COM 432

Corporate Finance and Law

Compulsory Course

M. Com (M 17) – Part II
Semester - IV

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

Copyright © Yashwantrao Chavan Maharashtra
Open University, Nashik.

All rights reserved. No part of this publication which is material protected by this copyright notice may be reproduced or transmitted or utilized or stored in any form or by any means now known or hereinafter invented, electronic, digital or mechanical, including photocopying, scanning, recording or by any information storage or retrieval system, without prior written permission from the Publisher.

The information contained in this book has been obtained by authors from sources believed to be reliable and are correct to the best of their knowledge. However, the publisher and its authors shall in no event be liable for any errors, omissions or damage arising out of use of this information and specially disclaim any implied warranties or merchantability or fitness for any particular use.

YASHWANTRAO CHAVAN MAHARASHTRA OPEN UNIVERSITY

Vice-Chancellor : Prof. Dr. E. Vayunandan

Director , School of Commerce & Management : Dr. Pandit Palande

State Level Advisory Committee

Dr. Pandit Palande
Director
School of Commerce & Management
Y.C.M.O.U., Nashik

Dr. Suhas Mahajan
Ex-Professor
Ness Wadia College of Commerce
Pune

Dr. V. V. Morajkar
Ex-Professor
B.Y.K. College, Nashik

Dr. Mahesh Kulkarni
Ex-Professor
B.Y.K. College, Nashik

Dr. J. F. Patil
Economist Kolhapur

Dr. Ashutosh Raravikar
Director, EDMU,
Ministry of Finance, New Delhi

Dr. A. G. Gosavi
Professor
Modern College,
Shivaji Nagar, Pune

Dr. Madhuri Sunil Deshpande
Professor
Swami Ramanand Teerth Marathwada
University, Nanded

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

Dr. S. V. Kuvalekar
Associate Professor and
Associate Dean (Training)(Finance)
National Institute of Bank Management,
Pune

Dr. Surendra Patole
Assistant Professor
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.

Copyright © Yashwantrao Chavan Maharashtra Open University, Nashik.

(First edition developed under DEC development grant)

- **First Publication :**
- **Type Setting :** Avinash R. Varpe ,Sangamner.
- **Cover Print :**
- **Printed by :**
- **Publisher :** Dr. Dinesh Bhonde, Registrar, Y.C.M.Open University, Nashik - 422 222.

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

Index

Unit No.	Unit Name	Page No.
1	INTRODUCTION TO A COMPANY	09
2	INCORPORATION OF A COMPANY	31
3	CAPITAL OF A COMPANY	50
4	PRIVATE AND PUBLIC PLACEMENT	74
5	ALLOTMENT OF SECURITIES	87
6	COMPANY ACCOUNTS AND AUDIT	103
7	REGULATORY FRAMEWORK RELATING TO SECURITIES MARKET INTERMEDIARIES	119
8	REGULATORY FRAMEWORK RELATING TO SECURITIES MARKET INTERMEDIARIES- II	137
9	CORPORATE FINANCE	156
10	SOURCES OF FINANCE	163
11	FINANCING DECISION- COST OF CAPITAL	174
12	FINANCING DECISION-CAPITAL STRUCTURE	188
13	CORPORATE TREASURY MANAGEMENT	205

SYLLABUS - CORPORATE FINANCE AND LAW-II

1) INTRODUCTION TO A COMPANY

Meaning and Definition of a Company, Nature and Characteristics of a Company, Types of Companies, Private Company, One Person company (OPC), Small Company, Public Company, Limited Company, Unlimited Company, Government Companies, Foreign Companies, Holding, Subsidiary Companies and Associate Companies, Associate Company, Investment Companies, Producer Companies, Nidhi Companies

2) INCORPORATION OF A COMPANY

Promoter, Incorporation of Companies - Procedural Aspects, Filing of Documents with Registrar of Companies, Issue of Certificate of Incorporation by Registrar, Allotment of Corporate Identity Number, Memorandum of Association, Contents of Memorandum, Name Clause, Situation Clause, Objects Clause, Doctrine of ULTRA VIRES, Liability Clause, Capital Clause, Articles of Association, Nature of Articles, Articles Subordinate to Memorandum, Registration of Articles, Statutory Requirements, Contents of Articles

3) CAPITAL OF A COMPANY

CAPITAL-Meaning, Comparison between Preference Share Capital and Equity Share Capital, Issue of Securities at a Premium, Prohibition to Issue Shares at Discount, Issue of Sweat Equity Shares, Shares with Differential Voting Rights, Further Issue of Shares, Bonus Shares, Employee Stock Option Scheme, Issue of Shares on Preferential Basis, Alteration of Share Capital, Difference between Share and Stock, Reduction of Share Capital (Section 66), Difference between Alteration of Share Capital and Reduction of Share Capital, Reduction of Share Capital without Sanction of the Court, Buy Back of Securities (Section 68)

4) PRIVATE AND PUBLIC PLACEMENT

Meaning and Definition of Prospectus, Invitation to Public, Private Placement, Public Offer, Deemed Prospectus, Shelf Prospectus, Red-Herring Prospectus, Abridged Prospectus, Liability for Untrue Statement in Prospectus

5) ALLOTMENT OF SECURITIES

Securities, General Principles Regarding Allotment of Securities, Provisions relating to allotment of securities - Companies Act 2013, Companies (Prospectus and Allotment of Securities) Rules, 2014, Issue of Certificates, Issuing duplicate share certificates to defraud Time of issue of Certificate of Securities, Significance of Share Certificate, Damages against Company and Directors for wrong certificates, Split Certificate, Purpose and Form of Share Certificate, Whether Share Certificate an Official Publication, Legal Effect of Share Certificate, Personation of Shareholder, Calls and Forfeiture, Forfeiture of Shares, Re-issue of Forfeited Shares, Surrender of shares

6) COMPANY ACCOUNTS AND AUDIT

Accounts of Companies, Requirement of Keeping Books of Account (Section 128), Financial Statements, Re-Opening of Accounts on Court's Or Tribunal's Orders, National Financial Reporting Authority (NFRA), Internal Audit, Who can be an Internal Auditor, Appointment of Auditors, Powers and Duties of an Auditor, Audit Report, Cost Audit, Meaning and Definition of Dividend, Final dividend, Interim dividend, Declaration of Dividend (Section 123), Unpaid Dividend Account (Section 124), Investor Education and Protection Fund (Section 125), Punishment for Failure to Distribute Dividends

7) REGULATORY FRAMEWORK RELATING TO SECURITIES MARKET INTERMEDIARIES

Role of Capital Market Intermediaries, Merchant Bankers, SEBI (Merchant Bankers) Regulations, 1992, Registrars and Share Transfer Agents, SEBI (Registrars to an Issue and Share Transfer Agents), Regulations, 1993, Underwriters, SEBI (Underwriters) Regulations, 1993, Bankers to an Issue, SEBI (Bankers to an Issue) Regulations, 1994, Debenture Trustees, SEBI (Debenture Trustees) Regulations, 1993, Syndicate Members

8) REGULATORY FRAMEWORK RELATING TO SECURITIES MARKET INTERMEDIARIES- II

Stock Brokers & Sub-Broker, SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992, Certification by Practising Company Secretary, Portfolio Managers, SEBI (Portfolio Managers) Regulations, 1993, Obligations of Portfolio Manager, Custodians, SEBI (Custodian of Securities) Regulations, 1996, Conditions of Certificate, Obligations of Custodian, Investment Adviser, SEBI (Investment Advisers) Regulations, 2013, General Obligations and Responsibilities

9) CORPORATE FINANCE

Corporate Finance, Concept of Corporate Financial Decisions, Nature of Financial Decisions, Types of Corporate Financial Decisions, Objectives of Corporate Financial Decisions, Factors Influencing Corporate Financial Decisions

10) SOURCES OF FINANCE

Sources of funds, Shares/ Securities, Loan stock, Retained earnings, Bank lending, Leasing, Hire purchase, Government assistance, Venture capital

11) FINANCING DECISION- COST OF CAPITAL

Cost of Capital, Classification of Cost of Capital, Importance of Cost of Capital, Factors Determining the Firm's Cost of Capital, Controllable Factors Affecting Cost of Capital, Measurement of Cost of Capital, Cost of Debt (Kd), Cost of Preference

Share Capital, Cost of Equity Capital, Weighted Average Cost of Capital, Cost of Capital and Its Implications in Budgeting Decisions

12) FINANCING DECISION-CAPITAL STRUCTURE

Meaning of Capital Structure, Significant of capital structure, Capital Structure Vis-A-Vis Financial Structure, Planning and Designing of Capital Structure, Optimal Capital Structure, Factors Influencing Capital Structure, Determinants of Capital Structure, Capital Structure and Valuation, Capital Structure Theories, EBIT - EPS Analysis, Measures of Operating and Financial Leverage, Operating Leverage, Financial Leverage, Distinguish Between Operating Leverage and Financial Leverage, Combined Leverage, Risk and Leverage

13) CORPORATE TREASURY MANAGEMENT

Objectives of Treasury Management, Role of Treasury Management and Benefits, Significance of Treasury Management Function, Functions and Scope of Treasury Management, Relationship between Treasury Management and Financial Management, Difference between Financial Management and Treasury Management, Treasury Organization: Picking The Right Model, Role and Responsibilities of Treasury Manager, Tools of Treasury Management, Environment for Treasury Management, Role of Information Technology in Treasury Management, Liquidity Management Vis-A-Vis Treasury Management, Regulation & Supervision of Treasury Operation, Treasury Control Mechanism, Treasury Operations in Banking

UNIT - 1
INTRODUCTION TO A COMPANY

1.1 Introduction
1.2 Objectives
1.3 Meaning and Definition of a Company
1.4 Nature and Characteristics of a Company
1.5 Types of Companies
- 1.5.1 Private Company
- 1.5.2 One Person company (OPC)
- 1.5.3 Small Company
- 1.5.4 Public Company
- 1.5.5 Limited Company
- 1.5.6 Unlimited Company
- 1.5.7 Government Companies
- 1.5.8 Foreign Companies
- 1.5.9 Holding, Subsidiary Companies and Associate Companies
- 1.5.10 Associate Company
- 1.5.11 Investment Companies
- 1.5.12 Producer Companies
- 1.5.13 Nidhi Companies

1.6 Key Concepts
1.7 Summary
1.8 Exercise & Questions
1.9 Further Readings & References

1.1 Introduction

The concept of 'Company' or 'Corporation' in business is not new, but was dealt with, in 4th century BC itself during 'Arthashastra' days. Its' shape got revamped over a period of time according to the needs of business dynamics. Company form of business has certain distinct advantages over other forms of businesses like Sole Proprietorship/Partnership etc. It includes features such as Limited Liability, Perpetual Succession etc.

Companies may be classified on the basis of their incorporation, number of members, size, basis of control and motive. On the basis of incorporation the companies may be classified into Charter Companies, Statutory Companies and Registered Companies. On the basis of liability, it may be Companies limited by shares/guarantee and unlimited liability companies. Further, on the basis of number of members, they may be classified into One Person Company, private company and public company. On the basis of size, they may be divided into small companies and other companies. On the basis of control, they may be classified into holding company, subsidiary company and associate company. Besides, companies may be nonprofit companies licensed under Section 8, Government companies, foreign companies, holding/subsidiary companies, investment companies, producer companies etc.

NOTES

1.2 Objectives

After reading this lesson, you would be able to understand

- The meaning and basic characteristics of company
- How company differs from other forms of businesses.
- The concepts of various types of companies, their legal basis,
- Special provisions and privileges for some classes of companies.
- Distinction between different types of companies etc.

1.3 Meaning and Definition of a Company

The word 'company' is derived from the Latin word (Com=with or together; panis =bread), and it originally referred to an association of persons who took their meals together. In the leisurely past, merchants took advantage of festive gatherings, to discuss business matters. Nowadays, the business matters have become more complicated and cannot be discussed at festive gatherings. Therefore, the company form of organization has assumed greater importance. In popular parlance, a company denotes an association of likeminded persons formed for the purpose of carrying on some business or undertaking. A company is a corporate body and a legal person having status and personality distinct and separate from the members constituting it. It is called a body corporate because the persons composing it are made into one body by incorporating it according to the law and clothing it with legal personality. The word 'corporation' is derived from the Latin term 'corpus' which means 'body'. Accordingly, 'corporation' is a legal person created by a process other than natural birth. It is, for this reason, sometimes called artificial legal person. As a legal person, a corporate is capable of enjoying many rights and incurring many liabilities of a natural person.

An incorporated company owes its existence either to a Special Act of Parliament or to company law. Public corporations like Life Insurance Corporation of India, SBI etc., have been brought into existence through special Acts of Parliament, whereas companies like Tata Steel Ltd., Reliance Industries Limited have been formed under the Company law i.e. Companies Act, 1956 which is replaced by the Companies Act, 2013. In the legal sense, a company is an association of both natural and artificial persons and is incorporated under the existing law of a country.

In terms of the Companies Act, 2013 (Act No. 18 of 2013) **a "company" means a company incorporated under this Act or under any previous company law [Section 2(20)].**

In common law, a company is a "legal person" or "legal entity" separate from, and capable of surviving beyond the lives of its members. A company is rather a legal device for the attainment of social and economic end. It is, therefore, a combined political, social, economic and legal institution. Thus, the term company has been described in many ways. "It is a means of cooperation and organisation in the conduct of an enterprise". It is "an intricate, centralised, economic and administrative structure run by professional managers who hire capital from the investor(s)".

Lord Justice Lindley has defined a company as "an association of many persons who contribute money or money's worth to a common stock and employ it in some trade or business and who share the profit and loss arising there from. The common stock so contributed is denoted in money and is the capital of the company.

The persons who contributed in it or form it, or to whom it belongs, are

members. The proportion of capital to which each member is entitled is his "share". The shares are always transferable although the right to transfer them may be restricted."

NOTES

1.4 Nature and Characteristics of a Company

Since a corporate body (i.e. a company) is the creation of law, it is not a human being, it is an artificial juridical person (i.e. created by law) and it is clothed with many rights, obligations, powers and duties prescribed by law.

The most striking characteristics of a company are discussed below:

(i) Corporate personality

A company incorporated under the Act is vested with a corporate personality so it redundant bears its own name, acts under name, has a seal of its own and its assets are separate and distinct from those of its members. It is a different 'person' from the members who compose it. Therefore it is capable of owning property, incurring debts, borrowing money, having a bank account, employing people, entering into contracts and suing or being sued in the same manner as an individual. Its members are its owners however they can be its creditors simultaneously. A shareholder cannot be held liable for the acts of the company even if he holds virtually the entire share capital.

The shareholders are not the agents of the company and so they cannot bind it by their acts. The company does not hold its property as an agent or trustee for its members and they cannot sue to enforce its rights, nor can they be sued in respect of its liabilities. Thus, 'incorporation' is the act of forming a legal corporation as a juristic person. A juristic person is in law also conferred with rights and obligations and is dealt with in accordance with law. In other words, the entity acts like a natural person but only through a designated person, whose acts are processed within the ambit of law.

(ii) Company as an artificial person

A Company is an artificial person created by law. It is not a human being but it acts through human beings. It is considered as a legal person which can enter into contracts, possess properties in its own name, sue and can be sued by others etc. It is called an artificial person since it is invisible, intangible, existing only in the contemplation of law. It is capable of enjoying rights and being subject to duties.

(iii) Company is not a citizen

The company, though a legal person, is not a citizen under the Citizenship Act, 1955 or the Constitution of India. In State Trading Corporation of India Ltd. v. C.T.O., A.I.R. 1963 S.C. 1811, the Supreme Court held that the State Trading Corporation though a legal person, was not a citizen and can act only through natural persons. Nevertheless, it is to be noted that certain fundamental rights enshrined in the Constitution for protection of "person", e.g., right to equality (Article 14) etc. are also available to company. Section 2(f) of Citizenship Act, 1955 expressly excludes a company or association or body of individuals from citizenship.

(iv) Company has Nationality and Residence

Though it is established through judicial decisions that a company cannot be a citizen, yet it has nationality, domicile and residence. In Gasque v. Inland Revenue Commissioners, (1940) 2 K.B. 88, Macnaghten. J. held that a limited company is capable of having a domicile and its domicile is the place of its registration and that domicile clings to it throughout its existence. He observed in this case: "It was suggested that a body corporate has no domicile. It is quite true that a body corporate cannot have a domicile in the same sense as an individual. But by analogy

NOTES

with a natural person the attributes of residence, domicile and nationality can be given to a body corporate."

(v) Limited Liability

"The privilege of limited liability for business debts is one of the principal advantages of doing business under the corporate form of organisation." The company, being a separate person, is the owner of its assets and bound by its liabilities. The liability of a member as shareholder, extends to the contribution to the capital of the company up to the nominal value of the shares held and not paid by him. Members, even as a whole, are neither the owners of the company's undertakings, nor liable for its debts. In other words, a shareholder is liable to pay the balance, if any, due on the shares held by him, when called upon to pay and nothing more, even if the liabilities of the company far exceed its assets. This means that the liability of a member is limited.

For example, if A holds shares of the total nominal value of Rs.1,000 and has already paid Rs. 500/- (or 50% of the value) as part payment at the time of allotment, he cannot be called upon to pay more than Rs.500/-, the amount remaining unpaid on his shares. If he holds fully-paid shares, he has no further liability to pay even if the company is declared insolvent. In the case of a company limited by guarantee, the liability of members is limited to a specified amount of the guarantee mentioned in the memorandum.

(vi) Perpetual Succession

An incorporated company never dies, except when it is wound up as per law. A company, being a separate legal person is unaffected by death or departure of any member and it remains the same entity, despite total change in the membership. Perpetual succession, means that the membership of a company may keep changing from time to time, but that shall not affect its continuity. The membership of an incorporated company may change either because one shareholder has sold/transferred his shares to another or his shares devolve on his legal representatives on his death or he ceases to be a member under some other provisions of the Companies Act. Thus, perpetual succession denotes the ability of a company to maintain its existence by the succession of new individuals who step into the shoes of those who cease to be members of the company. Professor L.C.B. Gower rightly mentions, "Members may come and go, but the company can go on forever. During the war all the members of one private company, while in general meeting, were killed by a bomb, but the company survived - not even a hydrogen bomb could have destroyed it".

(vii) Separate Property

A company being a legal person and entirely distinct from its members, is capable of owning, enjoying and disposing of property in its own name. The company is the real person in which all its property is vested, and by which it is controlled, managed and disposed off. "no member can claim himself to be the owner of the company's property during its existence or in its winding-up". A member does not even have an insurable interest in the property of the company.

(viii) Transferability of Shares

The capital of a company is divided into parts, called shares. The shares are said to be movable property and, subject to certain conditions, freely transferable, so that no shareholder is permanently or necessarily wedded to a company. When the joint stock companies were established, the object was that their shares should be capable of being easily transferred. Section 44 of the Companies Act, 2013 enunciates the principle by providing that the shares held by the members are movable property and can be transferred from one person to another in the manner provided by the articles. If the articles do not provide anything for the transfer of

shares and the Regulations contained in Table "F" in Schedule I to the Companies Act, 2013, are also expressly excluded, the transfer of shares will be governed by the general law relating to transfer of movable property. A member may sell his shares in the open market and realise the money invested by him. This provides liquidity to a member (as he can freely sell his shares) and ensures stability to the company (as the member is not withdrawing his money from the company). The Stock Exchanges provide adequate facilities for the sale and purchase of shares.

Further, as of now, in most of the listed companies, the shares are also transferable through Electronic mode i.e. through Depository Participants in dematerialised form instead of physical transfers. However there are restrictions with respect to transferability of shares of a Private Limited Company which are dealt in chapter 2.

(ix) Capacity to Sue and Be Sued

A company being a body corporate, can sue and be sued in its own name. To sue, means to institute legal proceedings against (a person) or to bring a suit in a court of law. All legal proceedings against the company are to be instituted in its name. Similarly, the company may bring an action against anyone in its own name. A company's right to sue arises when some loss is caused to the company, i.e. to the property or the personality of the company. Hence, the company is entitled to sue for damages in libel or slander as the case may be. A company, as a person distinct from its members, may even sue one of its own members.

A company has a right to seek damages where a defamatory material published about it, affects its business. Where video cassettes were prepared by the workmen of a company showing, their struggle against the company's management, it was held to be not actionable unless shown that the contents of the cassette would be defamatory. The court did not restrain the exhibition of the cassette. The company is not liable for contempt committed by its officer.

(x) Contractual Rights

A company, being a legal entity different from its members, can enter into contracts for the conduct of the business in its own name. A shareholder cannot enforce a contract made by his company; he is neither a party to the contract, nor be entitled to the benefit derived from of it, as a company is not a trustee for its shareholders. Likewise, a shareholder cannot be sued on contracts made by his company. The distinction between a company and its members is not confined to the rules of privity but permeates the whole law of contract. Thus, if a director fails to disclose a breach of his duties towards his company, and in consequence a shareholder is induced to enter into a contract with the director on behalf of the company which he would not have entered into had there been disclosure, the shareholder cannot rescind the contract. Similarly, a member of a company cannot sue in respect of torts committed against the company, nor can he be sued for torts committed by the company. Therefore, the company as a legal person can take action to enforce its legal rights or be sued for breach of its legal duties. Its rights and duties are distinct from those of its constituent members.

(xi) Limitation of Action

A company cannot go beyond the power stated in its Memorandum of Association. The Memorandum of Association of the company regulates the powers and fixes the objects of the company and provides the edifice upon which the entire structure of the company rests. The actions and objects of the company are limited within the scope of its Memorandum of Association. In order to enable it to carry out its actions without such restrictions and limitations in most cases, sufficient powers are granted in the Memorandum of Association. But once the powers have been laid down, it cannot go beyond such powers unless the Memorandum of

Association, itself altered prior to doing so.

(xii) Separate Management

As already noted, the members may derive profits without being burdened with the management of the company. They do not have effective and intimate control over its working and they elect their representatives as Directors on the Board of Directors of the company to conduct corporate functions through managerial personnel employed by them. In other words, the company is administered and managed by its managerial personnel.

(xiii) Voluntary Association for Profit

A company is a voluntary association for profit. It is formed for the accomplishment of some stated goals and whatsoever profit is gained is divided among its shareholders or saved for the future expansion of the company. Only a Section 8 company can be formed with no profit motive.

(xiv) Termination of Existence

A company, being an artificial juridical person, does not die a natural death. It is created by law, carries on its affairs according to law throughout its life and ultimately is effaced by law. Generally, the existence of a company is terminated by means of winding up. However, to avoid winding up, sometimes companies adopt strategies like reorganisation, reconstruction and amalgamation.

To sum up, "a company is a voluntary association for profit with capital divisible into transferable shares with limited liability, having a distinct corporate entity and a common seal with perpetual succession".

1.5 Types of Companies

The Companies Act, 2013 provides for the kinds of companies that can be promoted and registered under the Act. The three basic types of companies which may be registered under the Act are:

(a) Private Companies;

(b) Public Companies; and

(c) One Person Company (to be formed as Private Limited)

Section 3 (1) of the Companies Act 2013 states that a company may be formed for any lawful purpose by-

(a) Seven or more persons, where the company to be formed is to be a public company;

(b) Two or more persons, where the company to be formed is to be a private company; or

(c) one person, where the company to be formed is to be One Person Company that is to say, a private company, by subscribing their names or his name to a memorandum and complying with the requirements of this Act in respect of registration

(2) A company formed under sub-section (1) may be either-

(a) A company limited by shares; or

(b) A company limited by guarantee; or

(c) An unlimited company.

1.5.1 Private Company

As per Section 2(68) of the Companies Act, 2013, "private company" means

a company having a minimum paid-up share capital as may be prescribed, and which by its articles,-

(i) restricts the right to transfer its shares;

(ii) except in case of One Person Company, limits the number of its members to two hundred:

Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this definition, be treated as a single member:

Provided further that the following persons shall not be included in the number of members;-

(A) Persons who are in the employment of the company; and

(B) Persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased, and

(iii) prohibits any invitation to the public to subscribe for any securities of the company;

It must be noted that it is only the number of members that is limited to two hundred. A private company may issue debentures to any number of persons, the only condition being that an invitation to the public to subscribe for debentures is prohibited.

The aforesaid definition of private limited company specifies the restrictions, limitations and prohibitions, which must be expressly provided in the articles of association of a private limited company.

As per proviso to Section 14 (1), if a company being a private company alters its articles in such a manner that they no longer include the restrictions and limitations which are required to be included in the articles of a private company under this Act, such company shall, as from the date of such alteration, cease to be a private company.

A private company can only accept deposit from its members upto a particular limit in accordance with section 73 of the Companies Act, 2013.

The words 'Private Limited' must be added at the end of its name by a private limited company.

As per section 3 (1), a private company may be formed for any lawful purpose by two or more persons, by subscribing their names to a memorandum and complying with the requirements of this Act in respect of registration. Section 149(1) further lays down that a private company shall have a minimum number of two directors. The only two members may also be the two directors of the private company.

CHECK YOUR PROGRESS

State whether the following statement is "True" or "False"

The number of members of a private company is limited to 200.

Obligations of a Private Company

In addition to the restrictions imposed on Private Companies as contained in Section 2(68) of the Companies Act, a private company owes certain special obligations as compared to a public company, which are as follows:

A private company, while filing its annual return with the Registrar of Companies as required by Section 92, must also send with this return, a certificate stating that:

(i) The company has not, since the date of the closure of the last financial year with reference to which the last return was submitted or in the case of a first return since the date of the incorporation of the company, issued any invitation to the public to subscribe for any securities of the company;

(ii) Where the annual return discloses the fact that the number of members, except in case of a one person company, of the company exceeds two hundred, the excess consists wholly of persons who under second proviso to clause (ii) of sub-section (68) of section 2 (i.e. the person who is or were in the employment of the Co.) of the Act are not to be included in reckoning the number of two hundred;

(iii) The Company continued to be a Private Company during the financial year.

