholder who wishes to cease to be a member to a person desirous of becoming a member.
- It takes place when shares are transferred under the operation of law, either on the death of the registered shareholder or on his being adjudged as insolvent. It also takes place where the holder is a company if it goes into liquidation.
- The distinction between transfer and transmission, thus, is that the former is the effect of deliberate act of a member whereas the latter is the result of operation of law on the death or insolvency of a member.

6.11 Questions and Exercises

1. What are the regulations related to register of members of a company?
2. What are the modes of cessation of membership of a company?
3. What do you understand by transmission of shares?
4. What are the regulations related to dealing with refusal to transfer?

- **Fill in the blanks**

1) _____is not a mode of acquiring membership of a company.
(by subscribing to the memorandum of association, by agreeing to become a member, by holding equity share capital of the company, by applying orally to become a member)
2) Every company limited by shares shall, from the date of its registration, maintain a register of its members in Form No.____.
(MGT-1, MGT-2, MGT-3, MGT-4)
3) the maintenance of index of names to be included in the register is not necessary in case the number of members is_____.
(more than 100, more than fifty, less than 50, less than 10)
4) 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 in Form no._____ along with the fee.
(MGT-1, MGT-2, MGT-3, MGT-4)
5) The company shall transmit to its registered office in India a copy of every entry in any foreign register within _____after the entry is made.
(thirty days, forty days, sixty days, fifteen days)
6) The entries in the foreign register shall be authenticated by the _____ of the company or person authorised by the Board by appending his signature to each entry.
(Company secretary, chairperson, director, shareholder)
7) The register of members along with the index shall be preserved permanently and shall be kept in the custody of the _____of the company or any other person authorized by the Board for such purpose.
(company secretary, chairperson, director, shareholder)
8) The register of debenture holders or any other security holders along with the index shall be preserved for a period of _____ from the date of redemption of debentures or securities.
(four years, six months, two months, eight years)
9) In case of loss of transfer of deed, it is proved to the satisfaction of the_____ that the transfer deed signed by or on behalf of the

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transferor and by or on behalf of the transferee has been lost, the company may register the transfer on such terms as to indemnify as the Board may think fit.
(chairperson, Board of directors, Secretary, shareholders)

10) in the case of subscribers to the memorandum every company shall deliver the certificates of all securities allotted, transferred or transmitted Within a period of _____ from the date of incorporation.
(three months, four months, two months, one month)

11) No stamp duty is payable on _____ of shares.
(transfer, transmission, cessation, creation)

Answers: 1)by applying orally to became a member, 2)MGT-1, 3)less than fifty, 4)MGT-3, 5)fifteen days, 6)company secretary, 7)company secretary, 8)eight years, 9)Board of Directors, 10)two months, 11)transmission

6.12 Further Reading and References

Dr. Avtar Singh: Company Law; Eastern Book Company, 34, Lalbagh, Lucknow - 226 001

H.K. Saharay: Company Law; Universal Law Publishing Co., C-FF-1A, Dilkhush Industrial Estate, G.T. Karnal Road, Delhi. -110033.

UNIT - 7
COMPANY BOARD- ROLE, COMPOSITION & DIRECTORS POWER

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7.0 Introduction

The directors shall exercise their powers bona fide and in interest of the company. The directors while exercising their powers do not act as agents for the majority or even all the members and so the members cannot by resolution passed by a majority or even unanimously supercede the director's powers, or instruct them how they shall exercise their powers. This sovereignty of the directors within the limits of the powers conferred on them by the articles, and within limit laid down by the Act.

The relationship of the Board of directors with the shareholders is more of federation than one of subordinates and superior. Some powers are specially reserved for the Board e.g. appointing directors in casual vacancies, the power to issue debentures, etc. On the other hand, some powers are exclusively reserved for the members in general meeting e.g. borrowing in excess of the paid-up capital and free reserves, selling or disposing off the whole or substantially the whole of the undertaking etc.

This unit looks at the role, composition and power of the board of directors.

7.1 Objectives

In this unit, you will be introduced to the role and composition of the board of directors. You will also learn about the powers of the directors of a company. By the end of this unit, you should be able to:

- explain the rules dealing with incorporation of a board in a company
- describe the process of appointment of board of directors
- discuss the duties of directors
- discuss the procedure for calling and conducting board meeting
- describe the powers of board

7.2 Composition of Board of Directors

Every company shall have a Board of Directors consisting of individuals as directors and shall have-

(a) a minimum number of three directors in the case of a public company, two directors in the case of a private company, and one director in the case of a One Person Company; and

(b) a maximum of fifteen directors

7.3 Number of directorships

No person shall hold office as a director, including any alternate directorship, in more than twenty companies at the same time,

Provided that the maximum number of public companies in which a person can be appointed as a director shall not exceed ten.

7.4 Resident Director

Every company shall have at least one director who has stayed in India for a total period of not less than one hundred and eighty-two days in the previous calendar year.

7.5 Independent Director

(1) Every listed public company shall have at least one-third of the total number of directors as independent directors and the Central Government may prescribe the minimum number of independent directors in case of any class or classes of public companies.

(2) An independent director in relation to a company, means a director other than a managing director or a whole-time director or a nominee director,-

(a) Who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;

(b) (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;

(ii) Who is not related to promoters or directors in the company, its holding, subsidiary or associate company;

(c) who has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;

(d) none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

(e) Who, neither himself nor any of his relatives-

(i) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;

(ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of-

(A) A firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or

(B) Any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm;

(iii) Holds together with his relatives two per cent or more of the total voting power of the company; or

(iv) is a Chief Executive or director, by whatever name called, of any nonprofit organization that receives twenty-five per cent or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent or more of the total voting power of the company; or

(f) Who possesses such other qualifications as may be prescribed.

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(3) Every independent director shall at the first meeting of the Board in which he participates as a director and thereafter at the first meeting of the Board in every financial year or whenever there is any change in the circumstances which may affect his status as an independent director, give a declaration that he meets the criteria of independence.

(4) An independent director shall hold office for a term up to five consecutive years on the Board of a company, but shall be eligible for reappointment on passing of a special resolution by the company and disclosure of such appointment in the Board's report.

(5) No independent director shall hold office for more than two consecutive terms, but such independent director shall be eligible for appointment after the expiration of three years of ceasing to become an independent director:

Provided that an independent director shall not, during the said period of three years, be appointed in or be associated with the company in any other capacity, either directly or indirectly.

CHECK YOUR PROGRESS

Describe the provisions related to the appointment of independent directors on a company's board.

7.6 Woman director on the Board- The following class of companies shall appoint at least one woman director-

(i) every listed company;

(ii) every other public company having -

(a) paid-up share capital of one hundred crore rupees or more; or

(b) turnover of three hundred crore rupees or more

7.7 Appointment of Directors

(1) Where no provision is made in the articles of a company for the appointment of the first director, the subscribers to the memorandum who are individuals shall be deemed to be the first directors of the company until the directors are duly appointed and in case of a One Person Company an individual being member shall be deemed to be its first director until the director or directors are duly appointed by the member in accordance with the provisions of the law.

(2) Every director shall be appointed by the company in general meeting.

(3) No person shall be appointed as a director of a company unless he has been allotted the Director Identification Number.

(4) Every person proposed to be appointed as a director by the company in general meeting or otherwise, shall furnish his Director Identification Number and a declaration that he is not disqualified to become a director under this Act.

(5) A person appointed as a director shall not act as a director unless he gives his consent to hold the office as director and such consent has been filed with the Registrar within thirty days of his appointment in such manner as may be prescribed.

7.8 Application for allotment of Director Identification Number

Every individual intending to be appointed as director of a company shall make an application electronically for allotment of Director Identification Number to the Central Government in such form and manner and along with such fees as may be prescribed.

The central government shall provide an electronic system to facilitate submission of application for the allotment of DIN through the portal on the website of the Ministry of Corporate Affairs.

After downloading the form the required particulars are to be filled in by the applicant.

Documents to be attached with the form-

(i) Photograph;

(ii) Proof of identity;

(iii) Proof of residence;

(iv) Verification by the applicant for applying for allotment of DIN in Form DIR-4; and

(v) Specimen signature duly verified.

7.9 Allotment of Director Identification Number.

On the submission of the Form DIR-3 on the portal and payment of the requisite amount of fees through online mode the provisional DIN shall be generated by the system automatically which shall not be utilized till the DIN is confirmed by the Central Government.

The Central Government shall, within one month from the receipt of the application decide on acceptance or rejection thereof and communicate the same to the applicant.

The Director Identification Number so allotted under the prescribed rules is valid for the life-time of the applicant and shall not be allotted to any other person.

7.10 Prohibition to obtain more than one Director Identification Number

No individual, who has already been allotted a Director Identification Number under section 154, shall apply for, obtain or possess another Director Identification Number.

7.11 Director to intimate Director Identification Number

Every existing director shall, within one month of the receipt of Director Identification Number from the Central Government, intimate his Director Identification Number to the company or all companies wherein he is a director.

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7.12 Company to inform Director Identification Number to Registrar

(1) Every company shall, within fifteen days of the receipt of intimation under section 156, furnish the Director Identification Number of all its directors to the Registrar or any other officer or authority as may be specified by the Central Government with such fees as may be prescribed or with such additional fees as may be prescribed within the time specified under section 403 and every such intimation shall be furnished in such form and manner as may be prescribed.

(2) If a company fails to furnish Director Identification Number before the expiry of the period specified under section 403 with additional fee, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

CHECK YOUR PROGRESS
What is the procedure of Application for allotment of Director Identification Number?

7.13 Cancellation or deactivation of DIN

Any authorized person, upon being satisfied on verification of particulars of proof attached with the application received from any person seeking cancellation or deactivation of DIN, in case -

(a) The DIN is found to be duplicate;

(b) The DIN was obtained by wrongful manner or fraudulent means;

(c) Of the death of the concerned individual;

(d) The concerned individual has been declared as lunatic by the competent Court;

(e) If the concerned individual has been adjudicated an insolvent;

Then the allotted DIN shall be cancelled or deactivated by the Central Government or Regional Director (NR), Noida or any other officer authorised by the Regional Director (NR). Before cancellation or deactivation of DIN under clause (b), an opportunity of being heard shall be given to the concerned individual.

7.14 Surrender of DIN

On an application made in Form DIR-5 by the DIN holder to surrender his or her DIN along with declaration that he has never been appointed as director in any company and the said DIN has never been used for filing of any document with any authority, the Central Government may deactivate such DIN. Provided that before deactivation of any DIN in such case, the Central Government shall verify e-records.

7.15 Punishment For Contravention

If any individual or director of a company, contravenes any of the provisions, such individual or director of the company shall be punishable with imprisonment for a term which may extend to six months or with fine which may extend to fifty thousand rupees and where the contravention is a continuing one, with a further fine which may extend to five hundred rupees for every day after the first during which the contravention continues.

7.16 Disqualifications for appointment of director

(1) A person shall not be eligible for appointment as a director of a company, if -

(a) he is of unsound mind and stands so declared by a competent court;

(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, whether involving moral turpitude or otherwise, and sentenced in respect thereof to imprisonment for not less than six months and a period of five years has not elapsed from the date of expiry of the sentence:

Provided that if a person has been convicted of any offence and sentenced in respect thereof to imprisonment for a period of seven years or more, he shall not be eligible to be appointed as a director in any company;

(e) an order disqualifying him for appointment as a director has been passed by a court or Tribunal and the order is in force;

7.17 Duties of Directors

(1) A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.

(2) A director of a company shall exercise his duties with due and reasonable care, skill and diligence and shall exercise independent judgment.

(3) A director of a company shall not involve in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.

(4) A director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company.

(5) A director of a company shall not assign his office and any assignment so made shall be void.

(6) If a director of the company contravenes the provisions of this section such director shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

7.18 Vacation of Office of Director

The office of a director shall become vacant in case-

(a) he incurs any of the disqualifications specified in section 164;

(b) he absents himself from all the meetings of the Board of Directors held during a period of twelve months with or without seeking leave of absence of the Board;

(c) he acts in contravention of the provisions of section 184 relating to entering into contracts or arrangements in which he is directly or indirectly interested;

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(d) he fails to disclose his interest in any contract or arrangement in which he is directly or indirectly interested, in contravention of the provisions of section 184;

(e) he becomes disqualified by an order of a court or the Tribunal;

(f) he is convicted by a court of any offence, whether involving moral turpitude or otherwise and sentenced in respect thereof to imprisonment for not less than six months.

(g) he is removed in pursuance of the provisions of this Act;

(h) he, having been appointed a director by virtue of his holding any office or other employment in the holding, subsidiary or associate company, ceases to hold such office or other employment in that company.

A private company, which is not a subsidiary of a public company, may, by its articles, provide additional grounds for vacation of office of director.

On vacation of office of director, the company is required to file Form DIR - 12 to the Registrar of Companies.

CHECK YOUR PROGRESS
Explain the duties of the board of directors.

7.19 Meeting of Board

(1) Every company shall hold the first meeting of the Board of Directors within thirty days of the date of its incorporation and thereafter hold a minimum number of four meetings of its Board of Directors every year in such a manner that not more than one hundred and twenty days shall intervene between two consecutive meetings of the Board.

(2) The participation of directors in a meeting of the Board may be either in person or through video conferencing or other audio visual means, as may be prescribed, which are capable of recording and recognising the participation of the directors and of recording and storing the proceedings of such meetings along with date and time.

(3) A meeting of the Board shall be called by giving not less than seven days' notice in writing to every director at his address registered with the company and such notice shall be sent by hand delivery or by post or by electronic means:

Provided that a meeting of the Board may be called at shorter notice to transact urgent business subject to the condition that at least one independent director, if any, shall be present at the meeting:

Provided further that in case of absence of independent directors from such a meeting of the Board, decisions taken at such a meeting shall be circulated to all the directors and shall be final only on ratification thereof by at least one independent director, if any.

(4) Every officer of the company whose duty is to give notice under this section and who fails to do so shall be liable to a penalty of twenty-five thousand rupees.

7.19.1 Meetings of Board through video conferencing or other audio visual means

A company shall comply with the following procedure, for convening and conducting the Board meetings through video conferencing or other audio visual means.

(1) Every Company shall make necessary arrangements to avoid failure of video or audio visual connection.

(2) The Chairperson of the meeting and the company secretary, if any, shall take due and reasonable care -

(a) to safeguard the integrity of the meeting by ensuring sufficient security and identification procedures;

(b) to ensure availability of proper video conferencing or other audio visual equipment or facilities for providing transmission of the communications for effective participation of the directors and other authorised participants at the Board meeting;

(c) to record proceedings and prepare the minutes of the meeting;

(d) to store for safekeeping and marking the tape recording(s) or other electronic recording mechanism as part of the records of the company at least before the time of completion of audit of that particular year.

(e) to ensure that no person other than the concerned director are attending or have access to the proceedings of the meeting through video conferencing mode or other audio visual means; and

(f) to ensure that participants attending the meeting through audio visual means are able to hear and see the other participants clearly during the course of the meeting.

(3) (a) The notice of the meeting shall be sent to all the directors in accordance with the provisions of sub-section (3) of section 173 of the Act.

(b) The notice of the meeting shall inform the directors regarding the option available to them to participate through video conferencing mode or other audio visual means, and shall provide all the necessary information to enable the directors to participate through video conferencing mode or other audio visual means.

(c) A director intending to participate through video conferencing or audio visual means shall communicate his intention to the Chairperson or the company secretary of the company.

(d) If the director intends to participate through video conferencing or other audio visual means, he shall give prior intimation to that effect sufficiently in advance so that company is able to make suitable arrangements in this behalf.

(e) The director, who desire, to participate may intimate his intention of participation through the electronic mode at the beginning of the calendar year and such declaration shall be valid for one calendar year.

(f) In the absence of any intimation under clause (c), it shall be assumed that the director shall attend the meeting in person.

(4) At the commencement of the meeting, a roll call shall be taken by the Chairperson when every director participating through video conferencing or other audio visual means shall state, for the record, the following namely:-

(a) name;

(b) the location from where he is participating;

(c) that he has received the agenda and all the relevant material for the meeting; and

(d) that no one other than the concerned director is attending or having access to the proceedings of the meeting at the location mentioned in clause (b);

(5) After the roll call, the Chairperson or the Company Secretary shall inform

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the Board about the names of persons other than the directors who are present for the said meeting at the request or with the permission of the Chairperson and confirm that the required quorum is complete.

(6) With respect to every meeting conducted through video conferencing or other audio visual means authorised under these rules, the scheduled venue of the meeting as set forth in the notice convening the meeting, which shall be in India, shall be deemed to be the place of the said meeting and all recordings of the proceedings at the meeting shall be deemed to be made at such place.

(7) The statutory registers which are required to be placed in the Board meeting as per the provisions of the Act shall be placed at the scheduled venue of the meeting and where such registers are required to be signed by the directors, the same shall be deemed to have been signed by the directors participating through electronic mode, if they have given their consent to this effect and it is so recorded in the minutes of the meeting.

(8) (a) Every participant shall identify himself for the record before speaking on any item of business on the agenda.

(b) If a statement of a director in the meeting through video conferencing or other audio visual means is interrupted or garbled, the Chairperson or Company Secretary shall request for a repeat or reiteration by the Director.

(9) If a motion is objected to and there is a need to put it to vote, the Chairperson shall call the roll and note the vote of each director who shall identify himself while casting his vote.

(10) From the commencement of the meeting and until the conclusion of such meeting, no person other than the Chairperson, Directors, Company Secretary and any other person whose presence is required by the Board shall be allowed access to the place where any director is attending the meeting either physically or through video conferencing without the permission of the Board.

(11) (a) At the end of discussion on each agenda item, the Chairperson of the meeting shall announce the summary of the decision taken on such item along with names of the directors, if any, who dissented from the decision taken by majority.

(b) The minutes shall disclose the particulars of the directors who attended the meeting through video conferencing or other audio visual means.

(12) (a) The draft minutes of the meeting shall be circulated among all the directors within fifteen days of the meeting either in writing or in electronic mode as may be decided by the Board.

(b) Every director who attended the meeting, whether personally or through video conferencing or other audio visual means, shall confirm or give his comments in writing, about the accuracy of recording of the proceedings of that particular meeting in the draft minutes, within seven days or some reasonable time as decided by the Board, after receipt of the draft minutes failing which his approval shall be presumed.

(c) After completion of the meeting, the minutes shall be entered in the minute book as specified under section 118 of the Act and signed by the Chairperson.

7.19.2 Matters not to be dealt with in a meeting through video conferencing or other audio visual means

(1) The following matters shall not be dealt with in any meeting held through video conferencing or other audio visual means.-

(i) the approval of the annual financial statements;

(ii) the approval of the Board's report;

(iii) the approval of the prospectus;

(iv) the Audit Committee Meetings for consideration of accounts; and

(v) the approval of the matter relating to amalgamation, merger, demerger, acquisition and takeover.

7.20 Quorum for Meeting of Board

(1) The quorum for a meeting of the Board of Directors of a company shall be one third of its total strength or two directors, whichever is higher, and the participation of the directors by video conferencing or by other audio visual means shall also be counted for the purposes of quorum.

(2) Where a meeting of the Board could not be held for want of quorum, then, unless the articles of the company otherwise provide, the meeting shall automatically stand adjourned to the same day at the same time and place in the next week or if that day is a national holiday, till the next succeeding day, which is not a national holiday, at the same time and place.

CHECK YOUR PROGRESS

What is the Quorum for Meeting of Board of Directors?

7.21 Passing of Resolution by Circulation

No resolution shall be deemed to have been duly passed by the Board or by a committee thereof by circulation, unless the resolution has been circulated in draft, together with the necessary papers, if any, to all the directors, or members of the committee, as the case may be, at their addresses registered with the company in India by hand delivery or by post or by courier, or through such electronic means as may be prescribed and has been approved by a majority of the directors or members, who are entitled to vote on the resolution.

7.22 Powers of Board

(1) 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.

(2) The Board of Directors of a company shall exercise the following powers on behalf of the company by means of resolutions passed at meetings of the Board, namely:-

(a) to make calls on shareholders in respect of money unpaid on their shares;

(b) to authorise buy-back of securities under section 68;

(c) to issue securities, including debentures, whether in or outside India;

(d) to borrow monies;

(e) to invest the funds of the company;

(f) to grant loans or give guarantee or provide security in respect of loans;

(g) to approve financial statement and the Board's report;

(h) to diversify the business of the company;

(i) to approve amalgamation, merger or reconstruction;

(j) to take over a company or acquire a controlling or substantial stake in another company;

(k) any other matter which may be prescribed

Provided that he board may delegate some of its powers to the committees of directors, managing directors on such conditions as may be specified.