Consequences of Alteration of the Articles of Private Companies

As per proviso to section 14(1), where a company being a private company alters its articles in such a manner that they no longer include the restrictions and limitations which are required to be included in the articles of a private company under section 2(68), the company shall, as from the date of such alteration, cease to be a private company. In such a case, it shall be treated as a public company from the date of alteration of its articles.

1.5.2 One Person company (OPC)

With the implementation of the Companies Act, 2013, a single person could constitute a Company, under the One Person Company (OPC) concept.

The new Companies Act, 2013 has done away with redundant provisions of the previous Companies Act, 1956, and provides for a new entity in the form of one person company (OPC), while empowering the Central Government to provide a simpler compliance regime for small companies.

The introduction of OPC in the legal system is a move that would encourage corporatisation of micro businesses and entrepreneurship.

In India, in the year 2005, the JJ Irani Expert Committee recommended the formation of OPC. It had suggested that such an entity may be provided with a simpler legal regime through exemptions so that the small entrepreneur is not compelled to devote considerable time, energy and resources on complex legal compliance. OPC is a one shareholder corporate entity, where legal and financial liability is limited to the company only.

CHECK YOUR PROGRESS

State whether the following statement is "True" or "False"

If a Private company alters its articles in such manner that they do not include the restrictions and limitations as laid down in section 2(68), it shall cease to a private company from the date on which such alteration took place.

Status of OPC in other countries

Even in other countries like UK, Australia, Singapore, Pakistan, etc; a single person can form a company.

Various countries permit this kind of a corporate entity (China introduced it in October 2005) in which the promoting individual is both the director and the shareholder.

The amended company law of Pakistan permits one person to form a single-member company by filing with the registrar, at the time of incorporation, a nomination in the prescribed form indicating at least two individuals to act as nominee director and alternate nominee director.

In US, several states permit the formation and operation of a single-member Limited Liability Company (LLC). In China, one person is allowed to apply for opening a limited company with a minimum capital of 1, 00,000 Yuan. The amended law of China prescribes that the owner should pay the investment capital at one time and bars him from opening a second company of the same kind.

In most countries, the law governing companies enables a single-member company to have more than one director and grants exemptions to such companies from holding AGMs, though records and documents are to be maintained.

Difference between a Sole Proprietorship and an OPC

The fundamental difference between a sole proprietorship and an OPC is the way liability is treated in the latter.

A one-person company is different from a sole proprietorship because it is a separate legal entity that distinguishes between the promoter and the company.

The promoter's liability is limited in an OPC in the event of a default or legal issues. On the other hand, in sole proprietorships, the liability is not restricted and extends to the individual and his or her entire assets.

OPC in India under the Companies Act, 2013

The Companies Act, 2013 classifies companies on the basis of their number of members into One Person Company, private company and public company. As stated above, a private company requires a minimum of 2 members. In other words, a One Person Company is a kind of private company having only one member. As per section 2(62) of the Companies Act, 2013, "One Person Company" means a company which has only one person as a member.

Section 3(1)(c) lays down that a company may be formed for any lawful purpose by one person, where the company to be formed is to be One Person Company that is to say, a private company. In other words, one person company is a kind of private company.

A One person company shall have a minimum of one director. Therefore, a One Person Company will be registered as a private company with one member and one director.

By virture of section 3(2), an OPC may be formed either as a company limited by shares or a company limited by guarantee; or an unlimited liability company.

Rule 3 of Companies (Incorporation) Rules, 2014 - One Person Company

(1) Only a natural person who is an Indian citizen and resident in India-

(a) shall be eligible to incorporate a One Person Company;

(b) shall be a nominee for the sole member of a One Person Company.

Explanation-For the purposes of this rule, the term "resident in India" means a person who has stayed in India for a period of not less than one hundred and eighty two days during the immediately preceding one calendar year.

(2) No person shall be eligible to incorporate more than a One Person Company or become nominee in more than one such company.

(3) Where a natural person, being member in One Person Company in accordance with this rule becomes a member in another such Company by virtue of his being a nominee in that One Person Company, such person shall meet the eligibility criteria specified in sub rule (2) within a period of one hundred and eighty days.

(4) No minor shall become member or nominee of the One Person Company or can hold share with beneficial interest.

(5) Such Company cannot be incorporated or converted into a company under section 8 of the Act.

(6) Such Company cannot carry out Non-Banking Financial Investment activities including investment in securities of any body corporates.

(7) No such company can convert voluntarily into any kind of company unless two years have expired from the date of incorporation of One Person Company, except threshold limit (paid up share capital) is

increased beyond fifty lakh rupees or its average annual turnover during the relevant period exceeds two crore rupees.

NOTES

Contract by One Person Company

Section 193 (1) provides that where One Person Company limited by shares or by guarantee enters into a contract with the sole member of the company who is also the director of the company, the company shall, unless the contract is in writing, ensure that the terms of the contract or offer are recorded in a memorandum or are recorded in the minutes of the first meeting of the Board of Directors of the company held next after entering into contract.

However, above said provision shall not apply to contracts entered into by the one person company in the ordinary course of its business.

As per section 193 (2), the company shall inform the Registrar about every contract entered into by the company and recorded in the minutes of the meeting of its Board of Directors under sub-section (1) within a period of fifteen days of the date of approval by the Board of Directors.

As per section 152 (1), in case of a One Person Company an individual being its member shall be deemed to be its first director until a director or directors are duly appointed by the member in accordance with the provisions of that section.

Benefits of One Person Company

The concept of One person company is quite revolutionary. It gives the individual entrepreneurs all the benefits of a company, which means they will get credit, bank loans, access to market, limited liability, and legal protection available to companies.

Prior to the new Companies Act, 2013 coming into effect, at least two shareholders were required to start a company. But now the concept of One Person Company would provide tremendous opportunities for small businessmen and traders, including those working in areas like handloom, handicrafts and pottery. Earlier they were working as artisans and weavers on their own, so they did not have a legal entity of a company.

But now the OPC would help them do business as an enterprise and give them an opportunity to start their own ventures with a formal business structure,

Further, the amount of compliance by a one person company is much lesser in terms of filing returns, balance sheets, audit etc. Also, rather than the middlemen usurping profits, the one person company will have direct access to the market and the wholesale retailers. The new concept would also boost the confidence of small entrepreneurs.

1.5.3 Small Company

As recommended by the Dr. JJ Irani Committee, the concept of small companies has been introduced in the Companies, Act, 2013. The recommendation of the Irani committee in this regard was as under:

"The Committee sees no reason why small companies should suffer the consequences of regulation that may be designed to ensure balancing of interests of stakeholders of large, widely held corporates. Company law should enable simplified decision making procedures by relieving such companies from select statutory internal administrative procedures. Such companies should also be subjected to reduced financial reporting and audit requirements and simplified capital maintenance regimes. Essentially the regime for small companies should enable

them to achieve transparency at a low cost through simplified requirements. Such a framework may be applied to small companies through exemptions, consolidated in the form of a Schedule to the Act."

Small company is a new form of private company under the Companies Act, 2013. A classification of a private company into a small company is based on its size i.e. paid up capital and turnover. In other words, such companies are small sized private companies.

As per section 2(85) ''small company'' means a company, other than a public company,-

(i) paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than five crore rupees; and the MCA vide its Companies (Removal of Difficulties) Order, 2015 dated 13th February, 2015 notified that for the word "Or" occurring between clause sub-clause (i) and (ii) of clause (85) of section 2, the words "and" shall be substituted.)

(ii) turnover of which as per its last profit and loss account does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than twenty crore rupees: Provided that nothing in this defintion shall apply to-

(A) a holding company or a subsidiary company;

(B) a company registered under section 8; or

(C) a company or body corporate governed by any special Act;

1.5.4 Public Company

By virtue of Section 2(71), a public company means a company which:

(a) is not a private company;

(b) has a minimum paid-up share capital, as may be prescribed.

Provided that a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles

As per section 3 (1) (a), a public company may be formed for any lawful purpose by seven or more persons, by subscribing their names or his name to a memorandum and complying with the requirements of this Act in respect of registration.

A public company may be said to be an association consisting of not less than 7 members, which is registered under the Act. In principle, any member of the public who is willing to pay the price may acquire shares in or debentures of it. The securities of a public company may be quoted on a Stock Exchange. The number of members is not limited to two hundred.

As per section 58(2), the securities or other interest of any member in a public company shall be freely transferable. However, any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract.

The concept of free transferability of shares in public and private companies is very succinctly discussed in the case of Western Maharashtra Development Corpn. Ltd. V. Bajaj Auto Ltd [2010] 154 Com Cases 593 (Bom). It was held that the Companies Act, makes a clear distinction in regard to the transferability of shares relating to private and public companies. By definition, a "private company" is a company which restricts the right to transfer its shares. In the case of a public

NOTES

company, the Act provides that the shares or debentures and any interest therein, of a company, shall be freely transferable.

The provision contained in the law for the free transferability of shares in a public company is founded on the principle that members of the public must have the freedom to purchase and, every shareholder the freedom to transfer. The incorporation of a company in the public, as distinguished from the private, realm leads to specific consequences and the imposition of obligations envisaged in law. Those who promote and manage public companies assume those obligations. Corresponding to those obligations are rights, which the law recognizes as inherent in the members of the public who subscribe to shares.

1.5.5 Limited Company

As per section 3(2), a company formed under this Act may be either (a) a company limited by shares; or (b) a company limited by guarantee or (c) an unlimited company.

The term 'Limited Company' means a company limited by shares or by guarantee.

The liability of the members, in the case of a limited company, may be limited with reference to the nominal value of the shares, respectively held by them or to the amount which they have respectively guaranteed to contribute in the event of winding up of the company. Accordingly, a limited company can be further classified into: (a) Company limited by shares, and (b) Company limited by guarantee.

Companies Limited by Shares

As per section 2(22), "company limited by shares" means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them.

Accordingly, no member of a company limited by shares, can be called upon to pay more than the nominal value of the shares held by him. If his shares are fully paid-up, he has nothing more to pay. But in the case of partly-paid shares, the unpaid portion is payable at any time during the existence of the company on a call being made, whether the company is a going concern or is being wound up. This is the essence of a company limited by shares and is the most common form in existence.

Companies Limited by Guarantee

As per section 2(21) "company limited by guarantee" means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up. Clubs, trade associations and societies for promoting different objects are examples of such a company. It should be noted that a special feature of this type of company is that the liability of members to pay their guaranteed amounts arises only when the company has gone into liquidation and not when it is a going concern.

A guarantee company may or may not have a share capital.

As regards the funds, a guarantee company without share capital obtains working capital from other sources, e.g. fees or grants. But a guarantee company having a share capital raises its initial capital from its members, while the normal working funds would be provided from other sources, such as fees, charges, subscriptions, etc.

The Memorandum of Association of every guarantee company must state that every member of the company undertakes to contribute to assets of the company in the event of its being wound up while he is a member for the payment

of the debts and liabilities of the company contracted before he ceases to be a member, and of the charges, costs and expenses of winding up, and for adjustment of the rights of the contributories among themselves, such amount as may be required, not exceeding a specified amount.

The Memorandum of a company limited by guarantee must state the amount of guarantee. It may be of different denominations. In case of a guarantee company having share capital the shareholders have two-fold liability: to pay the amount which remains unpaid on their shares, whenever called upon to pay, and secondly, to pay the amount payable under the guarantee when the company goes into liquidation. The voting power of a guarantee company having share capital is determined by the shareholding and not by the guarantee.

A guarantee company must include the word 'limited" or the words "private limited" as part of its name, and must register its articles,and it shall adopt the provisions of the Table 'G' and 'H' of Schedule I. It must also state the number of members with which it proposes to be registered, although the number can be increased by means of a resolution.

Section 4(7) states that any provision in the memorandum of articles, in the case of company limited by guarantee and not having a share capital, purporting to give any person a right to participate in the divisible profits of the company otherwise than as a member shall be void.

CHECK YOUR PROGRESS

State whether the following statement is "True" or "False"

The voting power of a guarantee company having share capital is determined by the guarantee.

1.5.6 Unlimited Company

As per section 2(92), "unlimited company" means a company not having any limit on the liability of its members. Thus, the maximum liability of the member of such a company, in the event of its being wound up, might stretch up to the full extent of their assets to meet the obligations of the company by contributing to its assets. However, the members of an unlimited company are not liable directly to the creditors of the company, as in the case of partners of a firm. The liability of the members is only towards the company and in the event of its being wound up only the Liquidator can ask the members to contribute to the assets of the company which will be used in the discharge of the debts of the company.

An unlimited company may or may not have share capital.

Under Section 18, a company registered as an unlimited company may subsequently re-register itself as a limited company, by altering its memorandum and articles of the company in accordance with the provisions of Chapter II of the Companies Act subject to the provision that any debts, liabilities, obligations or contracts incurred or entered into, by or on behalf of the unlimited company before such conversion are not affected by such changed registration.

1.5.7 Government Companies

Section 2(45) defines a "Government Company" as any company in which not less than fifty one per cent of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

Notwithstanding all the pervasive control of the Government, the Government company is neither a Government department nor a Government establishmen. Since employees of Government companies are not Government servants, they have no legal right to claim that the Government should pay their salary or that the additional expenditure incurred on account of revision of their pay scales should be met by the Government. It is the responsibility of the company

to pay them the salaries.

When the Government engages itself in trading ventures, particularly as Government companies under the company law, it does not do so as a State but it does so in essence as a company. A Government company is not a department of the Government.

1.5.8 Foreign Companies

As per section 2(42), "foreign company" means any company or body corporate incorporated outside India which-

(a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(b) conducts any business activity in India in any other manner Sections 379 to 393 of the Act deal with such companies.

Section 380 of the Act lays down that every foreign company which establishes a place of business in India must, within 30 days of the establishment of such place of business, file with the Registrar of Companies for registration:

(a) a certified copy of the charter, statutes or memorandum and articles, of the company or other instrument constituting or defining the constitution of the company and, if the instrument is not in the English language, a certified translation thereof in the English language;

(b) the full address of the registered or principal office of the company;

(c) a list of the directors and secretary of the company containing such particulars as may be prescribed;

(d) the name and address or the names and addresses of one or more persons resident in India authorised to accept on behalf of the company service of process and any notices or other documents required to be served on the company;

(e) the full address of the office of the company in India which is deemed to be its principal place of business in India;

(f) particulars of opening and closing of a place of business in India on earlier occasion or occasions;

(g) declaration that none of the directors of the company or the authorised representative in India has ever been convicted or debarred from formation of companies and management in India or abroad; and

(h) any other information as may be prescribed.

Every foreign company has to ensure that the name of the company, the country of incorporation, the fact of limited liability of members is exhibited in the specified places or documents as required under Section 382.

Section 381 requires a Foreign Company to maintain books of Account and file a copy of balance sheet and profit and loss account in prescribed form with ROC every calendar year. These accounts should be accompanied by list of place of business established by the foreign company in India.

Section 376 of the Companies Act, 2013 provides further that when a foreign company, which has been carrying on business in India, ceases to carry on such business in India, it may be wound up as an unregistered company under Sections 375 to 378 of the Act, even though the company has been dissolved or ceased to exist under the laws of the country in which it was incorporated.

Section 379 provides that where not less than 50% of the paid-up share capital, whether equity or preference or partly equity and partly preference of a foreign company is held by one or more citizens of India or by one or more bodies

corporate incorporated in India, whether singly or in the aggregate, such company shall comply with such of the provisions of this Act, as may be prescribed by the Central Government with regard to the business carried on by it in India, as if it were a company incorporated in India.

As regards the applicability of the provisions of the Companies Act, 2013 to foreign companies the following provisions of section 384 are to be noted:

(i) The provisions of section 71 relating to Debenutes shall apply mutatis mutandis to a foreign company.

(ii) The provisions of Section 92 regarding (filing of annual returns) shall, subject to such exceptions, modifications or adaptations as may be made therein by the rules made under the Act, apply to a foreign company as they apply to a company incorporated in India.

(iii) The provisions of Section 128 relating to the (to the extent of requiring it to maintain at its principal place of business in India books of account with respect to moneys received and spent, sales and purchase made and assets and liabilities, in the course of or in relation to its business in India),

Section 209A (inspection of accounts), Section 233A (Special audit), Section 233B (audit of cost accounts), Section 234-246 (investigations), so far as may be, apply only to the Indian business of a foreign company having an established place of business in India as they apply to a company incorporated in India.

(iv) The provisions of Chapter VI (Registration of Charges) shall apply mutatis mutandis to charges on properties which are created or acquired by any foreign company.

(v) The provisions of Chapter XIV (Inspection, Inquiry and Investigation) shall apply mutatis mutandis to the Indian business of a foreign company as they apply to a company incorporated in India.

As per Section 386(c), having a share transfer office or share registration office will constitute a place of business.

1.5.9 Holding, Subsidiary Companies and Associate Companies

On the basis of control companies can be classified into holding, subsidiary and associate companies.

Holding company

As per Section 2 (46), holding company, in relation to one or more other companies, means a company of which such companies are subsidiary companies.

Subsidiary company

Section 2 (87) provides that subsidiary company or subsidiary, in relation to any other company (that is to say the holding company), means a company in which the holding company-

(i) controls the composition of the Board of Directors; or

(ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies:

Provided that such class or classes of holding companies, shall not have layers of subsidiaries beyond the prescribed limit. (Proviso is yet to be notified)

For the above purpose,-

(a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of

NOTES

another subsidiary company of the holding company;

(b) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;

(c) the expression "company" includes any body corporate;

The MCA has vide its General circular No. 27/2013 dated 27th December 2013 clarified that the shares held by a company or power exercisable by it in another company in a 'fiduciary capacity' shall not be counted for the purpose of determining the holding-subsidiary relationship in terms of the provision of section 2(87) of the Companies Act, 2013.

According to section 2 (27), control shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.

CHECK YOUR PROGRESS

State whether the following statement is "True" or "False"

A subsidiary company can be a member of the holding company also.

The Companies (Specification of Definitions details) Rules, 2014

As per 2(1)(r) "total Share Capital", for the purposes of sub- sections (6) and (87) of section 2, means aggregate of the:-

(a) paid-up equity share capital and

(b) convertible preference share capital.

Subsidiary company not to hold shares in its holding company [Section 19]

Section 19 (1) seeks to provide that subsidiary company shall not either by itself or through its nominees hold shares in its holding company and no holding company shall allot or transfer its shares to any of its subsidiary companies and any such allotment or transfer of shares of a company to its subsidiary company shall be void.

The reference in this section to the shares of a holding company which is a company limited by guarantee or an unlimited company, not having a share capital, shall be construed as a reference to the interest of its members, whatever be the form of interest.

Therefore, no company shall hold any interest in its holding company.

Following are the circumstances, where a subsidiary can hold the shares of its holding company:

(a) where the subsidiary company holds such shares as the legal representative of a deceased member of the holding company; or

(b) where the subsidiary company holds such shares as a trustee; or

(c) where the subsidiary company is a shareholder even before it became a subsidiary company of the holding company:

However, the subsidiary company referred above shall have a right to vote at a meeting of the holding company only in respect of the shares held by it as a legal representative or as a trustee, as referred to in item (a) or (b) aforesaid.

1.5.10 Associate Company

As per Section 2(6), "Associate company", in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and

includes a joint venture company.

Explanation to section 2(6) provides that "significant influence" means control of at least twenty per cent of total share capital, or of business decisions under an agreement.

To add more governance and transparency in the working of the company, the concept of associate company has been introduced. It will provide a more rational and objective framework of associate relationship between the companies.

Further, as per section 2 (76), Related party includes 'Associate Company'. Hence, contract with Associate Company will require disclosure/approval/entry in statutory register as is applicable to contract with a related party.

The MCA vide its General circular No. 24/2013 dated 25th June, 2014, clarified that the shares held by a company in another company in a 'fiduciary capacity' shall not be counted for the purpose of determining the relationship of 'associate company' under section 2(6) of the Companies Act, 2013.

1.5.11 Investment Companies

As per explanation (a) to section 186, "Investment Company" means a company whose principal business is the acquisition of shares, debentures or other securities.

An investment company is a company, the principal business of which consists in acquiring, holding and dealing in shares and securities. The word 'investment', no doubt, suggests only the acquisition and holding of shares and securities and thereby earning income by way of interest or dividend etc. But investment companies in actual practice earn their income not only through the acquisition and holding but also by dealing in shares and securities i.e. to buy with a view to sell later on at higher prices and to sell with a view to buy later on at lower prices.

If a company is engaged in any other business to an appreciable extent, it will not be treated as an investment company. The following two sets of legal opinions are quoted below as to the meaning of an investment company:

(i) According to one set of legal opinion, an "investment company" means company which acquires and holds shares and securities with an intent to earn income only from them by holding them. On the other hand, another school of legal opinion holds that "an Investment Company means a company, which acquires shares and securities for earning income by holding them as well as by dealing in such shares and other securities".

(ii) According to Section 2(10A) of the Insurance Act, 1938, an investment company means a company whose principal business is the acquisition of shares, stocks, debentures or other securities.

1.5.12 Producer Companies

Section 465(1) of the Companies Act, 2013 provides that the Companies Act, 1956 and the Registration of Companies (Sikkim) Act, 1961 (hereafter in this section referred to as the repealed enactments) shall stand repealed.

However, proviso to section 465(1) provides that the provisions of Part IX A of the Companies Act, 1956 shall be applicable mutatis mutandis to a Producer Company in a manner as if the Companies Act, 1956 has not been repealed until a special Act is enacted for Producer Companies.

In view of the above provision, Producer Companies are still governed by the Companies Act, 1956.

NOTES

Companies (Amendment) Act, 2002 had added a new Part IXA to the main Companies Act, 1956 consisting of 46 new Sections from 581A to 581ZT.

According to the provisions as prescribed under Section 581A(l) of the Companies Act, 1956, a producer company is a body corporate having objects or activities specified in Section 581B and which is registered as such under the provisions of the Act. The membership of producer companies is open to such people who themselves are the primary producers, which is an activity by which some agricultural produce is produced by such primary producers.

Objects of Producer Companies

In terms of Section 581B(1) of the Companies Act, 1956, the objects of a producer company registered under this Act may be all or any of the following matters:

(a) production, harvesting, procurement, grading, pooling, handling, marketing, selling, export of primary produce of the members or import of goods or services for their benefit.

(b) processing including preserving, drying, distilling, brewing, vinting, canning and packaging of the produce of its members.

(c) manufacturing, sale or supply of machinery, equipment or consumables mainly to its members.

(d) providing education on the mutual assistance principles to its members and others.

(e) rendering technical services, consultancy services, training, research and development and all other activities for the promotion of the interests of its members.

(f) generation, transmission and distribution of power, revitalisation of land and water resources, their use, conservation and communications relatable to primary produce.

(g) insurance of producers or their primary produce.

(h) promoting techniques of mutuality and mutual assistance.

(i) welfare measures or facilities for the benefit of the members as may be decided by the Board.

(j) any other activity, ancillary or incidental to any of the activities referred to in clauses (a) to (i) above or other activities which may promote the principles of mutuality and mutual assistance amongst the members in any other manner.

(k) financing of procurement, processing, marketing or other activities specified in clauses (a) to (j) above, which include extending of credit facilities or any other financial services to its members. Further, under Section 581B(2) it has also been clarified that every producer company shall deal primarily with the produce of its active members for carrying out any of its objects specified above.

1.5.13 Nidhi Companies

The primary object of Nidhis is to carry on the business of accepting deposits and lending money to member-borrowers only against jewels, etc., and mortgage of property. For over a century Nidhis, with the objective of cultivating the habit of thrift, generally promoted by public spirited men drawn from affluent local persons, lawyers and professionals like auditors, educationists, etc., including retired persons. The area of operation was local - within municipalities and panchayats. Some Nidhis on account of their financial and administrative strength opened branches within the respective revenue district and even outside. The principle of mutual

benefit has been to pool the savings from members and lend only to members and never have dealing with Non-members. Nidhis were not expected to engage themselves in the business of Chit Fund, hire purchase, insurance or in any other business including investments in shares or debentures. As stated these Nidhis do their business only with Members. Such Members are only individuals. Bodies Corporate or Trusts are never to be admitted as Members.

1.6 Key Concepts

- In terms of the Companies Act, 2013, a "company" means a company incorporated under this Act or under any previous company law [Section 2(20)].
- As per Section 2(68) of the Companies Act, 2013, "private company" means a company having a minimum paid-up share capital as may be prescribed, and which by its articles,- (i) restricts the right to transfer its shares; (ii) except in case of One Person Company, limits the number of its members to two hundred.
- By virtue of Section 2(71), a public company means a company which:

  (a) is not a private company;

  (b) has a minimum paid-up share capital, as may be prescribed.

1.7 Summary

- The word 'company' is derived from the Latin word (Com = with or together; panis = bread), and it originally referred to an association of persons who took their meals together.
- In the legal sense, a company is an association of both natural and artificial persons incorporated under the existing law of a country. A company has a separate legal entity from the persons constituting it.
- The main characteristics of a company are corporate personality, limited liability, perpetual succession, separate property, transferability of shares, capacity to sue and be sued, contractual rights, limitation of action, separate management, termination of existence etc.
- The company, though a legal person, is not a citizen under the Citizenship Act, 1955 or the Constitution of India.
- Though it has established through judicial decisions that a company cannot be a citizen, yet it has nationality, domicile and residence.
- From the point of view of incorporation, companies can be classified as chartered companies, statutory companies and registered companies. Companies can be categorized as unlimited companies, companies limited by guarantee and companies limited by shares. Companies can also be classified as public companies, private companies, one person companies, small companies, associations not for profit having licence under Section 8 of the Act, Government companies, foreign companies, holding companies, subsidiary companies, associate companies, investment companies and Producer Companies.
- A private company has been defined under Section 2(68) of the Companies Act, 2013 as a company which has a minimum paid-up capital as prescribed, and by its articles restricts the right to transfer its shares, limits the number of its members to two hundred, and prohibits any invitation to the public to

NOTES

subscribe for any securities of the company..

- Where a private company alters its articles in such a manner that they no longer include the restrictions and limitations which are required to be included therein under section 2(68), the company shall, as from the date of such alteration, cease to be a private company.
- A private company can be further classified into a One Person Company and Small Company.
- One Person Company" means a company which has only one person as a member.
- 'Small company" means a company, other than a public company, (i) paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than five crore rupees; and (ii) turnover of which as per its last profit and loss account does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than twenty crore rupees.
- Above definition of small company is not applicable to a holding company or a subsidiary company; or a company registered under section 8; or a company or body corporate governed by any special Act.
- A public company is a company which (a) is not a private company (b) has a minimum paid-up share capital as may be prescribed.
- A limited company is a company limited by shares or by guarantee. An unlimited company is a company not having any limit on the liability of its members.
- Associations not for profit with limited liability are permitted to be registered under a licence granted by the Central Government without using the word(s) 'Limited' or 'Private Limited'.
- Section 2(45) defines a Government company as a company in which not less than fifty one per cent of the paid-up share capital is held by Central or State Government or governments or partly by one and partly by others.
- Auditor of a government company shall be appointed or reappointed by the Comptroller and Auditor General of India (C.&A.G.).
- Foreign Company means any company or body corporate incorporated outside India which (a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and (b) conducts any business activity in India in any other manner
- Investment Company means a company whose principal business is the acquisition of shares, debentures or other securities.
- A Producer Company is a body corporate having objects or activities specified in Section 581B and which is registered as such under the provisions of the Act. Section 581B(1) of the Companies Act, 1956 provides the objects for which a producer company may be registered under the Act.
- The primary object of Nidhis is to carry on the business of accepting deposits and lending money to member borrowers only against jewels, etc., and mortgage of property. According to section 406 of Companies Act, 2013
- "Nidhi" means a company which has been incorporated as a Nidhi with the object of cultivating the habit of thrift and savings amongst its members, receiving deposits from, and lending to, its members only, for their mutual benefit, and which complies with such rules as are prescribed by the Central Government for regulation of such class of companies.
- A company formed under an Act of Parliament or State Legislature is called a Statutory Company/ Corporation.

- Principal characteristics of Statutory Corporation are State ownership, creation by special law, immunity from Parliamentary scrutiny, freedom in regard to personnel, body corporate features, distinct relation with the Government, independent finances, commercial audit and operation on business principles.
- Central Government has exempted applicability of various provisions of the Act, to Private Company, Nidhi Company, Section 8 Company and Government Company.

1.8 Questions and Exercise

1. State in brief the various kinds of companies which can be registered under the Companies Act, 2013.
2. Define a private company and state the exemptions which it enjoys under the Companies Act, 2013.
3. Discuss in brief disadvantages and obligations of a private company.
4. Define a public company and distinguish it from a private company.

- **Fill in the blanks**

1. Maximum number of persons to form a private company restricts to _____
   (50, 100, 200)
2. According to Companies Act, 2013 _____company prohibits any invitation to the public to subscribe for any securities of the company.
   (Public, Small, Private)
3. A _____ company is different from a sole proprietorship because it is a separate legal entity that distinguishes between the promoter and the company.
   (Small, Public, One-person)
4. The promoter's liability is limited in an _____ in the event of a default or legal issues.
   (Sole Proprietorship, OPC, Public)
5. A public company may be said to be an association consisting of not less than _____ members, which is registered under the Act.
   (12, 5, 7)
6. A company formed under an Act of Parliament or State Legislature is called a _____/ Corporation.
   (Investment, Statutory, Government)
7. Central Government has exempted applicability of various provisions of the Act, to Private Company, Nidhi Company, _____ Company and Government Company
   (Sction 8, Producer, Investment)
8. _____ Company means a company whose principal business is the acquisition of shares, debentures or other securities.
   (Government, Investment, Producer)
9. Auditor of a government company shall be appointed or reappointed by the _____.
   (Government, Board Of Directors, Comptroller and Auditor General of India (C.&A.G.))
10. Section 2(45) defines a _____ company as a company in which not

NOTES

less than fifty one per cent of the paid-up share capital is held by Central or State Government or governments or partly by one and partly by others.

(Government, Investment, Producer)

[**Ans:** 1) 200, 2) Private, 3) One-Person, 4) OPC, 5) 7, 6) Statutory, 7) Section8, 8) Investment, 9) Comptroller and Auditor General of India (C.&A.G.), 10) Government]

1.9 Further Reading and References

1. Dr. Avtar Singh : Company Law; Eastern Book Company, 34, Lalbagh, Lucknow - 226 001
2. C.R. Datta : Datta on the Company Law; Lexis Nexis, Butterworths Wadhwa, Nagpur
3. A. Ramaiya : Guide to the Companies Act; Lexis Nexis, Butterworths Wadhwa Nagpur
4. K.C. Garg, R.C. Chawla, Vijay Gupta: Company Law; Kalyani Publishers, 1/1, Rajinder Nagar, Civil Lines, Ludhiana - 141 001.
5. A.K. Majumdar, Dr. G.K. Kapoor, Sanjay Dhamija : Company Law and Practice; Taxmann, 59/32, New Rohtak Road, New Delhi-110 005.
6. V.S. Datey : Guide to Tax and Corporate Laws; Taxmann, 59/32, New Rohtak Road, New Delhi-110005.
7. M.C. Kuchhal : Modern Indian Company Law; Shri Mahavir Book Depot, 2603, Nai Sarak, Delhi-110006.
8. H.K. Saharay : Company Law; Universal Law Publishing Co., C-FF-1A, Dilkhush Industrial Estate, G.T. Karnal Road, Delhi. -110033.

UNIT - 2
INCORPORATION OF A COMPANY

2.1 Introduction
2.2 Objectives of the Study
2.3 Promoter
2.4 Incorporation of Companies - Procedural Aspects
2.5 Filing of Documents with Registrar of Companies
2.6 Issue of Certificate of Incorporation by Registrar
2.7 Allotment of Corporate Identity Number
2.8 Memorandum of Association
2.9 Contents of Memorandum
2.9.1 Name Clause
2.9.2 Situation Clause
2.9.3 Objects Clause
2.9.4 Doctrine of ULTRA VIRES
2.9.5 Liability Clause
2.9.6 Capital Clause
2.10 Articles of Association
2.10.1 Nature of Articles
2.10.2 Articles Subordinate to Memorandum
2.10.3 Registration of Articles
2.10.4 Statutory Requirements
2.10.5 Contents of Articles
2.11 Key Concepts
2.12 Summary
2.13 Exercise & Questions
2.14 Further Readings & References

2.1 Introduction

Promoters are persons who conceive the idea of forming a company and take the necessary steps to incorporate it by registration, provide it with share and loan capital and acquire for it business or property, which it is to manage.

The relationship between the promoter and the company that he has floated is a fiduciary relationship from the day on which he started the work of floating and it continues till he hands over the same to the directors. The memorandum and articles of association of a company are the most important documents for the formation of a company and for its functioning thereafter.

The memorandum of association contains the name, situation of registered office, objects, capital and liability clauses. The articles are its bye-laws or rules and regulations that govern the management and internal affairs and the conduct of its business. Both the documents are required to be registered with the Registrar of Companies at the stage of incorporation of the company. Before dealing with a company, it is advisable to read the memorandum and articles of the company to

NOTES

understand aspects, such as powers of Board, scope of company's activities etc. and its relationship with the outside world.

2.2 Objectives

After reading this lesson, you would be able to understand -

- The concept of promoters, their legal position, duties, liabilities and their remuneration.
- The important steps which are to be followed while forming a company.
- Different procedures for different type of companies.
- The concept of Memorandum of Association and Articles of Association, their purpose, contents and registration.
- The alterations that can be carried out in the Memorandum and Articles of Association and effect of such alterations. -The legal effect of these documents.
- Concept of doctrine of indoor management and Alter Ego.

2.3 Promoter

Section 2 (69) of the Companies Act, 2013 defines the term 'promoter' as under:-

"Promoter" means a person-

(a) who has been named as such in a prospectus or is identified by the company in the annual return referred to in section 92; or

(b) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or

(c) in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act.

Provided that sub-clause (c) shall not apply to a person who is acting merely in a professional capacity.

By virtue of above definition, persons in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act are also treated as promoters. However, if a person is merely acting in a professional capacity i.e. giving only professional advice to the Board of directors, he shall not be treated as a promoter.

A director/officer/employee who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise is considered as a promoter.

However, a director or officer or employee of the issuer or a person, if acting as such merely in his professional capacity, shall not be deemed as a promoter.

2.4 Incorporation of Companies - Procedural Aspects

(a) Application for Availability of Name of company

As per section 4(4) a person may make an application, in such form and manner and accompanied by such fee, as may be prescribed, to the Registrar for the reservation of a name set out in the application as-

(a) the name of the proposed company; or

(b) the name to which the company proposes to change its name.

As per Rule 9 of Companies (incorporation) Rules 2014, an application for the reservation of a name shall be made in Form No. INC.1 which may be approved or rejected by, Central Registration Centre along with the fee as provided in the Companies (Registration offices and fees) Rules, 2014.

According to section 4(2), the name stated in the memorandum of association shall not-

(a) be identical with or resemble too nearly to the name of an existing company registered under this Act or any previous company law; or

(b) be such that its use by the company-

(i) will constitute an offence under any law for the time being in force; or

(ii) is undesirable in the opinion of the Central Government.

Section 4(3) provides that without prejudice to the provisions of section 4(2), a company shall not be registered with a name which contains-

(a) any word or expression which is likely to give the impression that the company is in any way connected with, or having the patronage of, the Central Government, any State Government, or any local authority, corporation or body constituted by the Central Government or any State Government under any law for the time being in force; or

(b) such word or expression, as may be prescribed unless the previous approval of the Central Government has been obtained for the use of any such word or expression.

CHECK YOUR PROGRESS

Define promoter of a company.

Section 4(5)(i) lays down that upon receipt of an application under sub-section (4), the Registrar may, on the basis of information and documents furnished along with the application, reserve the name for a period of 60 days from the date of the application.

Section 4(5)(ii) lays down that where after reservation of name under clause (i), it is found that name was applied by furnishing wrong or incorrect information, then,- (a) if the company has not been incorporated, the reserved name shall be cancelled and the person making application under sub-section (4) shall be liable to a penalty which may extend to one lakh rupees; (b) if the company has been incorporated, the Registrar may, after giving the company an opportunity of being heard- (i) either direct the company to change its name within a period of three months, after passing an ordinary resolution; (ii) take action for striking off the name of the company from the register of companies; or (iii) make a petition for winding up of the company Rule 8 of Companies (Incorporation) Rules, 2014 states that in determining whether a proposed name is identical with another, the differences on account of certain aspects may be disregarded, the details of the same is stated in that rule.

(b) Preparation of Memorandum and Articles of Association

The Memorandum of Association is the charter of a company. It is a document, which amongst other things, defines the area within which the company can operate.

Section 4(1) states that the memorandum of a company shall state-

(a) the name of the company with the last word "Limited" in the case of a public limited company, or the last words "Private Limited" in the case of a private limited company

(b) the State in which the registered office of the company is to be situated;

(c) the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof;

(d) the liability of members of the company, whether limited or unlimited, and also state,- (i) in the case of a company limited by shares, that liability of its members is limited to the amount unpaid, if any, on the shares held by them; and (ii) in the case of a company limited by guarantee, the amount up to which each member undertakes to contribute- (A) to the assets of the company in the event of its being wound-up while he is a member or within one year after he ceases to be a member, for payment of the debts and liabilities of the company or of such debts and liabilities as may have been contracted before he ceases to be a member, as the case may be; and (B) to the costs, charges and expenses of winding-up and for adjustment of the rights of the contributories among themselves;

(e) in the case of a company having a share capital,- (i) the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the memorandum agree to subscribe which shall not be less than one share; and (ii) the number of shares each subscriber to the memorandum intends to take, indicated opposite his name;

(f) in the case of One Person Company, the name of the person who, in the event of death of the subscriber, shall become the member of the company.

As per Section 4(6), the memorandum of a company shall be in respective forms specified in Tables A, B, C, D and E in Schedule I as may be applicable to such company.

Section 5(1) states that the articles of a company shall contain the regulations for management of the company.

2.5 Filing of Documents with Registrar of Companies

Section 7(1) states that there shall be filed with the Registrar within whose jurisdiction the registered office of a company is proposed to be situated, the following documents and information for registration, namely:-

(a) Application for Incorporation of Companies: Rule 12 of Companies (Incorporation) Rules, 2014 states that an application for incorporation shall be filed with ROC in form INC-2 (in case of one Person Company or INC-7 in case of other companies.)

Integrated Incorporation of Companies- EForm INC-29 is a new e-form which provides an optional facility thereby simplifying the procedure of incorporation. It relates to a single application for approval of name of the company, incorporation of a new company and/or application for allotment of Director Identification Number (DIN). This eForm is accompanied by supporting documents including details of Directors & subscribers, MoA and AoA etc. Once the e-Form is processed and found complete, company would be registered and Corporate Identification Number (CIN) would be allocated. Also DINs gets issued to the proposed Directors who do not have a valid DIN. Maximum three Directors are allowed for using this integrated form for filing application of allotment of DIN while incorporating a company. [Rule 36 of Companies (Incorporation) Rules, 2014]

Memorandum and Articles of Association of the company duly signed

(b) Section 7(1)(a) the filing of the memorandum and articles of the company duly signed by all the subscribers to the memorandum in such manner as may be prescribed;

NOTES

Rule 13 of Companies (Incorporation) Rules 2014 states that

The Memorandum and Articles of Association of the company shall be signed in the following manner, namely:-

(1) The memorandum and articles of association of the company shall be signed by each subscriber to the memorandum, who shall add his name, address, description and occupation, if any, in the presence of at least one witness who shall attest the signature and shall likewise sign and add his name, address, description and occupation, if any and the witness shall state that "I witness to subscriber/subscriber(s), who has/have subscribed and signed in my presence (date and place to be given); further I have verified his or their Identity Details (ID) for their identification and satisfied myself of his/her/their identification particulars as filled in"

(2) Where a subscriber to the memorandum is illiterate, he shall affix his thumb impression or mark which shall be described as such by the person, writing for him, who shall place the name of the subscriber against or below the mark and authenticate it by his own signature and he shall also write against the name of the subscriber, the number of shares taken by him.

(3) Such person shall also read and explain the contents of the memorandum and articles of association to the subscriber and make an endorsement to that effect on the memorandum and articles of association.

(4) Where the subscriber to the memorandum is a body corporate, the memorandum and articles of association shall be signed by director, officer or employee of the body corporate duly authorized in this behalf by a resolution of the board of directors of the body corporate and where the subscriber is a Limited Liability Partnership, it shall be signed by a partner of the Limited Liability Partnership, duly authorized by a resolution approved by all the partners of the Limited Liability Partnership:

Provided that in either case, the person so authorized shall not, at the same time, be a subscriber to the memorandum and articles of Association.

(5) Where subscriber to the memorandum is a foreign national residing outside India-

(a) in a country in any part of the Commonwealth, his signatures and address on the memorandum and articles of association and proof of identity shall be notarized by a Notary (Public) in that part of the Commonwealth.

(b) in a country which is a party to the Hague Apostille Convention, 1961, his signatures and address on the memorandum and articles of association and proof of identity shall be notarized before the

Notary (Public) of the country of his origin and be duly apostillised in accordance with the said Hague Convention.

(c) in a country outside the Commonwealth and which is not a party to the Hague Apostille Convention,

1961, his signatures and address on the memorandum and articles of association and proof of identity, shall be notarized before the Notary (Public) of such country and the certificate of the Notary (Public) shall be authenticated by a Diplomatic or Consular Officer empowered

NOTES

in this behalf under section 3 of the Diplomatic and Consular Officers (Oaths and Fees) Act, 1948 (40 of 1948) or, where there is no such officer by any of the officials mentioned in section 6 of the Commissioners of Oaths Act, 1889 (52 and 53 Vic.C.10), or in any Act amending the same;

(d) visited in India and intended to incorporate a company, in such case the incorporation shall be allowed if, he/she is having a valid Business Visa.

Explanation.- For the purposes of this clause, it is hereby clarified that, in case of Person is of Indian Origin or Overseas Citizen of India, requirement of business Visa shall not be applicable.

(c) Declaration from the professional

Section 7(1)((b) requires filing of a declaration in the prescribed form by an advocate, a chartered accountant, cost accountant or company secretary in practice, who is engaged in the formation of the company, and by a person named in the articles as a director, manager or secretary of the company, that all the requirements of this Act and the rules made thereunder in respect of registration and matters precedent or incidental thereto have been complied with; Rule 14 of The Companies (Incorporation) Rules, 2014 states that for the purposes of clause (b) of subsection (1) of section 7, the declaration by an advocate, a Chartered Accountant, Cost accountant or Company Secretary in practice shall be in Form No. INC.8. Explanation (i) "chartered accountant" means a chartered accountant as defined in clause (b) of sub section (1) of section 2 of the Chartered Accountants Act, 1949 (ii) "Cost Accountant" means a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 and (iii) "company secretary" means a "company secretary" or "secretary" means as defined in clause (c) of subsection (1) of section 2 of the Company Secretaries Act, 1980.

(d) Affidavit from the subscribers to the Memorandum

Section 7(1)(c) requires the filing of an affidavit from each of the subscribers to the memorandum and from persons named as the first directors, if any, in the articles that he is not convicted of any offence in connection with the promotion, formation or management of any company, or that he has not been found guilty of any fraud or misfeasance or of any breach of duty to any company under this Act or any previous company law during the preceding five years and that all the documents filed with the Registrar for registration of the company contain information that is correct and complete and true to the best of his knowledge and belief;

Rule 15 of The Companies (Incorporation) Rules, 2014 states that

For the purposes of clause (c) of sub-section (1) of section 7, the affidavit shall be submitted by each of the subscribers to the memorandum and each of the first directors named in the articles in Form No.INC.9

(e) Furnishing verification of Registered Office

Under Section 12, a company shall, on and from the 15th day of its incorporation and at all times thereafter, have a registered office capable of receiving and acknowledging all communications and notices as may be addressed to it. The company can furnish to the registrar verification of registered office within 30 days of incorporation in the manner prescribed. As per rule 25(1) of Companies

(Incorporation) Rules 2014, the verification of registered office shall be filed in Form no INC 22.

Where the location of the registered office is finalised prior to Incorporation of a company by the promoters, the promoters can also file along with the Memorandum and Articles, the verification of its registered office in Form no INC 22.

(f) Particulars of subscribers

Section 7(1)(e) requires the filing of the particulars of name, including surname or family name, residential address, nationality and such other particulars of every subscriber to the memorandum along with proof of identity, as may be prescribed, and in the case of a subscriber being a body corporate, such particulars as may be prescribed;

Rule 16 of Companies (Incorporation) Rules states that Particulars of every subscriber to be filed with the Registrar at the time of incorporation.

(1) The following particulars of every subscriber to the memorandum shall be filed with the Registrar-

(a) Name (including surname or family name) and recent Photograph affixed and scan with MOA and AOA:
(b) Father's/Mother's name:
(c) Nationality:
(d) Date of Birth:
(e) Place of Birth (District and State):
(f) Educational qualification:
(g) Occupation:
(h) Income-tax permanent account number:
(i) Permanent residential address and also Present address (Time since residing at present address and address of previous residence address (es) if stay of present address is less than one year) similarly the office/business addresses :
(j) Email id of Subscriber;
(k) Phone No. of Subscriber;
(l) Fax no. of Subscriber (optional)
Explanation.- information related to (i) to (l) shall be of the individual subscriber and not of the professional engaged in the incorporation of the company;
(m) Proof of Identity:
For Indian Nationals:
- PAN Card (mandatory) and any one of the following
- Voter's identity card
- Passport copy
- Driving License copy
- Unique Identification Number (UIN)
For Foreign nationals and Non Resident Indians
- Passport
It was clarified by MCA vide Circular No. 16/2014 that, a declaration from foreign national in the prescribed format shall be furnished as an attachment of INC 7 (Application for Incorporation), in case if he does not have a PAN.
(n) Residential proof such as Bank Statement, Electricity Bill, Telephone / Mobile Bill:
Provided that Bank statement Electricity bill, Telephone or Mobile bill shall not be more than two months old;

(o) Proof of nationality in case the subscriber is a foreign national.

(p) If the subscriber is already a director or promoter of a company(s), the particulars relating to-
(i) Name of the company;
(ii) Corporate Identity Number;
(iii) Whether interested as a director or promoter;

(q) the promoter or first director shall self attest his signature and latest photograph in Form No.INC-10.

(2) Where the subscriber to the memorandum is a body corporate, then the following particulars shall be filed with the Registrar-

(a) Corporate Identity Number of the Company or Registration number of the body corporate, if any

(b) GLN, if any;

(c) the name of the body corporate

(d) the registered office address or principal place of business;

(e) E-mail Id;

(f) if the body corporate is a company, certified true copy of the board resolution specifying inter alia the authorization to subscribe to the memorandum of association of the proposed company and to make investment in the proposed company, the number of shares proposed to be subscribed by the body corporate, and the name, address and designation of the person authorized to subscribe to the Memorandum;

(g) if the body corporate is a limited liability partnership or partnership firm, certified true copy of the resolution agreed to by all the partners specifying inter alia the authorization to subscribe to the memorandum of association of the proposed company and to make investment in the proposed company, the number of shares proposed to be subscribed in the body corporate, and the name of the partner authorized to subscribe to the Memorandum;

(h) the particulars as specified above for subscribers in terms of clause (e) of sub- section (1) of section 7 for the person subscribing for body corporate;

(i) in case of foreign bodies corporate, the details relating to-
(i) the copy of certificate of incorporation of the foreign body corporate; and
(ii) the registered office address.

(j) in case of foreign bodied corporate, the details relating to -
(i) the copy of certificate of incorporation of the foreign body corporate; and
(ii) the registered office address

(g) Particulars of first directors along with their consent to act as directors

Section 7(1)(f) requires filing of the particulars of the persons mentioned in the articles as the first directors of the company, their names, including surnames or family names, the Director Identification Number, residential address, nationality and such other particulars including proof of identity as may be prescribed.

Section 7(1)(g) states that the particulars of the interests of the persons in form MGT 14 , mentioned in the articles as the first directors of the company in other firms or bodies corporate along with their consent to act as directors in form DIR 2 of the company in such form and manner as may be prescribed.

Rule 17 of Companies (Incorporation) Rules 2014 states that

The particulars of each person mentioned in the articles as first director of

the company and his interest in other firms or bodies corporate along with his consent to act as director of the company shall be filed in Form No.DIR.12 along with the fee as provided in the Companies (Registration offices and fees) Rules, 2014.

As per section 152 (3), no person shall be appointed as a director of a company unless he has been allotted the Director Identification Number under section 154. Section 152(4) provides that every person proposed to be appointed as a director by the company in general meeting or otherwise, shall furnish his Director Identification Number. By virtue of section 153, every individual intending to be appointed as director of a company shall make an application for allotment of Director Identification Number in Form no Dir 3. Any individual who intends to be a director of a company will have to mandatorily apply for DIN first. DIN has to be obtained by the directors of the company before commencing the procedure for incorporation of a company.

Integrated Process for Incorporation:

The companies opting for integrated incorporation of companies may apply for Director Identification Number for upto three in for INC-29

(h) Power of Attorney

With a view to fulfilling the various formalities that are required for incorporation of a company, the promoters may appoint an attorney empowering him to carry out the instructions/requirements stipulated by the Registrar. This requires execution of a Power of Attorney on a non-judicial stamp paper of a value prescribed in the respective State Stamp Laws.

2.6 Issue of Certificate of Incorporation by Registrar

Section 7(2) states that the Registrar on the basis of documents and information filed under sub-section (1) of section 7, shall register all the documents and information referred to in that sub- section in the register and issue a certificate of incorporation in the prescribed form to the effect that the proposed company is incorporated under this Act.

From the date of incorporation mentioned in the certificate of incorporation, the entity is formed as a body corporate by the name provided in the MoA, subscribers to the memorandum and all other persons, as may, from time to time, become members of the company, it is capable of exercising all the functions of an incorporated company under Companies Act, 2013 and having perpetual succession and a common seal (if the company has adopted or adopts the same), it has the power to acquire, hold and dispose of property, both movable and immovable, tangible and intangible, to contract and to sue and be sued, by the said name. (Section 9). The subscribers would become the members of the company.

As per the Companies (Amendment) Act, 2015 the mandatory requirement of Common seal has been omitted. The Company may or may not adopt a common seal.

Conclusive Evidence

A Certificate of Incorporation given by the Registrar in respect of any association shall be conclusive evidence that all the requirements of the Act have been complied with in respect of registration and matters precedent and incidental thereto, and that the association is a company authorised to be registered and duly registered under the Act. The Certificate of Incorporation is conclusive evidence that everything is in order as regards registration and that the company has come into existence from the earliest moment of the day of incorporation stated therein

NOTES

with rights and liabilities of a natural person, competent to enter into contracts. The validity of the registration cannot be questioned after the issue of the certificate.

It is for the purpose of incorporation only that the certificate was made conclusive by the legislature and the certificate cannot legalise the illegal object contained in the Memorandum. Where the object of a company is unlawful, it has been held that the certificate of registration is not conclusive for this purpose.