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7.23 Restrictions on Powers of Board

(1) The Board of Directors of a company shall exercise the following powers only with the consent of the company by a special resolution, namely:-

(a) to 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 of such undertakings.

(b) to invest otherwise in trust securities the amount of compensation received by it as a result of any merger or amalgamation;

(c) to borrow money, where the money to be borrowed, together with the money already borrowed by the company will exceed aggregate of its paid-up share capital and free reserves, apart from temporary loans obtained from the company's bankers in the ordinary course of business

(d) to remit, or give time for the repayment of, any debt due from a director.

7.24 Company to contribute to bona fide and charitable funds, etc

The Board of Directors of a company may contribute to bona fide charitable and other funds:

Provided that prior permission of the company in general meeting shall be required for such contribution in case any amount the aggregate of which, in any financial year, exceed five per cent of its average net profits for the three immediately preceding financial years.

7.25 Prohibitions and restrictions regarding political contributions

(1) A company, other than a Government company and a company which has been in existence for less than three financial years, may contribute any amount directly or indirectly to any political party:

Provided the aggregate of the amount which may be so contributed by the company in any financial year shall not exceed seven and a half per cent. of its average net profits during the three immediately preceding financial years:

Provided further that no such contribution shall be made by a company unless a resolution authorising the making of such contribution is passed at a meeting of the Board of Directors.

(2) Every company shall disclose in its profit and loss account any amount or amounts contributed by it to any political party during the financial year to which that account relates, giving particulars of the total amount contributed and the name of the party to which such amount has been contributed.

(3) If a company makes any contribution in contravention of the provisions of this section, the company shall be punishable with fine which may extend to

five times the amount so contributed and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to six months and with fine which may extend to five times the amount so contributed.

7.26 Power of Board and other persons to make contributions to national defense fund, etc

(1) The Board of Directors of any company or any person or authority exercising the powers of the Board of Directors of a company, or of the company in general meeting, may, notwithstanding anything contained in sections 180, 181 and section 182 or any other provision of this Act or in the memorandum, articles or any other instrument relating to the company, contribute such amount as it thinks fit to the National Defence Fund or any other Fund approved by the Central Government for the purpose of national defence.

(2) Every company shall disclose in its profits and loss account the total amount or amounts contributed by it to the Fund during the financial year to which the amount relates.

CHECK YOUR PROGRESS

What are the powers of Board of Directors?

7.27 Directors' & officers' Liability Insurance

Directors' and Officers' Liability Insurance provides financial protection for the Directors and Officers of the Company in the event they are sued in conjunction with the performance of their duties as they relate to the Company. Directors' and Officers' Insurance can also be treated as management Errors and Omissions Policy.

D & O policy is designed to protect the personal fortune of Directors and officers of a company (public or private) against the consequences of their personal liability for financial losses arising out of wrongful acts and or omissions done, or wrongfully attempted in their' capacity as Directors or officers.

Directors' and Officers' Liability coverage comprises two sections: (a) Damages awarded against Directors and officers including legal cost, (b) Company reimbursement.

D&O policy also covers former, present and future members of the board of Directors and the management. Cover will also apply to the above individuals of the parent company, the subsidiary companies and subsidiary companies newly acquired or incorporated during the policy period. (Outside Directors, public representatives or shadow Directors may also require cover). The company's auditor is generally not considered as an officer of the company so special mention is to be made to include him/her in the D&O policy.

What is not covered/ what Are the Main Exclusions:

- Criminal behavior,
- Libel, slander or other defamation,
- Fraudulent acts of an insured,
- Professional liability (cover under a professional liability policy),
- Environmental damage or pollution,
- Bodily injury or property damage (cover all under a general liability or property program),
- Fines, penalties and other penal liability.

Is the Policy on a "Claims Made" or an "Occurrence Basis":

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7.28 Key Concepts

Composition of Board of Directors

Every company shall have a Board of Directors consisting of individuals as directors and shall have-

(a) a minimum number of three directors in the case of a public company, two directors in the case of a private company, and one director in the case of a One Person Company; and

(b) a maximum of fifteen directors

7.29 Summary

- Every company shall have a Board of Directors consisting of individuals as directors and shall have a minimum number of three directors in the case of a public company, two directors in the case of a private company, and one director in the case of a One Person Company; and a maximum of fifteen directors.
- Every listed public company shall have at least one-third of the total number of directors as independent directors.
- No independent director shall hold office for more than two consecutive terms.
- Every director shall be appointed by the company in general meeting.
- Every individual intending to be appointed as director of a company shall make an application for allotment of Director Identification Number to the Central Government.
- If a person has been convicted of any offence and sentenced in respect thereof to imprisonment for a period of seven years or more, he shall not be eligible to be appointed as a director in any company.
- No person shall hold office as a director, including any alternate directorship, in more than twenty companies at the same time, provided that the maximum number of public companies in which a person can be appointed as a director shall not exceed ten.
- A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.
- Every company shall hold the first meeting of the Board of Directors within thirty days of the 1date of its incorporation and thereafter hold a minimum number of four meetings of its Board of Directors every year.
- The quorum for a meeting of the Board of Directors of a company shall be one third of its total strength or two directors, whichever is higher, and the participation of the directors by video conferencing or by other audio visual means shall also be counted for the purposes of quorum.
- D & O Liability Insurance policy normally indemnifies in respect of damages awarded against Directors or officers and the company reimbursement of the insured companies in case of a valid contractual obligation on their part to hold a director or officer harmless.

CHECK YOUR PROGRESS

Explain Directors' & officers' Liability Insurance.

7.30 Questions and Exercises

1. What is the quorum for conducting a meeting?
2. Explain the power of the board of the company.
3. Explain the provisions relating to meeting of the board through video-conferencing.
4. Under what circumstances the office of a director shall become vacant?

- **Fill in the blanks**

1) No person shall hold office as a director, including any alternate directorship, in more than _____companies at the same time.
(Ten, fifty, twenty, hundred)
2) The maximum number of _____companies in which a person can be appointed as a director shall not exceed ten.
(Private, public, one person, LLP)
3) _____director is not related to the promoters or directors of the company.
(dependent, independent, whole time, managing)
4) No person shall be appointed as a director of a company unless he has been allotted the _____.
(DIN, CIN, GIN,FIN)
5) A person appointed as a director shall not act as a director unless he gives his _____ to hold the office as director.
(name, chance, consent, property)
6) for surrender of DIN,application shall be made in form _____.
(DIR-2, DIR-4, DIR-6, DIR-5)
7) Every company shall hold the first meeting of the Board of Directors within _____ of the date of its incorporation.
(10 days, 3 months, 30 days, 40 days)
8) _____ days prior notice shall be given to every member for the meeting of the Board.
(10, 7, 15, 30)
9) Matters related to the _____ is not dealt with in a meeting through video conferencing or other audio visual means.
(approval of annual financial statements, appointment of a director, passing of a resolution, writing a note)
10) financial losses arising out of _____ are covered in the directors' & officers' liability insurance.
(omissions done ,Criminal behavior, Fraudulent acts of an insured, Professional liability)

Answers: 1)twenty, 2)public, 3)independent, 4)DIN, 5)consent, 6)DIR-5, 7)30, 8)7, 9)apprval of annual financial statements, 10)omissions done

7.31 Further Reading and References

A.K. Mujumdar, Dr. G.K. Kapoor : Company Law and Practice; Taxmann, 59/32, New Rohtak Road, New Delhi-110 005

V.S. Datey: Guide to Tax and Corporate Laws; Taxmann, 59/32, New Rohtak Road, New Delhi-110 005.

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UNIT - 8
COMPANY MEETINGS AND RESOLUTIONS

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8.0 Introduction

A meeting may be generally defined as a gathering or assembly or getting together of a number of persons for transacting any lawful business. There must be atleast two persons to constitute a meeting. Therefore, one shareholder usually cannot constitute a company meeting even if he holds proxies for other shareholders. However, in certain exceptional circumstances, even one person may constitute a meeting.

It is to be noted that every gathering or assembly does not constitute a

meeting. Company meetings must be convened and held in perfect compliance with the various provisions of the Companies Act, 2013 and the rules framed there under.

A company is composed of members, though it has its own entity distinct from members. The members of a company are the persons who, for the time being, constitute the company, as a corporate entity. However, a company, being an artificial person, cannot act on its own. It, therefore, expresses its will or takes its decisions through resolutions passed at validly held Meetings. The primary purpose of a Meeting is to ensure that a company gives reasonable and fair opportunity to those entitled to participate in the Meeting to take decisions as per the prescribed procedures.

The decision making powers of a company are vested in the Members and the Directors and they exercise their respective powers through Resolutions passed by them. General Meetings of the Members provide a platform to express their will in regard to the management of the affairs of the company.

Convening of one such meeting every year is compulsory. Holding of more general meetings is left to the choice of the management or to a given percentage of shareholders to exercise their power to compel the company to convene a meeting.

8.1 Objectives

In this unit, you will be introduced to the rules and regulations associated with conducting meetings and passing resolutions. By the end of this unit, you should be able to:

- explain the rules dealing with calling various kinds of meetings
- describe the procedure for issuing notice of meeting
- discuss the rules dealing with voting
- discuss the regulations dealing with resolutions
- describe the regulations dealing with proceedings of general meeting

8.2 Annual General Meeting

(1) Every company other than a One Person Company shall in each year hold in addition to any other meetings, a general meeting as its annual general meeting and shall specify the meeting as such in the notices calling it, and not more than fifteen months shall elapse between the date of one annual general meeting of a company and that of the next:

Provided that in case of the first annual general meeting, it shall be held within a period of nine months from the date of closing of the first financial year of the company and in any other case, within a period of six months, from the date of closing of the financial year.

(2) If a company holds its first annual general meeting as aforesaid, it shall not be necessary for the company to hold any annual general meeting in the year of its incorporation.

(3) Every annual general meeting shall be called during business hours, that is, between 9 a.m. and 6 p.m. on any day that is not a National Holiday and shall be held either at the registered office of the company or at some other place within the city, town or village in which the registered office of the company is situate.

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8.2.1 Power of Tribunal to call annual general meeting.

If any default is made in holding the annual general meeting of a company under section 96, the Tribunal may on the application of any member of the company, call, or direct the calling of, an annual general meeting of the company and give such ancillary or consequential directions as the Tribunal thinks expedient:

Provided that such directions may include a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting.

8.2.2 Power of Tribunal to call meetings of members, etc.

If for any reason it is impracticable to call a meeting of a company, other than an annual general meeting, in any manner in which meetings of the company may be called, or to hold or conduct the meeting of the company in the manner prescribed by this Act or the articles of the company, the Tribunal may, either suo motu or on the application of any director or member of the company who would be entitled to vote at the meeting-

(a) order a meeting of the company to be called, held and conducted in such manner as the Tribunal thinks fit; and

(b) give such ancillary or consequential directions as the Tribunal thinks expedient, including directions modifying or supplementing in relation to the calling, holding and conducting of the meeting, the operation of the provisions of this Act or articles of the company:

Provided that such directions may include a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting.

8.2.3 Calling of extraordinary general meeting

(1) Any general meeting held between two annual general meetings will be called an extraordinary general meeting. Business, which arises between two annual general meetings and being urgent and cannot be deferred till the next annual general meeting, is transacted at an extraordinary general meeting.

(2) The Board may, whenever it deems fit, call an extraordinary general meeting of the company.

(3) The Board shall, at the requisition made by,-

(a) in the case of a company having a share capital, such number of members who hold, on the date of the receipt of the requisition, not less than one-tenth of such of the paid-up share capital of the company as on that date carries the right of voting;

(b) in the case of a company not having a share capital, such number of members who have, on the date of receipt of the requisition, not less than one-tenth of the total voting power of all the members having on the said date a right to vote, call an extraordinary general meeting of the company.

(4) If the Board does not, within twenty-one days from the date of receipt of a valid requisition in regard to any matter, proceed to call a meeting for the consideration of that matter on a day not later than forty-five days from the date of receipt of such requisition, the meeting may be called and held by the requisitionists themselves within a period of three months from the date of the requisition.

(5) A meeting under sub-section (3) by the requisitionists shall be called and held in the same manner in which the meeting is called and held by the Board.

(6) Any reasonable expenses incurred by the requisitionists in calling a meeting under subsection (3) shall be reimbursed to the requisitionists by the company and the sums so paid shall be deducted from any fee or other remuneration under section 197 payable to such of the directors who were in default in calling the meeting.

8.3 Notice of Meeting

(1) A general meeting of a company may be called by giving not less than clear twenty-one days'notice either in writing or through electronic mode in such manner as may be prescribed:

Provided that a general meeting may be called after giving a shorter notice if consent is given in writing or by electronic mode by not less than ninety-five per cent of the members entitled to vote at such meeting.

(2) Every notice of a meeting shall specify the place, date, day and the hour of the meeting and shall contain a statement of the business to be transacted at such meeting.

(3) The notice of every meeting of the company shall be given to-

(a) every member of the company, legal representative of any deceased member or the assignee of an insolvent member;

(b) the auditor or auditors of the company; and

(c) every director of the company.

(4) Any accidental omission to give notice to, or the non-receipt of such notice by, any member or other person who is entitled to such notice for any meeting shall not invalidate the proceedings of the meeting.

CHECK YOUR PROGRESS

Discuss the power of tribunal to call annual general meeting.

8.3.1 Notice through electronic means

(1) A company may give notice through electronic mode.

(2) A notice may be sent through e-mail as a text or as an attachment to e-mail or as a notification providing electronic link or Uniform Resource Locator for accessing such notice.

(3) (i) The e-mail shall be addressed to the person entitled to receive such e-mail as per the records of the company or as provided by the depository.

(ii) The subject line in e-mail shall state the name of the company, notice of the type of meeting, place and the date on which the meeting is scheduled.

(iii) If notice is sent in the form of a non-editable attachment to e-mail, such attachment shall be in the Portable Document Format or in a non-editable format together with a 'link or instructions' for recipient for downloading relevant version of the software.

(iv) When notice or notifications of availability of notice are sent by e-mail, the company should ensure that it uses a system which produces confirmation of the total number of recipients e-mailed and a record of each recipient to whom the notice has been sent and copy of such record and any notices of any failed transmissions and subsequent re-sending shall be retained by or on behalf of the company as proof of sending.

(v) The company's obligation shall be satisfied when it transmits the e-mail and the company shall not be held responsible for a failure in transmission beyond its control.

(vi) If a member entitled to receive notice fails to provide or update relevant

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e-mail address to the company, or to the depository participant as the case may be, the company shall not be in default for not delivering notice via e-mail.

(vii) The company may send e-mail through in-house facility or its registrar and transfer agent or authorise any third party agency providing bulk e-mail facility.

(viii) The notice made available on the electronic link or Uniform Resource Locator has to be readable, and the recipient should be able to obtain and retain copies and the company shall give the complete Uniform Resource Locator or address of the website and full details of how to access the document or information.

(ix) The notice of the general meeting of the company shall be simultaneously placed on the website of the company if any and on the website as may be notified by the Central Government.

8.4 Quorum for Meeting

(1) Unless the articles of the company provide for a larger number,-

(a) in case of a public company,-

(i) five members personally present if the number of members as on the date of meeting is not more than one thousand;

(ii) fifteen members personally present if the number of members as on the date of meeting is more than one thousand but up to five thousand;

(iii) thirty members personally present if the number of members as on the date of the meeting exceeds five thousand;

(b) in the case of a private company, two members personally present, shall be the quorum for a meeting of the company.

(2) If the quorum is not present within half-an-hour from the time appointed for holding a meeting of the company-

(a) the meeting shall stand adjourned to the same day in the next week at the same time and place, or to such other date and such other time and place as the Board may determine; or

(b) the meeting, if called by requisitionists under section 100, shall stand cancelled:

Provided that in case of an adjourned meeting or of a change of day, time or place of meeting under clause (a), the company shall give not less than three days notice to the members either individually or by publishing an advertisement in the newspapers (one in English and one in vernacular language) which is in circulation at the place where the registered office of the company is situated.

(3) If at the adjourned meeting also, a quorum is not present within half-an-hour from the time appointed for holding meeting, the members present shall be the quorum.

8.5 Proxies

(1) Any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person as a proxy to attend and vote at the meeting on his behalf.

(2) The instrument appointing a proxy shall-

(a) be in writing; and

(b) be signed by the appointer or his attorney duly authorised in writing or, if the appointer is a body corporate, be under its seal or be signed by an officer or an attorney duly authorised by it.

8.6 Voting by Show of Hands

(1) At any general meeting, a resolution put to the vote of the meeting shall, unless a poll is demanded under section 109 or the voting is carried out electronically, be decided on a show of hands.

(2) A declaration by the Chairman of the meeting of the passing of a resolution or otherwise by show of hands under sub-section (1) and an entry to that effect in the books containing the minutes of the meeting of the company shall be conclusive evidence of the fact of passing of such resolution or otherwise.

8.7 Voting through Electronic Means

(1) Every listed company or a company having not less than one thousand shareholders, shall provide to its members facility to exercise their right to vote at general meetings by electronic means.

(2) A member may exercise his right to vote at any general meeting by electronic means and company may pass any resolution by electronic voting system in accordance with the provisions of this rule.

(3) A company which opts to provide the facility to its members to exercise their votes at any general meeting by electronic voting system shall follow the following procedure, namely;

(i) the notices of the meeting shall be sent to all the members, auditors of the company, or directors either -

(a) by registered post or speed post ; or

(b) through electronic means like registered e-mail id;

(c) through courier service;

(ii) the notice shall also be placed on the website of the company, if any and of the agency forthwith after it is sent to the members;

(iii) the notice of the meeting shall clearly mention that the business may be transacted through electronic voting system and the company is providing facility for voting by electronic means;

(iv) the notice shall clearly indicate the process and manner for voting by electronic means and the time schedule including the time period during which the votes may be cast and shall also provide the login ID and create a facility for generating password and for keeping security and casting of vote in a secure manner;

(v) the company shall cause an advertisement to be published, not less than five days before the date of beginning of the voting period, at least once in a vernacular newspaper in the principal vernacular language of the district in which the registered office of the company is situated, and having a wide circulation in that district, and at least once in English language in an English newspaper having a wide circulation in that district, about having sent the notice of the meeting and specifying therein, inter alia, the following matters, namely:-

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(a) statement that the business may be transacted by electronic voting;

(b) the date of completion of sending of notices;

(c) the date and time of commencement of voting through electronic means;

(d) the date and time of end of voting through electronic means;

(e) the statement that voting shall not be allowed beyond the said date and time;

(f) website address of the company and agency, if any, where notice of the meeting is displayed; and

(g) contact details of the person responsible to address the grievances connected with the electronic voting;

(vi) the e-voting shall remain open for not less than one day and not more than three days:

Provided that in all such cases, such voting period shall be completed three days prior to the date of the general meeting;

(vii) during the e-voting period, shareholders of the company, holding shares either in physical form or in dematerialized form, as on the record date, may cast their vote electronically:

Provided that once the vote on a resolution is cast by the shareholder, he shall not be allowed to change it subsequently.

(viii) at the end of the voting period, the portal where votes are cast shall forthwith be blocked.

(ix) the Board of directors shall appoint one scrutinizer, who may be chartered Accountant in practice, Cost Accountant in practice, or Company Secretary in practice or an advocate, but not in employment of the company and is a person of repute who, in the opinion of the Board can scrutinize the e-voting process in a fair and transparent manner:

(x) the scrutinizer shall be willing to be appointed and be available for the purpose of ascertaining the requisite majority;

(xi) the scrutinizer shall, within a period of not exceeding three working days from the date of conclusion of e-voting period, unblock the votes in the presence of at least two witnesses not in the employment of the company and make a scrutinizer's report of the votes cast in favour or against, if any, forthwith to the Chairman;

(xii) the scrutinizer shall maintain a register either manually or electronically to record the assent or dissent, received, mentioning the particulars of name, address, folio number or client ID of the shareholders, number of shares held by them, nominal value of such shares and whether the shares have differential voting rights;

(xiii) the register and all other papers relating to electronic voting shall remain in the safe custody of the scrutinizer until the chairman considers, approves and signs the minutes and thereafter, the scrutinizer shall return the register and other related papers to the company.

(xiv) the results declared along with the scrutinizer's report shall be placed on the website of the company and on the website of the agency within two days of passing of the resolution at the relevant general meeting of members;

(xv) subject to receipt of sufficient votes, the resolution shall be deemed to be passed on the date of the relevant general meeting of members.