2.7 Allotment of Corporate Identity Number

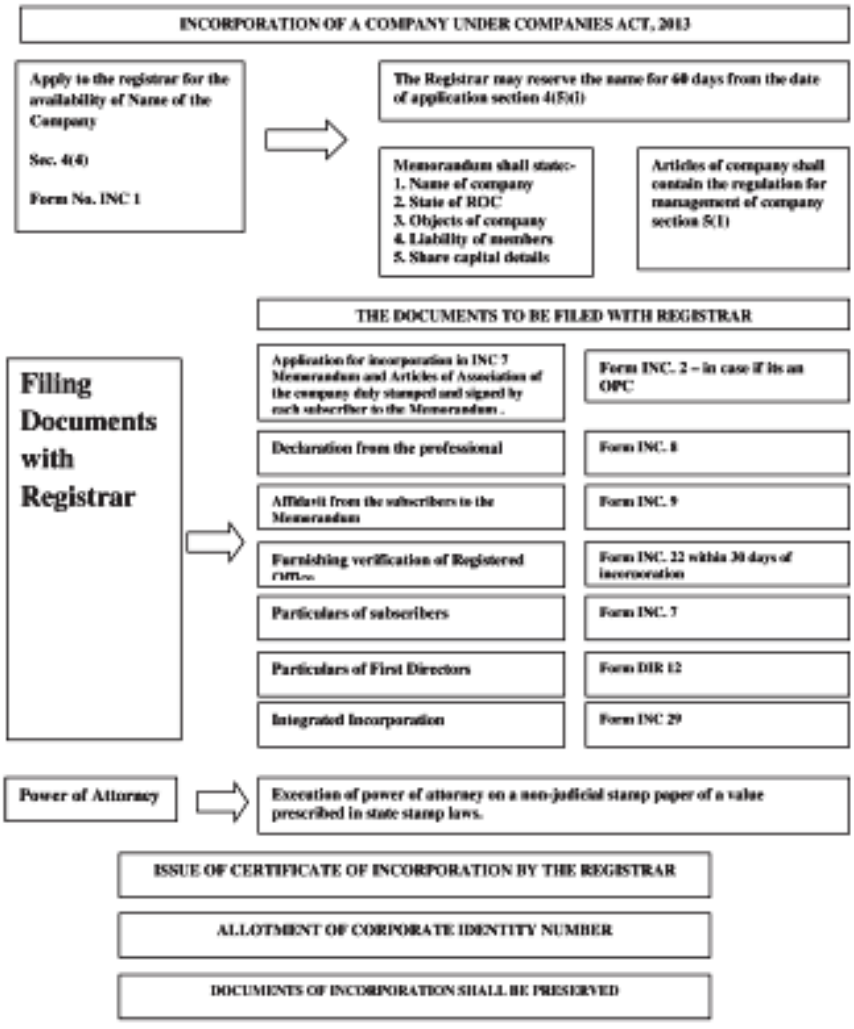
Section 7(3) states that on and from the date mentioned in the certificate of incorporation issued under subsection (2), the Registrar shall allot to the company a corporate identity number, which shall be a distinct identity for the company and which shall also be included in the certificate.

Documents of incorporation to be preserved

Section 7(4) states that the company shall maintain and preserve at its registered office copies of all documents and information as originally filed under sub-section (1) till its dissolution under this Act.

As per Section 12(c) every company shall get its name, address of its registered office and the Corporate Identity Number along with telephone number, fax number, if any, e-mail and website addresses, if any, printed in all its business letters, billheads, letter papers and in all its notices and other official publications.

Figure



2.8 Memorandum of Association

The Memorandum of Association is a document which sets out the constitution of a company and is therefore the foundation on which the structure of the company is built. It defines the scope of the company's activities and its relations with the outside world.

The first step in the formation of a company is to prepare a document called the memorandum of association. In fact memorandum is one of the most essential pre-requisites for incorporating any form of company under the Companies Act,2013 (hereinafter referred to as 'Act"). This is evidenced in Section 3 of the Act, which provides the mode of incorporation of a company and states that a company may be formed for any lawful purpose by seven or more persons, where the company to be formed is a public company; two or more persons, where the company to be formed is a private company; or one person, where the company to be formed is a One Person Company by subscribing their names or his name to a memorandum and complying with the requirements of this Act in respect of its registration.

To subscribe means to append one's signature or mark a document as an approval or attestation of its contents.

According to Section 2(56) of the Act "memorandum" means the memorandum of association of a company as originally framed and altered, from time to time, in pursuance of any previous company law or this Act. Section 4 of the Act specifies in clear terms the contents of this important document which is the charter of the company. The memorandum of association of a company contains the objects of the company which it shall pursue. It not only shows the objects of formation of the company but also determines the scope of its operations beyond which its actions cannot go. "THE MEMORANDUM OF ASSOCIATION", as observed by Palmer, "is a document of great importance in relation to the proposed company".

2.9 Contents of Memorandum

2.9.1 Name Clause

Name of the company should indicate whether the company is private or public. No undesirable name as specified in Rule 8 of Companies (Incorporation) Rules, 2014 No identical name that resembles the name of an existing company.

A company being a legal entity must have a name of its own to establish its separate identity. The name of the company is a symbol of its independent corporate existence. The first clause in the memorandum of association of the company states the name by which a company is to be known. The company may adopt any suitable name provided it is not undesirable.

According to section 4(2), the name stated in the memorandum shall not-

(a) be identical with or resemble too nearly to the name of an existing company registered under this Act or any previous company law; or

(b) be such that its use by the company-

(i) will constitute an offence under any law for the time being in force; or

(ii) is undesirable in the opinion of the Central Government.

Section 4(3) provides that without prejudice to the provisions of section 4(2), a company shall not be registered with a name which contains-

(a) any word or expression which is likely to give the impression that the company is in any way connected with, or having the patronage of, the Central

NOTES

Government, any State Government, or any local authority, corporation or body constituted by the Central Government or any State Government under any law for the time being in force; or

(b) such word or expression, as may be prescribed, (See annexure 3.1 of Chapter 3) unless the previous approval of the Central Government has been obtained for the use of any such word or expression.

As per section 4(4) a person may make an application, in form (e-Form INC1) accompanied by prescribed fee to the Registrar for the reservation of a name set out in the application as-

(a) the name of the proposed company; or

(b) the name to which the company proposes to change its name.

Section 4(5)(i) lays down that upon receipt of an application under sub-section (4), the Registrar may, on the basis of information and documents furnished along with the application, reserve the name for a period of 60 days from the date of the application.

CHECK YOUR PROGRESS

Describe the provisions of Name Clause?

The Central Government under Section 16 is empowered to direct a company, at any point of time to rectify its name if by inadvertence it has been registered with a name which is identical to or too nearly resembles the name of an existing company whether registered under this Act or the previous company law. The company shall change its name within a period of 3 months from the issue of the above direction after passing an ordinary resolution for the purpose.

This section also gives enhanced power to the Central Government to order rectification of name where such name in its opinion constitutes an infringement of a registered trademark. The proprietor of the registered trade mark may make an application to the Central Government for an order for rectification of name of the company because it is identical to or too nearly resembles the applicant's registered trademarks. Such application must be made within three years from the date of incorporation or the registration or change of name whether under this Act or previous company law. In such a case the Central Government may direct the company to change its name and the company shall change its name, within a period of six months from the issue of such direction, after passing an ordinary resolution for the purpose.

Where a company changes its name or obtains a new name, it shall within a period of fifteen days from the date of such change, give notice of the change to the Registrar along with the order of the Central Government, who shall carry out necessary changes in the certificate of incorporation and the memorandum.

2.9.2 Situation Clause

The name of the State in which the registered office of the company is to be situated must be given in the memorandum. But the exact address of the registered office is not required to be stated therein. According to section 12 of the Act within 15 days of company's incorporation, and at all times thereafter, the company must have a registered office to which all communications and notices may be sent. The company must also furnish to the Registrar verification of its registered office within a period of thirty days of its incorporation in such manner as may be prescribed. (e-form INC-22)

Publication of Name and Address of the Company

According to Section 12(3) every company is required to display its name and address in legible letters in conspicuous position and in all its business letters, bill heads, letter papers. Accordingly, the company shall-

(a) paint or affix its name, and the address of its registered office, and keep the same painted or affixed, on the outside of every office or place in which its business is carried on, in a conspicuous position, in legible letters, and if the characters employed therefor are not those of the

language or of one of the languages in general use in that locality, also in the characters of that language or of one of those languages;

(b) in case the company has adopted common seal then the name shall be engraved in legible characters on its seal;

(c) get its name, address of its registered office and the Corporate Identity Number along with telephone number, fax number, if any, e-mail and website addresses, if any, printed in all its business letters, billheads, letter papers and in all its notices and other official publications; and

(d) have its name printed on negotiable instruments such as hundies, promissory notes, bills of exchange.

However, where a company has changed its name or names during the last two years, it shall paint or affix or print, as the case may be, along with its name, the former name or names so changed during the last two years.

Further in case of One Person Company, the words "One Person Company" shall be mentioned in brackets below the name of such company, wherever its name is printed, affixed or engraved.

Ministry of Corporate Affairs (MCA) has clarified that display of its name in English in addition to the display in the local language will be a sufficient compliance with the requirements of the section.

The MCA has also clarified that a share certificate is not an official publication of a company within the meaning of Section 147 of the Companies Act, 1956 [This corresponds to Section 12 of the Companies Act, 2013] [Circular No. 3/73/8/10(147)/ 72-CC-V dated 3.2.1973].

CHECK YOUR PROGRESS

Describe objective clause?

2.9.3 Objects Clause

The third compulsory clause in the memorandum sets out the objects for which the company has been formed. Under section 4(1)(c) of the Act, all companies must state in their memorandum the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof.

The objects clause is of great importance because it determines the purpose and the capacity of the company. It indicates the purpose for which the company has been set up and its actual capability, besides its sphere of activities. It states affirmatively the ambit and extent of powers of the company and, stated negatively, that nothing should be done beyond that ambit and that no attempt shall be made to use the company for any other purpose than that which is specified. The purpose of the objects clause is to enable the persons dealing with the company to know its permitted range of activities. The acts beyond this ambit are ultra vires and hence void. Even the entire body of shareholders cannot ratify such acts.

The company shall furnish to the Registrar of Companies, the verification of its registered office within 30 days of incorporation in Form INC 22.

Although express powers are necessary, a company may do anything which is incidental to and consequential upon the powers specified, and the act will not be ultra vires. Thus, a trading company has an implied power to borrow money, draw and accept bills of exchange in the ordinary form, but a railway company cannot issue bills although it may borrow money.

The subscribers to the memorandum of association enjoy almost unrestricted freedom to choose the objects. The only restriction is that objects should not be illegal and against the provisions of the Companies Act, 2013.

The memorandum of association of a company is its charter defining the objects of its existence and operations. The objects clause or clauses in the memorandum are to be so construed as to confer on the company all powers reasonably required to the attainment of the objects.' "A memorandum of association like any other document must be read fairly and its importance derived from a reasonable interpretation of the language which it employs"

2.9.4 Doctrine of ULTRA VIRES

In the case of a company whatever is not stated in the memorandum as the objects or powers is prohibited by the doctrine of ultra vires. As a result, an act which is ultra vires is void, and does not bind the company.

Neither the company nor the contracting party can sue on it. Also, as stated earlier, the company cannot make it valid, even if every member assents to it.

The general rule is that an act which is ultra vires the company is incapable of ratification. An act which is intra vires the company but outside the authority of the directors may be ratified by the company in proper form.

The rule is meant to protect shareholders and the creditors of the company. If the act is ultra vires (beyond the powers of) the directors only, the shareholders can ratify it. If it is ultra vires the articles of association, the company can alter its articles in the proper way.

2.9.5 Liability Clause

Section 4 sub-section 1(d) of the Act, states that the liability of members of the company is to be specifically mentioned in the MoA. It is provided that the liability of member may either be limited or unlimited, further it shall also state that,-

(i) in the case of a company limited by shares, the liability of its members is limited to the amount unpaid, if any, on the shares held by them; and

(ii) in the case of a company limited by guarantee, the amount up to which each member undertakes to contribute-

(A) to the assets of the company in the event of its being wound-up while he is a member or within one year after he ceases to be a member, for payment of the debts and liabilities of the company or of such debts and liabilities as may have been contracted before he ceases to be a member, as the case may be; and

(B) to the costs, charges and expenses of winding-up and for adjustment of the rights of the contributories among themselves;

2.9.6 Capital Clause

This clause shall state the amount of the capital with which the company is registered. The shares into which the capital is divided must be of fixed value, which is commonly known as the nominal value of the share.

The capital is variously described as "nominal", "authorised" or "registered".

The amount of nominal capital is determined having regard to the present as well as future requirements of the company with reference to its objects. The usual way to state the capital in the memorandum is: "The capital of the company is Rs. 10,00,000 divided into 1,00,000 equity shares of ` 10 each". This amount lays down the maximum limit beyond which the company cannot issue shares without altering the memorandum as provided by Section 61 of the Companies Act, 2013.

If there are both equity and preference shares, then the division of the capital is to be shown under these two heads. A company is not authorised to issue capital beyond its authorised/nominal/registered capital. If it receives applications for shares beyond the shares covered by the authorised capital, the amount received on excess number of shares should be returned.

Out of the issued capital, the total amount actually subscribed or agreed to be subscribed is known as subscribed capital, and this subscribed capital again may be wholly paid or partly paid, in which latter case the balance would be payable on future calls when made. The amount actually paid by the shareholders is called the paid-up capital.

According to Section 60 of the Act, if the amount of the authorised capital (nominal capital), of the company is stated in any notice, advertisement, official publication, business letter, bill head or letter paper, it shall also contain a statement in an equally prominent position and in equally conspicuous terms the amount of capital which has been subscribed and the amount paid-up.

2.10 Articles of Association

2.10.1 Nature of Articles

According to Section 2(5) of the Companies Act, 2013, 'articles' means the articles of association of a company as originally framed or as altered from time to time or applied in pursuance of any previous company law or of this Act. It also includes the regulations contained in Table A in Schedule I of the Act, in so far as they apply to the company.

In terms of section 5(1), the articles of a company shall contain the regulations for management of the company. The articles of association of a company are its bye-laws or rules and regulations that govern the management of its internal affairs and the conduct of its business. The articles play a very important role in the affairs of a company. It deals with the rights of the members of the company inter se. They are subordinate to and are controlled by the memorandum of association. The general functions of the articles have been aptly summed up by Lord Cairns, L.C. in Ashbury Railway Carriage and Iron Co. Ltd. v. Riche, (1875) L.R. 7 H.L. 653 as follows:

"The articles play a part that is subsidiary to the memorandum of association. They accept the memorandum of association as the charter of incorporation of the company, and so accepting it, the articles proceed to define the duties, rights and powers of the governing body as between themselves and the company at large, and the mode and form in which business of the company is to be carried on, and the mode and form in which changes in the internal regulations of the company may from time to time be made... The memorandum, is as it were... the area beyond which the action of the company cannot go; inside that area shareholders may make such regulations for the governance of the company as they think fit".

Thus, the memorandum lays down the scope and powers of the company, and the articles govern the ways in which the objects of the company are to be carried out and can be framed and altered by the members. But they must keep within the limits marked out by the memorandum and the Companies Act.

The articles regulate the internal management of the affairs of the company by way of defining the powers of its officers and establishing a contract between the company and the members and between the members inter se. This contract governs the ordinary rights and obligations incidental to membership in the company. But the Articles of Association of a company are not 'law' and do not have the force of law.

2.10.2 Articles Subordinate to Memorandum

The articles of a company are subordinate to and subject to the memorandum of association and any clause in the Articles going beyond the memorandum will be ultra vires. But the articles are only internal regulations, over which the members of the company have full control and may alter them according to what they think fit.

Only care has to be taken to see that regulations provided for in the articles do not exceed the powers of the company as laid down by its memorandum. Articles that go beyond the company's sphere of action are inoperative, and anything done under the authority of such article is void and incapable of ratification.

NOTES

But neither the articles nor the memorandum can authorise the company to do anything so as to contravene any of the provisions of the Act.

2.10.3 Registration of Articles

Section 7(1) provides that at the time of incorporation of a company the company shall file with the Registrar within whose jurisdiction the registered office of a company is proposed to be situated, the memorandum and articles of the company duly signed by all the subscribers to the memorandum in the prescribed manner.

Every type of company whether public or private and whether limited by shares or limited by guarantee having a share capital or not having a share capital or an unlimited liability company must register their articles of association.

Section 5(2) provides that the articles shall also contain such matters, as prescribed in Rule 11 of

Companies (Incorporation) Rules,2014. However, nothing prescribed in this sub-section shall be deemed to prevent a company from including such additional matters in its articles as may be considered necessary for its management. The articles of a company shall be in respective forms specified in Tables, F, G, H, I and J in Schedule I as may be applicable to such company either in totality or otherwise. [Section 5(6)] A company may adopt all or any of the regulations contained in the model articles applicable to such company. [Section 5(7)]

Section 5(8) provides that in case of any company, which is registered after the commencement of Companies Act 2013, in so far as the registered articles of such company do not exclude or modify the regulations contained in the model articles applicable to such company, those regulations shall, so far as applicable, be the regulations of that company in the same manner and to the extent as if they were contained in the duly registered articles of the company.

Therefore in terms of Section 5 of the Companies Act, 2013 a public company limited by shares may at its option register its articles of association signed by the same subscribers as to the memorandum, or alternatively it may adopt all or any of the regulations contained in Table F of First Schedule of the Act. If articles are not registered, automatically Table F in Schedule I apply, and if registered, Table F in Schedule I apply except in so far as it is excluded or modified by the articles. To avoid any confusion, normally every public company delivers its articles along with the memorandum for registration. Further it will be specifically stated therein that Table 'F' will not apply. The articles of a private company must contain the three restrictions as contained in Section 2(68).

A company limited by guarantee having a share capital or a company limited by guarantee not having a share capital or an unlimited company having a share capital or an unlimited company not having a share capital might adopt any of the appropriate regulations of Table G, H, I and J respectively in Schedule I [Section 5(6)].

However nothing in section 5 shall apply to the articles of a company registered under any previous company law unless amended under this Act [Section 5(9)].

2.10.4 Statutory Requirements

The articles must be printed, divided into paragraphs, numbered consecutively, stamped adequately, signed by each subscriber to the memorandum and duly witnessed and filed along with the memorandum. The articles must not contain anything illegal or ultra vires the memorandum, nor should it be contrary to the provisions of the Companies Act, 2013.

2.10.5 Contents of Articles

The articles set out the rules and regulations framed by the company for its own working. The articles should contain generally the following matters:

1. Exclusion wholly or in part of Table F.
2. Adoption of preliminary contracts.
3. Number and value of shares.
4. Issue of preference shares.
5. Allotment of shares.
6. Calls on shares.
7. Lien on shares.
8. Transfer and transmission of shares.
9. Nomination.
10. Forfeiture of shares.
11. Alteration of capital.
12. Buy back.
13. Share certificates.
14. Dematerialisation.
15. Conversion of shares into stock.
16. Voting rights and proxies.
17. Meetings and rules regarding committees.
18. Directors, their appointment and delegations of powers.
19. Nominee directors.
20. Issue of Debentures and stocks.
21. Audit committee.
22. Managing director, Whole-time director, Manager, Secretary.
23. Additional directors.
24. Seal.
25. Remuneration of directors.
26. General meetings.
27. Directors meetings.
28. Borrowing powers.
29. Dividends and reserves.
30. Accounts and audit.
31. Winding up.
32. Indemnity.
33. Capitalisation of reserves.

Utmost caution must be exercised in the preparation of the articles of association of a company. At the same time, certain provisions of the Act are applicable to the company "notwithstanding anything to the contrary in the articles". Therefore, the articles must contain provisions in respect of all matters which are required to be contained therein so as not to hamper the working of the company later.

2.11 Key Concepts

Prospectus Any document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any securities of a body corporate.

Certificate of Incorporation A certificate issued by the Registrar of Companies of a State indicating that a company's memorandum of association and articles of association have been accepted for filing and that the company is incorporated.

Conclusive Evidence is Preponderant evidence that may not be disputed and must be accepted by a Court as a definitive proof of a fact.

NOTES

2.12 Summary

- Promoters are the persons who conceive the idea of forming a company, and take the necessary steps to incorporate it by registration, provide it with share and loan capital and acquire the business or property which it is to manage.
- A promoter is neither an agent of, nor a trustee for the company. But he occupies a fiduciary position in relation to the company.
- A promoter is not forbidden to make profit but he should not make any secret profit.
- Disclosure by promoters to the company should be through the medium of the Board of Directors.
- Disclosures of sources of promoter's contribution have to be made in the prospectus.
- Civil as well as criminal liability may be imposed on a promoter for any misleading statement in the prospectus if loss or damage has been sustained by a person who has subscribed for any securities of the company on the faith of the prospectus.
- A promoter has no legal right to claim promotional expenses for his services unless there is a valid contract.
- The first few steps to be taken by a promoter in incorporating a company are to apply for availability of name of company, prepare the memorandum and articles of association and get them vetted, printed, stamped and signed.
- The promoter should then execute power of attorney and file additional documents as required under section 7. He should then file statutory declaration and pay the registration fees.
- The Registrar on the basis of documents and information filed above shall register all those documents and information in the register and issue a certificate of incorporation in the prescribed form to the effect that the proposed company is incorporated under this Act.
- The certificate of incorporation is conclusive evidence that everything is in order as regards registration and that the company has come into existence from the earliest moment of the day of incorporation stated therein.
- Any person who furnishes any false or incorrect particulars of any information or suppresses any material information, of which he is aware in any of the documents filed with the Registrar in relation to the registration of a company, shall be punishable for fraud under section 447. In such a case, the Tribunal may also on an application made to it pass suitable orders.

2.13 Questions and Exercises

1. Who is a promoter? Write a note on the duties and liabilities of promoters.
2. What are the remedies available to the Company against a promoter?
3. What does 'conclusive evidence' means in relation to certificate of incorporation? Discuss the same citing case laws?
4. "A promoter is not a trustee or agent for the company but he stands in a fiduciary position towards it." Discuss.

- **Fill in the blanks**

1. A promoter is neither an agent of, nor a trustee for the company. But he occupies a _____ position in relation to the company.
   (higher, last, fiduciary)
2. _____ is issued by the Registrar of Companies on the basis of documents and information filed by the applicant.
   (Certificate of Incorporation, Order of Incorporation, Book of Incorporation)

3. The certificate of incorporation is _____ evidence that everything is in order as regards registration and that the company has come into existence from the earliest moment of the day of incorporation stated therein.
(unconvincing, only, conclusive)
4. Articles of Association contain _____ and they are applied to the company.
(Regulations, Orders, Names)
5. Under _____, the shares into which the capital is divided must be of fixed value, which is commonly known as the nominal value of the share.
(Object Clause, Liability Clause, Capital Clause)
6. Under _____ it is provided that the liability of member may either be limited or unlimited.
(Object Clause, Liability Clause, Capital Clause)
7. In the case of a company whatever is not stated in the memorandum as the objects or powers is _____ by the doctrine of ultra vires.
(allowed, permitted, prohibited)
8. The company shall furnish to the Registrar of Companies, the verification of its registered office within 30 days of incorporation in Form _____.
(INC11, INC22, INC33)
9. _____ indicates the purpose for which the company has been set up and its actual capability, besides its sphere of activities.
(Object Clause, Liability Clause, Capital Clause)
10. According to section 4(2), the name stated in the memorandum shall not be _____ with or resemble too nearly to the name of an existing company registered under this Act or any previous company law.
(opposite, identical, negative)

[**Ans:** 1) Fiduciary, 2) Certificate of Incorporation, 3) Conclusive Evidence, 4) Regulations, 5) Capital Clause, 6) Liability Clause, 7) Prohibited, 8) INC 22, 9) Object Clause, 10) identical]

2.14 Further Reading and References

1. Dr. Avtar Singh : Company Law; Eastern Book Company, 34, Lalbagh, Lucknow - 226 001
2. C.R. Datta : Datta on the Company Law; Lexis Nexis, Butterworths Wadhwa, Nagpur
3. A. Ramaiya : Guide to the Companies Act; Lexis Nexis, Butterworths Wadhwa Nagpur
4. K.C. Garg, R.C. Chawla, Vijay Gupta: Company Law; Kalyani Publishers, 1/1, Rajinder Nagar, Civil Lines, Ludhiana - 141 001.
5. A.K. Majumdar, Dr. G.K. Kapoor, Sanjay Dhamija : Company Law and Practice; Taxmann, 59/32, New Rohtak Road, New Delhi-110 005.
6. V.S. Datey : Guide to Tax and Corporate Laws; Taxmann, 59/32, New Rohtak Road, New Delhi-110005.
7. M.C. Kuchhal : Modern Indian Company Law; Shri Mahavir Book Depot, 2603, Nai Sarak, Delhi-110006.
8. H.K. Saharay : Company Law; Universal Law Publishing Co., C-FF-1A, Dilkhush Industrial Estate, G.T. Karnal Road, Delhi. -110033.

NOTES

UNIT - 3
CAPITAL OF A COMPANY

3.1 Introduction
3.2 Objectives
3.3 CAPITAL-Meaning
3.4 Comparison between Preference Share Capital and Equity Share Capital
3.5 Issue of Securities at a Premium
3.6 Prohibition to Issue Shares at Discount
3.7 Issue of Sweat Equity Shares
3.8 Shares with Differential Voting Rights
3.9 Further Issue of Shares
3.10 Bonus Shares
3.11 Employee Stock Option Scheme
3.12 Issue of Shares on Preferential Basis
3.13 Alteration of Share Capital
3.14 Difference between Share and Stock
3.15 Reduction of Share Capital (Section 66)
3.16 Difference between Alteration of Share Capital and Reduction of Share Capital
3.17 Reduction of Share Capital without Sanction of the Court
3.18 Buy Back of Securities (Section 68)
3.19 Key Concepts
3.20 Summary
3.21 Exercise & Questions
3.22 Further Readings & References

3.1 Introduction

Sources of capital broadly include equity capital and preference capital. There are various ways to raise capital which include preferential allotment, employee stock option, issue of rights shares, issue of shares with differential voting rights. It involves various approvals, disclosures, filings, maintenance of records etc which are prescribed under Chapter IV of the Companies Act 2013. Besides this Companies (Share Capital and Debentures) Rules, 2014 also prescribes various aspects such as disclosures in the directors' report, matters to be stated in the explanatory statement to the resolution, prescribed forms as to maintenance of records, filings with registrar and so on.

Financial restructuring involves alteration of share capital which includes aspects such as increase of share capital, reduction of share capital, buy back of shares etc.

3.2 Objectives

After reading this lesson you will be able to understand -

- The concept of capital

- The regulatory aspects and the broader procedural aspects involved in different types of issue of capital
- Different provisions for issue of capital under Companies Act 2013 and Companies (Share Capital and Debentures) Rules, 2014.
- he legal and procedural aspects relating to consolidation, sub-division and reduction of capital and buy-back of securities
- The Regulatory and Procedural aspects involved in alteration of share capital through consolidation, sub-division, reduction of share capital, buy back of shares etc

NOTES

3.3 CAPITAL-Meaning

The term "Capital" has variety of meanings. It may mean one thing to an economist, one to an accountant, while another to a businessman or a lawyer. A layman views capital as the money, which a company has raised by issue of its shares. It uses this money to meet its requirements by way of acquiring business premises and stock-in-trade, which are called the fixed capital and the circulating capital respectively.

The phrase "loan or borrowed capital" is sometimes used to mean money borrowed by the company and secured by issuing debentures. This, however, is not the proper use of the word "capital".

In relation to a company limited by shares, the word "capital" means the share capital i.e., the capital in terms of rupees divided into specified number of shares of a fixed amount each. For e.g. share capital of a company is Rs.1,00,000 which can be divided into 10,000 shares of Rs.10 each or 1,000 shares of Rs.100 each, whichever is feasible to the company.

CHECK YOUR PROGRESS

Define the term capital?

"CAPITAL" under Company Law

In Company Law, the "Capital" is the share capital of a company, which is classified as:

(a) Nominal, Authorised or Registered Capital: As per section 2(8), "authorised capital" or "nominal capital" means such capital as is authorised by the memorandum of a company to be the maximum amount of share capital of the company.

(b) Issued Capital: As per section 2(50), "issued capital" means such capital as the company issues from time to time for subscription. It is that part of the authorised or nominal capital which the company issues for the time being for public subscription and allotment. This is computed at the face or nominal value.

(c) Subscribed Capital: According to Section 2(86), "subscribed capital" means such part of the capital which is for the time being subscribed by the members of a company. It is that portion of the issued capital at face value which has been subscribed for or taken up by the subscribers of shares in the company. It is clear that the entire issued capital may or may not be subscribed.

(d) Called up Capital: As per section 2(15), "called-up capital" means such part of the capital, which has been called for payment. It is that portion of the subscribed capital which has been called up or demanded on the shares by the company

(e) Paid-up Share Capital: As per section 2(64), "paid-up share capital" or "share capital paid-up" means such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid-up in respect of shares issued and also includes any amount credited as paid-up in respect of shares of the company, but does not include any other amount

NOTES

received in respect of such shares, by whatever name called.

(g) Preference and Equity Share Capital: As per explanation to Section 43 "equity share capital", with reference to any company limited by shares, means all share capital which is not preference share capital; "preference share capital", with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right with respect to-

(a) payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and

(b) repayment, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company;

A preference share has a preference in regard to payment of fixed amount of dividend or fixed rate of dividend and preferential right of the repayment of capital in the event of winding up of company.

3.4 Comparison between Preference Share Capital and Equity Share Capital

No.	Preference Capital	Equity Share Capital
1	Preference shares are entitled to a fixed rate of dividend.	The rate of dividend on equity shares depends upon the amount of profit available and the funds requirements of the company for future expansion etc.
2	Dividend on the preference shares is paid in preference to the equity shares.	The dividend on equity shares is paid only after the preference dividend has been paid.
3	In case of winding up, preference share holder get preference over equity share holders with regard to the payment of capital.	In case of winding up, equity share holder get payment of capital after the payment of capital to preference shareholders.
4	Dividend on preference share may be cumulative.	The dividend on equity shares is paid only after the preference dividend has been paid and it is not cumulative.
5	The voting rights of preference shareholders are restricted. A preference shareholder can vote only when his special rights as a preference shareholder are being varied, or on any resolution for the winding up of the company or for the repayment or reduction of its equity or preference share capital or their dividend has not been paid for a period of two years or more	An equity shareholder can vote on all matters affecting the company.
6	No bonus shares/right shares are issued to preference share holders.	A company may issue rights shares or bonus shares to the company's existing equity shareholders.

7	A company can issue preference shares which are redeemable within 20 years except in certain circumstances.	Equity shares cannot be redeemed except under a scheme involving reduction of capital or buy back of its own shares.
8	Voting right of a preference shareholders on a poll shall be in proportion to his share in the paid-up preference share capital of the company.	Voting right of an equity shareholders on a poll shall be in proportion to his share in the paid up equity share capital of the company.

3.5 Issue of Securities at a Premium

A company may issue securities at a premium when it is able to sell them at a price above par or above nominal value. The Companies Act, 2013, does not stipulate any conditions or restrictions regulating the issue of securities by a company at a premium. However, the Companies Act does impose conditions regulating the utilization of the amount of premium collected on securities.

Share Premium to be transferred to 'Securities Premium Account'

Section 52 (1) states that when a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount of the premium received on those shares shall be transferred to a "securities premium account" and the provisions of this Act relating to reduction of share capital of a company shall, except as provided in this section, apply as if the securities premium account were the paid up share capital of the company.

CHECK YOUR PROGRESS

For which type of capital a company pays the prescribed fees at the time of registration?

Utilisation of Securities premium

In accordance with the provisions of Section 52(2) of the Act, the securities premium can be utilised only for:

(a) issuing fully paid bonus shares to members;
(b) writing off the balance of the preliminary expenses of the company;
(c) writing off commission paid or discount allowed, or the expenses incurred on issue of shares or debentures of the company;
(d) for providing for the premium payable on redemption of any redeemable preference shares or debentures of the company; or
(e) for the purchase of its own shares or other securities under section 68.

3.6 Prohibition to Issue Shares at Discount

Section 53 states that except as provided in section 54 (i.e. issue of sweat equity shares), a company shall not issue shares at a discount. Any share issued by a company at a discounted price shall be void. When a company contravenes the provisions of 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 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 one lakh rupees but which may extend to five lakh rupees, or with both.

3.7 Issue of Sweat Equity Shares

According to section 2(88), sweat equity shares mean equity shares issued by a company to its directors or employees at a discount or for consideration, other than cash for providing know-how or making available rights in the nature of

NOTES

intellectual property rights or value additions, by whatever name called.

Conditions for Issue of Sweat Equity Shares

Section 54(1) provides that notwithstanding anything contained in Section 53, a company can issue sweat equity shares, of a class of shares already issued, if the following conditions are satisfied:

(i) the issue has been authorised by a special resolution passed by the company in the general meeting.

(ii) the following are clearly specified in the resolution:

(a) number of shares;

(b) current market price;

(c) consideration, if any; and

(d) class or classes of directors or employees to whom such equity shares are to be issued.

(iii) as on the date of issue, at least one year should have elapsed from the date on which the company had commenced business.

(iv) a company whose shares are listed on a recognized stock exchange issuing sweat equity shares should comply with the regulations made in this behalf by SEBI.

(v) a company whose shares are not so listed should issue sweat equity shares in compliance with the rules made in this behalf by the Central Government.

Holders of Sweat Equity Shares to be ranked pari passu with other Equity share holders

Section 54(2) provides that the rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank pari passu with other equity shareholders.

Issue of Sweat Equity Shares!

- Issue of Sweat equity shares to be authorized by special resolution at a general meeting.
- Explanatory statement to the special resolution to contain certain particulars.
- The special resolution authorizing Sweat equity shares is not valid if the allotment is made after 12 months of passing the resolution, i.e. the validity of special resolution is 12 months.
- Issue of Sweat Equity shares not to exceed fifteen percent of the existing paid up equity share capital in a year or shares of the issue value of rupees five crores, whichever is higher and twenty five percent, of the paid up equity capital of the Company at any time.
- The price of Sweat Equity shares is to be determined by a registered valuer.
- Board's Report to contain certain specified details of sweat equity shares issued.
- The company shall maintain a Register of Sweat Equity Shares in Form No. SH.3
- Issue of Sweat Equity shares to employees and directors at a discount under section 54 is outside the scope of section 53.

NOTES

3.8 Shares with Differential Voting Rights

While Section 43 enables companies to issue equity shares with differential rights as to dividend, voting rights etc. Rule 4 of Companies (Share Capital and Debentures) Rules, 2014 states the following conditions regarding shares with differential voting rights.

Conditions for issuing shares with differential rights (Rule 4) Companies (Share Capital and Debentures) Rules, 2014

No company limited by shares shall issue equity shares with differential rights as to dividend, voting or otherwise, unless it complies with the following conditions, namely:-

(a) the articles of association of the company authorizes the issue of shares with differential rights;

(b) the issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders. When the equity shares of a company are listed on a recognized stock exchange, the issue of such shares shall be approved by the shareholders through postal ballot ;

(c) the shares with differential rights shall not exceed twenty-six percent of the total post-issue paid up equity share capital including equity shares with differential rights issued at any point of time;

(d) the company having consistent track record of distributable profits for the last three years;

(e) the company has not defaulted in filing financial statements and annual returns for three financial years immediately preceding the financial year in which it is decided to issue such shares;

(f) the company has no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits or redemption of its preference shares or debentures that have become due for redemption or payment of interest on such deposits or debentures or payment of dividend;

(g) the company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution or State level financial institution or scheduled Bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government;

(h) the company has not been penalized by Court or Tribunal during the last three years of any offence under the Reserve Bank of India Act, 1934 , the Securities and Exchange Board of India Act, 1992, the Securities Contracts Regulation Act, 1956, the Foreign Exchange Management Act, 1999 or any other special Act, under which such companies being regulated by sectoral regulators.

Vital aspects relating to issue of shares with differential voting rights.

- Articles of association to authorise the issue
- An ordinary resolution is to be passed at a general meeting of the shareholders. If listed, approval by shareholders through postal ballot is required.
- It shall not exceed twenty-six percent of the total post-issue paid up equity share capital including equity shares with differential rights issued at any point of time;

- consistent track record of distributable profits for the last three years;
- No default in filing financial statements and annual returns for the last three financial years
- No subsisting default in the payment of a declared dividend or repayment of its matured deposits or redemption of its preference shares or debentures that have become due
- No default in repayment of any term loan from a public financial institution or State level financial institution or scheduled Bank that has become repayable or interest payable thereon or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government;
- Not to be penalized by Court or Tribunal during the last three years of any offence under specified legilsations.
- Details of the issue to be disclosed in the Board's Report
- Register of Members to contain the details of shares with differential voting rights.

3.9 Further Issue of Shares

Section 62 of the Companies Act provides for the issue of "Rights Shares" and states that whenever at any time, a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be offered to the existing holders of equity shares in proportion to the paid-up share capital on their shares at the time of further issue by sending a letter of offer. For listed companies, the information as regards the quantum of such issue and the proportion in which rights shall be offered shall be supplied to the concerned Stock Exchanges in advance.

The company must give notice to each of the equity shareholders, giving him option to take the shares offered to him by the company. The shareholder must be informed of the number of shares he has opted to buy giving him at least 15 days but not more than 30 days to decide. The said notice shall be dispatched through registered post or speed post or through electronic mode to all the existing shareholders at least 3 days before the opening of the issue. If the shareholder does not convey to the company his acceptance of the company's offer of further shares he shall be deemed to have declined the offer. Unless the articles of the company otherwise provide, the directors must state in the notice of offer of rights shares the fact that the shareholder has also the right to renounce the offer in whole or in part, in favour of some other persons.

However in case of a private company case ninety per cent. of the members of a private company have given their consent in writing or in electronic mode, the periods lesser than those specified in the said subclause or subsection shall apply. Accordingly time limit for acceptance of offer by existing shareholders may be less than 15 days if 90% of the members a private limited company have given their consent either in writing or through electronic mode.

If a shareholder has neither renounced in favour of another person nor accepted the shares, the Board of directors may dispose of the shares so declined in such manner which is not dis-advantageous to the shareholders and the company.

Section 62(1)(b) provides that a company may issue further shares to its employees under a scheme of employees' stock option, subject to special resolution passed by company and subject to such conditions as may be prescribed. However

in case of private limited companies if it passes the ordinary resolution then it will be sufficient.

Section 62(1)(c) deals with issue of shares to persons other than existing shareholders and provides that a company can issue further shares to persons other than existing shareholders either for cash or for a consideration other than cash, if -

NOTES

(1) the company in General Meeting passes a special resolution to this effect; and

(2) the price of such shares is determined by the valuation report of a registered valuer subject to such conditions as may be prescribed.

The provisions of section 62 are applicable to all types of companies except the Nidhi companies.

The restrictions contained in Section 62 of the Act regarding issue of further shares do not apply to:-

(a) increase of the subscribed capital of a company caused by the exercise of an option as a term attached to the debentures issued or loans raised by the company to convert such debentures or loans into shares in the company [Section 62(3)].

Provided that the terms of issue of such debentures or loan containing such an option have been approved before the issue of such debentures or the raising of loans by a special resolution passed by the company in the general meeting.

(b) conversion of part or whole of the debentures issued to or loans obtained from any Government in shares of the company in pursuance of a direction issued by that Government in public interest on such terms and conditions as appear to be fair and reasonable to the Government even if the terms of issue of such debentures or loans do not contain a term providing for an option for such conversion.[Section 62(4)].

Provided that where the terms and conditions of such conversion are not acceptable to the company, it may, within sixty days from the date of communication of such order, appeal to the Tribunal which shall after hearing the company and the Government pass such order as it deems fit.

In determining the terms and conditions of conversion under section 62(4), the Government shall have due regard to the financial position of the company, the terms of issue of debentures or loans, as the case may be, the rate of interest payable on such debentures or loans and such other matters as it may consider necessary. [Section 62(5)]

Where the Government has, by an order made under section 62(4), directed that any debenture or loan or any part thereof shall be converted into shares in a company and where no appeal has been preferred to the Tribunal under section 62(4) or where such appeal has been dismissed, the memorandum of such company shall, where such order has the effect of increasing the authorised share capital of the company, stand altered and the authorised share capital of such company shall stand increased by an amount equal to the amount of the value of shares which such debentures or loans or part thereof has been converted into. [Section 62(6)]

3.10 Bonus Shares

A company may, if its Articles provide, capitalize its profits by issuing fully-paid bonus shares. The issue of bonus shares by a company is a common

feature. When a company is prosperous and accumulates large distributable profits, it converts these accumulated profits into capital and divides the capital among the existing members in proportion to their entitlements. Members do not have to pay any amount for such shares. They are given free. The bonus shares allotted to the members do not represent taxable income in their hands. Issue of bonus shares is a bare machinery for capitalizing undistributed profits. The vesting of the rights in the bonus shares takes place when the shares are actually allotted and not from any earlier date.

Advantages of Issuing Bonus Shares

1. Fund flow is not affected adversely.
2. Market value of the Company's shares comes down to their nominal value by issue of bonus shares.
3. Market value of the members' shareholdings increases with the increase in number of shares in the company.
4. Bonus shares is not an income. Hence it is not a taxable income.
5. Paid-up share capital increases with the issue of bonus shares.

Sources for issue of Bonus shares

According to section 63(1), a company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of-

(i) its free reserves;

(ii) the securities premium account; or

(iii) the capital redemption reserve account.

No issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

Conditions for issue of Bonus Shares

In terms of section 63(2), no company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares, unless-

(a) it is authorised by its articles;

(b) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

(c) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(d) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(e) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

No Bonus shares in lieu of dividend

The bonus shares shall not be issued in lieu of dividend. [Section 63(3)],

SEBI has issued regulations for Bonus Issue which are contained in Chapter IX of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 with regard to bonus issues by listed companies. Students may refer to study material 'Capital Markets and Securities Laws' for details.

Prescriptions under Companies (Share Capital and Debentures) Rules, 2014 with regard to issue

Rule 14 states that the company which has once announced the decision of its Board recommending a bonus issue, shall not subsequently withdraw the same.

3.11 Employee Stock Option Scheme

NOTES

The term 'Employee Stock Option' (ESOP) has been defined under Sub-section (37) of Section 2 of the

Companies Act, 2013, according to which "employees' stock option" means the option given to the directors, officers or employees of a company or of its holding company or subsidiary company or companies, if any, which gives such directors, officers or employees, the benefit or right to purchase, or to subscribe for, the shares of the company at a future date at a pre-determined price.

As discussed earlier, Section 62(1)(b) provides that a company may issue further shares to its employees under a scheme of employees' stock option, subject to special resolution passed by company and subject to such conditions as may be prescribed. In case of private company special resolution has been substituted by ordinary resolution. Rule 12 of Companies (Share Capital and Debentures) Rules, 2014 with regard to issue of Employee stock options covers issue of ESOPs.

Rule 12 of Companies (Share Capital and Debentures) Rules, 2014 with regard to issue of Employee stock options

A company, other than a listed company, which is not required to comply with Securities and Exchange

Board of India Employee Stock Option Scheme Guidelines shall not offer shares to its employees under a scheme of employees' stock option (hereinafter referred to as "Employees Stock Option Scheme"), unless it complies with the following requirements, namely:-

(i) the issue of Employees Stock Option Scheme has been approved by the shareholders of the company by passing a special resolution (exception in case of private company where ordinary resolution is required).

Who is an employee for the purpose of Section 62(1)(b)

(a) a permanent employee of the company who has been working in India or outside India; or

(b) a director of the company, whether a whole time director or not but excluding an independent director; or

(c) an employee as defined in clauses (a) or (b) of a subsidiary, in India or outside India, or of a holding company of the company but does not include-

(i) an employee who is a promoter or a person belonging to the promoter group; or

(ii) a director who either himself or through his relative or through any body corporate, directly or indirectly, holds more than ten percent of the outstanding equity shares of the company.

Free pricing in conformity with accounting policies

Rule 12(3) states that the companies granting option to its employees pursuant to Employees Stock Option Scheme will have the freedom to determine the exercise price in conformity with the applicable accounting policies, if any.

Separate resolution for granting options to employees of holding/subsidiary companies etc in certain cases

Rule 12 (4) states that the approval of shareholders by way of separate resolution shall be obtained by the company in case of-

(a) grant of option to employees of subsidiary or holding company; or

(b) grant of option to identified employees, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option.

CHECK YOUR PROGRESS

What is Employee Stock Option Scheme?

NOTES

Varying the terms of ESOP requires special resolution

Rule 12(5) the company may by special resolution, vary the terms of Employees Stock Option Scheme not yet exercised by the employees provided such variation is not prejudicial to the interests of the option holders. The notice for passing special resolution for variation of terms of Employees Stock Option Scheme shall disclose full of the variation, the rationale therefor, and the details of the employees who are beneficiaries of such variation.

Minimum one year vesting period

Rule 12 (6)(a) states that there shall be a minimum period of one year between the grant of options and vesting of option. In a case where options are granted by a company under its Employees Stock Option

Scheme in lieu of options held by the same person under an Employees Stock Option Scheme in another company, which has merged or amalgamated with the first mentioned company, the period during which the options granted by the merging or amalgamating company were held by him shall be adjusted against the minimum vesting period required under this clause;

Company has freedom to specify lock-in period

Rule 12(6)(b) states that the company shall have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option.

No right of dividend or voting till exercise of option

Rule 12(6)(c) states that the Employees shall not have right to receive any dividend or to vote or in any manner enjoy the benefits of a shareholder in respect of option granted to them, till shares are issued on exercise of option.

Forfeiture/refund

Rule 12(7) states that the the amount, if any, payable by the employees, at the time of grant of option-

(a) may be forfeited by the company if the option is not exercised by the employees within the exercise period; or

(b) the amount may be refunded to the employees if the options are not vested due to non-fulfillment of conditions relating to vesting of option as per the Employees Stock Option Scheme.

Conditions

Rule 12(8) states the following conditions:

-The option granted to employees shall not be transferable to any other person.

-The option granted to the employees shall not be pledged, hypothecated, mortgaged or otherwise encumbered or alienated in any other manner.

-No person other than the employees to whom the option is granted shall be entitled to exercise the option.

Death/permanent disability/resignation of employees who were granted with options

Rule 12(8) states that in the event of the death of employee while in employment, all the options granted to him till such date shall vest in the legal heirs or nominees of the deceased employee.

In case the employee suffers a permanent incapacity while in employment, all the options granted to him as on the date of permanent incapacitation, shall vest in him on that day.

In the event of resignation or termination of employment, all options not vested in the employee as on that day shall expire. However, the employee can exercise the options granted to him which are vested within the period specified in

this behalf, subject to the terms and conditions under the scheme granting such options as approved by the Board.

Disclosure in the Board's Report

NOTES

Rule 12(9) states that the Board of directors, shall, inter alia, disclose in the Directors' Report for the year the following details of the Employees Stock Option Scheme:

(a) options granted;

(b) options vested;

(c) options exercised;

(d) the total number of shares arising as a result of exercise of option;

(e) options lapsed;

(f) the exercise price;

(g) variation of terms of options;

(h) money realized by exercise of options;

(i) total number of options in force;

(j) employee wise details of options granted to;-

-key managerial personnel;

-any other employee who receives a grant of options in any one year of option amounting to five percent or more of options granted during that year.

-identified employees who were granted option, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

Maintenance of Register Rule 12(10) states that the company shall maintain a Register of Employee Stock Options in Form No. SH.6 and shall forthwith enter therein the particulars of option granted under clause (b) of sub-section (1) of section 62.

The Register of Employee Stock Options shall be maintained at the registered office of the company or such other place as the Board may decide. The entries in the register shall be authenticated by the company secretary of the company or by any other person authorized by the Board for the purpose.

Listed companies has to comply with the SEBI guidelines

Where the equity shares of the company are listed on a recognized stock exchange, the Employees Stock Option Scheme shall be issued, in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

3.12 Issue of Shares on Preferential Basis

As discussed earlier, Section 62(1)(c) deals with issue of shares to persons other than existing shareholders and provides that a company can issue further shares to persons other than existing shareholders either for cash or for a consideration other than cash, if -

(1) the company in General Meeting passes a special resolution to this effect; and

(2) the price of such shares is determined by the valuation report of a registered valuer subject to such conditions as may be prescribed.

NOTES

3.13 Iteration of Share Capital

Section 61 of the Companies Act, 2013 provides that a company limited by shares or guarantee and having a share capital may, if so authorised by its articles, alter, by an ordinary resolution, its memorandum in the following ways:

(a) It may increase the authorised share capital by such amount, as it thinks expedient;

(b) It may consolidate and divide, all or any of its existing shares into a larger denomination than of its existing shares e.g., by consolidating ten shares of Rs. 10 each into one share of Rs. 100 each.

Proviso to Section 61(1)(b) states that no consolidation and division which results in changes in the voting percentage of shareholders shall take effect unless it is approved by the Tribunal on an application made in the prescribed manner; (Proviso to Section 61(1)(b) is yet to be notified).

(c) It may convert all or any of its fully paid-up shares into stock or reconvert that stock into fully paid-up shares of any denomination.

(d) It may sub-divide its existing shares or any of them into smaller denomination than fixed by its Memorandum but it must keep the existing proportion between the paid-up and unpaid amount e.g., one share of Rs 100 each, Rs 60 paid up and be sub-divided into ten shares of Rs 10 each, Rs 6 paid-up per share.

(e) It may cancel shares which have not been taken up or agreed to be taken by any person and diminish the amount of the share capital by the amount of the shares so cancelled. However, such cancellation of shares will not be deemed to be a reduction of share capital, within the meaning of Section 66 of the Companies Act, 2013. In other words, it is cancellation of unissued share capital not being taken or agreed to be taken up by any person.

CHECK YOUR PROGRESS

Does the company require to file notice of alteration (Form No. SH7) when they redeem preference shares?

In order to alter its capital clause in the Memorandum, the company requires authority in its articles. But if the articles give no power to this effect, the articles must be amended by a special resolution before the power to alter the capital clause can be exercised by the company.

Further, the power to alter capital clause should be exercised bona fide and in the interest of the company and not for the benefit of any group. An ordinary resolution will be enough for altering capital clause in the Memorandum of Association.

3.14 Difference Between Share and Stock

No.	Share	Stock
1	Shares in physical form bear distinct Numbers	Stocks are the consolidated value of share capital
2	Shares may or may not be fully paidup	Stock is always fully paid-up
3	Shares have a nominal value	Stock does not have any nominal value
4	All shares are of equal denomination	Denomination of stocks varies
5	It is not possible to transfer shares into Fraction	Stock is divisible into any amount required. Thus, it is possible to transfer even into fractions

6	Shares comes into existence before the stock and it is issued initially	Stock comes into existence after conversion of shares into stock and on conversion of shares into stock, the provisions of the Act governing the shares shall cease to apply to the share capital as it is converted into stock

3.15 Reduction of Share Capital (Section 66) (Section 66 Is Yet To Be Notified)

Reduction of Capital to Be Approved By Special Resolution and Confirmed By the Tribunal [Section 66(1)]

(1) Subject to confirmation by the Tribunal on an application by the company, a company limited by shares or limited by guarantee and having a share capital may, by a special resolution, reduce the share capital in any manner and in particular, may-

(a) extinguish or reduce the liability on any of its shares in respect of the share capital not paid-up; or

(b) either with or without extinguishing or reducing liability on any of its shares,-

(i) cancel any paid-up share capital which is lost or is unrepresented by available assets; or

(ii) pay off any paid-up share capital which is in excess of the wants of the company, alter its memorandum by reducing the amount of its share capital and of its shares accordingly:

No Reduction of Capital would be allowed in case of Arrears in the Repayment of Deposits and Interest thereon [Proviso to Section 66(1)].

It may be noted that reduction of capital shall not be made if the company is in arrears in the repayment of any deposits accepted by it, either before or after the commencement of this Act, or the interest payable thereon.

Notice by Tribunal [Section 66(2)]

The Tribunal shall give notice of every application made to it under sub-section (1) to

- the Central Government,
- Registrar
- the Securities and Exchange Board, in the case of listed companies, and
- he creditors of the company

It shall take into consideration the representations, if any, made to it by that Government, Registrar, the Securities and Exchange Board and the creditors within a period of three months from the date of receipt of the notice.