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8.8 Circulation of Member's Resolution

(1) A company shall, on requisition in writing of such number of members, as required in section 100-

(a) give notice to members of any resolution which may properly be moved and is intended to be moved at a meeting; and

(b) circulate to members any statement with respect to the matters referred to in proposed resolution or business to be dealt with at that meeting.

8.9 Representation of President and Governors in Meeting

(1) The President of India or the Governor of a State, if he is a member of a company, may appoint such person as he thinks fit to act as his representative at any meeting of the company or at any meeting of any class of members of the company.

(2) A person appointed to act under sub-section (1) shall, for the purposes of this Act, be deemed to be a member of such a company and shall be entitled to exercise the same rights and powers, including the right to vote by proxy and postal ballot, as the President or, as the case may be, the Governor could exercise as a member of the company.

8.10 Resolutions

All resolutions, no matter how simple they are, should be drafted in clear and distinct terms since resolutions embody the decisions of the meetings. The following points should be remembered while drafting resolutions, both for Board and general meetings :

(a) All essential facts are included in the resolution - e.g., the resolution for re-appointment of a managing director should indicate that the re-appointment is subject to the approval of the Central Government if approval of the Central Government is required and should also cover the period of appointment, terms and conditions of such appointment.

(b) Surplus and meaningless words or phrases should not be included in resolutions.

(c) Reference to documents approved at a meeting should be clearly identified, e.g., the re-appointment of a managing director should indicate that such appointment is on the terms and conditions contained in the draft agreement, a copy of which was placed before the meeting and initialled by the chairman for the purpose of identification.

(d) Resolutions must indicate the relevant provisions or sections of the Act and the Rules pursuant to which they are being passed.

(e) If a resolution is one which requires the approval of the Central Government or confirmation of the National Company Law Tribunal/ Court, this must be stated in the resolution.

(f) A resolution must indicate when it will become effective.

(g) A resolution must confine itself to one subject matter and two distinct

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matters should not be covered in one resolution.

(h) A resolution should be crisp, concise and precise and should be flexible enough to take care of eventualities.

(i) Where lengthy resolutions have to be approved, they should be divided into paragraphs and should be arranged in their logical order having regard to the subject matter of the resolution.

(j) A resolution must be so drafted that anybody not present at the meeting or anybody referring to it at a later date will know clearly what the decision was at that meeting without referring to any other document.

8.10.1 Ordinary and special resolutions

(1) A resolution shall be an ordinary resolution if the notice required under this Act has been duly given and it is required to be passed by the votes cast, whether on a show of hands, or electronically or on a poll, as the case may be, in favour of the resolution, including the casting vote, if any, of the Chairman, by members who, being entitled so to do, vote in person, or where proxies are allowed, by proxy or by postal ballot, exceed the votes, if any, cast against the resolution by members, so entitled and voting.

CHECK YOUR PROGRESS
Discuss the concept of proxies.

(2) A resolution shall be a special resolution when-

(a) the intention to propose the resolution as a special resolution has been duly specified in the notice calling the general meeting or other intimation given to the members of the resolution;

(b) the notice required under this Act has been duly given; and

(c) the votes cast in favour of the resolution, whether on a show of hands, or electronically or on a poll, as the case may be, by members who, being entitled so to do, vote in person or by proxy or by postal ballot, are required to be not less than three times the number of the votes, if any, cast against the resolution by members so entitled and voting.

8.10.2 Resolutions and agreements to be filed

(1) A copy of every resolution or any agreement if any, annexed to the notice calling the meeting in which the resolution is proposed, shall be filed with the Registrar within thirty days of the passing or making thereof in such manner and with such fees as may be prescribed within the time specified.

(2) If a company fails to file the resolution or the agreement under sub-section (1) before the expiry of the period, the company shall be punishable with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees and every officer of the company who is in default, including liquidator of the company, if any, shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

8.11 Postal Ballot

According to Section 110, a company shall transact businesses of notified items through postal ballot. A company may transact any business through postal ballot except -

(i) ordinary business in an annual general meeting; and

(ii) business in respect of which directors or auditors have a right to be heard at any meeting.

A resolution passed through postal ballot shall be deemed to have been passed at a general meeting.

Postal Ballot is not same as voting through electronic mode. The concept of Postal Ballot is a unique provision which gives shareholders the right to vote on items of business of a corporate body without actually attending its general meetings either personally or through their proxies/representatives. Postal Ballot provides an opportunity even to such shareholders to take part in the decision making process The facility now provided to all shareholders, regardless of their location or their ability to be physically present at an appointed day and place, to approve or reject a proposal of the Board and to vote on items of business by postal or electronic mode, is a further step to encourage corporate democracy and to promote good corporate governance.

One person company and other companies having upto two hundered members are not required to transact any business through postal ballot.

CHECK YOUR PROGRESS
Types of Resolutions at AGM.

8.11.1 Items of business to be transacted through postal ballot

following items of business shall be transacted only by means of voting through a postal ballot-

(a) Alteration of the objects clause of the memorandum and in the case of the company in existence immediately before the commencement of the Act, alteration of the main objects of the memorandum;

(b) Alteration of articles of association in relation to insertion or removal of provisions which, under subsection (68) of section 2, are required to be included in the articles of a company in order to constitute it a private company;

(c) Change in place of registered office outside the local limits of any city, town or village as specified in sub-section (5) of section 12;

(d) Change in objects for which a company has raised money from public through prospectus and still has any unutilized amount out of the money so raised under sub-section (8) of section 13;

(e) Issue of shares with differential rights

(f) Variation in the rights attached to a class of shares or debentures or other securities as specified

(g) Buy-back of shares

(h) Election of a director

(i) Sale of the whole or substantially the whole of an undertaking

(j) Giving loans or extending guarantee

8.12 Minutes

Minutes are of two types namely, minutes of narration and minutes of resolution, but in practice the precise form of minutes is often a matter of discretion and lies somewhere between two methods or a combination of the two.

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8.12.1 Minutes of Narration-

These are records of events or items of business which do not required formal resolution to establish them. Generally these include minutes covering :

(a) Names of those who are present at the meeting;

(b) Signing of minutes of the previous meeting;

(c) Recording of leave of absence;

(d) Taking note of financial statements, reports, plans, etc., which are tabled and considered at the meeting;

(e) Recording and tabling and consideration of correspondence; and

(f) Taking a note of receipt of notice of interest from the directors.

8.12.2 Minutes of Resolution-

These are records of formal decisions of directors or shareholders and are prefixed by the word 'Resolved', such resolution may simply cover the resolution passed or alternatively may also indicate the name of the proposer and the seconder and showing the quantum of votes with which it was carried. Normally, however, especially minutes of Board meetings, do have a preamble or background leading to the decision namely the resolution that was passed. Such a recital or preamble or background is a brief explanation why it was necessary or expedient to pass the resolution.

8.13 Minutes of proceedings of general meeting, meeting of Board of Directors and other meeting and resolutions passed by postal ballot

(1) Every company shall cause minutes of the proceedings of every general meeting of any class of shareholders or creditors, and every resolution passed by postal ballot and every meeting of its Board of Directors or of every committee of the Board, to be prepared and signed in such manner as may be prescribed and kept within thirty days of the conclusion of every such meeting concerned, or passing of resolution by postal ballot in books kept for that purpose with their pages consecutively numbered.

(2) The minutes of each meeting shall contain a fair and correct summary of the proceedings thereat.

(3) All appointments made at any of the meetings aforesaid shall be included in the minutes of the meeting.

(4) In the case of a meeting of the Board of Directors or of a committee of the Board, the minutes shall also contain-

(a) the names of the directors present at the meeting; and

(b) in the case of each resolution passed at the meeting, the names of the directors, if any, dissenting from, or not concurring with the resolution.

(5) There shall not be included in the minutes, any matter which, in the opinion of the Chairman of the meeting,-

(a) is or could reasonably be regarded as defamatory of any person; or

(b) is irrelevant or immaterial to the proceedings; or

(c) is detrimental to the interests of the company.

(6) The Chairman shall exercise absolute discretion in regard to the inclusion or non inclusion of any matter in the minutes on the grounds specified in sub-

section (5).

(7) The minutes kept in accordance with the provisions of this section shall be evidence of the proceedings recorded therein.

(8) Where the minutes have been kept in accordance with sub-section (1) then, until the contrary is proved, the meeting shall be deemed to have been duly called and held, and all proceedings thereat to have duly taken place, and the resolutions passed by postal ballot to have been duly passed and in particular, all appointments of directors, key managerial personnel, auditors or company secretary in practice, shall be deemed to be valid.

(9) No document purporting to be a report of the proceedings of any general meeting of a company shall be circulated or advertised at the expense of the company, unless it includes the matters required by this section to be contained in the minutes of the proceedings of such meeting.

(10) Every company shall observe secretarial standards with respect to general and Board meetings specified by the Institute of Company Secretaries of India constituted under section 3 of the Company Secretaries Act, 1980, and approved as such by the Central Government.

(11) If any default is made in complying with the provisions of this section in respect of any meeting, the company shall be liable to a penalty of twenty-five thousand rupees and every officer of the company who is in default shall be liable to a penalty of five thousand rupees.

(12) If a person is found guilty of tampering with the minutes of the proceedings of meeting, he shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

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CHECK YOUR PROGRESS

Procedure for Voting at the meeting through Postal Ballot.

8.14 Inspection of minute-books of general meeting

(1) The books containing the minutes of the proceedings of any general meeting of a company or of a resolution passed by postal ballot, shall-

(a) be kept at the registered office of the company; and

(b) be open, during business hours, to the inspection by any member without charge, subject to such reasonable restrictions as the company may, by its articles or in general meeting, impose, so, however, that not less than two hours in each business day are allowed for inspection.

(2) Any member shall be entitled to be furnished, within seven working days after he has made a request in that behalf to the company and on payment of such fees as may be prescribed, with a copy of any minutes referred to in sub-section (1).

(3) If any inspection under sub-section (1) is refused, or if any copy required under subsection (2) is not furnished within the time specified therein, the company shall be liable to a penalty of twenty-five thousand rupees and every officer of the company who is in default shall be liable to a penalty of five thousand rupees for each such refusal or default, as the case may be.

(4) In the case of any such refusal or default, the Tribunal may, by order, direct an immediate inspection of the minute-books or direct that the copy required shall forthwith be sent to the person requiring it.

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8.15 Report on Annual General Meeting

(1) The report under this section shall be prepared in addition to the minutes of the general meeting;

(2) Every listed public company shall prepare in the prescribed manner a report on each annual general meeting including the confirmation to the effect that the meeting was convened, held and conducted as per the provisions of this Act and the rules made there under.

(3) The report shall be signed and dated by the Chairman of the meeting or in case of his inability to sign, by any two directors of the company, one of whom shall be the Managing director, if there is one and Company Secretary of the company;

(4) The report shall contain the details in respect of the following, namely:-

(i) the day, date, hour and venue of the annual general meeting;

(ii) confirmation with respect to appointment of Chairman of the meeting;

(iii) number of members attending the meeting;

(iv) confirmation of quorum;

(v) confirmation with respect to compliance of the Act and the Rules, secretarial standards made there under with respect to calling, convening and conducting the meeting;

(vi) business transacted at the meeting and result thereof;

(vii) particulars with respect to any adjournment, postponement of meeting, change in venue; and

(viii) any other points relevant for inclusion in the report.

(d) the Report shall contain fair and correct summary of the proceedings of the meeting.

(5) The company shall file with the Registrar a copy of the report referred to in subsection (1) within thirty days of the conclusion of the annual general meeting with such fees as may be prescribed, or with such additional fees as may be prescribed, within the time as specified, under section 403.

(6) If the company fails to file the report under sub-section (2) before the expiry of the period specified under section 403 with additional fee, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

8.16 Adjournment of Meeting

Adjournment means to defer or suspend the Meeting to a future time, either at an appointed date or indefinitely or as decided by the members present at the scheduled Meeting. For a valid adjournment of a General Meeting, the holding of the Meeting at its scheduled time is necessary. A duly convened Meeting should not be adjourned arbitrarily by the Chairman. The Chairman may adjourn a Meeting with the consent of the members and shall adjourn a Meeting if so decided by the members. The Meeting may, however, be adjourned at any time. It may be adjourned after some items of business have been transacted and the remaining items can be transacted at the adjourned Meeting.

8.17 Key Concepts

- **AGM :** Annual General Meeting
- **EGM :** Extra Ordinary General Meeting
- **Proxies :** Any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person as a proxy to attend and vote at the meeting on his behalf.

8.18 Summary

- Every company other than a One Person Company shall in each year hold an annual general meeting.
- First annual general meeting shall be held within a period of nine months from the date of closing of the first financial year of the company and in any other case, within a period of six months, from the date of closing of the financial year.
- A general meeting of a company may be called by giving not less than clear twenty-one days' notice either in writing or through electronic mode in such manner as may be prescribed.
- Every notice of a meeting shall specify the place, date, day and the hour of the meeting.
- Any member of a company entitled to attend and vote at a meeting of the company shall be entitled to appoint another person as a proxy to attend and vote at the meeting on his behalf.
- A resolution shall be an ordinary resolution if the notice required under this Act has been duly given and it is required to be passed by the votes cast.
- A copy of every resolution or any agreement if any, annexed to the notice calling the meeting in which the resolution is proposed, shall be filed with the Registrar within thirty days of the passing.
- Every company shall cause minutes of the proceedings of every general meeting of any class of shareholders or creditors, and every resolution passed by postal ballot and every meeting of its Board of Directors or of every committee of the Board, to be prepared and signed in such manner as may be prescribed and kept within thirty days of the conclusion of every such meeting concerned.

CHECK YOUR PROGRESS

List out contents of Report on Annual General Meeting.

8.19 Questions and Exercises

1. Discuss the provisions relating to voting through electronic means.
2. What are regulations relating to calling of extraordinary general meeting?
3. Mention the contents of Report of Annual General Meeting.
4. What are the items of business to be transacted through postal ballot?

- **Fill in the blanks**

1) A general meeting of a company may be called by giving not less than clear _____ days' notice either in writing or through electronic mode in such manner as may be prescribed.

(twenty one, thirty one, sixty one, fifteen)

2) If the quorum is not present within half-an-hour from the time appointed for

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holding a meeting of the company the meeting shall stand adjourned to the _____ at the same time and place.

(same day in the next month, same day in the next week, next day, same day at the next year)

3) A copy of every resolution or any agreement if any, annexed to the notice calling the meeting in which the resolution is proposed, shall be filed with the Registrar within _____ of the passing or making thereof in such manner and with such fees as may be prescribed within the time specified.

(15 days, 60 days, 10 days, 30 days)

4)) If a company fails to file the resolution or the agreement under sub-section (1) before the expiry of the period, the company shall be punishable with fine which shall not be _____ rupees.

(more than 5 lakh, less than 2 lakh, less than 5 lakh, less than 10 thousand)

5) One person company and other companies having upto _____ members are not required to transact any business through postal ballot.

(3 hundred, 2 hundred, 5 hundred, 1 hundred)

6) _____is not transacted through postal ballot.

(Buy-back of shares, Election of a director, Issue of shares with differential rights, ordinary business in an annual general meeting)

7) If a person is found guilty of tampering with the minutes of the proceedings of meeting, he shall be punishable with fine which shall not be less than _____ rupees but which may extend to one lakh rupees.

(25000, 20000, 35000, 50000)

8) The books containing the minutes of the proceedings of any general meeting of a company or of a resolution passed by postal ballot, shall be kept at the _____ of the company.

(branch office, registered office, liaison office, minutes office)

9) _____ of meeting means to suspend the meeting to a future time.

(Adjournment, cancellation, cessation)

10) The _____ may adjourn a Meeting with the consent of the members and shall adjourn a Meeting if so decided by the members.

(chairman, secretary, director, shareholder)

Answers: 1) twenty one, 2) same day in the next week, 3) 30 days, 4) less than 5 lakh, 5) 2 hundred, 6) ordinary business in an annual general meeting, 7) 25000, 8) registered office, 9) Adjournment, 10) chairman

8.20 Further Reading and References

M.C. Kuchhal: Modern Indian Company Law; Shri Mahavir Book Depot, 2603, Nai Sarak, Delhi-110 006.

H.K. Saharay: Company Law; Universal Law Publishing Co., C-FF-1A, Dilkhush Industrial Estate, G.T. Karnal Road, Delhi. -110033.

UNIT - 9 MANAGEMENT OF WORKING CAPITAL-I

9.0 Introduction
9.1 Objectives
9.2 Concept of Working Capital
9.3 Origin of Concept of Working Capital
9.4 Classification of working capital
9.5 Importance of Working Capital Management
9.6 Determinants of Working Capital
9.7 Importance of adequate working capital
9.8 Excess or Inadequate Working Capital
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9.11 Summary
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9.0 Introduction

In the unit related to investment decisions, we have dealt with the issue of long term financing of assets and management of fixed assets. However, along with fixed assets, a firm also needs short term financing resources which can be used to meet daily expenditure requirements. Such financial resources, known as working capital, constitute an important component of the overall financing structure of the firm. For this reason, it is important to conduct an analysis of the impact of risk and profitability of even this source of finance like we do for long term finance on the business enterprise.

However, there are some major differences between working capital management and fixed assets management. The first major difference between the two is the time for which the assets are employed and yield returns. Fixed assets are retained for a long period of time and also provide returns over the asset's life. Therefore, time factor becomes important in fixed assets management. However, in working capital management, there is quick turnover of assets mostly within a year and hence time factor is not of any significance. This unit provides an overview of the basic concepts of working capital, determinants of working capital, importance of adequate working capital and so on.

9.1 Objectives

In this unit, we will introduce you to the concept of working capital and the various types of working capital. By the end of this unit, you should be able to:

- explain the concept of working capital
- explain the origin of the concept of working capital
- discuss the importance of working capital management
- describe the determinants of working capital
- discuss the importance of adequate working capital and disadvantages of inadequate working capital
- explain the principles of working capital management

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9.2 Concept of Working Capital

Working capital commonly refers to the capital required for meeting day-to-day expenses in a business such as payment of salaries, wages, purchasing raw material etc. Various authors have provided their own interpretation of working capital. According to J.S.Mill, "The sum of the current assets is the working capital of the business". As per Mead, Baker & Malott, "Working capital means current assets". Working capital can also be defined as "excess of current assets over current liabilities". It is also known as circulating capital as these assets keep on transforming itself from one form to another with cash getting transformed into products which again get converted into cash once the products are sold.

Working capital management attempts to deal with the problems arising out of an attempt to manage current assets with current liabilities. The objective of working capital management is to make sure that a match of current assets with current liabilities is made in such a manner that the optimum capital requirements of the firm are met. If the firm is not able to meet its working capital requirements, it may get insolvent and forced into bankruptcy. Therefore, the current assets should be large enough not just to meet the current liabilities of the firm but also ensure sufficient margin of safety.

It is important to understand the meaning of current assets and current liabilities for learning the meaning of working capital, which is described below.

Current assets - These types of assets are engaged in current operation of a business and normally used for short- term operations of the firm during an accounting period i.e. within twelve months.

The two important characteristics of such assets are: (i) Short life span, and (ii) Swift transformation into other form of assets. Cash balance may be held idle for a week or two, account receivable may have a life span of 30 to 60 days, and inventories may be held for 30 to 100 days." Fitzgerald defined current assets as, "cash and other assets which are expected to be converted in to cash in the ordinary course of business within one year or within such longer period as constitutes the normal operating cycle of a business."

Current liabilities - The firm creates a Current Liability towards creditors (sellers) from whom it has purchased raw materials on credit. This liability is also known as accounts payable and shown in the balance sheet till the payment has been made to the creditors. The claims or obligations which are normally expected to mature for payment within an accounting cycle are known as current liabilities.

9.3 Origin of Concept of Working Capital

The term working capital started in a time period when most industries were closely related to agriculture. Processing industries would buy crops in the fall, process them, sell the finished product, and end up just before the next harvest with relatively low inventories. Bank loans with maximum maturities of one year were used to finance both the purchase and the processing costs, and these loans were returned with the proceeds from the sale of the finished products. As the economy became more and more industrialized, the production and financing cycles of typical business changed. Although seasonal patterns were still present, and business cycles also caused asset requirements to fluctuate, it became clear that current assets rarely, if ever, dropped to zero. This realization led to the development of the idea of permanent working capital.

9.4 Classification of Working Capital

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The working capital in certain enterprise may be classified into the following kinds.

1. Initial working capital: The capital, which is required at the time of the commencement of business, is called initial working capital. These are the promotion expenses incurred at the earliest stage of formation of the enterprise which include the incorporation fees. Attorney's fees, office expenses and other preliminary expenses.
2. Regular working capital: This type of working capital remains always in the enterprise for the successful operation. It supplies the funds necessary to meet the current working expenses i.e. for purchasing raw material and supplies, payment of wages, salaries and other sundry expenses.
3. Fluctuating working capital: This capital is needed to meet the seasonal requirements of the business. It is used to raise the volume of production by improvement or extension of machinery. It may be secured from any financial institution which can, of course, be met with short term capital. It is also called variable working capital.
4. Reserve margin working capital: It represents the amount utilized at the time of contingencies. These unpleasant events may occur at any time in the running life of the business such as inflation, depression, slump, flood, fire, earthquakes, strike, lay off and unavoidable competition etc. In this case greater amount of capital is required for maintenance of the business.
5. Permanent and Temporary Working Capital: The Operating Cycle creates the need for Current Assets (Working Capital). However the need does not come to an end once the cycle is completed. It continues to exist.

   To explain the continuing need of current assets, a distinction should be drawn between temporary and permanent working capital.

   Business Activity does not come to an end after the realization of cash from customers. For a company, the process is continuing, and hence, the need for regular supply of working capital. However, the, magnitude of Working Capital required is not constant but fluctuating. To carry on a business, a certain minimum level of working capital is necessary on a continuous and uninterrupted basis. For all practical purposes, this requirement has to be met permanently as with other fixed assets. This requirement is referred to as permanent or fixed working capital.

   Any amount over and above the permanent level of working capital is temporary, fluctuating or variable working capital. The position of the required working capital is needed to meet fluctuations in demand consequent upon changes in production and sales as a result of seasonal changes.

   Both kinds of working capital are necessary to facilitate the sales proceeds through the Operating Cycle.
6. Long Term working capital: The long-term working capital represents the amount of funds needed to keep a company running in order to satisfy demand at lowest point. There may be many situations where Demand may fluctuate considerably. It is not possible to retrench the work force or instantly sell all the inventories whenever demand declines Due to temporary reasons. Therefore the value, which represents the long-term working capital, stays with the business process all the time. It is for all practical purpose as permanent as fixed assets. In other words, it consists of the minimum current assets to be maintained at all times. The size of the permanent working capital varies

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directly with the size of Operation of a firm.

7. Short term working capital: Short-term capital varies directly with the level of activity achieved by a company.

The Volume of Operation decides the quantum of Short-term working capital. It also changes from one firm to another; from cash to inventory from inventory to debtors and from debtors back to cash. It may not always be gain fully employed. Temporary Working capital should be obtained from such sources, which will allow its return when it is not in use.

8. Gross Working Capital: Gross working capital refers to the firm's investment in current assets. Current assets are those assets which can be converted in to cash with in an accounting year and includes cash short term securities, debtors bills receivable and stock.

9. Net Working Capital: Net working capital refers to the difference between current asset and Current liabilities. Current liabilities are those claims of outsiders, which are expected to mature for payment within accounting year and include creditors, bills payable and outstanding expenses. Net Working capital can be positive or negative. A positive net working capital will arise when current assets exceed current liabilities.

The Gross working capital concept focuses attention on two aspect of current assets management.

(a) How to optimize investment in current assets?

(b) How should current assets be finance?

Both the question is the most decision making action of the management. It should be give due consideration before taking decision.

Both Net and Gross working capital is important and they have equal significance from management point of view.

The concepts of gross working capital and net working capital have equal significance from the management viewpoint. The gross working capital concept focuses attention on two aspects of current assets management: (a) How should investment in current assets be optimised? (b) What should be the financing structure of current assets?

The consideration of the level of investment in current assets should avoid two dangers- excessive investment and inadequate investment in current assets. Investment in current assets should be just adequate to meet the needs of the business firm. Excessive investment in current assets should be avoided because it hampers the firm's profitability, as idle investment earns nothing. On the other hand, inadequate amount of working capital can threaten solvency of the firm because of its inability to meet its current obligation. It should be understood that the working capital needs of the firm may be fluctuating with changing business activity. This may frequently cause excess or shortage of working capital. The management should be prompt to take an appropriate remedial action in this regard.

Another aspect of the gross working capital points to the need of arranging founds to finance current assets. Whenever a need of working capital funds arises due to the increasing level of business activity, or for any others reason, financing arrangement should be made quickly. Similarly, if suddenly, some surplus funds arise, they should not be allowed to remain idle, but should be invested in short-term securities. Thus the financial manager should have knowledge of the sources of working capital funds as well as investment avenues where idle funds may be temporarily invested.

Net working capital indicates the liquidity position of firm and suggests the extent to which working capital needs may be financed by permanent sources of funds. Current assets should be sufficiently in excess of current liabilities to constitute a margin or buffer for maturing obligations within the ordinary operating cycle of a business. In order to protect their interests, short-term creditors always like a company to maintain current assets at a higher level than current liabilities. It is a conventional rule to maintain the level of current assets twice the level of current liabilities. However, the quality of current assets should be considered in determining the level of current assets vis.-a-vis. current liabilities. A weak liquidity position poses a threat to the solvency of the company and makes it unsafe and unsound. A negative working capital means a negative liquidity, and may prove to be harmful for the company's reputation. Excessive liquidity is also bad. It may be due to mismanagement of current assets. Therefore, prompt and timely action should be taken by management improve and correct the imbalances in the liquidity position of the firm.

Net working capital concept also covers the question of judicious mix of long-term and short-term funds for financing current assets. For every firm, there is a minimum amount of net working capital which is permanent. Therefore, a portion of the working capital should be financed with the permanent sources of funds such as equity share capital, debentures, long-term debt, preference share capital or retained earnings. Management must, therefore, decide the extent to which current assets should be financed with equity capital and/or borrowed capital.

CHECK YOUR PROGRESS

Describe the concept and origin of working capital.

To summarise, it may be emphasised that both gross and net concepts of working capital are equally important for the efficient management of working capital. There is no precise way to determine the exact amount of gross or net working capital for any firm. The data and problems of each company should be analysed to determine the amount of working capital. There is no specific rule as to how current assets should be financed. It is not feasible in practice to finance current assets by short-term source only. Keeping in view the constraints of the individual company, a judicious mix of long and short-term finances should be invested in current assets. Since current assets involve cost of funds, they should be put to productive use.

9.5 Importance of Working Capital Management

Working Capital Management refers to the financing, investment, and control of net current assets within the policy guidelines. Effective provision of working capital can do much to ensure the success of the business, while its inefficient management can lead to the downfall of the enterprise. There is enough evidence to prove the fact that working capital management is important for the survival of any business enterprise. Management of working capital is critical for the financial health of all size of businesses. A firm may not have much investment in fixed assets, but it has to invest in current assets.

Working Capital Management is an essential part of overall financial management. It includes a number of aspects that makes it an important topic for study. It is therefore, important that the investment is carefully controlled. This is important for many reasons. Firstly, the amount invested in working capital is most of the times high in proportion to total assets employed and so it is important that it is used in an economical way. Second, the liquidity and the profitability of the corporate firm are directly influenced by its working capital management. The purpose of working Capital is therefore to maintain a balance between liquidity and profitability while managing the daily operations of a business concern. Each firm

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has to make arrangements for sufficient funds to meet the daily expenditure. The internal resources of a business organization are mostly not sufficient for meeting all its needs. Also it is not always possible for the owners or promoters to arrange finance from their personal resources. Resources therefore have to be financed through borrowing, keeping in view the short, medium and/or long term requirements of trade or industry for funds.

It has been suggested that the firm should maintain a sound working capital position. It should have adequate working capital to run its operations. Both excessive as well as inadequate working capital position are dangerous from a firm's point of view. Excessive working capital means idle funds which earn no profits for the firm, while inadequate working capital not only impairs firm's profitability, but also results in production interruptions and inefficiencies. Management of working capital therefore, is imperative to ensure that the right amount of working capital is available. Estimation of working capital involves forecasting requirements in subsequent months and regular updating as and when substantial change in the working capital requirements is expected according to past experience and/or because of new developments. Proper management would improve generation of funds from internal operation. Constant management is required to maintain appropriate levels in the working capital accounts. Investments in current assets and the level of current liabilities have to be geared quickly to changes in sales. Even fixed assets investments and long term financing are also receptive to variations in sales. However, this relationship is not as close and straight forward as it is in the case of working capital component. It has been found that the largest portion of a financial manager's time is utilized in the management of working capital. Typically, current assets represent more than half the total assets of a business firm. Since they represent such a large investment, this investment tends to be relatively volatile, and hence worthy of the financial manager's careful attention.

9.6 Determinants of Working Capital

Number of factors has an influence on the size and need of working capital in an organisation. So no definite rule or formula can be prescribed for calculating the amount of working capital. The data of each company should be analysed to determine the amount of working capital. Still the following factors can be broadly said to affect the working capital requirement:

1. Nature of business

Trading and industrial concerns need more working capital funds. Enterprises engaged in public utility services need less working capital. For example, if a concern is engaged in electric supply, it will need less current assets, firstly due to cash nature of the transactions and secondly due to sale of services. However, it will invest more in fixed assets. In addition to it, the investment varies concern to concern, depending upon the size of business, the nature of the product, and the production technique.

2. Processing Period

Time required for keeping the inventory in store is called storage period. The amount of working capital required is in direct proportion to the storage period. Higher the storage period, higher the amount of goods that a firm should keep in store and higher the working capital. Also, if the processing time is more, then more quantity of goods must be held in store as work-in-progress which leads to

higher working capital requirement.

3. Manual Labour or Automation:

Larger working capital will be required in labour intensive industries than in the automated ones. Industries which are automated will need a large proportion of fixed capital. However to some extent, the decision to use manual labour or machinery rests with the management. Therefore, it is possible in lot of cases to decrease the requirements of working capital and increase investments in fixed assets and vice versa.

4. Conditions of supply

If the supply of inventory is swift and adequate, less funds will be needed. But, if the supply is unpredictable, more funds will be invested in inventory. Investment in working capital will fluctuate in case of seasonal nature of supply of raw materials, spare parts and stores.

5. Firm's credit policy

The credit policy of a firm determines requirement of working capital. A firm following liberal credit policy to all customers requires more funds. On the other hand, the firm adopting strict credit policy will require less amount of working capital.

6. Firm's production policy

The production policy of the firm is an important factor to decide the working capital requirement. The manufacturing cycle starts with the purchase and use of raw material and completes with the production of finished goods. On the other side, the kind of production policy i.e. whether the production policy is uniform production policy or seasonal production policy etc., also has an influence on the working capital decisions. Larger the manufacturing cycle and uniform production policy, larger will be the requirement of working capital. The working capital requirement will be higher with varying production schedules in accordance with the changing demand.

7. Availability of credit

The working capital requirements of a firm are also affected by credit terms granted by its creditors. A firm will need less working capital if liberal credit terms are available to it.

8. Growth and expansion

The need of working capital is increasing with the growth and expansion of an enterprise. It is difficult to precisely determine the relationship between volume of sales and the working capital needs. The critical fact, however, is that the need for increased working capital funds does not follow growth in business activities but precedes it. It is clear that advance planning is essential for a growing concern.

9. Profit margin and dividend policy

The quantum of working capital in a firm depends upon its profit margin and dividend policy. A high net profit margin contributes towards the working capital pool. To the extent the net profit has been earned in cash, it becomes a source of working capital. Also, distribution of high proportion of profits in the form of cash

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CHECK YOUR PROGRESS

How working capital is classified?

dividends results in a drain on cash resources and thus reduces company's working capital to that extent. The working capital position of the firm is strengthened if the management follows conservative dividend policy and vice versa.

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10. Access to Money Market

If any firm has good access to capital market, it can easily raise loan from bank and financial institutions. It therefore results in minimization of need of working capital.

11. Operating efficiency of the firm

Operating efficiency means the best possible utilisation of a firm's resources at minimum cost. If a firm successfully controls operating cost, it will be able to improve net profit margin which, will, in turn, release greater funds for working capital purposes.

12. Business fluctuations

Most firms experience variations in demand for their products and services. These businesses fluctuations affect the working capital requirements. When there is an upward swing in the economy, sales will increase, correspondingly, the firm's investment in inventories will also increase. Under boom, additional investment in fixed assets may be made by some firms to increase productive capacity. This will require additional funds. While on the other hand, when there is a decline in economy, sales will come down and consequently the firms try to reduce their short-term borrowings.

13. Changes in the technology

The technological changes and developments in the area of production can have immediate effects on the need for working capital. If the firm wish to install a new machine in the place of old system, the new system can utilise less expensive raw materials, the inventory needs may be reduced there by working capital needs.

9.7 Importance of adequate working capital

The main advantages of maintaining adequate amount of working capital are as follows:

(1) It permits the carrying of inventories at a level that would enable a business to serve satisfactorily the needs of its customers.

(2) A concern having adequate working capital & credit standing can arrange loans from banks and other on easy and favourable terms.

(3) It protects a business form the adverse effects of shrinkage in the values of current assets.

(4) It is possible to pay all the current obligations promptly and to take advantage of cash discounts.

(5) It ensures, to a greater extent, the maintenance of a company's credit standing and provides for such emergencies as strikes, floods, fires etc.

(6) It enables a company to extend favourable credit terms to its customers.

(7) It enables a company to operate its business more efficiently because there is no delay in obtaining materials, etc., because of credit difficulties.

(8) It enables a business to withstand periods of depression smoothly.

(9) The management may fail to obtain funds from other sources for purposes of expansion and having adequate working capital will help them in this kind of situation.

(10) There may be an unwise dividend policy and with a cushion of adequate working capital, it may be able to survive a wrong decision.

(11) Increasing price may necessitate bigger investments in inventories and fixed asset.

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9.8 Excess or Inadequate Working Capital

Every business concern should have adequate working capital to run its business operations. It should have neither redundant or excess working capital nor inadequate nor shortage of working capital. Both excess as well as short working capital positions are bad for any business. However, out of the two, it is the inadequacy of working capital which is more dangerous from the point of view of the firm.

CHECK YOUR PROGRESS

What are determinants of working capital?

Disadvantages of Excessive Working Capital

1. Excessive Working Capital means ideal funds which earn no profits for the business and hence the business cannot earn a proper rate of return on its investments.
2. When there is a redundant working capital, it may lead to unnecessary purchasing and accumulation of inventories causing more chances of theft, waste and losses.
3. Excessive working capital implies excessive debtors and defective credit policy which may cause higher incidence of bad debts.
4. It may result into overall inefficiency in the organization.
5. When there is excessive working capital, relations with banks and other financial institutions may not be maintained.
6. Due to low rate of return on investments, the value of shares may also fall.
7. The redundant working capital gives rise to speculative transactions.

Dangers of Inadequate Working Capital

1. A concern which has inadequate working capital cannot pay its short-term liabilities in time. Thus, it will lose its reputation and shall not be able to get good credit facilities.
2. It cannot buy its requirements in bulk and cannot avail of discounts, etc.
3. It becomes difficult for the firm to exploit favourable market conditions and undertake profitable projects due to lack of working capital.
4. The firm cannot pay day-to-day expenses of its operations and it creates inefficiencies, increases costs and reduces the profits of the business.
5. It becomes impossible to utilize efficiently the fixed assets due to non-availability of liquid funds.
6. The rate of return on investments also falls with the shortage of working capital.

9.9 Principles of Working Capital Management

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The following are the principles of working capital management:

(i) Principle of risk variation

Risk here refers to the inability of firm to maintain sufficient current assets to pay its obligations. If working capital is varied relative to sales, the amount of risk that a firm assumes is also varied and the opportunity for gain or loss is increased. In other words, there is a definite relationship between the degree of risk and the rate of return. As a firm assumes more risk, the opportunity for gain or loss increases. As the level of working capital relative to sales decreases, the degree of risk increases. When the degree of risk increases, the opportunity for gain and loss also increases. Thus, if the level of working capital goes up, amount of risk goes down, and vice-versa, the opportunity for gain is like-wise adversely affected.

(ii) Principle of equity position

According to this principle, the amount of working capital invested in each component should be adequately justified by a firm's equity position. Every rupee invested in the working capital should contribute to the net worth of the firm.

(iii) Principle of cost of capital

This principle emphasizes that different sources of finance have different cost of capital. It should be remembered that the cost of capital moves inversely with risk. Thus, additional risk capital results in decline in the cost of capital.

(iv) Principle of maturity of payment

A company should make every effort to relate maturity of payments to its flow of internally generated funds. There should be the least disparity between the maturities of a firm's short-term debt instruments and its flow of internally generated funds, because a greater risk is generated with greater disparity. A margin of safety should, however, be provided for any short-term debt payment.

9.10 Key Concepts

- **Working capital** commonly refers to the capital required for meeting day-to-day expenses in a business such as payment of salaries, wages, purchasing raw material etc.
- **Working Capital** = Current Assets - Current Liabilities

9.11 Summary

- Working capital commonly refers to the capital required for meeting day-to-day expenses in a business
- Working capital can also be defined as the sum of the current assets. It can also be explained as excess of current assets over current liabilities.
- It is also known as circulating capital as these assets keep on transforming itself from one form to another with cash getting transformed into products which again get converted into cash once the products are sold.
- The objective of working capital management is to make sure that a match of

current assets with current liabilities is made in such a manner that the optimum capital requirements of the firm are met.

- Current assets are those types of assets which are engaged in current operation of a business and normally used for short- term operations of the firm during an accounting period i.e. within twelve months.
- The claims or obligations which are normally expected to mature for payment within an accounting cycle are known as current liabilities.
- There are four classifications of working capital: (i) Gross working capital (ii) Net working capital (iii) Permanent Working capital (iv) Temporary working capital
- Gross working capital can be defined as the total current assets of the firm.
- Net working capital: It has been defined in two different ways. They are (i) It is the difference between current assets and liabilities (ii) It is the portion of current assets which are financed through long term funds.
- Permanent Working capital is the minimum level of working capital required to meet the business needs of the firm.
- Temporary working capital keeps on changing on the basis of fluctuation in production.
- Working Capital Management refers to the financing, investment, and control of net current assets within the policy guidelines.
- The following are the principles of working capital management: (i) Principle of risk variation (ii) Principle of equity position (iii) Principle of cost of capital (iv)Principle of maturity of payment

9.12 Questions and Exercises

1. Explain the principles of working capital management.
2. Explain the importance of adequate working capital.
3. What are the consequences of excessive working capital?
4. What disadvantages does a firm with inadequate working capital have?

- **Fill in the blanks**

1. _____can be defined as "excess of current assets over current liabilities.
   (working capital, capital budgeting, fund flow)
2. The two important characteristics of _____are Short life span, and Swift transformation into other form of assets.
   (fixed assets, current assets, semi fixed assets)
3. The claims or obligations which are normally expected to mature for payment within an accounting cycle are known as_____.
   (reserves, current liabilities, fixed assets)
4. The capital, which is required at the time of the commencement of business, is called _____working capital.
   (permanent , primary, initial)
5. _____working capital represents the amount utilized at the time of contingencies.
   (reserve margin, primary, initial)

6. Nature of business, Processing Period, Manual Labour or Automation, Conditions of supply are some of the _____of working capital.

   (merits, demerits, determinents)

7. If any firm has good access to capital market, it can easily raise loan from bank and financial institutions. It therefore results in_____ of need of working capital.

   (minimization, maximization, creation)

8. Operating efficiency means the best possible utilisation of a firm's resources at_____.

   (maximum cost, minimum cost, excess cost)

9. _____Working Capital means ideal funds which earn no profits for the business and hence the business cannot earn a proper rate of return on its investments.

   (limited, inadequate, excessive)

10. There is a definite relationship between the degree of risk and the_____.

    (rate of return, profit on investment, rate of investment)

Answers: 1) Working capital, 2) current assets, 3) current liabilities, 4) initial, 5) Reserve margin, 6) determinants, 7) minimization, 8) minimum cost, 9) Excessive, 10) rate of return

9.13 Further Reading and References

Brigham & Ehrhardt: Financial Management-Theory and Practice, Cengage Learning

I.M.Pandey: Financial Management, S.Chand & Company Ltd.