If no representation has been received from the Central Government, Registrar, the Securities and Exchange Board or the creditors within the said period, it shall be presumed that they have no objection to the reduction [Proviso to Section 66(2)]

Confirmation of Reduction of Capital [Section 66(3)]

The Tribunal may, if it is satisfied that the debt or claim of every creditor of the company has been discharged or determined or has been secured or his consent is obtained, make an order confirming the reduction of share capital on such terms

NOTES

and conditions as it deems fit:

No sanction for reduction unless complied with accounting standards.

Proviso to Section 66(3) provides that - No application for reduction of share capital shall be sanctioned by the Tribunal unless the accounting treatment, proposed by the company for such reduction is in conformity with the accounting standards specified in section 133 or any other provision of this Act and a certificate to that effect by the company's auditor has been filed with the Tribunal.

Publication of the Order of the Tribunal [Section 66(4)]

The order of confirmation of the reduction of share capital by the Tribunal under Section 66(3) shall be published by the company in such manner as the Tribunal may direct.

Deliver a Copy of Order of Tribunal to Registrar (Section 66(5)

The company shall deliver a certified copy of the order of the Tribunal under subsection (3) and of a minute approved by the Tribunal showing-

(a) the amount of share capital;

(b) the number of shares into which it is to be divided;

(c) the amount of each share; and

(d) the amount, if any, at the date of registration deemed to be paid-up on each share, to the Registrar within thirty days of the receipt of the copy of the order, who shall register the same and issue a certificate to that effect.

3.16 Difference between Alteration of Share Capital and Reduction of Share Capital

No.	Alteration of Share Capital	Reduction of Share Capital
1	Alteration of share capital is governed by the provisions of section 61 of the Companies Act, 2013	Reduction of share capital is governed by the provisions of section 66 of the Companies Act, 2013
2	Alteration of share capital is required to be done by ordinary resolution.	Reduction of share capital is required to be done by special resolution.
3	Alteration of share capital is not required to be confirmed by the Tribunal.	Reduction of share capital is to be confirmed by the Tribunal.
4	Alteration of share capital may be done in the following manner:- (a) Increasing its nominal capital by issuing new shares (b) Consolidating and dividing all or any of its share capital into shares of large denomination (c) Converting fully paid up shares into stock or vice versa (d) Sub dividing its shares or any of them into shares of smaller amount	Reduction of share capital may be done in the following manner:- (a) Extinguishing or reducing the liability of members in respect of the capital not paid up (b) Writing off or canceling any paid up capital which is in excess of the needs of the company (c) Paying off any paid up share capital which is in excess of the needs of the company

	(e) Canceling shares which have not been taken up and diminishing the amount of share capital by the amount of the shares so cancelled.	

3.17 Reduction of Share Capital without Sanction of the Court

The following are cases which amount to reduction of share capital and where no confirmation by the Tribunal is necessary:

(a) Surrender of shares - "Surrender of shares" means the surrender to the company on the part of the registered holder of shares already issued. Where shares are surrendered to the company, whether by way of settlement of a dispute or for any other reason, it will have the same effect as a transfer in favour of the company and amount to a reduction of capital. But if, under any arrangement, such shares, instead of being surrendered to the company, are transferred to a nominee of the company then there will be no reduction of. Surrender may be accepted by the company under the same circumstances where forfeiture is justified. It has the effect of releasing the shareholder whose surrender is accepted from further liability on shares.

The Companies Act contains no provision for surrender of shares. Thus, surrender of shares is valid only when Articles of Association provide for the same and:

(i) Where forfeiture of such shares is justified; or

(ii) When shares are surrendered in exchange for new shares of same nominal value.

Both forfeiture and surrender lead to termination of membership. But in the former case, it is at the initiative of company and in the latter case at the initiative of member or shareholder.

(b) Forfeiture of shares - A company may if authorised by its articles, forfeit shares for non-payment of calls and the same will not require confirmation of the Tribunal.

Where power is given in the articles, it must be exercised strictly in accordance with the regulations regarding notice, procedure and manner stated therein, otherwise the forfeiture will be void. Forfeiture will be effected by means of Board resolution. The power of forfeiture must be exercised bona fide and in the interest of the company.

Creditors' Right to Object to Reduction

After passing the special resolution for the reduction of capital, the company is required to apply to the Court by way of petition for the confirmation of the resolution under Section 101. Where the proposed reduction of share capital involves either (i) diminution of liability in respect of unpaid share capital, or (ii) the payment to any shareholder of any paid-up share capital, or (iii) in any other case, if the Court so directs, the following provisions shall have effect:

The creditors having a debt or claim admissible in winding up are entitled to object. To enable them to do so, the Court will settle a list of creditors entitled to object. If any creditor objects, then either his consent to the proposed reduction should be obtained or he should be paid off or his payment be secured. The Court,

NOTES

in deciding whether or not to confirm the reduction will take into consideration the minority shareholders and creditors.

A Company might decide to return a part of its capital when its paid-up share capital is in excess of its needs.

It is not simply handed over to shareholders in proportion to their holdings. Their class rights will be considered with the Court treating the reduction as though it was analogous to liquidation. Therefore, the preference shareholders who have priority to return of capital in liquidation will be the first to have their share capital returned to them in a share capital reduction, even if they prefer to remain members of the company.

Confirmation and Registration of reduction of share capital

Section 102 of the Act states that if the Court is satisfied that either the creditors entitled to object have consented to the reduction, or that their debts have been determined, discharged, paid or secured, it may confirm the reduction. The Court may also direct that the words "and reduced" be added to the company's name for a specified period, and that the company must publish the reasons for the reduction, and the causes which led to it, with a view to giving proper information to the public.

The Court's order confirming the reduction together with the minutes giving the details of the company's share capital, as altered, should be delivered to the Registrar who will register them. The reduction takes effect only on registration of the order and minutes, and not before. The Registrar will then issue a certificate of registration which will be a conclusive evidence that the requirements of the Act have been complied with and that the share capital is now as set out in the minutes. The Memorandum has to be altered accordingly.

Conclusiveness of certificate for reduction of capital

Where the Registrar had issued his certificate confirming the reduction, the same was held to be conclusive although it was discovered later that the company had no authority under its articles to reduce.

3.18 Buy Back of Securities (Section 68)

Sources

According to Section 68(1) of the Companies Act, 2013 a company may purchase its own shares or other specified securities (hereinafter referred to as "buy-back") out of:

(i) its free reserves*; or

(ii) the securities premium account; or

(iii) the proceeds of any shares or other specified securities.

However, no buy-back of any kind of shares or other specified securities can be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

Thus, the company must have at the time of buy-back, sufficient balance in any one or more of these accounts to accommodate the total value of the buy-back.

*Explanation: As per Section 2(43) of the Act, "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend: Provided that- (i) any amount representing unrealised

gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or (ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves.

Authorisation Section 68(2)

The primary requirement is that the articles of association of the company should authorise buyback. In case, such a provision is not available, it would be necessary to alter the articles of association to authorise buyback.

Buy-back can be made with the approval of the Board of directors at a board meeting and/or by a special resolution passed by shareholders in a general meeting, depending on the quantum of buy back. In case of a listed company, approval of shareholders shall be obtained only by postal ballot.

Quantum Section 68(2)

(a) Board of directors can approve buy-back up to 10% of the total paid-up equity capital and free reserves of the company and such buy back has to be authorized by the board by means of a resolution passed at the meeting.

(b) Shareholders by a special resolution can approve buy-back up to 25% of the total paid-up capital and free reserves of the company. In respect of any financial year, the shareholders can approve by special resolution upto 25% of total equity capital in that year.

Special Resolution to be accompanied by Explanatory Statement (Section 68(3)

The notice of the meeting at which the special resolution is proposed to be passed shall be accompanied by an explanatory statement stating-

(a) a full and complete disclosure of all material facts;

(b) the necessity for the buy-back;

(c) the class of shares or securities intended to be purchased under the buy-back;

(d) the amount to be invested under the buy-back; and

(e) the time-limit for completion of buy-back.

Rule 17(1) Companies (Share Capital and Debentures) Rules, 2014 states that Explanatory statement to contain certain disclosures

Explanatory statement to the special resolution authorising buy-back, to be annexed to the notice of the\ general meeting pursuant to section 102 shall contain the following disclosures:

(a) the date of the board meeting at which the proposal for buy-back was approved by the board of directors of the company;

(b) the objective of the buy-back;

(c) the class of shares or other securities intended to be purchased under the buy-back;

(d) the number of securities that the company proposes to buy-back;

(e) the method to be adopted for the buy-back;

(f) the price at which the buy-back of shares or other securities shall be made;

(g) the basis of arriving at the buy-back price;

(h) the maximum amount to be paid for the buy-back and the sources of funds from which the buy-back would be financed

(i) the time-limit for the completion of buy-back;

NOTES

CHECK YOUR PROGRESS

Describe the provisions of Buy Back of Securities?

(j) (i) the aggregate shareholding of the promoters and of the directors of the promoter, where the promoter is a company and of the directors and key managerial personnel as on the date of the notice convening the general meeting;

(ii) the aggregate number of equity shares purchased or sold by persons mentioned in (i) above during a period of twelve months preceding the date of the board meeting at which the buy-back was approved and from that date till the date of notice convening the general meeting;

(iii) the maximum and minimum price at which purchases and sales referred to in (ii) above were made along with the relevant date;

(k) if the persons mentioned in sub-clause (i) of clause (j) intend to tender their shares for buy-back -

(i) the quantum of shares proposed to be tendered;

(ii) the details of their transactions and their holdings for the last twelve months prior to the date of the board meeting at which the buy-back was approved including information of number of shares acquired, the price and the date of acquisition.

(l) a confirmation that there are no defaults subsisting in repayment of deposits, interest payment thereon, redemption of debentures or payment of interest thereon or redemption of preference shares or payment of dividend due to any shareholder, or repayment of any term loans or interest payable thereon to any financial institution or banking company;

(m) a confirmation that the Board of directors have made a full enquiry into the affairs and prospects of the company and that they have formed the opinion-

(i) that immediately following the date on which the general meeting is convened there will be no grounds on which the company could be found unable to pay its debts;

(ii) as regards its prospects for the year immediately following that date, that, having regard to their intentions with respect to the management of the company's business during that year and to the amount and character of the financial resources which will in their view be available to the company during that year, the company will be able to meet its liabilities as and when they fall due and will not be rendered insolvent within a period of one year from that date; and

(iii) in forming their opinion for the above purposes, the directors have taken into account the liabilities(including prospective and contingent liabilities); as if the company were being wound up under the provisions of the Companies Act, 2013.

(n) a report addressed to the Board of directors by the company's auditors stating that:

(i) they have inquired into the company's state of affairs;

(ii) the amount of the permissible capital payment for the securities in question is in their view properly determined;

(iii) that the audited accounts on the basis of which calculation with reference to buy back is done is not more than six months old from the date of offer document, and

(iv) the Board of directors have formed the opinion as specified in clause (m) on reasonable grounds and that the company, having regard to its state of affairs, will not be rendered insolvent within a period of one year from that date;

Letter of Offer to be Filed with Registrar of Companies before Buy-Back(Rule 17(2))

The company which has been authorized by a special resolution shall, before the buy-back of shares, file with the Registrar of Companies a letter of offer in Form No SH 8, along with the fee as prescribed. Such letter of offer shall be dated and signed on behalf of the Board of directors of the company by not less than two directors of the company, one of whom shall be the managing director, where there is one.

NOTES

Dispatch of letter of offer to shareholders(Rule 17(4))

The letter of offer shall be dispatched to the shareholders or security holders immediately after filing the same with the Registrar of Companies but not later than 21 days from its filing with the Registrar of Companies.

Offer for buy back open for(Rule 17(5))

The offer for buy-back shall remain open for a period of not less than 15 days and not exceeding 30 days from the date of dispatch of the letter of offer.

Post buy-back debt-equity ratio not to exceed 2:1(Section 68(2)(d))

The ratio of the aggregate of secured and unsecured debts owed by the company after buy-back is not more than twice the paid-up capital and its free reserves. However, the Central Government may, by order, notify a higher ratio of the debt to capital and free reserves for a class or classes of companies;

Shares/Securities being Bought Back are to be Fully Paid up(Section 68(2))

All the shares or other specified securities for buy-back are to be fully paid-up.

Time gap between two buybacks (proviso to Section 68(2))

No offer of buy-back under Section 68(2) shall be made within a period of one year reckoned from the date of the closure of the preceding offer of buy-back, if any.

Time limit for completion of buyback (Section 68(4))

Every buy-back shall be completed within a period of one year from the date of passing of the special resolution, or as the case may be, the resolution passed by the Board.

Methods of buy-back(Section 68(5))

The buy-back under sub-section (1) may be-

(a) from the existing shareholders or security holders on a proportionate basis;

(b) from the open market;

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

Filing Declaration of Solvency with SEBI/ROC as the case may be (Section 68(6) read with

Rule 17(3) of Companies Share Capital & Debentures) Rules, 2014.

When a company proposes to buy-back its own shares or other specified securities under this section in pursuance of a special resolution or board resolution as the case may be , it shall, before making such buyback, file with the Registrar and the Securities and Exchange Board(in case of listed companies), a declaration of solvency signed by at least two directors of the company, one of whom shall be the managing director, if any, in Form No. SH.9 and verified by an affidavit to the effect that the Board of Directors of the company has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period

NOTES

of one year from the date of declaration adopted by the Board.

Extinguishment of securities bought back section 68(7)

When a company buys back its own shares or other specified securities, it shall extinguish and physically destroy the shares or securities so bought back within seven days of the last date of completion of buy-back.

Prohibition of further issue of shares or securities(Section 68(8)

When a a company completes a buy-back of its shares or other specified securities it shall not make a further issue of the same kind of shares or other securities including allotment of new shares under clause (a) of sub-section (1) of section 62 or other specified securities within a period of six months except by way of a bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

Register of buy-back(Section 68(9)

When a company buys back its shares or other specified securities under this section, it shall maintain a register of the shares or securities so bought, the consideration paid for the shares or securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities and such other particulars as may be prescribed.

Return of buyback(Section 68(10)

A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board (in case of listed companies) a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed:

Rule 17(14) of Companies(Share Capital and Debentures) Rules, 2014 states that a certificate in Form No. SH.15 signed by two directors of the company including the managing director, if any, certifying that the buyback of securities has been made in compliance with the provisions of the Act and the rules made thereunder shall be annexed to the return filed with the Registrar in Form No. SH.11,

Punishments(Section 68(11))

If a company makes any default in complying with the provisions of this section or any regulation made by the Securities and Exchange Board, in case of listed companies, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

Transfer to and application of Capital Redemption Reserve Account(Section 69)

When a company purchases its own shares out of free reserves or securities premium account, a sum equal to the nominal value of the shares so purchased shall be transferred to the capital redemption reserve account and details of such transfer shall be disclosed in the balance sheet. The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Circumstances prohibits buy-back(Section 70(1)

No company shall directly or indirectly purchase its own shares or other specified securities -

- through any subsidiary company including its own subsidiary companies;
- through any investment company or group of investment companies; or

- if a default, is made by the company, in the repayment of deposits accepted either before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company: However, the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist. (Proviso to Section 70(i) No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of sections 92 (Annual Return), section 123(Declaration of Dividend), section 127(punishment for failure to distribute dividend) and section 129(Financial Statement).

3.19 Key Concepts

Stock Stock is always fully paid-up. These are the consolidated value of share capital. They comes into existence after conversion of shares into stock and on conversion of shares into stock, the provisions of the Act governing the shares shall cease to apply to the share capital as it is converted into stock.

Surrender of Shares Surrender of shares means the surrender to the company on the part of the registered holder of shares already issued.

Buyback of shares The repurchase of shares by a company in order to reduce the number of shares on the market. Companies will buy back shares either to increase the value of shares still available (reducing supply), or to eliminate any threats by shareholders who may be looking for a controlling stake.

CHECK YOUR PROGRESS

Can "Share premium account" be used for buy back of Shares?

3.20 Summary

- Share capital of a company can be classified as:

  (a) nominal, authorized or registered capital;

  (b) issued and subscribed capital;

  (c) called up and uncalled capital;
- share is defined as a share in the share capital of a company, including stock except where a distinction between stock and shares is expressed or implied.
- he Companies Act, 2013 permits a company limited by shares to issue two classes of shares, namely equity share capital and preference share capital.
- preference share or preference share capital is that part of share capital which carries a preferential right with respect to both dividend and capital.
- reference shares may be of various types, namely participating and non-participating, cumulative and noncumulative shares, redeemable and irredeemable preference shares.
- quity share capital means all share capital which is not preference share capital.
- weat equity shares means equity shares issued by a company to its employees or directors at a discount or for consideration, other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever name called.

NOTES

- company limited by shares or guarantee and having a share capital may alter its share capital in any of the ways provided under the Companies Act. These powers can be exercised by the members in general meeting only if authorized by the articles.
- eduction of capital means reduction of issued, subscribed or paid-up share capital of the company. Various modes of reduction have been laid down in the Companies Act.
- he Registrar's certificate on confirmation of reduction will be conclusive evidence that the requirements of the Act have been complied with.
- Certain provisions introduced in the Companies Act allow the companies to buy-back their own shares, subject to the conditions and in any of the modes provided therein. They also provide for prohibition for buy-back in certain circumstances.

3.21 Questions and Exercises

1. Discuss the various kinds of share capital. How is the preference share capital distinguished from equity share capital?
2. Define and explain the term "share". What are the different classes of shares which a company may issue?
3. State the provisions of the Companies Act, 2013, relating to issue of shares at premium and at discount.
4. Discuss the procedure for issue of further shares to existing shareholders under Section 62(1) of the Companies Act.

- **Fill in the Blanks**

1. Board can authorise buy back upto _____equity capital and free reserves in a resolution passed at the Board Meeting.
   (5%, 15%, 10%)
2. Shareholders can authorize buy back by special resolution upto _____ of the total paid-up capital and free reserves of the company and in a financial year, upto 25% of total equity capital in that year.
   (25%, 30%, 15%)
3. According to Section 2(86), "_____capital" means such part of the capital which is for the time being subscribed by the members of a company.
   (Subscribed, Equity, Preference share)
4. _____ capital, with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right with respect to payment of dividend, either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax.
   (Subscribed, Equity, Preference share)
5. The dividend on _____ shares is paid only after the preference dividend has been paid.
   (bonus, equity, rights)
6. A company can issue preference shares which are redeemable within _____ years except in certain circumstances.
   (5, 20, 15)
7. A company shall not issue _____ at a discount.
   (bonus shares, sweat equity shares, preference shares)
8. Issue of Sweat Equity shares not to exceed _____ of the existing paid up equity share capital in a year or shares of the issue value of rupees

five crores, whichever is higher and twenty five percent, of the paid up equity capital of the Company at any time.
(five percent, ten percent, fifteen percent)

9. With the issue of _____ Market value of the members' shareholdings increases with the increase in number of shares in the company.
(bonus shares, rights shares, preference shares)
10. The _____ shall not be issued in lieu of dividend.
(bonus shares, rights shares, preference shares)

[**Ans:** 1)10%, 2)25%, 3)Subscribed, 4)Preference Share, 5)equity, 6)20 years 7)Sweat Equity Shares, 8)fifteen per cent, 9)Bonus shares, 10)Bonus shares]

NOTES

3.22 Further Reading and References

1. Dr. Avtar Singh : Company Law; Eastern Book Company, 34, Lalbagh, Lucknow - 226 001
2. C.R. Datta : Datta on the Company Law; Lexis Nexis, Butterworths Wadhwa, Nagpur
3. A. Ramaiya : Guide to the Companies Act; Lexis Nexis, Butterworths Wadhwa Nagpur
4. K.C. Garg, R.C. Chawla, Vijay Gupta: Company Law; Kalyani Publishers, 1/1, Rajinder Nagar, Civil Lines, Ludhiana - 141 001.
5. A.K. Majumdar, Dr. G.K. Kapoor, Sanjay Dhamija : Company Law and Practice; Taxmann, 59/32, New Rohtak Road, New Delhi-110 005.
6. V.S. Datey : Guide to Tax and Corporate Laws; Taxmann, 59/32, New Rohtak Road, New Delhi-110005.
7. M.C. Kuchhal : Modern Indian Company Law; Shri Mahavir Book Depot, 2603, Nai Sarak, Delhi-110006.
8. H.K. Saharay : Company Law; Universal Law Publishing Co., C-FF-1A, Dilkhush Industrial Estate, G.T. Karnal Road, Delhi. -110033.

NOTES

UNIT - 4
PRIVATE AND PUBLIC PLACEMENT

4.1 Introduction
4.2 Objectives of the Study
4.3 Meaning and Definition of Prospectus
4.4 Invitation to Public
4.5 Private Placement
4.6 Public Offer
4.7 Deemed Prospectus
4.8 Shelf Prospectus
4.9 Red-Herring Prospectus
4.10 Abridged Prospectus
4.11 Liability for Untrue Statement in Prospectus
4.12 Key Concepts
4.13 Summary
4.14 Questions & Exercise
4.15 Further Reading and References

4.1 Introduction

Prospectus is a disclosure document inviting public, to subscribe for the securities of the company, to enable the investors to take rational investment decisions and to protect their rights, by giving various material facts and prospects about the company.

Chapter III of Companies Act, 2013 covers procedural aspects as to private placement , which are dealt in Part II of Chapter III and Part I covers and procedural aspects relating to public offer which include registration of prospectus, its' format, disclosures, remedy against misstatement in prospectus, civil/criminal liabilities of directors, penalty for fraudulent inducement to purchase securities etc. The Companies (Prospectus and Allotment of Securities) Rules, 2014 cover the procedural aspects.

4.2 Objectives

After reading this lesson you will be able to understand

- The meaning of prospectus, shelf prospectus information memorandum and red-herring prospectus
- The provisions regarding prospectus under Companies Act, 2013.
- The concept of private and Public placement

4.3 Meaning and Definition of Prospectus

Section 2(70) of the Companies Act, 2013 defines a prospectus as "any document described or issued as a prospectus and includes a red herring prospectus referred to in section 32 or shelf prospectus referred to in section 31 or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate."

On the basis of aforesaid definition, it may be said that a document should have following ingredients to constitute a prospectus:

(a) There must be an invitation to the public;
(b) The invitation must be made "by or on behalf of the company or in relation to an intended company";
(c) The invitation must be "to subscribe or purchase";
(d) The invitation must relate to any securities of the company.

4.4 Invitation to Public

In essence, it means that a prospectus is an invitation issued to the public to offer for purchase/subscribe any securities of the company. A document is deemed to be issued to the public, if the invitation to subscribe for share capital is such as to be open to anyone who brings his money and applies in prescribed form, whether the prospectus was addressed to him or not. The test is not who receives the document, but who can apply for the securities in response to the invitation contained in it.

However, an issue will not be "Public" if-

(i) It is directed to a specified person or a group of persons, and
(ii) It is not calculated to result in the securities becoming available to other persons.

CHECK YOUR PROGRESS

Define prospectus?

Provisions of Companies Act, 2013 with respect to Prospectus

According to section 23(1), a public company may issue securities-

(a) to public through prospectus (herein referred to as "public offer") by complying with the provisions of this Part(i.e Part I); or

(b) through private placement by complying with the provisions of Part II of this Chapter; or

(c) through a rights issue or a bonus issue in accordance with the provisions of this Act and in case of a listed company or a company which intends to get its securities listed also with the provisions of the Securities and Exchange Board of India Act, 1992 and the rules and regulations made there under.

Section 23(2) lays down that a private company may issue securities-

(a) by way of rights issue or bonus issue in accordance with the provisions of this Act; or

(b) through private placement by complying with the provisions of Part II of this Chapter.

As per explanation to section 23, for the purposes of Chapter III, "public offer" includes initial public offer or further public offer of securities to the public by a company, or an offer for sale of securities to the public by an existing shareholder, through issue of a prospectus.

4.5 Private Placement

As per Explanation II(ii) to Section 42(2), "private placement" means any offer of securities or invitation to subscribe securities to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter and which satisfies the conditions specified in section 42.

Private placement offer letter

Section 42(1) provides that without prejudice to the provisions of section 26(dealing with matters to be stated in the prospectus) a company may, subject to the provisions of this section, make private placement through issue of a private placement offer letter in Form PAS-4.(Refer to Rule 14 of Companies (Prospectus

NOTES

and Allotment of Securities) Rules, 2014) However it has been provided by MCA vide notification no. 210 (E) dated 18th March, 2015, that the provisions relating to private placement offer letters and maintenance of complete records of such offers shall not apply, where offer has been made to one or more existing shareholders of the company under Section 62 (1)(c).

The company has to issue private placement offer letter in Form PAS-4

Maximum number of persons to whom offer can be made and other incidental matters

As per section 42(2), the offer of securities or invitation to subscribe securities i.e. private placement, shall be made to such number of persons not exceeding fifty or such higher number as may be prescribed, [excluding qualified institutional buyers and employees of the company being offered securities under a scheme of employees stock option as per provisions of clause (b) of sub-section (1) of section 62], in a financial year and on such conditions (including the form and manner of private placement) as may be prescribed.

Private placement to be approved by special resolution

Rule 14(2) of Companies (Prospectus and Allotment of Securities) Rules, 2014

The rule states that a company shall not make a private placement of its securities unless -

(a) the proposed offer of securities or invitation to subscribe securities has been previously approved by the shareholders of the company, by a special resolution, for each of the offers or invitations:

In the explanatory statement annexed to the notice for the general meeting the basis or justification for the price (including premium, if any) at which the offer or invitation is being made shall be disclosed.

In case of offer or invitation for non-convertible debentures, it shall be sufficient if the company passes a previous special resolution only once in a year for all the offers or invitation for such debentures during the year.

Section 42(3) states that no fresh offer or invitation under this section shall be made unless the allotments with respect to any offer or invitation made earlier have been completed or that offer or invitation has been withdrawn or abandoned by the company.

Private placement under section 42 to be treated as public offer if conditions prescribed there under is not fulfilled

Mode of payment of subscription money

Section 42(5) states that all monies payable towards subscription of securities under this section shall be paid through cheque or demand draft or other banking channels but not by cash.