Prasanna Chandra: Financial Management-Theory and Practice, McGraw Hill Education India Private Limited

James C.Van Horne: Financial Management & Policy, Prentice-Hall, Inc.,

UNIT - 10
MANAGEMENT OF WORKING CAPITAL-II

10.0 Objectives

10.1 Operating Cycle

10.2 Structure of Working Capital

10.3 Measurement of Working Capital

10.4 Key Concepts

10.5 Summary

10.6 Questions and Exercises

10.7 Further Reading and References

10.0 Objectives

The purpose of this unit is to build on the concepts related to working capital that were discussed in the previous unit. By the end of this unit, you should be able to:

Explain the concept of operating cycle

Explain the structure of working capital

Discuss the methods of calculating working capital requirements

Calculate working capital requirements

10.1 Operating Cycle

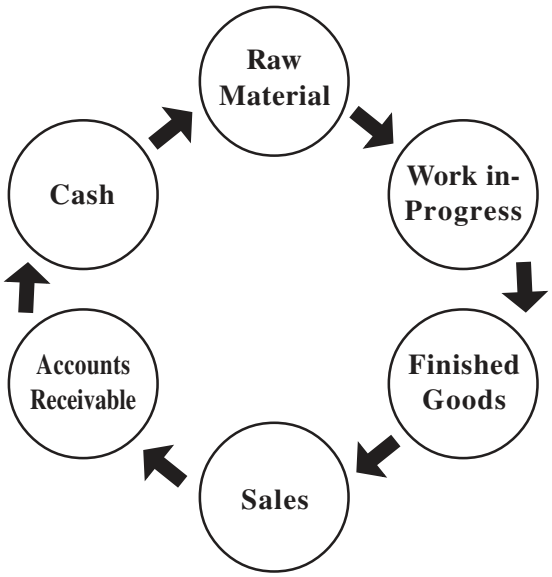
The duration of time required to complete the following sequence of events, in case of manufacturing firm, is called the operating cycle:

1. Conversion of cash into raw materials.
2. Conversion of raw materials into work-in-progress.
3. Conversion of work in process into finished goods.
4. Conversion of finished goods into debtors and bills receivables through sales.
5. Conversion of debtors and bills receivables into cash.

The length of cycle will depend on the nature of business. Non manufacturing concerns, service concerns and financial concerns will not have raw material and work-in-process so their cycle will be shorter. Financial Concerns have a shortest operating cycle.

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Operating Cycle of a Manufacturing concern



The duration of the operating cycle is equal to the sum of the duration of each of these stages less the credit period allowed by the suppliers of the firm. In symbols,

O = R + W + F + D - C

Where,

O = duration of operating cycle.

R = raw material storage period.

W= work-in-process period.

F= finished goods storage period.

D=debtors collection period, and

C = creditors payment period.

10.2 Structure of Working Capital

The study of structure of working capital is another name for the study of working capital cycle. In other words, it can be said that the study of structure of working capital is the study of the elements of current assets viz. inventory, receivable, cash and bank balances and other liquid resources like short-term or temporary investments. Current liabilities usually comprise bank borrowings, trade credits, assessed tax and unpaid dividends or any other such things.

(a) Inventory

Inventory is major item of current assets. The management of inventories - raw material, goods-in-process and finished goods is an important factor in the short-run liquidity positions and long-term profitability of the company.

Raw material inventories- Uncertainties about the future demand for finished goods, together with the cost of adjusting production to change in demand will cause a financial manager to desire some level of raw material inventory. In the absence of such inventory, the company could respond to increased demand for finished goods only by incurring explicit clerical and other transactions costs of

ordinary raw material for processing into finished goods to meet that demand. If changes in demand are frequent, these order costs may become relatively large. Moreover, attempts to purchases hastily the needed raw material may necessitate payment of premium purchases prices to obtain quick delivery and, thus, raises cost of production. Finally, unavoidable delays in acquiring raw material may cause the production process to shut down and then re-start again raising cost of production. Under these conditions the company cannot respond promptly to changes in demand without sustaining high costs. Hence, some level of raw materials inventory has to be held to reduce such costs. Determining its proper level requires an assessment of costs of buying and holding inventories and a comparison with the costs of maintaining insufficient level of inventories.

Work-in-process inventory- This inventory is built up due to production cycle. Production cycle is the time-span between introduction of raw material into production and emergence of finished product at the completion of production cycle. Till the production cycle is completed, the stock of work-in-process has to be maintained.

Finished goods inventory- Finished goods are required for reasons similar to those causing the company to hold raw materials inventories. Customer's demand for finished goods is uncertain and variable. If a company carries no finished goods inventory, unanticipated increases in customer demand would require sudden increases in the rate of production to meet the demand. Such rapid increase in the rate of production may be very expensive to accomplish. Rather than loss of sales, because the additional finished goods are not immediately available or sustain high costs of rapid additional production, it may be cheaper to hold a finished goods inventory. The flexibility afforded by such an inventory allows a company to meet unanticipated customer demands at relatively lower costs than if such an inventory is not held.

Thus, to develop successfully optimum inventory policies, the management needs to know about the functions of inventory, the cost of carrying inventory, economic order quantity and safety stock. Industrial machinery is usually very costly and it is highly uneconomical to allow it to lie idle. Skilled labour also cannot be hired and fired at will. Modern requirements are also urgent. Since requirements cannot wait and since the cost of keeping machine and men idle is higher, than the cost of storing the material, it is economical to hold inventories to the required extent. The objectives of inventory management are:

(1) To minimize idle cost of men and machines causes by shortage of raw materials and stores

(2) To keep down:

(a) Inventory ordering cost.

(b) Inventory carrying cost,

(c) Capital investment in inventories.

(d) Obsolescence losses

(b) Receivables

Many firms make credit sales and as a result thereof carry receivable as a current asset. The practice of carrying receivables has several advantages viz., (i) reduction of collection costs over cash collection, (ii) Reduction in the variability

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of sales, and (iii) increase in the level of near-term sales. While immediate collection of cash appears to be in the interest of shareholders, the cost of that policy may be very high relative to costs associated with delaying the receipt of cash by extension of credit. Imagine, for example, an electric supply company employing a person at every house constantly reading electricity meter and collecting cash from him every minute as electricity is consumed. It is far cheaper for accumulating electricity usage and bill once a month. This of course, is a decision to carry receivables on the part of the company.

It may also be true that the extension of credit by the firm to its customers may reduce the variability of sales over time. Customers confined to cash purchases may tend to purchase goods when cash is available to them. Erratic and perhaps cyclical purchasing patterns may then result unless credit can be obtained elsewhere. Even if customers do obtain credit elsewhere, they must incur additional cost of search in arranging for a loan costs that can be estimated when credit is given by a supplier. Therefore, extension of credit to customers may well smooth out of the pattern of sales and cash inflows to the firm over time since customers need not wait for some inflows of cash to make a purchase. To the extent that sales are smoothed, cost of adjusting production to changes in the level of sales should be reduced. Finally, the extension of credit by firms may act to increase near-term sales. Customers need not wait to accumulate necessary cash to purchase an item but can acquire it immediately on credit. This behaviour has the effect of shifting future sales close to the present time.

CHECK YOUR PROGRESS

Explain the meaning of operating cycle.

Therefore, the extension of credit by a firm and the resulting investment in receivables occurs because it pays a firm to do so. Costs of collecting revenues and adapting to fluctuating customer demands may make it desirable to offer the convenience associated with credit to firm's customers. To the extents that near sales are also increased, extension of credit is made even more attractive for the firm.

(c) Cash and interest-bearing liquid assets

Cash is one of the most important tools of day-to-day operation, because it is a form of liquid capital which is available for assignment to any use. Cash is often the primary factor which decides the course of business destiny. The decision to expand a business may be determined by the availability of cash and the borrowing of funds will frequently be dictated by cash position. Cash-in-hand, however, is a non-earning asset. This leads to the question as to what is the optimum level of this idle resource. This optimum depends on various factors such as the manufacturing cycle, the sale and collection cycle, age of the bills and on the maturing of debt. It also depends upon the liquidity of other current assets and the matter of expansion. While a liberal maintenance of cash provides a sense of security, a lack of sufficiency of cash hampers day-to-day operations. Prudence, therefore, requires that no more cash should be kept on hand than the optimum required for handling miscellaneous transactions over the counter and petty disbursements etc.

It has not become a practice with business enterprises to avoid too much redundant cash by investing a portion of their earnings in assets which are susceptible to easy conversion into cash. Such assets may include government securities, bonds, debentures and shares that are known to be readily marketable and that may be liquidated at a moment's notice when cash is needed.

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10.3 Measurement of Working Capital

There are 3 methods for assessing the working capital requirement as explained below:

a) Percent of Sales Method

Based on the past experience, some percentage of sales may be taken for determining the quantum of working capital.

b) Regression Analysis Method

The relationship between sales and working capital and its various components may be plotted on Scatter diagram and the average percentage of past 5 years may be ascertained. This average percentage of sales may be taken as working capital. Similar exercise may be carried out at the beginning of the year for assessing the working capital requirement. This method is suitable for simple as well as complex situations.

c) Operating Cycle Method

This involves estimation of current assets and current liabilities. The following method can be adopted to calculate working capital (Khan & Jain, 2005):

Estimation of Current Assets

(i) Raw Materials Inventory

= (Production (in units) x Per unit raw material cost x Average inventory holding period (months/days)) / (12months/365days)

(ii) Work-in-process (WIP) Inventory

= (Production (in units) x Per unit WIP cost x Average time span of WIP inventory (months/days)) / (12months/365days)

(iii) Finished goods inventory

= (Production (in units) x Per unit cost of finished goods (excluding depreciation) x Holding period of finished goods (months/days)) / (12months/365days)

(iv) Debtors

= (Credit sales (in units) x Per unit cost of sales (excluding depreciation) x Average debt collection period (months/days)) / (12months/365days)

(v) Cash and Bank balance

Estimation of Current Liabilities

(i)Trade creditors

= (Yearly Production (in units) x Per unit raw material cost x Credit period granted (months/days)) / (12months/365days)

(ii) Direct Wages

= (Yearly Production (in units) x Per unit direct labour cost x Average time lag in payment of wages (months/days)) / (12months/365days)

(iii) Overheads (Other than depreciation and amortisation)

= (Yearly Production (in units) x Per unit overhead cost x Average time lag in payment of overheads (months/days)) / (12months/365days)

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After computation of all the current assets and current liabilities, the working capital can be computed as follows:

(I) Estimation of Current Assets

(a) Cash and bank balance

(b) Inventories

Raw Material

Work-in-process

Finished Goods

(c) Debtors

Total current assets= (a) + (b) + (c)

(II) Estimation of Current Liabilities

(a)Creditors

(b) Wages

(c) Overheads

Total current liabilities= (a) + (b) +(c)

(III) Net working capital = (I) - (II)

Add: Margin for contingency

(IV) Net working capital required

Example.1

Hi-tech Ltd. plans to sell 30,000 units next year. The expected cost of goods sold is as follows:

	Rs. (Per Unit)
Raw material	100
Manufacturing expenses	30
Selling, administration and financial expenses	20
Selling price	200

The duration at various stages of the operating cycle is expected to be as follows

Raw material stage	2 months
Work-in-progress stage	1 month
Finished stage	1/2 month
Debtor's stage	1 month

Assuming the monthly sales level of 2,500 units, estimate the gross working capital requirement.

Desired cash balance is 5% of the gross working capital requirement, and

work-in-progress in 25%
complete with respect to manufacturing expenses.

Solution

Statement of Working Capital Requirement

1. Current Assets	**Amt. (Rs.)**	**Amt. (Rs.)**
Stock of Raw material (2500X2X100)		5,00,000
Work-in-progress:		
Raw Material (2500 X 100)	2,50,000	
Manufacturing expenses 25% of (2500X30)	8,750	2,68,750
Finished Goods:		
Raw Materials (2500 X ½ X 100)	1,25,000	
Manufacturing Expenses (2500 X ½ X 30)	37,500	1,62,500
Debtors (2500 X 150)		3,75,000
		13,06,250
Cash Balance (13,06,250 X 5/95)		68,750
Gross Working Capital Required		13,75,000

Example.2

Calculate the amount of working capital requirement for SRCC Lt d. from the following information:

	Rs. (Per Unit)
Raw materials	160
Direct labour	60
Overheads	120
Total cost	340
Profit	60
Selling price	400

Raw materials are held in stock on an average for one month. Materials are in process on an average for half-a-month. Finished goods are in stock on an average for one month. Credit allowed by suppliers is one month and credit allowed to debtors is two months. Time lag in payment of wages is 1½ weeks. Time lag in payment of overhead expenses is one month. One fourth of the sales are made on cash basis.

Cash in hand and at the bank is expected to be Rs. 50,000; and expected level of production. Cash in hand and at the bank is expected to be Rs. 50,000; and expected level of production amounts to 1,04,000 units for a year of 52 weeks. You may assume that production is carried on evenly throughout the year and a time period of four weeks is equivalent to a month.

Solution

Statement of Working Capital Requirement

1. Current Assets	**Amt. (Rs.)**	**Amt. (Rs.)**
Cash Balance		50,000

NOTES

CHECK YOUR PROGRESS

Explain the regression method for estimation of working capital.

Stock of Raw material (2000X160X4)		12,80,000
Work-in-progress:		
Raw Material (2000 X 160X2)	6,40,000	
Labour & Overheads (2000X180X2)X50%	3,60,000	10,00,000
Finished Goods (2000X340X4)		27,20,000
Debtors (2000 X 340 X 8 X 75%)		40,80,000
Total current assets		91,30,000

2. Current Liabilities

Creditors (2000 X Rs.160 X 4)	12,80,000
Creditors for Wages (2000 X Rs.60 X 1.5)	1,80,000
Creditors for Overheads (2000 X Rs.120 X 4)	9,60,000
Total Current Liabilities	24,20,000
Net working capital (CA-CL)	67,10,000

Example.3

JBC Ltd. sells goods on a gross profit of 25%. Depreciation is considered as a part of cost of production. The following are the annual figures given to you:

Sales (2 months credit)	18,00,000
Materials consumed (1 month credit)	4,50,000
Wages paid (1 month lag in payment)	3,60,000
Cash manufacturing expenses (1 month lag in payment)	4,80,000
Administrative expenses (1 month lag in payment)	1,20,000
Sales promotion expenses (paid quarterly in advance)	60,000

The company keeps one month's stock each of raw materials and finished goods. It also keeps Rs. 1,00,000 in cash. You are required to estimate the working capital requirements of the company on cash cost basis, assuming 15% safety margin.

Solution

Statement of Working Capital Requirement

1. Current Assets	**Amt. (Rs.)**	**Amt. (Rs.)**
Cash in hand		1,00,000
Debtors (cost of sales i.e. 14,70,000 X 2/12)		2,45,000
Prepaid Sales promotion expenses		15,000
Inventories:		
Raw Materials (4,50,000/12)		37,500
Finished Goods (12,90,000/12)		1,07,500
Total current assets		5,05,000
2. Current Liabilities		
Sundry Creditors (4,50,000/12)		37,500
Outstanding manufacturing expenses (4,80,000/12)		40,000
Outstanding administrative expenses (1,20,000/12)		10,000
Outstanding wages (3,60,000/12)		30,000

Total current liabilities		1,17,500
Net working capital (CA-CL)		3,87,500
+ 15% for contingencies		58,125
Working Capital required		4,45,625

Working Notes

1.Cost structure		
Sales		18,00,000
(-) Gross profit 25% on sales		4,50,000
Cost of production		13,50,000
(-) Cost of materials	4,50,000	
(-) Wages	3,60,000	8,10,000
Manufacturing expenses (total)		5,40,000
(-) Cash manufacturing expenses		4,80,000
Therefore, Depreciation		60,000
2.Total cash cost		
Cost of production		13,50,000
(-) Depreciation		60,000
(+) Administrative expenses		1,20,000
(+) Sales promotion expenses		60,000
Total cash cost		14,70,000

10.4 Key Concepts

- **Working capital** commonly refers to the capital required for meeting day-to-day expenses in a business such as payment of salaries, wages, purchasing raw material etc.

- **Working Capital** = Current Assets - Current Liabilities

10.5 Summary

The duration of time required to complete the sequence of events from cash to finished products to cash again is called as operating cycle.

The length of cycle will depend on the nature of business.

Financial Concerns have a shortest operating cycle.

The study of structure of working capital is the study of the elements of current assets viz. inventory, receivable, cash and bank balances and other liquid resources like short-term or temporary investments.

There are 3 methods for assessing the working capital requirement: Percent of Sales Method; Regression Analysis Method and Operating Cycle Method.

In Percent of Sales Method, some percentage of sales may be taken for determining the quantum of working capital.

In Regression Analysis Method, the relationship between sales and working capital and its various components may be plotted on Scatter diagram and the average percentage of past 5 years may be ascertained.

Operating Cycle Method involves estimation of current assets and current liabilities.

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10.6 Questions and Exercises

1. Explain the various methods for measurement of working capital.
2. Explain the structure of working capital.

● **Fill in the Blanks**

1) The duration of time required to complete the sequence of events from cash to finished products to cash again is called as_____.
(production cycle, operating cycle, cash cycle)
2) The duration of the operating cycle is equal to the sum of the duration of each of these stages less the _____of the firm.
(debtors collection period, credit period allowed by suppliers, credit period allowed to customers)
3) _____is the time-span between introduction of raw material into production and emergence of finished product at the completion of production cycle.
(production cycle, operating cycle, cash cycle)
4) Determining the proper level of _____inventory requires an assessment of costs of buying and holding inventories and a comparison with the costs of maintaining insufficient level of inventories.
(finished goods, work in progress, raw materials)
5) The extension of credit by the firm to its customers may reduce the variability of ____over time.
(profit, purchase, sales)
6) _____is often the primary factor which decides the course of business destiny.
(cash, finished goods, asset)
7) The _____level of the idle resource depends on various factors such as the manufacturing cycle, the sale and collection cycle, age of the bills and on the maturing of debt.
(adequate, optimum, excessive)
8) In_____, the relationship between sales and working capital and its various components may be plotted on Scatter diagram and the average percentage of past 5 years may be ascertained.
(percent of sales method, regression analysis method, operating cycle method)
9) Operating cycle method involves _____of current assets and current liabilities.
(estimation, creation, analysis)

Answers: 1) operating cycle, 2) credit period allowed by the suppliers, 3) Production cycle, 4) raw materials, 5) sales, 6) Cash, 7) optimum, 8) regression analysis method, 9) estimation

10.7 Further Reading and References

Brigham & Ehrhardt: Financial Management-Theory and Practice, Cengage Learning
I.M.Pandey: Financial Management, S.Chand & Company Ltd.
Prasanna Chandra: Financial Management-Theory and Practice, McGraw Hill Education India Private Limited
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UNIT - 11
LIMITED LIABILITY PARTNERSHIP

NOTES

11.0 Introduction
11.1 Objectives
11.2 Meaning of LLP
11.3 Salient Features
11.4 Need for Limited Liability Partnership
11.5 Distinction between LLP and Partnership
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11.0 Introduction

The Limited Liability Partnership Act, 2008 passed in January 2009 heralds Limited Liability Partnership ("LLP") as a new corporate form of business and an alternative to the traditional partnership model, with unlimited personal liability on one hand and a limited liability company with detailed compliance requirements and restrictions on the other. An LLP structure has features of both a partnership firm and a body corporate and, therefore, helps businesses organize and operate in a flexible, innovative and efficient manner.

11.1 Objectives

In this unit, you will be introduced to the various aspects of Limited Liability Partnership (LLP) . By the end of this unit, you should be able to:

- explain the meaning of LLP
- describe the need for LLP
- discuss the concept of members and partners
- discuss the regulations dealing with incorporation of LLP
- explain the difference between LLP and partnership

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11.2 Meaning of LLP

A Limited Liability Partnership (LLP) is a body corporate, with a distinct legal entity separate from that of its partners. It has perpetual succession and a common seal. A LLP, which is a separate legal person, will be liable to the third parties independent of the other partners. Any change in its partners, will not affect the existence, rights or liabilities of the limited liability partnership. Like a company, a limited liability partnership can do all the things an individual or company can do. It can make contracts, sue or be sued, hold property in its name etc.

The Limited Liability Partnership (LLP) is viewed as an alternative corporate business vehicle that provides the benefits of limited liability but allows its members the flexibility of organizing their internal structure as a partnership based on a mutually arrived agreement. A LLP combines the advantages of both the Company and Partnership into a single form of organization.

The Limited Liability Partnership form of business organization was introduced in India by way of Limited Liability Partnership Act, 2008 (LLP Act 2008) which came into effect by way of notification dated 31st March 2009.

This form of business structure has been prevalent in many countries including USA, UK, Japan, and Singapore While retaining this basic structure, different countries have framed their laws with suitable changes. A brief mention about the LLP laws prevalent in other countries will be most appropriate at this juncture.