Time limit for allotment and payment of interest/refund of subscription money otherwise

Section 42(6) states that a company making an offer or invitation under this section shall allot its securities within sixty days from the date of receipt of the application money for such securities and if the company is not able to allot the securities within that period, it shall repay the application money to the subscribers within fifteen days from the date of completion of sixty days and if the company fails to repay the application money within the aforesaid period, it shall be liable to repay that money with interest at the rate of twelve per cent per annum from the expiry of the sixtieth day:

Subscription money to be kept in a separate bank account

Proviso to Section 42(6) states that monies received on application under this section shall be kept in a separate bank account in a scheduled bank and shall not be utilised for any purpose other than -

(a) for adjustment against allotment of securities; or

(b) for the repayment of monies where the company is unable to allot securities.

Offer to be made specifically addressing persons

Section 42(7) states that Private Placement shall be made only to such persons whose names are recorded by the company prior to the invitation to subscribe, and that such person shall receive the offer by name, and that a complete record of such offers shall be kept by the company in such manner as may be prescribed and complete information about such offer shall be filed with the Registrar within a period of thirty days of circulation of relevant private placement offer letter.

NOTES

Rule 14(1)(b) states that a private placement offer letter shall be accompanied by an application form serially numbered and addressed specifically to the person to whom the offer is made and shall be sent to him, either in writing or in electronic mode, within thirty days of recording the names of such persons in accordance with sub-section (7) of section 42:

Proviso to Rule 14(I)(b) states that that no person other than the person so addressed in the application form shall be allowed to apply through such application form and any application not conforming to this condition shall be treated as invalid.

No public advertisements for private placement

Section 42(8) states that no company offering securities under this section shall release any public advertisements or utilise any media, marketing or distribution channels or agents to inform the public at large about such an offer.

Return of allotment

Section 42 (9) states that whenever a company makes any allotment of securities under this section, it shall file with the Registrar a return of allotment in such manner as may be prescribed, including the complete list of all security-holders, with their full names, addresses, number of securities allotted and such other relevant information as may be prescribed.

Rule 14 (4) in this context states that a return of allotment of securities under section 42 shall be filed with the Registrar within thirty days of allotment in Form PAS-3 and with the fee as provided in the Companies (Registration Offices and Fees) Rules, 2014 along with a complete list of all security holders containing-

(i) the full name, address, Permanent Account Number and E-mail ID of such security holder;
(ii) the class of security held;
(iii) the date of allotment of security ;
(iv) the number of securities held, nominal value and amount paid on such securities; and particulars of consideration received if the securities were issued for consideration other than cash.

Maintenance of Record of Private Placement offer

Rule 14(3) of Companies (Prospectus and Allotment of Securities) Rules, 2014 states that the company shall maintain a complete record of private placement offers in Form PAS-5. A copy of such record along with the private placement offer letter in Form PAS-4 shall be filed with the Registrar with fee as provided in Companies (Registration Offices and Fees) Rules, 2014 and where the company is listed, with the Securities and Exchange Board within a period of thirty days of circulation of the private placement offer letter. As discussed earlier where preferential offer is made to existing shareholders then it is not required to maintain a complete record of private placement in Form PAS-5.

Penalty

Section 42 (10) states that if a company makes an offer or accepts monies in contravention of this section, the company, its promoters and directors shall be liable for a penalty which may extend to the amount involved in the offer or invitation or two crore rupees, whichever is higher, and the company shall also refund all

NOTES

monies to subscribers within a period of thirty days of the order imposing the penalty.

4.6 Public Offer

What is Public Offer?

Explanation to Section 23 states that for the purposes of Chapter III, "public offer" includes initial public offer or further public offer of securities to the public by a company, or an offer for sale of securities to the public by an existing shareholder, through issue of a prospectus.

4.7 Deemed Prospectus

Section 25(1) states that when a company allots or agrees to allot any securities of the company with a view to all or any of those securities being offered for sale to the public,

- any document by which the offer for sale to the public is made shall, for all purposes, be deemed to be a prospectus issued by the company; and
- all enactments and rules of law as to the contents of prospectus and as to liability in respect of misstatements, in and omissions from, prospectus, or otherwise relating to prospectus, shall apply with the modifications specified in subsections (3) and (4) and shall have effect accordingly, as if the securities had been offered to the public for subscription and as if persons accepting the offer in respect of any securities were subscribers for those securities, but without prejudice to the liability, if any, of the\ persons by whom the offer is made in respect of mis-statements contained in the document or otherwise in respect thereof.

Section 25(2) states that unless the contrary is proved, it shall be evidence that an allotment of, or an agreement to allot, securities was made with a view to the securities being offered for sale to the public if it is shown-

(a) that an offer of the securities or of any of them for sale to the public was made within six months after the allotment or agreement to allot; or

(b) that at the date when the offer was made, the whole consideration to be received by the company in respect of the securities had not been received by it.

As per section 25(3); section 26 as applied by this section shall have effect as if -

(i) it required a prospectus to state in addition to the matters required by that section to be stated in a prospectus-

(a) the net amount of the consideration received or to be received by the company in respect of the securities to which the offer relates; and

(b) the time and place at which the contract where under the said securities have been or are to be allotted may be inspected;

(ii) the persons making the offer were persons named in a prospectus as directors of a company.

Section 25(4) states that where a person making an offer to which this section relates is a company or a firm, it shall be sufficient if the abovesaid document is signed on behalf of the company or firm by two directors of the company or by not less than one-half of the partners in the firm, as the case may be.

Unless the contrary is proved, it shall be evidence that an allotment of, or an agreement to allot, securities was made with a view to the securities being offered for sale to the public if it is shown-

(a) that an offer of the securities or of any of them for sale to the public

was made within six months after the allotment or agreement to allot; or

(b) that at the date when the offer was made, the whole consideration to be received by the company in respect of the securities had not been received by it.

Matters to be stated in the prospectus

Section 26(1) states that every prospectus issued by or on behalf of a public company either with reference to its formation or subsequently, or by or on behalf of any person who is or has been engaged or interested in the formation of a public company, shall be dated and signed and shall state the information, stated in the following table.

As regards to the matters prescribed in the prospectus the company has to comply with Section 26(1) read with Rule 3 of Companies (Prospectus and Allotment of Securities) Rules 2014. Accordingly the company has to comply with the disclosure requirements prescribed under Section 26(1) of the Act and Rule 3.

Disclosures to be made in the prospectus

(1) Matters relating to terms and conditions of the term loans
(2) The aggregate number of securities of the issuer company and its subsidiary companies purchased or sold by the promoter group and by the director
(3) The related party transactions entered during the last five financial years
(4) Summary of reservations or qualifications or adverse remarks of auditors in the last five financial years.
(5) Inquiry, inspection or investigation initiated or conducted under the companies act or any previous company law in the last five years
(6) Fines imposed

Reports to be set out

(1) Reports by auditors of the company
(2) Reports relating to profit and loss for each of five financial years immediately preceding the issuing financial year
(3) Reports made by auditors upon the profit and losses of business of the company for each of five financial year immediately preceding issue and assets and liabilities of the business on the last date to which the accounts of the business were being made up but not more than 180 days.
(4) Reports about the Business or transactions to which the proceeds of the securities are to be applied directly or indirectly.

Other Compliances to be done

(1) Prospectus shall be dated and signed
(2) On or before the date of publication the company shall register a copy of prospectus with registrar
(3) Expert's statement to be included in prospectus
(4)Prospectus filed with ROC is valid for 90 days from the date of filing

For advertisement of prospectus a company shall specify:

1. Contents of memorandum, capital, objects and liability of members.
2. Name of signatories to memorandum and number of shares issued to them
3. Its capital structure

CHECK YOUR PROGRESS

What is public offer?

4.8 Shelf Prospectus

"Shelf Prospectus" means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus. ***Accordingly as per Section 31-***

1. Any class of companies, as prescribed by the Securities and Exchange Board may file a shelf prospectus with the Registrar at the stage of the first offer of securities included therein which shall indicate a period not exceeding one year as the period of validity of such prospectus which shall commence from the date of opening of the first offer of securities under such prospectus. Further, in respect of a second or subsequent offer issued during the period of validity of shelf prospectus, no further prospectus is required.

2. A company filing a shelf prospectus shall be required to file an information memorandum containing all material facts relating to new charges created, changes in the financial position of the company as have occurred between the first offer of securities or the previous offer of securities and the succeeding offer and other prescribed changes, with the Registrar within the prescribed time, prior to the issue of a second or subsequent offer of securities under such prospectus.

Where a company or any other person has received applications for the allotment of securities along with advance payments of subscription before the making of any such change, they shall intimate the changes to such applicants. If the applicants express a desire to withdraw their application, the company or other person shall refund all the monies received as subscription within fifteen days.

3. Where an information memorandum is filed, every time an offer of securities is made as aforesaid, such memorandum together with the shelf prospectus shall be deemed to be a prospectus.

The concept of shelf prospectus will save expenditure and time of the companies in issuing a new prospectus every time they wish to issue securities to the public within a period of one year.

Information Memorandum to be filed before the issue of a second or subsequent offer of securities under the shelf prospectus

Rule 10 of Companies (Prospectus and Allotment of Securities) Rules, 2014 states that the information memorandum shall be prepared in Form PAS-2 and filed with the Registrar along with the fee as provided in the Companies (Registration Offices and Fees) Rules, 2014 within one month prior to the issue of a second or subsequent offer of securities under the shelf prospectus.

4.9 Red-Herring Prospectus

"Red Herring Prospectus" means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.

Section 32 of the Act deals with Red Herring Prospectus. It provides that?

1. As per this section, a company proposing to make an offer of securities may issue a red herring prospectus prior to the issue of a prospectus.
2. A company proposing to issue a red herring prospectus shall file it with the Registrar at least three days prior to the opening of the subscription list and the offer.
3. A red herring prospectus shall carry the same obligations as are applicable to a prospectus. Any variation between the red herring prospectus and a prospectus shall be highlighted as variations in the prospectus.
4. Upon the closing of the offer of securities, the prospectus stating therein the total capital raised, whether by way of debt or share capital, and the closing price of the securities and any other details as are not included in the red herring prospectus shall be filed with the Registrar and the Securities and Exchange Board.

Red herring prospectus is issued during book building process. Red herring prospectus contains either the floor price of securities offered or a price band along with the range within which the Bids can move. The applicants bid for the

shares quoting the price and the quantity that they would like to bid at. SEBI (ICDR) Regulations prescribe certain disclosures to be made in the red-herring prospectus.

Once the offer for securities is closed, a final prospectus stating therein the total capital raised whether by way of debt or share capital, the closing price of the securities and any other details which are not complete in the red-herring prospectus shall be filed with SEBI in the case of listed public company and in any other case with the Registrar of companies only.

The compliances under SEBI (Issue of Capital and Disclosure Requirements) Regulations 2009 relating to shelf prospectus and red-herring prospectus is covered under chapter 'Issue of Securities' in paper Capital Markets and Securities Laws of Executive programme.

4.10 Abridged Prospectus

"Abridged Prospectus" means a memorandum containing such salient features of a prospectus as may be specified by the Securities and Exchange Board by making regulations in this behalf. ***[Section 2(1)]***

Section 33 states that no form of application can be issued for the purchase of any securities of a company unless it is accompanied by an abridged prospectus. There are, however, four exceptions to this rule:

(a) where the offer is made in connection with the bona fide invitation to a person to enter into an underwriting agreement with respect to such securities;

(b) where the securities are not offered to the public;

(c) where the offer is made only to the existing members or debenture holders of the company with or without a right to renounce;

(d) where the shares or debentures offered are in all respects uniform with shares or debentures already issued and quoted on a recognised stock exchange.

A copy of the prospectus shall be furnished to a person on a request being made by him before the closing of the subscription list and the offer.

If a company makes any default in complying with the provisions of this section, it shall be liable to a penalty of fifty thousand rupees for each default.

4.11 Liability for Untrue Statement in Prospectus

It is now clear that a prospectus must be complete and perfect in all details or in other words nothing should be omitted and nothing must be untrue in a prospectus.

Where an untrue statement occurs in a prospectus, there may arise (i) civil liability (ii) criminal liability. Every person who is a director of the company at the time of the issue of the prospectus, every promoter of the company and every person, including an expert, who has authorised the issue of a prospectus, shall be liable. Since the liability of these persons is to the allottee of securities, we may discuss this matter under the heading remedies for mis-statements in a prospectus.

What is an Untrue Statement?

It is essential to know as to what constitutes an untrue statement. To protect the interests of prospective investors in the securities of a company, the law prescribes a wider meaning to this term. Whether a statement is untrue or not is to be judged by the context in which it appears and the totality of impression it would create. A statement included in a prospectus shall be deemed to be untrue, if the statement is misleading in the form and context in which it is included.

NOTES

Further, where any inclusion or omission of any matter in a prospectus is likely to mislead, the prospectus shall be deemed, in respect of such omission, to be a prospectus in which an untrue statement is included.

The expression "Included" with reference to a prospectus means included in the prospectus itself or contained in any report or memorandum appearing on the face thereof or by reference incorporated therein or issued therewith. Even if every word included in the prospectus is true, the suppression of material facts may cause the prospectus to be fraudulent.

Onus for Proof of Mis-statement

The burden of proof in a suit by an allottee that he has been misled by the mis-statement in the prospectus lies on the allottee. He must prove the following:

(i) The misrepresentation was of a fact;
(ii) It was in respect of a material fact. What is a material statement of fact will depend upon the circumstances of each case.
(iii) He acted on the misrepresentation; and
(iv) He suffered damages in consequence.

Remedies for Misrepresentation in Prospectus

A company is responsible for a statement in prospectus only if it is shown that the prospectus was issued by the company or by some one with the authority of the company, e.g., the Board of directors. The company is also liable for misstatement in prospectus even though the prospectus is issued by the promoters & the Board ratifies and adopts the issue of prospectus.

The first remedy against the company is to rescind the contract. A person who takes securities on the faith of a prospectus containing false statements, may apply to the Court for setting contract aside, and striking off his name from the register of members. He may also claim his money back. But the allottee must act within a reasonable time, before any proceedings to wind up the company have been commenced, and before he does anything after notice of misrepresentation which is inconsistent with the right to rescind.

The second remedy against the company is to sue for damages for deceit. This suit is founded on the tort of deceit, and is not a case of fraud on the part of directors or promoters. The allottee may recover damages from the company for any loss he may have suffered if the invitation to take securities is emanating from the company and the persons making it on behalf of the company have fraudulently mis-represented material facts. The allottee cannot both retain the securities and get damages against the company. In actual practice, however, suits for damages against the company are rarely filed. Damages are generally claimed from the directors, promoters and other persons who authorised the issue of the prospectus.

Remedies against Directors or Promoters

A person who subscribed for shares on the faith of a false prospectus may claim from directors or promoters:

(i) Damages for fraudulent misrepresentation,
(ii) Compensation under Section 35 of the Act,
(iii) Damages for non-compliance with the requirements of Section 26 of the Act.

(i) Damages for fraudulent misrepresentation

An allottee may sue the director for damages for deceit, if there are fraudulent misrepresentations in the prospectus. But the directors will not be liable for damages for mis-statement if they believed them to be true.

(ii) Compensation for untrue Statement

An allottee is also entitled to claim compensation from directors, promoters and any other persons who authorised the issue of the false prospectus, for damages sustained by reason of any untrue statement in it.

As per section 35(1), where a person has subscribed for securities of a

company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company, then, the following persons are liable to pay compensation to every person who has sustained loss or damage by reason of untrue statement included in a prospectus:

(a) every person who is a director of the company at the time of the issue of the prospectus;
(b) every person who has authorised himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;
(c) every person who is a promoter of the company;
(d) every person who has authorised the issue of the prospectus; and
(e) is an expert referred to in sub-section (5) of section 26

The above stated liability shall be without prejudice to any punishment to which any person may be liable under section 36.

When civil liability can be avoided [Section 35(2)]

No person referred above shall be liable for civil action if he proves:

(i) that having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or
(ii) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave reasonable public notice that it was issued without his knowledge or consent; or

Further an expert may also escape the liability, if he proves that having given his consent under Section 26 to the issue of the prospectus, he withdrew it in writing before delivery of a copy of the prospectus for registration to the Registrar.

Criminal Liability for Mis-statements in Prospectus

According to Section 34 of the Companies Act, 2013, where a prospectus, issued, circulated or distributed includes any statement which is untrue or misleading in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorizes the issue of such prospectus shall be liable under section 447. Section 447 provides that any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

However, where the fraud in question involves public interest, the term of imprisonment shall not be less than three years

However, where a person who has authorised the issue of prospectus proves, either that such statement or omission was immaterial or that he had reasonable grounds to believe, and did up to the time of issue of the prospectus believe, that the statement was true or the inclusion or omission was necessary may be relieved from the criminal liability.

Action by affected persons

Section 37 states that a suit may be filed or any other action may be taken under section 34 or section 35 or section 36 by any person, group of persons or any association of persons affected by any misleading statement or the inclusion or omission of any matter in the prospectus.

This above provision provides for filing class action suits by a persons or group of persons or association of persons affected by misleading statements.

Who is entitled to remedies?

The right to claim compensation for any loss or damage sustained by reason of any untrue statement in a prospectus is available only to a person who has "subscribed" for securities on the faith of the prospectus containing untrue statement.

CHECK YOUR PROGRESS

Describe Red-Herring Prospectus & Shelf prospectus?

The word 'subscribed' denotes that the shares were acquired directly from the company by allotment. A subsequent purchaser of shares in the open market has no remedy against the company or the directors or promoters. Also, a subscriber to the memorandum cannot seek relief, as the company cannot be said to be in existence when he signed the memorandum, and he cannot be said to have been influenced by any statement, in the prospectus. Again, liability under a prospectus can only arise when the prospectus has been issued, and only in favour of persons who subscribe for securities in response to it and relied upon the statement made therein.

If, however, a prospectus is issued with the object of inducing persons to buy securities in the open market, any person who buys on the strength of the false representation made in it, has a right of action for fraudulent misrepresentation against the company. But the purchaser must have been directly induced by the false statement in the prospectus and nothing else.

Penalty For Fraudulently Inducing To Invest Money

Section 36 provides that any person who, either knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading, or deliberately conceals any material facts, to induce another person to enter into, or to offer to enter into,-

(a) any agreement for, or with a view to, acquiring, disposing of, subscribing for, or underwriting securities; or

(b) any agreement, the purpose or the pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities; or

(c) any agreement for, or with a view to obtaining credit facilities from any bank or financial institution, shall be liable for action under section 447.

Prohibition of personation for acquisition etc. of securities

As per Section 38(i) any person who-

(a) makes or abets making of an application in a fictitious name to a company for acquiring, or subscribing for, its securities; or

(b) makes or abets making of multiple applications to a company in different names or in different combinations of his name or surname for acquiring or subscribing for its securities; or

(c) otherwise induces directly or indirectly a company to allot, or register any transfer of, securities to him, or to any other person in a fictitious name, shall be liable for action under section 447.

Section 38 (2)

The provisions of section 38(1) shall be prominently reproduced in every prospectus issued by a company and in every form of application for securities.

Section 38 (3)

Where a person has been convicted under this section, the Court may also order disgorgement of gain, if any, made by, and seizure and disposal of the securities in possession of, such person.

Section 38 (4)

The amount received through disgorgement or disposal of securities shall be credited to the Investor Education and Protection Fund.

4.12 Key Concepts

"Shelf Prospectus" means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus.

"Red Herring Prospectus" means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.

"Abridged Prospectus" means a memorandum containing such salient

features of a prospectus as may be specified by the Securities and Exchange Board by making regulations in this behalf.

4.13 Summary

NOTES

- Prospectus has been defined as any document described or issued as a prospectus and includes a red herring prospectus referred to in section 32 or shelf prospectus referred to in section 31 or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate.
- One of the ingredients of a prospectus is to make invitation to the public to subscribe for securities of a body corporate which is construed as including a reference to any section of the public, whether selected as members or debenture-holders of the company or as clients of the person issuing the prospectus. However, there are exceptions to it.
- All public companies making public offer issue a prospectus.
- Shelf prospectus means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus.
- Red herring prospectus means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.
- Companies Act and SEBI guidelines provide for contents and disclosures required in a prospectus.
- No application form can be issued for securities unless it is accompanied by a memorandum containing such salient features of prospectus as may be prescribed.
- A company is responsible for a statement in prospectus only if it is shown that the prospectus was issued by the company or by someone with the authority of the company. The company is also liable if though the prospectus is issued by the promoters, the Board ratifies and adopts the issue.
- A person who subscribed for securities on the faith of a false prospectus may claim from directors or promoters damages for fraudulent misrepresentation, compensation, damages for non-compliance with the requirements of the Act.
- Where a prospectus includes any untrue statement, every person who has authorised the issue of the prospectus shall be punishable with imprisonment, fine or both.
- The right to claim compensation for any loss or damage sustained by reason of any untrue statement in a prospectus is available only to a person who has subscribed for securities on the faith of the prospectus containing untrue statement.
- Penalty is also leviable under the Act for fraudulently inducing a person to invest money.
- Impersonation for the acquisition of securities has been made an offence under the Companies Act, punishable with imprisonment.

4.14 Questions and Exercise

1. What is a prospectus? Is the issue of a prospectus compulsory on the part of a company?
2. Discuss the liability of a company for untrue statements or omissions in its prospectus.
3. Explain the legal provisions relating to issue and registration of a prospectus?

● **Fill in the blanks**

1. All public companies making public offer issue a _____.
(form, manual, prospectus)
2. _____ prospectus means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.
(Red herring, Abridged, Shelf)
3. Companies Act and SEBI guidelines provide for contents and _____ required in a prospectus.
(disclosures, rules, types)
4. Where a prospectus includes any _____ statement, every person who has authorised the issue of the prospectus shall be punishable with imprisonment, fine or both.
(untrue, correct, wrong)
5. Penalty is also leviable under the Act for fraudulently _____a person to invest money.
(ordering, inducing, forcing)
6. In prospectus, invitation must be made by or on behalf of the _____ or in relation to an intended company.
(company, manager, chairperson)
7. If the issue is directed to a specified person or a group of persons, then it is called as a _____ Issue.
(public, private, group)
8. Maximum number of persons to whom offer can be made and other incidental matters is _____ or such higher number as may be prescribed.
(fifty, forty, sixty)
9. A company making an offer or invitation under the prescribed section shall allot its securities within _____ days from the date of receipt of the application money for such securities.
(thirty, fifteen, sixty)
10. If the company fails to repay the application money within fifteen days period, it shall be liable to repay that money with interest at the rate of _____ per cent per annum from the expiry of the sixtieth day.
(12, 14, 16)

[**Ans:** 1)prospectus, 2)Red Herring, 3)disclosures, 4)untrue, 5)inducing, 6)company, 7)private, 8)fifty, 9)sixty 10)12]

4.15 Further Reading and References

1. Dr. Avtar Singh : Company Law; Eastern Book Company, 34, Lalbagh, Lucknow - 226 001
2. C.R. Datta : Datta on the Company Law; Lexis Nexis, Butterworths Wadhwa, Nagpur
3. A. Ramaiya : Guide to the Companies Act; Lexis Nexis, Butterworths Wadhwa Nagpur
4. K.C. Garg, R.C. Chawla, Vijay Gupta: Company Law; Kalyani Publishers, 1/1, Rajinder Nagar, Civil Lines, Ludhiana - 141 001.
5. A.K. Majumdar, Dr. G.K. Kapoor, Sanjay Dhamija : Company Law and Practice; Taxmann, 59/32, New Rohtak Road, New Delhi-110 005.
6. V.S. Datey : Guide to Tax and Corporate Laws; Taxmann, 59/32, New Rohtak Road, New Delhi-110005.
7. M.C. Kuchhal : Modern Indian Company Law; Shri Mahavir Book Depot, 2603, Nai Sarak, Delhi-110006.
8. H.K. Saharay : Company Law; Universal Law Publishing Co., C-FF-1A, Dilkhush Industrial Estate, G.T. Karnal Road, Delhi. -110033.

UNIT - 5
ALLOTMENT OF SECURITIES

NOTES

5.1 Introduction
5.2 Objectives
5.3 Securities
5.4 General Principles Regarding Allotment of Securities
5.5 Provisions relating to allotment of securities - Companies Act 2013
5.6 Companies (Prospectus and Allotment of Securities) Rules, 2014
5.7 Issue of Certificates
5.7.1 Issuing duplicate share certificates to defraud
5.7.2 Time of issue of Certificate of Securities
5.7.3 Significance of Share Certificate
5.7.4 Damages against Company and Directors for wrong certificates
5.7.5 Split Certificate
5.7.6 Purpose and Form of Share Certificate
5.7.7 Whether Share Certificate an Official Publication
5.7.8 Legal Effect of Share Certificate
5.7.9 Personation of Shareholder
5.8 Calls and Forfeiture
5.9 Forfeiture of Shares
5.10 Re-issue of Forfeited Shares
5.11 Surrender of shares
5.12 Key Concepts
5.13 Summary
5.14 Questions & Exercise
5.15 Further Reading and References

5.1 Introduction

Allotment is an act of appropriation of certain number of securities to those persons who have applied for it. The Certificate conveys the title to the security and is issued subsequent to allotment. The Companies Act, 2013, SEBI (Issue of Capital and Disclosure Requirements), Regulations, 2009 ("SEBI ICDR Regulations"), Securities (Contracts) Regulations, etc. provide for procedural aspects as to allotment and issue of Certificates for securities.

In fact, in the present era of compulsory Dematerialization, physical share certificate is a rare phenomenon especially for listed companies which are also governed by Securities and Exchange Board of India ("SEBI") Regulations, SEBI (Listing Obligations and Requirements) Regulations, 2015 etc. Companies Act 2013(the Act) also mandates public offer of companies and such class of companies as may be prescribed should issue securities only in dematerialized form.

5.2 Objectives

After reading this lesson, you will be able to understand,

- The concepts, regulatory and procedural aspects relating to allotment and issue of certificates in the light of Companies Act 2013.
- Procedure and rules for surrender of shares.
- Regulations and criteria for buy back of shares.