In the United States of America, Limited liability partnerships emerged in the early 1990s while only two states allowed LLPs in 1992, over forty had adopted LLP statutes by the time LLPs were added to the Uniform Partnership Act in 1996. In USA, each individual State has its own law governing formation of LLP and the liability of the partners varies from state to state.

In some U.S. states (including California and New York), LLPs can only be formed among professional, particularly lawyers, accountants and architects. This position is very different from Japenese LLPs as Japanese LLPs may not be used by lawyers or accountants, as these professions are required to do business through an unlimited liability entity. Limited liability partnerships were introduced to Japan in 2006. A Japanese LLP is not a corporation, but rather exists as a contractual relationship between the partners, similarly to an American LLP.

11.3 Salient Features

The salient features of the Limited Liability Partnership are as follows:-

(i) The LLP is a body corporate and a legal entity separate from its partners. Any two or more persons, associated for carrying on a lawful business with a view to profit, may by subscribing their names to an incorporation document and filing the same with the Registrar, form a Limited Liability Partnership. The LLP has a perpetual succession;

(ii) The mutual rights and duties of partners of an LLP inter se and those of the LLP and its partners shall be governed by an agreement between partners or between the LLP and the partners subject to the provisions of the proposed legislation. There would be flexibility to devise the agreement as per their choice. In the absence of any such agreement, the mutual rights and duties shall be governed by the provisions of the proposed legislation;

(iii) A LLP is a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP

which may be tangible or intangible in nature or both tangible and intangible in nature. No partner would be liable on account of the independent or un-authorized acts of other partners or their misconduct;

(iv) Every LLP shall have at least two partners and shall also have at least two individuals as Designated Partners, of whom at least one shall be resident in India.

(v) A LLP shall maintain annual accounts reflecting true and fair view of its state of affairs. A statement of accounts and solvency shall be filed by every LLP with the Registrar every year. The accounts of LLPs shall also be audited, subject to any class of LLPs being exempted from this requirement by the Central Government;

(vi) The Central Government has power to investigate the affairs of an LLP, if required, by appointment of competent inspector for the purpose;

(vii) The Indian Partnership Act, 1932 shall not be applicable to LLPs. A partnership firm, a private company and an unlisted public company may convert themselves to LLP in accordance with provisions of the proposed legislation;

(viii) The Central Government has made rules for carrying out the provisions of the LLP Act.

11.4 Need for Limited Liability Partnership

At the outset it is clarified that the Limited Liability Partnership Act 2008 (LLP Act 2008) does not restrict the benefit of LLP structure only to certain classes of professionals and will be available for use by any enterprise that fulfils the requirements of this proposed Act.

The LLP form of business organization would enable entrepreneurs, professionals and enterprises providing services of any kind or engaged in scientific and technical disciplines, to form commercially efficient vehicles suited to their requirements. Owing to flexibility in its structure and operations, the LLP would also be a suitable vehicle for small enterprises and for investment by venture capital. Accordingly, the LLP form of Organization is available to Professionals, Service Providers, Traders and Manufacturers.

The existing organization structures in India, which are most commonly used - like proprietary concerns, partnerships and companies are subject to varying regulatory and tax requirements and are not suitable for some businesses and professions. In India, several professionals are barred from forming companies with limited liability.

In general Partnerships, the unlimited liability of the partners is an increasing cause of concern in light of general increase in the incidence of litigation for professional negligence; and the size of claims and the risk to a partner's personal assets when a claim exceeds the sum of the assets of the partnership. The unlimited liability of the partners has been the chief reason why partnership firms have not grown in size to meet the challenges posed by international competition.

The adverse consequences faced by such firms on account of unlimited liability are:

1. They are not able to increase in size to expand
2. They are unable to compete with international firms in the lucrative consultancy/ advisory and non-statutory work markets.
3. They are not financially strong enough to spend on training and top class

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professional development. 4. There has been a general increase in the incidence of litigation on professional firms on grounds of professional negligence. The size of claims and consequently risk to partner's personal assets are severely restricting the growth of firms.

5. Newly qualified or less experienced persons are hesitant to join as partners for fear of having to bear liability of multiple partners.

Observing this scenario, in the year 1997, Abid Hussain Committee recommended legislation of LLP in India. Further on, the Government of India constituted a Committee under the Chairmanship of Shri Naresh Chandra in January 2003. The Naresh Chandra committee on ?Regulation of Private Companies and Partnership? felt the need for professionals to consolidate and grow to compete with the best and the biggest in the world. The committee submitted its report in July 2003 and agreed to the suggestion of introducing the concept of 'limited liability', as per prevalent international norms, in India for partnership firms of professionals. The Committee however wanted to restrict the LLPs to professionals only and did not favour extension of LLP to trading or manufacturing firms.

CHECK YOUR PROGRESS
Explain the meaning and need of LLP.

Subsequently, Dr. J.J Irani Committee was appointed in August 2004 to examine the issue of Limited Liability Partnerships. In India, a concept paper on Limited Liability Partnership Law was brought out by the Ministry of Company Affairs in 2005. In the year 2006 the Limited Liability Partnership Bill was introduced in the Parliament.

11.5 Distinction between LLP and Partnership

The principle points of difference between a company and a partnership are as follows:

1. LLP is a separate legal entity and therefore, can be sued or it can sue others without involving the partners. A partnership firm is not distinct from the several persons who compose it.
2. The partners of a LLP would have limited liability i.e. they would not be liable beyond the money contributed by them. Whereas, partners of a firm would have unlimited liability.
3. The retirement or death of a partner would not dissolve the LLP. On the other hand, the death or retirement of a partner would dissolve the partnership firm.
4. In a partnership, the property of the firm is the property of the individuals comprising it. In a LLP, it belongs to the LLP and not to the individuals comprising it.
5. Whereas a partnership can be formed either orally or by a deed of agreement whether registered or not, LLP is formed by an incorporation document and an LLP agreement, thus, giving it a legality.
6. Whereas a registered or unregistered partnership cannot have more than 20 partners, LLP can have more than that number since no upper limit has been laid down by the Act.
7. A LLP has perpetual succession, i.e. the death or insolvency of a shareholder or all of them does not affect the life of the LLP, whereas the death or

insolvency of a partner dissolves the firm, unless otherwise provided.

8. Whereas an individual partner would not be able to conduct business transaction with the partnership firm of which he is a partner, a partner of LLP in his separate capacity as a legal person can do business with the LLP since the LLP is a separate legal entity by itself.

11.6 Distinction between LLP and Company

1. In case of LLP, the need for defining the objects to be pursued and the other matters which are necessary for furtherance of the objects as well as framing the Share Capital clause in the memorandum for incorporating a company is reduced into a simple procedure of filling of the prescribed information in the Incorporation document and statement in Form No. 2.
2. In case of LLP, a 'limited liability partnership agreement' (LLPA) is prepared which is a variant of the 'articles of association' of a company.
3. Whereas the memorandum of a company is required to name the state in which it is required to be incorporated, there is no such obligation in the case of LLP. Consequently, the detail procedure involved in changing the registered office from the state of incorporation to another state is not required to be followed in case of a LLP.
4. In the LLP Act, there is no such stipulation for meeting of partners either periodically or compulsory at the year end as stipulated for directors and shareholders' meetings in the Companies Act.
5. There is no separation between management of the company and the ownership as is observed in a company since all the partners, unlike all the directors, can take part in the day to day affairs of the LLP.
6. In case of a company no individual director can conduct the business of the company but in an LLP, each partner has the authority to do so unless expressly prohibited by the partnership terms.
7. Whereas, the Companies Act contemplates regulating the remuneration payable to directors, there are no corresponding provisions in the LLP Act for remuneration payable to designated partners.

   The same could be as per the LLP Agreement.
8. In the case of LLP, unlike in the case of companies, there are no restrictions on the borrowing powers.
9. The LLP can choose to maintain the accounts on cash basis/accrual basis whereas under the Companies Act, accrual method is compulsory.
10. Audit of a company is compulsory. Conversely, the audit of LLP is not compulsory if the capital contributed does not exceed Rs. 25 lakh or if the turnover does not exceed Rs. 40 lakhs.
11. Cost audit as contemplated in Section 148 of the Companies Act, 2013 has not been prescribed for LLPs.
12. The appointment of Company Secretaries as required under Section 203 of the Companies Act, 2013 is not provided in the LLP Act. However, the annual return of a LLP in form 11 is to be certified as 'true and correct' by a Company Secretary in practice.

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11.7 Incorporation of Limited Liability partnership

1. According to section 11 (1) of the Limited Liability Partnership Act, 2008, for a limited liability partnership to be incorporated-
   (a) two or more persons associated for carrying on a lawful business with a view to profit shall subscribe their names to an incorporation document;
   (b) the incorporation document shall be filed in such manner and with such fees, as may be prescribed with the registrar of the state in which the registered office of the limited liability partnership is to be situated; and
   (c) a statement in the prescribed form shall be filed along with the incorporation document, made by either an advocate, or a Company Secretary or a Chartered Accountant or a Cost Accountant, who is engaged in the formation of the limited liability partnership and by any one who subscribed his name to the incorporation document, that all the requirements of this Act and the rules made thereunder have been complied with, in respect of incorporation and matters precedent and incidental thereto.

2. The incorporation document shall-
   (a) be in form 2 as per rule 11.
   (b) state the name of the limited liability partnership;
   (c) state the proposed business of the limited liability partnership;
   (d) state the address of the registered office of the limited liability partnership;
   (e) state the name and address of each of the persons who are to be partners of the limited liability partnership on incorporation;
   (f) state the name and address of the persons who are to be designated partners of the limited liability partnership on incorporation;
   (g) contain such other information concerning the proposed limited liability partnership as may be prescribed.

3. If a person makes a statement under clause (c) of Sub-Section (1) which he-
   (a) knows to be false; or
   (b) does not believe to be true, shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than ten thousand rupees but which may extend to five lakh rupees.

Subject to prior compliance with the requirements of section 11(1) of the Act, section 12(1) mandates the Registrar to register the incorporation document and issue a certificate of incorporation within 14 days. The certificate of incorporation shall be conclusive evidence that the limited liability partnership is incorporated by the name specified in the incorporation document.

11.7.1 LLP Agreement

No provision has been made for directors or a board structure on the lines of Company Law. The LLP agreement determines the mutual rights and duties of the partners and their rights and duties in relation to limited liability partnership. This LLP agreement is required to be filed with the Registrar.

It has been provided under Section 23 - Save as otherwise provided by this Act, the mutual rights and duties of the partners of a limited liability partnership, and the mutual rights and duties of a limited liability partnership and its partners, shall be governed by the limited liability partnership agreement between the partners, or between the limited liability partnership and its partners.

Limited liability partnership agreement should be filed with the Registrar

within 30 days of incorporation in form 3. A person becomes a Partner by virtue of LLP agreement. This means that the LLP agreement is a must and it serves as a basic document and, to a certain extent, takes the place of MOA and AOA applicable in the case of a company registered under the Companies Act, 1956. Any change in the LLP agreement is also required to be notified to the Registrar of Companies. The importance of the said document lies in the fact that it is a public document and it is open to public inspection being on the records of the Registrar.

In the absence of agreement as to any matter, the mutual rights and duties of the partners and the mutual rights and duties of the limited liability partnership and the partners shall be determined by the provisions relating to that matter as are set out in the First Schedule.

11.8 Members & Partners

Every limited liability partnership shall have at least two partners. The following persons are disqualified from becoming partners:

1. Person of Unsound mind
2. Person who has applied to be adjudicated as insolvent and his application pending
3. Undischarged insolvent

There is no limit on the maximum no. of partners. According to Section 6(2) of the Act, the minimum no. of partners should not drop below 2 at any point of time. If the minimum no. drops and still the LLP carries on business for a period more than 6 months, the remaining partner, if he is aware of the fact that the minimum no. of members has not been achieved, he is personally liable for the obligations of the LLP during that period.

LLP Agreement must specify the amount of interest on capital to be paid on their contributions. Profits and losses must be distributed to partners in the ratio of their capital contribution.

11.8.1 A Designated Partner

Designated Partner means any partner designated as such in Section No. 7 of the Act. According to Section 7(1), every LLP must have two designated partners who are individuals. Out of the two designated partners, at least one of them must be a resident in India. Resident means a person who has stayed in India for not less than 182 days during the preceding one year. In case of an LLP in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such LLP or nominees of such bodies corporate shall act as designated partners.

Every designated partner of a LLP shall obtain a Designated Partner Identification Number (DPIN) from the Central Government and the provisions of sections 266A to 266G of the Companies Act, 1956 shall apply mutatis mutandis for the said purpose.

If an LLP contravenes the provision of Section 7(1), then the LLP and its every partner shall be punishable with a fine, which is not less than Rs. 10,000 but not more than Rs. 500,000.

11.8.2 Responsibilities of designated partners:

The designated partner is responsible for all acts to be performed under the LLP Act like filing of documents, returns, statements, those mentioned in the LLP Agreement and penalties for non-compliance.

- Registering the LLP with the Registrar
- Appointing an auditor - if one is needed
- Preparing and signing the accounts on behalf of the members
- Delivering the accounts to the Registrar
- Notifying Registrar of any membership changes, or of a change to the registered office address or name of the LLP
- Preparing, signing and delivering the annual return to the Registrar
- Acting on behalf of the LLP if it is wound up and dissolved

Hence designated members generally face more responsibilities as compared to ordinary members.

11.9 Accounts & audit of an LLP

11.9.1 Maintenance of accounts:

An LLP shall be under obligation to maintain annual accounts reflecting true and fair view of its state of affairs. A "Statement of Accounts and Solvency" in prescribed form should be filed by every LLP with the Registrar every year.

11.9.2 Applicability of audit:

Only LLPs where the contribution exceeds Rs. 25 Lakh or the LLP whose turnover exceed Rs. 40 Lakh are required to annually get their accounts audited by any Chartered Accountant in practice. The accounts of every LLP shall be audited in accordance with Rule 24 of LLP, Rules 2009.

Every LLP would be required to file annual return in Form 11 with ROC within 60 days of closer of financial year. The annual return will be available for public inspection on payment of prescribed fees to Registrar.

11.10 The incorporation & regulatory forms

There are specific guidelines given by the Limited Liability Partnership Act, 2008, towards the incorporation of an LLP. Incorporation procedure is similar to that of a Company. For a limited liability partnership to be incorporated:

- Name of LLP: The name of LLP must end with the word "Limited Liability Partnership" or "LLP". Under similar lines of regulation for a company, an LLP's name should not resemble the name of an existing LLP. In case the name contains the words Company Secretary / Cost Accountant / Chartered Accountant, etc., the same should be allowed only after obtaining approval from the Council governing institute or any other authority specified by the government. Section 16, of the LLP Act, 2008, specifies that the application for reservation of name should be made in Form No.1 to the Registrar having Jurisdiction over the registered office of the LLP. The reservation of the name is valid for 3 months within which the person incorporating the LLP must file all documents relevant for incorporation.
- Registered office of LLP need not be the same place where the business is conducted. LLP may give another address for service of documents within the jurisdiction in which registered office is situated. Form No. 12 should be submitted within 30 days for intimating the above address.

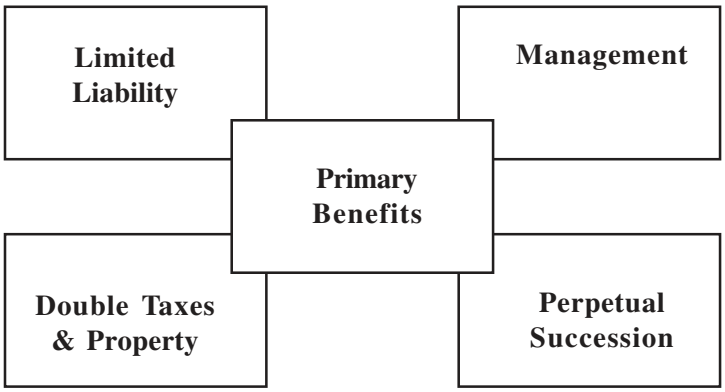
11.11 Capital Contribution

Partners in an LLP must agree to contribute in accordance to the LLP

agreement. There is no provision in the Act, regarding the minimum level of contribution by partners. In case of no agreement, the contribution should be made as agreed by partners.

Contribution can be in the form of Cash / Tangible / Intangible / Movable / Immovable assets and any other benefits like promissory notes, contracts to be executed etc. If any Immovable / Movable / Tangible / Intangible assets or any other benefit is brought as the contribution, then the same has to be valued by a Chartered Accountant or Cost Accountant in practice.

11.12 Benefits, hence the Differences



- **Liability -** LLPs have a limited liability, which means each partner is responsible only for the money he has given or promised in the agreement, and each partner is not personally liable. Whereas, in an ordinary partnership, the partners are jointly and personally liable for the debts of the firm. Hence this gives LLPs an edge over partnership as it is more secure and less financially risky.
- **Management -** LLPs have a significant advantage over companies in view of management. In companies, shareholders hold shares in a company and appoint a board of directors, who in turn make the executive decisions of the company. Whereas, LLPs avoid unnecessary steps by allowing each partner to directly run / control and own a portion of the partnership.
- **Profits, taxed twice -** Profits from corporations are subjected to "double taxation," whereby the income from the corporation is taxed, as are the profits distributed to shareholders, while partnerships are not subject to this double taxation.
- **Perpetual succession -** An LLP is a body corporate and a legal entity which has perpetual succession and is separate from its partners. The liability of its partners is limited to their agreed contribution to the LLP. Furthermore, the concept of joint and several liability is done away with and no partner is liable on account of independent or unauthorized actions of the other partners.
- **Purchase of property -** Like a company, LLPs have an advantage over ordinary partnerships, as they can purchase movable and immovable property in their own name. The firm / body corporate have ownership of assets and partners only have capital contribution.

Hence, the various attributes of the LLP structure such as lower compliance costs, flexibility in operations, better control over management and limited liability make it an attractive alternative.

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Sr. No.	Particulars	Limited Liability Partnership Act 2008	Partnership Act 1932
1	Registration	Compulsory	Optional
2	Creation	Created by law	Created by contract
3	Separate Legal Entity	It is separate legal entity, separate from its partners\ designated partners.	It is not separate legal entity from partners. Partners are collectively referred as firm.
4	Perpetual succession	Yes.	No.
5	Purchase of Property	LLP can purchase property in its name	Cannot purchase property in its name
6	Common Seal	It denotes the signature of the Company and LLP may have its own common seal, if it besides to have one.	Not required
7	Formalities of Incorporation	Various documents / declarations executed in prescribed formats pre-filled in designated e-forms are required to be filed with ROC along with filing fee.	Partnership deed along with form/ affidavit required to be filed with Registrar of firms along with requisite filing fees.
8	Expenses for formation	Minimum Statutory fee for incorporation of LLP is Rs. 1500/- and Maximum fee for incorporation of LLP is Rs. 7000/- (approx.)	Minimum Statutory Fee does not exceed to Rs. 500/- and Maximum Statutory Fee is Rs. 5000/-
9	Legal Proceeding	LLP can also sue and be sued	Only registered partnership can sue.
10	Name	Suffix 'LLP' or Limited Liability Partnership has to be added to the name.	No such requirement.
11	Change of name	The name of the LLP can be changed with the prior approval of Central Govt.	The name of the Partnership firm can be changed
12	Liability	Liability of partners is limited upto their capital contribution	Liability of partners is unlimited
13	Agency Relationship	Partners are agents of LLP	Partners are agents of the firm and each other
14	Contracts / Business transaction by Member / Directors / Partners	A partner can enter into contract with the LLP	A partner can not enter into contract with the firm
15	Power of Member \ Partner\ Director	The power of partners / designated partners to conduct the day to day affairs is specified by LLP agreement / LLP act.	All the partners have say in the day to day management of the firm or as specified in the partnership deed if there is any

16	Dissolution by an act of partners / members / directors	Continuance of LLP is not affected by the acts of its Partners.	Partnership contract can be put to an end by anyone of the members \ on happening of event specified in Act
17	Jurisdiction of Company Law Board	CLB has jurisdiction over the affairs of the LLP	CLB has no jurisdiction
18	Compromise\arrangements \ merger \ amalgamation	Provisions exist for Compromise\arrangements \ merger \ amalgamation for LLP in the act.	There is no provision for Compromise \ arrangements \ merger \ amalgamation in the Partnership firm.
19	Books of Accounts	Needs to be maintained.	Not applicable
20	Filing of Annual Accounts	Statement of accounts and solvency are required to be filed with ROC annually in the prescribed format.	Not applicable
21	Audit of Accounts	As per the provisions of LLP act, accounts to be audited annually except for LLP's having turnover less than Rs. 40 lacs or Rs. 25 lacs contribution in any financial year.	The Audit of accounts is as per the provisions of income tax act.
22	Mode of Service documents	Documents to be served on LLP / designated partners may be served through electronic means	Service of documents can not be served through electronic means
23	Annual Return	Must be filed annually	Not applicable
24	Director Identification Number / Designated Partner Identification Number	Each Designated partner required to have a DPIN before being appointed as a Designated Partner of LLP.	No such requirement
25	Minimum Number of Member	Minimum two partners	Minimum two partner
26	Maximum number of Member	No cap of maximum number of its partners	Maximum 10 for banking business and 20 for other business.
27	Designated partner	Minimum two designated partner	No cap on the minimum number of Managing partner
28	Memorandum and Articles of Association \ Partnership deed/ Partnership Agreement	LLP Agreement is a charter of the LLP which denotes its scope of operation.	Partnership Deed is a charter of the firm which denotes its scope of operation.
29	Meetings	Meeting of the Designated Partners have to be held at specific time period as per the Provisions of LLP Act.	No such requirement

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30	Publication of name	The full name of the company and address of the registered office and a statement that it is registered with limited liability.	Not applicable
31	Minutes	Decisions taken in meetings must be recorded as minutes with in 30 days	Not applicable
32	Voting Rights	Each partner has only one vote	Not applicable
33	Admission as partner/ member	A person can be admitted as a partner with the consent of all the partners.	A person can be admitted as a partner with the consent of all the partners.

11.13 Users of LLP

CHECK YOUR PROGRESS
Explain the provisions related to accounts and audit of an LLP.

India has witnessed considerable growth in services sector and the quality of our professionals is acknowledged internationally. It is necessary that entrepreneurship knowledge and risk capital combine to provide a further impetus to our impressive economic growth. Equally the services sector promises an economic opportunity similar to that provided by information technology over the past few years. It is likely that in the years to come Indian professionals would be providing accountancy, legal and various other professional/technical services to a large number of entities across the globe. Such services would require multidisciplinary combinations that would offer a menu of solutions to international clients. In view of all this, the LLP framework could be used for many enterprises, such as:-

- Persons providing services of any kind
- Enterprises in new knowledge and technology based fields where the corporate form is not suited.
- For professionals such as Chartered Accountants (CAs), Cost and Works Accountants (CWAs), Company Secretaries (CSs) and Advocates, etc.
- Venture capital funds where risk capital combines with knowledge and expertise
- Professionals and enterprises engaged in any scientific, technical or artistic discipline, for any activity relating to research production, design and provision of services.
- Small Sector Enterprises (including Micro, Small and Medium Enterprises)
- Producer Companies in Handloom, Handicrafts sector

11.14 Position of LLP's Under the Income Tax Act 1961

The follow is the current position of LLPs under the Income Tax Act, 1961. This position has not been cleared by the Income Tax department as of date.

- LLPs will be treated as Partnership Firms for the purpose of Income Tax w.e.f assessment year 2010-11.
- No surcharge will be levied on income tax.

- Profit will be taxed in the hands of the LLP and not in the hands of the partners.
- Minimum Alternate Tax and Dividend Distribution Tax will not be applicable for LLP.
- Remuneration to partners will be taxed as "Income from Business & Profession".
- No capital gain on conversion of partnership firms into LLP.
- Designated Partners will be liable to sign and file the Income Tax return.
- LLP shall not be eligible for presumptive taxation.
- Capital Gain on conversion of Company into LLP will be exempt from tax, if prescribed conditions are complied with.
- On conversion, the successor LLP will be allowed to carry forward and set off of accumulated loss and unabsorbed depreciation allowance.

11.15 Why a New Legislation for LLP

Why not amendments in Companies Act or Partnership Act are made?

The Companies Act is not suited to the liability and governance structure intended for LLPs. The overall intent of the legislation to regulate widely-held companies is different. Therefore, in accordance with the recommendations of the Irani Committee, it is felt appropriate to bring about a separate legislation for LLPs. The administration and enforcement of partnership firms under the Indian Partnership Act, 1932 is at the State level. Besides, a partnership firm involves full joint and several liability of the partners. Because of this, many firms/enterprises engaged in biotech, information technology, Intellectual property and other knowledge based sectors find traditional partnerships unsuitable. The traditional partnerships are also considered unsuitable for multi-disciplinary combinations comprising a large number of partners, seeking a flexible working environment but with limited liability. LLP structure would promote growth and enable such firms/enterprises expand their trade/business or services across States in India as also abroad.

11.16Key Concepts

Limited Liability Partnership (LLP) is a body corporate, with a distinct legal entity. It has perpetual succession and a common seal.

11.16 Summary

- A Limited Liability Partnership (LLP) is a body corporate, with a distinct legal entity separate from that of its partners. It has perpetual succession and a common seal.
- The Limited Liability Partnership (LLP) is viewed as an alternative corporate business vehicle that provides the benefits of limited liability but allows its members the flexibility of organizing their internal structure as a partnership based on a mutually arrived agreement.
- LLP is different from A Company as well as partnership firm.
- There is no limit on the maximum no. of partners in an LLP.
- Only LLPs where the contribution exceeds Rs. 25 Lakh or the LLP whose turnover exceed Rs. 40 Lakh are required to annually get their accounts audited by any Chartered Accountant in practice.
- Partners in an LLP must agree to contribute in accordance to the LLP

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agreement. There is no provision in the Act, regarding the minimum level of contribution by partners. In case of no agreement, the contribution should be made as agreed by partners.

11.17 Questions and Exercises

1. Explain the need for a new legislation on LLP.
2. Describe some differences between LLP Act, 2008 & Partnership Act, 1932.
3. What are the salient features of LLP?
4. Write a short note on LLP Agreement.

- **Fill in the blanks**

1. Unlike the partnership firm, the partners of a LLP would have _____ i.e. they would not be liable beyond the money contributed by them.
   (larger liability, limited liability, unlimited liability, smaller liability)
2. In case of LLP, a 'limited liability partnership agreement' (LLPA) is prepared which is a variant of the '_____ of a company.
   (memorandum of association, prospectus, certificate of incorporation, articles of association)
3. The audit of LLP is not compulsory if the capital contributed does not exceed Rs. _____ or if the turnover does not exceed Rs. _____.
   (25 lakhs- 40 lakhs, 40 lakhs- 25 lakhs, 10 lakhs- 40 lakhs, 15 lakhs- 30 lakhs)
4. For a LLLP to be incorporated ____or more persons associated for carrying on a lawful business with a view to profit shall subscribe their names to an incorporation document.
   (three, two, five, ten)
5. If a person makes a statement which is to be filed with incorporation document and which he knows to be false shall be punishable with imprisonment for a term which may extend to two years and with fine which shall not be less than _____ rupees but which may extend to _____ rupees.
   (5000-2 lakhs, 5000-3 lakhs, 10000-2 lakhs, 10000- 5 lakhs)
6. The _____ determines the mutual rights and duties of the partners and their rights and duties in relation to limited liability partnership.
   (LLP agreement, partnership agreement, contract agreement, agency agreement)
7. Limited liability partnership agreement should be filed with the Registrar within ____ of incorporation in form 3.
   (60 days, 25 days, 90 days, 30 days)
8. The maximum number of partners in LLP are_____.
   (fifty, hundred, unlimited, five hundred)
9. A "Statement of Accounts and Solvency" in prescribed form should be filed by every LLP with the Registrar every year.
   (statement of accounts, statement of accounts and insolvency, liability statement, audit statement)
10. _____ should be submitted within 30 days for intimating the registered office address of LLP.
    (Form No. 2, Form No. 12, Form No.22, Form No. 5)

Answer: 1)limited liability, 2)articles of association, 3)25 lakhs- 40 lakhs, 4) two, 5)10000- 5 lakhs, 6)LLP Agreement, 7) 30 days, 8) unlimited, 9) Statement of Accounts and Solvency, 10) Form no. 12

11.18 Further Reading and References

Taxmann's Circulars & Clarifications on Company Law; Taxmann, 59/32, New Rohtak Road, New Delhi-110 005.

R. Suryanarayanan Company Law Ready Reckoner; Commercial Law Publishers, 151, Rajinder Market, Opp. Tis Hazari Court, Delhi-110054.

UNIT - 12
E-GOVERNANCE AND XBRL

NOTES

12.0 Introduction
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12.2 Organisation of ROC offices under MCA-21
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12.0 Introduction

MCA-21 stands for e-governance initiative of Ministry of Corporate Affairs (MCA) of the 21st Century. The project is named MCA-21 as it aims at repositioning MCA as an organization capable of fulfilling the aspirations of its stakeholders in the 21st Century. It is based on the Government's vision of National e-governance in the country. E-governance or Electronic Governance is the application of Information Technology to the Government functioning in order to bring about Simple, Moral, Accountable, Responsive and Transparent (SMART) Governance. This project of MCA aims at moving from paper based to nearly paperless environment.

The scope of MCA-21 project covers only the offices of ROCs, Regional Directors, and the Headquarters at New Delhi at present. It does not include other offices of MCA like Official Liquidators, Company Law

Board/Tribunal and Courts. An e-form is only a re-engineered conventional form notified and represents a document in electronic format for filing with MCA authorities through the Internet. This may be either a form filed for compliance or information purpose or an application seeking approval from the MCA.

12.1 Objectives

The era of technology have significantly impacted the world at large. The technological advancement leads to the revolutionary changes in every part of life. The functions under the gamut of companies have also impacted. The advancement in the technology is not static; it is developing day by day.

The concept of physical filing has given way to electronic filing. Now, the

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filing of forms with the Registrar of Companies is done in electronic manner with the help of internet and computer through MCA portal.

In Company Law, the e-filing was the outcome of this technology. It helps the companies to submit the returns, forms and other information in electronic mode. The data captured by electronic mode being easier to use and it helps the regulators to take steps immediately.

But, the information received through e-filing is not very useful to the regulator and investors due to its uneasiness to read. The development of XBRL is the milestone in the usability of the information. The XBRL is the language which can be used to use the information readable. After reading this lesson you will be able to understand the e governance, e-filing of forms and XBRL.

12.2 Organisation of ROC offices under MCA-21

The major components involved in this comprehensive e-governance project are front office and back office.

Front Office

The Front Office represents the interface of the corporate and public user with the MCA21 system. This comprises of Virtual Front Office and Physical Front Office.

(i) Virtual front office

Virtual front office is one of the various channels available to stakeholders (companies and the professionals) to enable them to do the statutory filing with ROC Offices across the country. Virtual Front Office facilitates online filing of the e-Forms using Internet. It merely represents a computer facility for filing of digitally signed e Forms by accessing the My MCA portal through Internet. It also pre-supposes availability of related facilities to convert documents into PDF format and scanning of documents wherever required. When a company or user does not have these computer facilities, it can avail of these facilities at the designated facilitation centers, known as the Physical Front Offices.

(ii) Physical Front Office (PFO)/ Registrar's Front Office (RFO)

To facilitate the change over from Physical Document Filing to Digital Document Filing, the Ministry of Corporate Affairs had established 53 Physical Front Offices known as facilitation centers for a initial period of three years. As on date only 4 facilitation centers are operational in the four metro cities i.e. Delhi, Mumbai, Kolkata and Chennai. PFOs have all facilities which will be required for online filing of e-forms including trained manpower, broadband connectivity, scanner, printer and related computer accessories. All the services for scanning and uploading of e Forms are available free of cost at these Physical Front Offices.

Back Office

Back Office represents the offices of Registrar of Companies, Regional Directors and Headquarters' and takes care of internal processing of the forms filed by the corporate user as per MCA norms and guidelines.

The e-forms are routed dynamically to the concerned authority for processing depending upon the assigned role. All the e-forms along with attachments are stored in the electronic depository, which the staff of MCA can view depending upon the access rights.

Let us understand certain terms

E-form

An e-form is the electronic equivalent of the paper form. The Ministry of Corporate Affairs has recently launched a major e-governance initiative MCA 21. In the new system, it is envisaged that all company related documents would be filed electronically. The new e-forms have been devised and notified by the Ministry for this purpose.

Digital Signature Certificates (DSC)

Digital Signature Certificates (DSC) are the digital equivalent (that is electronic format) of physical or paper certificates. Examples of physical certificates are drivers' licenses, passports or membership cards. Certificates serve as proof of identity of an individual for a certain purpose; for example, a driver's license identifies someone who can legally drive in a particular country. Likewise, a digital certificate can be presented electronically to prove your identity, to access information or services on the Internet or to sign certain documents digitally. Physical documents are signed manually, similarly, electronic documents, for example e-forms are required to be signed digitally using a Digital Signature Certificate.

CHECK YOUR PROGRESS

Explain what do you understand by Digital Signature Certificates?

The different types of Digital Signature Certificates are:

Class 2: Here, the identity of a person is verified against a trusted, pre-verified database.

Class 3: This is the highest level where the person needs to present himself or herself in front of a Registration Authority (RA) and prove his/ her identity.

Pre-scrutiny of forms

Once you have filled up the e-Form and done "Check Form", you are required to click the "Pre- Scrutiny" button on the e-Form. Please ensure that when you click this button, your computer is connected to the internet. In case the MCA system finds some inconsistency in data, it will throw an error and advise the user to do the necessary rectifications. In case you have filled up the e-Form correctly, the system will "lock" the e-Form. If you need to modify any data after the successful pre-scrutiny, click on the "Modify" button. This will "Unlock" the e-Form and remove the Digital signature (if already made) after which you can carry out the required modifications. Once the modifications are over you are required to do the Pre-Scrutiny again.

Stamp Duty payable on Filing of e-form INC-2/7 (including MOA & AOA),), SH-7 and FC-1 can be paid through MCA21 system. when user selects option to pay stamp duty through MCA21 system, the system itself prefills relevant details in the e-form. In case user opts to pay stamp duty in With effect from 1st April, 2010, stamp duty shall have to be paid only through electronic mode for the states which have agreed for e-stamping. . There are two modes, stamp duty can be paid through MCA21 system either off-line or on-line.

Corporate Identity Number (CIN) based Search of Companies

Every company has been allocated a Corporate Identity Number (CIN). CIN can be found from the MCA 21 portal through search based on:

- ROC Registration No.
- Existing Company Name
- Old Name of Company (in case of change of name, user is required to enter old name and the system displays corresponding current name).
- Inactive CIN [In case of change of CIN, the user is required to enter

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previous (inactive) CIN Number].

Foreign Company Registration Number (FCRN)

Every foreign company has been allocated a Foreign Company Registration Number (FCRN).

Corporate Identity Number (CIN), works as a unique identifier of an Indian company. Foreign Company

Registration Number (FCRN) is a unique identifier in the case of a Foreign Company.

12.3 Digital Signature Certificate

The e-forms are required to be authenticated by the authorized signatories using digital signatures as defined under the Information Technology Act, 2000. A digital signature is the electronic signature duly issued by a certifying authority that shows the authority of the person signing the same. It is an electronic analogue of a written signature. Every user who is required to sign an e-form for submission with MCA is required to obtain a Digital Signature Certificate. Under the MCA-21 system the following four types of users are identified as users of Digital Signatures and are required to obtain digital signature certificate:

1. MCA (Government) Employees.
2. Professionals (Company Secretaries, Chartered Accountants, Cost Accountants and Lawyers) who interact with MCA and companies in the context of Companies Act.
3. Authorized signatories of the Company including Managing Director, Directors, Manager or Secretary.
4. Representatives of Banks and Financial Institutions.

A person requiring a Digital Signature Certificate can approach any of the Certifying authorities identified by the MCA for issuance of Digital Signature Certificate.

12.4 Other features of e-filing of documents under the MCA-21 system

Certified Filing Centre (CFC)

CFC is an extended arm of the Ministry which is manned by professionals from three core areas i.e., Company Secretaries, Chartered Accountants and Cost Accountants. It is one of the various channels available to the stakeholders to enable them to do the statutory filing with ROC Offices across the country. These are managed and operated by professionals on user charge basis.

In order to provide the Companies to do their eFiling, Professional Institutes (ICSI, ICAI, ICAI- cost), their Regional Councils/ Local chapters, individual practising members and firms of professionals were authorised to create and set-up the required facilities for facilitating the eFiling process. The Certified Filing Centres, thus set-up by the Professionals are over and above the 53 Registrar's Front Office set-up by the Ministry under the programme. While the services available from the Facilitation Centres set-up by the Ministry are without any charge, the services provided by these Certified Filing Centres entail payment of service charges.

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Infrastructure for e-filing

The Minimum system requirements for e-filing are:

- P-4 computer with printer;
- Windows 2000/Windows XP/Windows Vista/Windows 7;
- Internet Explorer 6.0 version and above;
- Above Acrobat Reader 9.4 and lower versions;
- Scanner; and
- Java Runtime Environment (JRE) 1.6 updated version 30.

Mode of payment of statutory fee under Companies Act

MCA-21 system provides for the facility of payment of statutory fees through multiple modes i.e. (i) Off-line payment through a challan generated by the system and payment of fees at the counter of the notified bank branches through DDs/Cash; (ii) on-line payments through Internet Banking and Credit Cards [Master Card/VISA]. In case a stakeholder chooses to pay through the off-line method (i.e. over the counter in a bank branch), it takes about two to three days time for the bank to intimate the realisation of payment to the MCA- 21 system and the transaction gets passed on to the back office for processing only after payment is recognised by the banking system. On the other hand, the on-line payment through Internet banking/ Credit Card is instants. The transaction gets passed on the same day.

However, the Ministry of Corporate Affairs vide its Circular dated 9th March, 2011 has decided to accept payments of value upto `50,000, for MCA 21 services, only in electronic mode w.e.f. 27th March, 2011. For the payments of value above `50,000, stakeholders have the option to either make the payment in electronic mode, or paper challan. However such payments can also be made in electronic mode w.e.f. 1st October, 2011. This has improved the service delivery time and lead to speedier disposal of an application/e-form leading to convenience of stakeholders.

Service Request Number (SRN)

Each transaction under e-filing is uniquely identified by a Service Request Number (SRN). On filing of an e-form, the system will generate and provide a Service Request Number (SRN). A user can check the status of the document/ transaction, by entering the SRN.

Payment of Stamp Duty

Stamp duty is a state subject. It is payable on Memorandum and Articles of Association of every Company. In some states, duty is also payable on the authorized capital mentioned in the Memorandum of Association of the Company. Some states have authorized MCA to collect the stamp duty on their behalf and to remit the same to them.

Physical submission of certain documents

In view of practical constraints, certain documents requiring stamp paper or Stamp fees like stamped memorandum of association, declaration on stamp paper, original certified copy of the Company Law Board/Court order are required to be sent by the Companies in the physical form to the ROCs. The user will be providing SRN while sending these forms/documents to MCA. This would ensure the authenticity and reliability of such key documents and enable the MCA authorities to further act upon the same.

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Annual filing

As a part of annual filing, companies incorporated under the Companies Act, 1956 are required to file the following documents along with the e-forms with the Registrar of Companies:

Document	E-form
Balance Sheet	Form 23AC to be filed by companies not covered under XBRL filing. Form 23AC-XBRL to be filed by companies for filing balance Sheet and other documents in XBRL mode.
Profit and Loss Account	Form 23ACA to be filed by companies not covered under XBRL filing. Form 23ACA-XBRL to be filed by companies for filing Profit & Loss account and other documents in XBRL mode.
Annual Return	Form 20B to be filed by companies having share capital.
Annual Return	Form 21A to be filed by companies without share capital.
Compliance Certificate	Form 66 to be filed by companies with paid up capital between 10 lacs to 5 crores.

CHECK YOUR PROGRESS

What documents have to be filed by the companies as part of their annual returns?

12.5 Pre-certification of E-forms

Apart from authentication of e-forms by authorized signatories using digital signatures, some e-forms are also required to be pre-certified by practising professionals. Pre-certification means certification of correctness of any document by a professional before the same is filed with the Registrar.

This pre-certification is to be carried out by inter-alia, Company Secretaries, Chartered Accountants, Cost Accountants, in whole-time practice.

12.6 Terms used while e-filing the forms

Pre-fill

Pre-fill is functionality in an e-Form that is used for filling automatically, the requisite data from the system without repeatedly entering the same. For example, by entering the CIN of the company, the name and registered office address of the company shall automatically be pre-filled by the system without any fresh entry.

Attachment

An attachment refers to a document that is sent as an enclosure with an e-Form by means of an attached file. The objective of the attachment is to provide details relevant to the e-Form for processing. While some attachments are optional some are mandatory in nature.

The attachments to an e-Form will be only in Adobe PDF format. MCA portal shall not accept attachment file of more than 2.5MB and the user is advised to keep the attachment size to minimum.

Check Form

By clicking "Check Form", the user will be in a position to find out whether the mandatory fields in an e-Form are duly filled-in. For example, if the user enters alphabets in "Date of Appointment of Director" field, he/she will be asked to correct the entered information.

If the size of attachment is much bigger then the details may be submitted in a floppy or compact disc at the ROC office. For example, In the case of Annual Return filed by the companies having large shareholders base, the list of shareholders may be submitted separately in a CD at the concerned ROC office indicating SRN No. of e-form filed.

Modify

Once the user has done 'Check Form', the form gets locked and it cannot be edited. If the user wishes to make any alterations, the form can be overwritten by clicking "Modify" button.

Pre-Scrutiny

Pre-scrutiny is a functionality that is used for checking whether certain core aspects are properly filled in the e-Form. The user has to login on MCA portal to perform the pre-scrutiny of e-from. The necessary attachments and digital signatures should be affixed before submitting the e-Form for pre-scrutiny. The difference between check form and pre-scrutiny is that the Check form is done by internal features of the form which ensure that all the mandatory and required field are filled up and attachment are made to the e-form, while Pre-Scrutiny is a complete legal and technical scrutiny of an e-form done by the MCA portal before accepting the form.

Addendum to e-Form

The user may have to submit some additional supporting documents that are not submitted during the e- Form (application) filing but are required for the processing of the e-Form. MCA may also ask the applicant to provide some additional documents in support of the e-Form already filed so as to expedite the processing of the same.

The user can initiate this on their own by checking the track transaction status on My MCA portal or on being notified by MCA through email. Payment of fees is not required for filing an addendum.

The supporting documents that the applicant uploads, as an addendum, gets duly associated with the e-Form that was submitted earlier with the given SRN.

Online Inspection of Documents

The documents filed online, once taken on record by ROC Offices shall be available for public viewing on payment of requisite fees. These documents, which shall be in the domain of public documents, include documents relating to incorporation, charges, annual returns and balance sheets and change in directors. A certified copy of the documents can also be obtained by anyone so interested.

12.7 E-Stamp

Registrars of Companies have to ensure that proper stamp duty is paid on the instruments registered with their office. Accordingly, physical submission of documents is necessary to ascertain that applicable stamp duty has been paid. In the MCA-21 system, even though the e-Form is submitted instantly, the RoC office has to wait for receipt of physical stamp papers to initiate necessary processing. It

results in service delivery time getting longer. Hence, in furtherance of e-governance initiatives, provisions regarding stamp duty applicable on filing of e-forms have been amended and stakeholders shall have facility to pay stamp duty in electronic manner also. It provides that if the stamp duty on documents which are required to be filed on non-judicial stamp paper is paid electronically through Ministry of Corporate Affairs portal www.mca.gov.in, in such case, the company shall not be required to make physical submission of such documents, in addition to their submission in the electronic form.

Keeping in view the requirement of stakeholders' awareness, process of e-stamp has not been mad mandatory, meaning thereby, stakeholders have option to pay stamp duty in electronic manner through MCA21 system or in physical form as per the existing procedure. Further this process shall be applicable only to such States/Union Territories which have agreed to the request of Ministry of Corporate Affairs for collection of e-stamp duty on their behalf.

12.8 Key benefits of MCA 21 Project

MCA 21 seeks to fulfill the requirements of the various stakeholders including the Corporates, Professionals, Public Financial Institutions and Banks, Government and the MCA employees. The key benefits of MCA 21 project are as follows:

1. On-line incorporation of companies.
2. Simplified and easy mode of filing of Forms/Returns.
3. Registration as well as verification of charges anytime and from anywhere.
4. Inspection of public documents of companies anytime from anywhere.
5. Corporate-centric approach.
6. Building up a centralized database repository of corporates operating in India.
7. Enhanced service level fulfillment and customer relationship building.
8. Total transparency through e-Governance.
9. Timely redressal of investor grievances.
10. Availability of more time for MCA employees for qualitative analysis of corporate information

Substantial Benefits of MCA21 System

Elimination of interface with the offices of ROCs, RDs and the MCA

MCA-21 has been designed virtually to eliminate the physical interface between the companies and the offices of ROCs, RDs and even MCA. It has not only saved time and energy of the company representatives but also enabled them to focus on other creative tasks. Highly time consuming works of Chartered Accountants, Company

Secretaries and Cost Accountants in practice i.e. the tasks of incorporation of new companies, conducting searches of important documents, obtaining certificates of creation, modification and satisfaction of charges, filing of statutory forms and returns etc. have now become very quick and easy.

The problem of becoming defaulter by the company for non-filing of Annual returns due to long queues at ROC offices is now eliminated with e-filing. Conducting search was very painful in physical maintenance of statutory records. E-filing is panacea to all these problems.

Effective use of database

With the help of database collected, the vital information has been collected, segregated in such a way that it can be used by various stakeholders for various

purposes. It will help in transparency in operations and benefits to players in stock markets as well as easy and prominent exposure of defaulters.

The following websites are created:

Website for Investor Education and Protection Fund: http://iepf.gov.in

Ministry of Corporate Affairs has set up the Investor Education and Protection Fund (IEPF) with the dedicated purpose of empowering investors through education and awareness building. It has been established under Section 205C of the Companies Act, 1956 and now under Section 125 of the Companies Act 2013 for promotion of investors awareness and protection of the interests of investors.

There was no unified website providing information on all financial instruments. Moreover, almost all individual websites that exist provide information from their own respective perspectives and not what and how the small investors want it. This website would fulfill the need for an information resource for small investors on all aspects of the financial markets and would attempt to do it in the small investors language.

It would provide information about IEPF and the various activities that have been undertaken/funded by it. It would also provide information relevant for investors, including about various instruments for investment, regulatory system and grievance redressal mechanism.

CHECK YOUR PROGRESS

What are the Key benefits of MCA 21 Project?

www.watchoutinvestors.com:

Over the years, thousands of unscrupulous entities have defrauded the investors. Investors have lost confidence in the market consequent to a series of mishaps. In many cases, though penal regulatory action has been taken against such entities, the information about such actions lies scattered and is in a difficult-to-access, difficult-touse format. Absence of any organized database prevents regulators and investors from taking any pre-emptive action www.watchoutinvestors.com alerts various entities and about persons with information that one should be aware of before investing. It is sponsored and aided by Investor education and protection fund and Securities and exchange board of India.

www.watchoutinvestors.com is a national web-based registry covering entities including companies and

Lesson 16 E-filing 545 intermediaries and, wherever available the persons associated with such entities, who have been indicted for an economic default and/or for non-compliance of laws/guidelines and/or who are no longer in the specified activity.

www.directorsdatabase.com

It is important that investors, analysts, regulators and the market know not only about the directors who are at the helm of affairs of a company but more so about the independent directors who are supposed to bring better corporate governance and protect the interests of the minority shareholders.

www.directorsdatabase.com is Corporate Governance initiative of Bombay Stock Exchange Limited and is conceptualized, designed and maintained by Prime Database.

This website is the worlds first website providing not only a single point access to information on the board of directors of listed companies, but also a profile with age, qualification, experience and other directorships of each director. It also provides information about the independent directors on the board of a specific company.

The information on the website is based on BSE listed companies who have filed information.

Better supervision and monitoring of compliance

MCA-21 has ensured better supervision and control of the MCA over Companies with regard to compliance with the provisions of the Companies Act. Thus, enforcement of law has become easier and will ultimately benefit the investors, the stake holders and the concerned Regulatory bodies. With specific details of companies and their directors available in the electronic form, it ensures proactive & effective compliance of relevant law(s) and also in turn fosters corporate governance.

Mutually beneficial system

The focus of the MCA-21 program is on bringing about a fine balance between trade facilitation on one hand and enforcement requirements on the other.

Speed, transparency and efficiency

MCA-21 project aims to bring speed, transparency and efficiency in the delivery of the services rendered by the MCA to all the stakeholders through a set of pre-defined service levels.

Effective due diligence

Banks and Financial Institutions can conduct a through scrutiny of the documents filed by the company before advancing loan(s) and other financial assistance to such a company

Efficient services by professionals

Professionals will be able to offer efficient services to their client companies.

Environment Friendly

MCA-21 will also prove to be environment friendly since paper work involved in filing of forms and documents would be totally eliminated. One can imagine the quantum of paper required by lakhs of companies for filing almost all forms with their attachments on an annual basis. Elimination of paper work will ensure cutting of lesser number of trees. Hence the ecological balance will be sustained.

12.9 General structure of an e-form and e-filing process

An e-Form contains certain standardized features. Each e-Form contains the form reference and the description as well as the particular section of the Companies Act or the relevant rules or regulations under which it is required to be submitted. It starts with the Corporate Identity Number (CIN), which works as a unique identifier of an Indian Company and the Foreign Company Registration Number in the case of a Foreign Company that is required to be filled up. By entering the CIN, the company details to the extent these are available in static form in the database, are automatically filled in by using the pre-fill functionality.

Features of e-form and e-filing process has been given as below:

- The e-Form contains a number of mandatory fields which are required to be filled-in. Certain other fields are non-mandatory in nature which may be filled-in as may be relevant in any particular case.
- An instruction kit is available for each e-Form, which contains details of the instructions for properly filling the e-Form.
- An e-Form may be filled in either online or offline. Online filling implies that

the e-Form is filled while being still connected to My MCA portal through the Internet. Offline filling denotes that the e-Form is downloaded into the user's computer and filled later without being connected to the Internet.

- An e-Form may require certain mandatory attachments to be filed along with it. Optional attachments may also be filed with an e-Form. The list of such attachments is displayed in the e- Form.
- Next to attachment, there is a declaration that is sought from the person filing the e-Form to the effect that the information given in the e-Form and the attachments is correct and complete.
- Most of the e-Forms require the digital signature of the Managing Director or Director, Manager or Secretary of the company for successful filing/ submission.
- Further, the digital signature of a third party may also be required in certain cases. In the case of an e-Form for creation or modification of charges, such digital signature is also required from the Bank or Financial Institution.
- In certain cases, certification from the Chartered Accountant or Cost Accountant or Company Secretary in whole-time practice is also required to authenticate the particulars contained in the e- Form. For example, this requirement is mandatory in the case of an e-Form for creation or modification of charges.
- There are built-in facilities to check the filled-in e-Form for requisite validations, to do pre-scrutiny and to modify the e-Form when the same is required to be re-submitted.
- When the "Submitted" button is pressed, the e-Form gets uploaded into the MCA central document repository.
- Thereafter, the requisite fees as applicable for the e-Form should be paid either on-line or off-line.
- Once the e-Form has been accepted and payment of fees has been acknowledged, a work item is created and assigned to the appropriate MCA employee based on pre-defined assignment rules as part of MCA back office workflow automation.
- In the case of an e-Form, the authorized officer affixes his/her digital signature for registering/approving/rejecting the same.
- After the processing of the e-Form is completed, an acknowledgement email is sent to the user regarding its approval/rejection.

12.10 XBRL

XBRL is a language for the electronic communication of business and financial data which is revolutionizing business reporting around the world. It provides major benefits in the preparation, analysis and communication of business information. It offers cost savings, greater efficiency and improved accuracy and reliability to all those involved in supplying or using financial data. It is an open standard, free of licence fees, being developed by a non-profit making international consortium. Other pages on this web site provide detailed information on XBRL, its technical features and its business opportunities.

XBRL is a data-rich dialect of XML (Extensible Markup Language), the universally preferred language for transmitting information via the Internet. It was developed specifically to communicate information between businesses and other

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users of financial information, such as analysts, investors and regulators. XBRL provides a common, electronic format for business reporting. It does not change what is being reported. It only changes how it is reported.

XBRL is a world-wide standard, developed by an international, non-profit-making consortium, XBRL

International Inc. (XII). XII is made up of many hundred members, including government agencies, accounting firms, software companies, large and small corporations, academics and business reporting experts. XII has agreed the basic specifications which define how XBRL works.

12.10.1 XBRL tags

In XBRL, information is not treated as a static block of text or set of numbers.

Instead, information is broken down into unique items of data (e.g. total liabilities = 100). These data items are then assigned mark-up tags that make them computer-readable. For example, the tag <Liabilities>100</Liabilities> enables a computer to understand that the item is liabilities, and it has a value of 100.

Computers can treat information that has been tagged using XBRL 'intelligently'; they can recognize, process, store, exchange and analyse it automatically using software.

Because XBRL tags are formed in a universally-accepted way, they can be read and processed by any computer that has XBRL software. XBRL tags are defined and organized using categorization schemes called taxonomies.

12.10.2 XBRL taxonomies

Different countries use different accounting standards. Reporting under each standard reflects differing definitions. The XBRL language uses different dictionaries, known as 'taxonomies', to define the specific tags used for each standard. Different dictionaries may be defined for different purposes and types of reporting. Taxonomies are the computer-readable 'dictionaries' of XBRL. Taxonomies provide definitions for XBRL tags, they provide information about the tags, and they organize the tags so that they have a meaningful structure.

As a result, taxonomies enable computers with XBRL software to:

- understand what the tag is (e.g. whether it is a monetary item, a percentage or text);
- what characteristics the tag has (e.g. if it has a negative value);
- its relationship to other items (e.g. if it is part of a calculation).

This additional information is called meta-data. When information that has been tagged with XBRL is transmitted, the meta-data contained within the tags is also transmitted.

Taxonomies differ according to reporting purposes, the type of information being reported and reporting presentation requirements. Consequently, a company may use one taxonomy when reporting to a stock exchange, but use a different taxonomy when reporting to a securities regulator. Taxonomies are available for most of the major national accounting standards around the world.

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XBRL Filing-

The Ministry of Corporate Affairs has mandated the following select class of companies mentioned below to file financial statements in XBRL (eXtensible Business Reporting Language) mode and by using the XBRL taxonomy:

(i) all companies listed with any Stock Exchange(s) in India and their Indian subsidiaries; or

(ii) all companies having paid-up capital of Rupees five crore and above; or

(iii) all companies having turnover of Rupees one hundred crore and above; or

(iv) all companies who were required to file their financial statements for FY 2010-11, using XBRL mode.

However, banking companies, insurance companies, power companies and Non-Banking Financial Companies (NBFCs) are exempted from XBRL filing till further orders.

Creation of Instance Document

The taxonomy as applicable for the relevant financial year is to be used

1. Download XBRL validation tool from MCA Portal
2. Load the instance document in the validation tool
3. Validate the instance document
4. Pre-scrutiny of the instance document
5. Convert to pdf and verify the contents of the instance document. (This step is essential to ensure that the disclosures contained in XBRL document are as per Audited Financial Statement adopted in the AGM and the textual information entered in the instance document is clearly viewable)
6. Attach instance document to the Form 23AC-XBRL and 23ACA-XBRL]
7. Submitting the XBRL Form on the MCA portal
8. Viewing of balance sheet and profit and loss submitted in XBRL form on MCA portal.

CHECK YOUR PROGRESS

Explain XBRL Filing Procedure.

Key benefits of XBRL filing are as under:

Relevant data has tags and selective information can be fetched for specific purposes by various government and regulatory agencies

It is in conformity with Global Reporting Standards, which helps in improved data mining and relevant information search.

12.10.3 Benefits of XBRL

XBRL offers major benefits at all stages of business reporting and analysis. The benefits are seen in automation, cost saving, faster, more reliable and more accurate handling of data, improved analysis and in better quality of information and decision-making. All types of organisations can use XBRL to save costs and improve efficiency in handling business and financial information. Because XBRL is extensible and flexible, it can be adapted to a wide variety of different requirements. All participants in the financial information supply chain can benefit, whether they are preparers, transmitters or users of business data.

XBRL enables producers and consumers of financial data to switch resources away from costly manual processes, typically involving time-consuming comparison, assembly and re-entry of data. They are able to concentrate effort on

analysis, aided by software which can validate and manipulate XBRL information.

Data Collection and Reporting

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By using XBRL, companies and other producers of financial data and business reports can automate the processes of data collection. For example, data from different company divisions with different accounting systems can be assembled quickly, cheaply and efficiently if the sources of information have been upgraded to using XBRL. Once data is gathered in XBRL, different types of reports using varying subsets of the data can be produced with minimum effort. A company finance division, for example, could quickly and reliably generate internal management reports, financial statements for publication, tax and other regulatory filings, as well as credit reports for lenders. Not only can data handling be automated, removing time-consuming, error-prone processes, but the data can be checked by software for accuracy.

Data Consumption and Analysis

Users of data which is received electronically in XBRL can automate its handling, cutting out time-consuming and costly collation and re-entry of information. Software can also immediately validate the data, highlighting errors and gaps which can immediately be addressed. It can also help in analysing, selecting, and processing the data for re-use. Human effort can switch to higher, more value-added aspects of analysis, review, reporting and decision-making. In this way, investment analysts can save effort, greatly simplify the selection and comparison of data, and deepen their company analysis. Lenders can save costs and speed up their dealings with borrowers. Regulators and government departments can assemble, validate and review data much more efficiently and usefully than they have hitherto been able to do.

12.11 Key Concepts

- **Front Office** represents the interface of the corporate and public user with the MCA21 system. This comprises of Virtual Front Office and Physical Front Office.
- **DSC :** Digital Signature Certificates

12.12 Summary

- An e-form is a re-engineered conventional form, represents a document in electronic format.
- Director Identification Number (DIN), Corporate Identity Number (CIN) and Digital Signature Certificate (DSC) are the important features under e-governance mode (MCA-21).
- MCA-21 system provides for the facility of payment of statutory fees through multiple modes i.e. (i) Off-line payment through a challan generated by the system and payment of fees at the counter of the notified bank branches through DDs/ Cash; (ii) on-line payments through Internet Banking and Credit Cards [Master Card/ VISA].
- Each transaction under e-filing is uniquely identified by a Service Request Number (SRN). On filing of an e-form, the system will generate and provide a Service Request Number (SRN). A user can check the status of the document/ transaction, by entering the SRN.

- If the stamp duty on documents which are required to be filed on non-judicial stamp paper is paid electronically through Ministry of Corporate Affairs portal www.mca.gov.in, in such case, the company shall not be required to make physical submission of such documents, in addition to their submission in the electronic form.
- The e-forms are being constantly revised. The updated e-forms are available at the website of MCA (www.mca.gov.in)

12.13 Questions and Exercises

1. Explain the terms CIN and DIN.
2. What are the substantial and key benefits of MCA-21 project?
3. Write short note on Digital Signature Certificate.
4. Briefly explain the general structure of an e-form and the e-filing process.

- **Fill in the blanks**

1. While filling the E-form, by pressing the _____button if the MCA system finds some inconsistency in data, it will throw an error and advise the user to do the necessary rectifications.
   (Pre-scrutiny, pre-fill, pre-check, autofill)
2. Corporate Identity Number (CIN), works as a unique identifier of an Indian company while _____ is a unique identifier in the case of a Foreign Company.
   (FCRN, SRN, CRN)
3. A _____ is an electronic analogue of a written signature.
   (automatic Signature, Binary signature, digital signature)
4. _____ is one of the various channels available to the stakeholders to enable them to do the statutory filing with ROC Offices across the country. These are managed and operated by professionals on user charge basis.
   (Certain Filling Centre, Certified filing centre, information Filling Centre)
5. Each transaction under e-filing is uniquely identified by a Service _____. A user can check the status of the document/ transaction, by entering it.
   (SRN, PRN, CRN)
6. For Balance sheet and Annual Return filing the e- forms required are____&_____ respectively.
   (23AC & 20B, 20AC & 23B, 23ACA & 20B)
7. For obtaining Compliance Certificate form-66 is to be filed with ROC by companies with paid up capital of Rs. _____.
   (10 lacs to 2 crores, 5 lacs to 1 crore, 10 lacs to 5 crores)
8. While filing the E-form, If the user wishes to make any alterations, the form can be overwritten by clicking "_____" button.
   (Pre-fill, Modify, pre-scrutiny)
9. XBRL tags are defined and organized using categorization schemes called _____.
   (hexanomies, betanomy,taxonomies)

10. XBRL stands for _____.

(Extensible Business Reporting Language, Extensible Business Recognition Language, Extensive Business Recognition Library)

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Answers: 1)pre-scrutiny, 2)Foregin Company Registration Number (FCRN), 3)digital signature, 4)Certified filling Centre, 5)SRN, 6)23AC & 20B, 7)10 lacs to 5 crores, 8) Modify, 9)taxonomies, 10) Extensible Business Reporting Language

12.14 Further Reading and References

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