NOTES

5.3 Securities

According to 2(81) of Companies Act, 2013 "securities" means the securities as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956.

According to 2(84) of the Act, "share" means a share in the share capital of a company and includes stock.

As per Section 2(h) of the Securities Contracts (Regulation) Act, 1956 "securities" include-

(1) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate;
(a) derivative;
(b) units or any other instrument issued by any collective investment scheme to the investors in such schemes;]
(c) security receipt as defined in clause (zg) of section 2 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
(d) units or any other such instrument issued to the investors under any mutual fund scheme;
(e) any certificate or instrument (by whatever name called), issued to an investor by any issuer being a special purpose distinct entity which possesses any debt or receivable, including mortgage debt, assigned to such entity, and acknowledging beneficial interest of such investor in such debt or receivable including mortgage debt, as the case may be;

(2) Government securities;
(a) such other instruments as may be declared by the Central Government to be securities; and

(3) rights or interests in securities;

Thus, the word "securities" includes shares and other instruments.

5.4 General Principles Regarding Allotment of Securities

The following general principles should be observed with regard to allotment of securities:

(1) The allotment should be made by proper authority, i.e. the Board Directors of the company, or a committee authorised to allot securities on behalf of the Board.

(2) Allotment of securities must be made within a reasonable time (As per Section 6 of the Indian Contract Act, 1872, an offer must be accepted within a reasonable time). What is a reasonable time is a question of fact in each case. An applicant may refuse to take securities if the allotment is made after a long time.(As per Section 56 within a period of two months from the date of allotment in the case of allotment of any of

its shares.)

(3) The allotment should be absolute and unconditional. Securities must be allotted on same terms on which they were applied for and as they are stated in the application for securities. Allotment of securities subject to certain conditions is also not valid. Similarly, if the number of securities allotted is less than those applied for, it cannot be termed as absolute allotment.

(4) The allotment must be communicated. As mentioned earlier posting of letter of allotment or allotment advice will be taken as a valid communication even if the letter is lost in transit.

(5) Allotment against application only - Section 2(55) of the Act requires that a person should agree in writing to become a member.

(6) Allotment should not be in contravention of any other law - If securities are allotted on an application of a minor, the allotment will be void.

NOTES

5.5 Provisions relating to allotment of securities - Companies Act 2013

Allotment of Securities ? Conditions

Section 39(1) states that no allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument.

Minimum Application Money [Section 39(2)]

The amount payable on application on every security shall not be less than five per cent. of the nominal amount of the security or such other percentage or amount, as may be specified by the Securities and Exchange Board by making regulations in this behalf.

Money to be returned if minimum application money is not received

If the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus, or such other period as may be specified by the Securities and Exchange Board, the amount so received shall be returned within 15 days from the closure of the issue. If any such money is not so repaid within such period the directors of the company who are officers in default shall jointly and severally be liable to repay that money with interest at 15% P.A.

Company to file Return of allotment

Whenever a company having a share capital makes any allotment of securities, it shall file with the Registrar a return of allotment in Form PAS-3.

CHECK YOUR PROGRESS

What are the General Principles Regarding Allotment of Securities?

5.6 Companies (Prospectus and Allotment of Securities) Rules, 2014- Rules relating to allotment of securities

-Rule 12 states that whenever company having a share capital makes any allotment of its securities, the company shall, within thirty days thereafter, file with the Registrar a return of allotment in Form PAS-3, along with the fee as specified in the Companies (Registration Offices and Fees) Rules, 2014. There shall be attached to the Form PAS-3 a list of allottees stating their names, address, occupation, if any, and number of securities allotted to each of the allottees and the list shall be certified by the signatory of the Form PAS-3 as being complete and correct as per

the records of the company.

Further, in the case of securities (not being bonus shares) allotted as fully or partly paid up for consideration other than cash, there shall be attached to the Form PAS-3 a copy of the contract, duly stamped, pursuant to which the securities have been allotted together with any contract of sale if relating to a property or an asset, or a contract for services or other consideration. When a contract is not reduced to writing, the company shall furnish along with the Form PAS-3 complete particulars of the contract stamped with the same stamp duty as would have been payable if the contract had been reduced to writing and those particulars shall be deemed to be an instrument within the meaning of the Indian Stamp Act, 1899 (2 of 1899), and the Registrar may, as a condition of filing the particulars, require that the stamp duty payable thereon be adjudicated under section 31 of the Indian Stamp Act, 1899. Further a report of a registered valuer in respect of valuation of the consideration shall also be attached along with the contract of sale if relating to property or an asset or a contract for services, as the case may be.

- In the case of issue of bonus shares, a copy of the resolution passed in the general meeting authorizing the issue of such shares shall be attached to the Form PAS-3.
- In case the shares have been issued in pursuance of clause (c) of sub-section (1) of section 62 by a company other than a listed company whose equity shares or convertible preference shares are listed on any recognised stock exchange, there shall be attached to Form PAS-3, the valuation report of the registered valuer.

Explanation.- Pending notification of sub-section (1) of section 247 of the Act and finalisation of qualifications and experience of valuers, valuation of stocks, shares, debentures, securities etc. shall be conducted by an independent merchant banker who is registered with the Securities and Exchange Board of India or an independent chartered accountant in practice having a minimum experience of ten years.

Penalty for default

In case of any default, the company and its officer who is in default shall be liable to a penalty, for each default, of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less.

5.7 Issue of Certificates

What is a share certificate?

A share certificate is a certificate issued to the members by the company, specifying the number of shares held by him and the amount paid on each share. According to Section 45 of the Companies Act, 2013 each share of the share capital of the company shall be distinguished with a distinct number for its individual identification. However, such distinction shall not be required, as per proviso to Section 45, if the shares are held by a person whose name is entered as holder of beneficial interest in such share in the records of a depository.

In terms of Section 46(1) of the Act, a certificate under the common seal, if any, of the company or signed by two directors or by a director and the company secretary, wherever, the company has appointed a company secretary, is prima facie evidence of the title of the person to the shares specified therein. The certificate is the only documentary evidence of title in the possession of the shareholder. But it is not a warranty of title by the company issuing it.

When can a company issue Duplicate Share Certificate?

Section 46 (2) states that a duplicate certificate of shares may be issued, if such certificate -

(a) is proved to have been lost or destroyed; or

(b) has been defaced, mutilated or torn and is surrendered to the company.

Manner of issuing share certificates/ Duplicate Share Certificates

Section 46(3) states that notwithstanding anything contained in the articles of a company, the manner of issue of

-a certificate of shares or

-the duplicate thereof, the form of such certificate, the particulars to be entered in the register of members and other matters shall be such as may be prescribed.

NOTES

(A) Rule 5 of Companies (Share Capital and Debentures) Rules, 2014, relating issue of Certificates

Rule 5 and Rule 6 of Companies (Share Capital and Debentures) Rules, 2014 provides the following relating to issue of Securities:

What is prescribed relating to issue of share certificates?

(a) Certificate of shares (where shares are not in demat form)[(Rule 5(1)]-

(1) Where a company issues any share capital, no certificate of any share or shares held in the company shall be issued, except-

(a) by passing a Board resolution and

(b) on surrender to the company of the letter of allotment or fractional coupons of requisite value, except in cases of issues against letters of acceptance or of renunciation, or in cases of issue of bonus shares:

If, the letter of allotment is lost or destroyed, the Board may impose such reasonable terms, if any, as to seek supporting evidence and indemnity and the payment of out-of-pocket expenses incurred by the company in investigating evidence, as it may think fit.

CHECK YOUR PROGRESS

Describe provisions of Issue of Certificates?

(b) Share Certificate Format [Rule 5(2)]

Every certificate of share or shares shall be in Form No. SH.1 or as near thereto as possible and shall specify the name(s) of the person(s) in whose favor the certificate is issued, the shares to which it relates and the amount paid-up thereon.

(c) Share certificate to be issued under the common seal, if any, of the company and where the company does not have a common seal then the signatories to share certificates shall sign the certificate [Rule 5(3)]

As discussed earlier the section 46(1) provides that the a share certificate shall bear a common seal, if any, of the company or shall be signed by two directors or by a director and the company secretary, wherever, the company has appointed a company secretary

As per the rule every share certificate shall be issued under the seal, if any, of the company, which shall be affixed in the presence of, and signed by-

(a) two directors duly authorized by the Board of Directors of the company for the purpose or the committee of the Board, if so authorized by the Board; and

(b) the secretary or any person authorised by the Board for the purpose:

In case a company does not have a common seal, the share certificate shall be signed by two directors or by a director and the Company Secretary, wherever the company has appointed a Company Secretary.

If the composition of the Board permits of it, at least one of the aforesaid two directors shall be a person other than a managing director or a whole-time director.

Further in case of a One Person Company, every share certificate shall be issued under the seal, if any, of the company, which shall be affixed in the presence of and signed by one director or a person authorised by the Board of Directors of

NOTES

the company for the purpose and the Company Secretary, or any other person authorised by the Board for the purpose, and in case the One Person Company does not have a common seal, the share certificate shall be signed by the persons in the presence of whom the seal is required to be affixed in this proviso.

A director shall be deemed to have signed the share certificate if his signature is printed thereon as a facsimile signature by means of any machine, equipment or other mechanical means such as engraving in metal or lithography, or digitally signed, but not by means of a rubber stamp, provided that the director shall be personally responsible for permitting the affixation of his signature thus and the safe custody of any machine, equipment or other material used for the purpose.

(d) Particulars of Share certificates to be entered in the Register of Members [Rule 5(4)]

The particulars of every share certificate issued shall be entered in the Register of Members maintained in accordance with the provisions of section 88 along with the name(s) of person(s) to whom it has been issued, indicating the date of issue.

(B) Rule 6 of Companies (Share Capital and Debentures) Rules, 2014 relating to issue of duplicate certificates

Issue of renewed or duplicate share certificate (Rule 6).-

(1) The certificate of any share or shares shall not be issued either in exchange for those which are subdivided or consolidated or in replacement of those which are defaced, mutilated, torn or old, decrepit, worn out, or where the pages on the reverse for recording transfers have been duly utilised, unless the certificate in lieu of which it is issued is surrendered to the company:

(a) The company may charge such fee as the Board thinks fit, not exceeding fifty rupees per certificate issued on splitting or consolidation of share certificate(s) or in replacement of share certificate(s) that are defaced, mutilated, torn or old, decrepit or worn out:

(b) when a certificate is issued in any of the circumstances specified in this sub-rule, it shall be stated on the face of it and be recorded in the Register maintained for the purpose, that it is "Issued in lieu of share certificate No..... sub-divided/replaced/on consolidation" and also that no fee shall be payable pursuant to scheme of arrangement sanctioned by the High Court or Central Government:

(c) A company may replace all the existing certificates by new certificates upon sub-division or consolidation of shares or merger or demerger or any reconstitution without requiring old certificates to be surrendered subject to compliance with the rules.

(2) (a) The duplicate share certificate shall not be issued in lieu of those that are lost or destroyed, without the prior consent of the Board and without payment of such fees as the Board thinks fit, not exceeding rupees fifty per certificate and on such reasonable terms, such as furnishing supporting evidence and indemnity and the payment of out-of-pocket expenses incurred by the company in investigating the evidence produced. The Ministry of Corporate Affairs vide a circular dated June 12, 2014 clarified that a committee of directors may exercise such powers, subject to any regulations imposed by the Board in this regard.

(b) when a certificate is issued in any of the circumstances specified in this sub-rule, it shall be stated prominently on the face of it and be recorded in the Register maintained for the purpose, that it is "duplicate issued in lieu of share certificate No.....". and the word "duplicate" shall be stamped

or printed prominently on the face of the share certificate:

(c) In case unlisted companies, the duplicate share certificates shall be issued within a period of three months and in case of listed companies such certificate shall be issued within forty-five days, from the date of submission of complete documents with the company respectively.

Register of renewed and duplicate share certificates

(3) (a) The particulars of every share certificate issued in accordance with sub-rules (1) and (2) shall be entered forthwith in a Register of Renewed and Duplicate Share Certificates maintained in Form No.SH.2 indicating against the name(s) of the person(s) to whom the certificate is issued, the number and date of issue of the share certificate in lieu of which the new certificate is issued, and the necessary changes indicated in the Register of Members by suitable cross references in the "Remarks" column.

(b) The register shall be kept at the registered office of the company or at such other place where the Register of Members is kept and it 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 the purpose.

(c) All entries made in the Register of Renewed and Duplicate Share Certificates shall be authenticated by the company secretary or such other person as may be authorised by the Board for the purposes of sealing and signing the share certificate under the provisions of sub rule (3) of rule 5.

(C)Maintenance of share certificate forms and related books and documents.-(Rule 7)

(1) All blank forms to be used for issue of share certificates shall be printed and the printing shall be done only on the authority of a resolution of the Board and the blank form shall be consecutively machine numbered and the forms and the blocks, engravings, facsimiles and hues relating to the printing of such forms shall be kept in the custody of the secretary or such other person as the Board may authorise for the purpose; and the company secretary or other person aforesaid shall be responsible for rendering an account of these forms to the Board.

(2) The following persons shall be responsible for the maintenance, preservation and safe custody of all books and documents relating to the issue of share certificates, including the blank forms of share certificates referred to in sub-rule (1), namely:-

(a) the committee of the Board, if so authorized by the Board or where the company has a company secretary, the company secretary; or

(b) where the company has no company secretary, a Director specifically authorised by the Board for such purpose.

(3) All books referred to in sub-rule (2) shall be preserved in good order not less than thirty years and in case of disputed cases, shall be preserved permanently, and all certificates surrendered to a company shall immediately be defaced by stamping or printing the word "cancelled" in bold letters and may be destroyed after the expiry of three years from the date on which they are surrendered, under the authority of a resolution of the Board and in the presence of a person duly appointed by the Board in this behalf:

Provisio to Rule 7(3) provides that nothing in this sub-rule shall apply to cancellation of the certificates of securities, under sub-section (2) of section 6 of

the Depositories Act, 1996 (22 of 1996), when such certificates are cancelled in accordance with sub-regulation (5) of regulation 54 of the Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996, made under section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992) read with section 25 of the Depositories Act, 1996 (22 of 1996).

Record of depository is prima facie evidence for shares in depository form

Section 46 (4) states that where a share is held in depository form, the record of the depository is the prima facie evidence of the interest of the beneficial owner.

5.7.1 Issuing duplicate share certificates to defraud

According to Section 46 (5), if a company with an intention to defraud, issues a duplicate certificate of shares, the company shall be punishable with fine which shall not be less than five times the face value of the shares involved in the issue of the duplicate certificate but which may extend to ten times the face value of such shares or rupees ten crores whichever is higher and every officer of the company who is in default shall be liable for action under section 447, for fraud.

5.7.2 Time of issue of Certificate of Securities

Under Section 56(4) of the Act, every company, (unless prohibited by any provision of law or any order of any Court, Tribunal or other authority) must deliver the certificates of all securities allotted, transferred or transmitted:-

(a) within a period of two months from the date of incorporation, in the case of subscribers to the memorandum;
(b) within a period of two months from the date of allotment, in the case of any allotment of any of its shares;
(c) within a period of one month from the date of receipt by the company of the instrument of transfer or, as the case may be, of the intimation of transmission, in the case of a transfer or transmission of securities;
(d) within a period of six months from the date of allotment in the case of any allotment of debenture.

However, 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. [See proviso to Section 56(4)].

Where any default is made in complying with the above provisions, the company shall be punishable with fine which shall not be less than Rs 25,000 but which may extend to Rs 5 lakh and every officer of the company who is in default shall be punishable with fine which shall not be less than Rs 10,000 but which may extend to Rs.1,00,000. [Section 56(6)]

5.7.3 Significance of Share Certificate

A certificate of shares is evidence to the effect that the allottee is holding a certain number of shares of the company showing their nominal and paid-up value and distinctive numbers. This certificate is a prime facie evidence of title to the shares in the possession of shareholders. Moreover, when the company issues a certificate, it holds that the facts contained therein are true. Any person acting on the faith of the share certificate of the company, can compel the company to pay compensation for any damage caused by reason of any misstatement in the share certificate as the company is bound by any statements made in the certificate.

Share certificate is the only documentary evidence of title and that the share certificate is a declaration by the company that the person in whose name the certificate is issued is a shareholder in the company.

5.7.4 Damages against Company and Directors for wrong certificates

As already mentioned, a person acting on the share certificate issued by the company may recover compensation for the damages suffered by him. The measure of damage is the value of the shares at the time of the refusal by the company to recognise him as a shareholder together with interest from that date.

Where directors issue a certificate of title of shares which the company has no power to issue, they may be held personally liable to damages on an implied warranty of authority to any person who acts on such certificate.

5.7.5 Split Certificate

A split certificate means a separate certificate claimed by a shareholder for a portion of his holding. The advantages of a split certificate are that the shareholder may benefit in case of a transfer by way of sale or mortgage in small lots and the right to multiply the certificates into as many shares held by the shareholder.

5.7.6 Purpose and Form of Share Certificate

CHECK YOUR PROGRESS

Give Significance of Share Certificate?

With the help of a share certificate a member of a company may deal with his shares in the market whether it is one of sale, mortgage or pledge by showing a good prima facie marketable title to the shares. A share certificate is a documentary evidence of title to shares in the possession of the shareholder. It is a prima facie evidence of his title to the shares.

Section 46(4) provides that where a share is held in depository form, the record of the depository is the prima facie evidence of the interest of the beneficial owner.

5.7.7 Whether Share Certificate an Official Publication

The question whether a share certificate is an official publication within the meaning of Section 12(3)(c) was considered by the Department of Company Affairs (Now, Ministry of Corporate Affairs) and the Department has clarified vide Circular No. 3/73[8/10(47)]/72-CL-V dated 3.2.1973 as follows:

"It will be seen that in terms of Section 82 [Corresponds to section 44 of the Companies Act, 2013], the shares in a company are movable property transferable in the manner provided in the articles of the company.

Section 84 [Corresponds to section 46 of the Companies Act, 2013] provides that a certificate under the common seal of the company specifying any share held by any member shall be prima facie evidence of the title of the member to such share.(with the Companies (Amendment) Act, 2015 coming into force the common seal is no more mandatory, The implications and signatories have been discussed earlier)

Thus, shares are movable property transferable in the manner provided in the articles of the company and that the share certificates are certificates of title and are movable property but are not publications in the nature of prospectus, balance sheet, profit and loss account, notice or advertisement.

The conclusion reached, therefore, is that the share certificate is not an official publication within the meaning of Section 12(3)(c) of Companies Act, 2013.

5.7.8 Legal Effect of Share Certificate

We have already stated that a share certificate is prima facie evidence to the title of the person whose name is entered on it. It means that the share certificate is a statement by the company that the moment when it was issued, the person

named in it was the legal owner of the shares specified in it, and those shares were paid-up to the extent stated. It does not constitute title but it is merely evidence of title. It is, however a statement of considerable importance, for it is made with the knowledge that other persons may act upon it in the belief that it is true and this fact brings into operation the doctrine of estoppel. As a result, a share certificate once issued by the company binds it in two ways, namely:

(a) by estoppel as to title, and

(b) by estoppel as to payment.

(a) Estoppel as to Title: A share certificate once issued binds the company in two ways. In the first place, it is a declaration by the company to the entire world that the person in whose name the certificate is made out and to whom it is given is a shareholder in the company. In other words the company is estopped from denying his title to the shares.

(b) Estoppel as to Payment: If the certificate states that on each of the shares full amount has been paid, the company is estopped as against a bona fide purchaser of the shares, from alleging that they are not fully paid. If a person knows that the statements in a certificate are not true, he cannot claim an estoppel against the company Barrow case (1880) 14 Ch D 432: 42LT 891CA.

Despite everything, a certificate must be issued by someone who has the authority. For example, where the secretary forged the signature of two directors in a company, the company had refused to register the holder of shares as a member. Further a certificate is not evidence as to the equitable interest in shares. Also, where an individual is aware of the false statements in a certificate, he will not be entitled to claim an estoppel.

5.7.9 Personation of Shareholder

Section 57 of the Companies Act provides that if any person deceitfully personates as an owner of any security or interest in a company, or of any share warrant or coupon issued in pursuance of this Act, and thereby obtains or attempts to obtain any such security or interest or any such share warrant or coupon, or receives or attempts to receive any money due to any such owner, he shall be punishable with imprisonment for a term which shall not be less than one year but which may extend to three years and with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

5.8 Calls and Forfeiture

Calls

A company issuing shares to its members may call the money due on shares at intervals depending upon the requirements for funds for implementing the project and the shareholders also prefer to pay the nominal value on their shares in installments as and when demanded by the company.

A call is a demand, by the company in pursuance of a Board resolution and in accordance with the articles of the company, upon its shareholders to pay the whole or part of the balance still due on each class of shares allotted or held by them made at any time during the life of the company. A call may also be made by the liquidator in the course of winding up of the company. The amount payable in application on each share shall not be less than five per cent of the nominal amount of the share. The balance may be payable as and when called for in one or more calls. The prospectus and the articles of a company generally specify the amount payable at different times, as call(s).

Under Section 10(2) of the Act all moneys payable by any member to the

company on the shares held by him under the memorandum or articles is a debt due from him to the company. In the event of default in payment of a valid call, the company can enforce payment of such moneys by legal process and forfeit the shares in case the call is not paid. The liability of members is enforceable only after a proper notice which is called 'call letter' or call notice as 1st, 2nd and final or so on, is given to him in accordance with the articles.

Requisites of a valid call

1. Board of Directors to make call(s) on shares

The power to make calls is exercised by the Board in its meeting by means of a resolution [Section 179(3)(a)]. The Board, in making a call, must observe the provisions of the articles, otherwise the call will be invalid, and the shareholder is not bound to pay. A proper notice must be given, and the notice must specify the amount called up and manner i.e. the date for payment and place and to whom it is to be paid. It may be emphasised that the time and place at which the call is to be paid are essential ingredients of a valid call. Apart from this rule, "in making call, care must be taken that the directors making it are duly appointed and qualified; the meeting of the directors has been duly convened; proper quorum was present, and that the resolution making the call was duly passed and specifies the amount of the call, the time and place of payment.

2. Call(s) to be made bonafide in the interest of the company

The power to make call is in the nature of trust and must be exercised only for the benefit of the company, and not for the private ends of the directors. If the call is made for the personal benefit of directors, the call will be invalid. In Alexander v. Automatic Telephone Co., (1900) 2 Ch. 56, the directors of the company paid nothing on their shares but did not disclose this fact to the shareholders and called on them to pay certain amount partly as allotment money and partly as call money. The directors were held guilty of breach of trust and the call was held invalid.

3. Call(s) must be made on uniform basis

According to Section 49 of the Act, calls on same class of shares must be made on a uniform basis. Hence a call cannot be made only on some of the members unless they constitute a separate class. In other words, there cannot be any discrimination between shareholders of the same class as regards amount and time of payment of call.

4. Notice of call(s)

The notice of call must specify the exact amount and time of payment. In Shackleyford & Co. Dangerfield (1868) (R3 CP 407) the notice had specified the time and amount to be paid as a call, it will be a valid call inspite of the fact that the form of notice was an inaccurate one. A call must be made by serving upon member formal notice in accordance with the provisions of Section 53 of Companies Act, 1956 (Corresponding to Section 20 of Companies Act, 2013).

5. Time limitations for receiving the call money

If the issuer proposes to receive subscription monies in calls, it shall ensure that the outstanding subscription money is called within twelve months from the date of allotment of the issue.

Usually Articles of association of companies provide for the manner in which calls should be made. They follow the pattern set out in Regulations 13 to 18 of Table-F of Schedule-I appended to the Companies Act, 2013:-.

(a) For each call at least 14 days notice must be given to members.

(b) An interval of one month is required between two successive calls and not more than one-fourth of the nominal value of shares can be called at one time. However, companies may have their own articles and raise the limit.

(c) The Board of directors has the power to revoke or postpone a call after

CHECK YOUR PROGRESS

Describe the provisions of Forfeiture of shares?

NOTES

it is made.

(d) Joint shareholders are jointly and severally liable for payment of calls.

(e) If a member fails to pay call money he is liable to pay interest not exceeding the rate specified in the articles or terms of issue or such lower rate, as the Board may determine. The directors are free to waive the payment of interest wholly or in part.

(f) If any member desires to pay the call money in advance, the directors may at their discretion accept and pay interest not exceeding the rate specified in the articles.

(g) A defaulting member will not have any voting right till call money is paid by him.

Interest on calls due but not paid - A member is generally made liable to pay interest on the calls made but not paid. The rate of interest to be charged is as specified in the Articles. Regulation 16 of Table F, in this regard provides: "16(i) If a sum called in respect of a share is not paid before or on the day appointed for payment thereof, the person from whom the sum is due shall pay interest thereon from the day appointed for payment thereof to the time of actual payment at 10% per annum or at such lower rate, if any, as the Board may determine.

(ii) The Board shall be at liberty to waive payment of any such interest wholly or in part."

Acceptance of uncalled capital

Section 50(1) states that if authorized by its articles, a company may accept from any member the whole or part of the amount remaining unpaid on any shares held by him, even if no part of that amount has been called up.

Where section 50(2) provides that a member who has paid the whole or part of the amount remaining unpaid on the shares held by him even though the company has not made a call for it is not entitled for any voting right at a general meeting on the amount so paid until that amount has been called up

Quantum and Interval between two calls

Proviso to Regulation 13(i) to the Table 'F' of Schedule I of the Companies Act, 2013 provides that no call shall exceed 25% of the nominal value of the share or be payable at less than one month from the date fixed for the payment of the last proceeding call.

If the issuer proposes to receive subscription monies in calls, it shall ensure that the outstanding subscription money is called within twelve months from the date of allotment of the issue and if any applicant fails to pay the call money within the said twelve months, the equity shares on which there are calls in arrear along with the subscription money already paid on such shares shall be forfeited. However, it shall not be necessary to call the outstanding subscription money within twelve months, if the issuer has appointed a monitoring agency in terms of regulation 16 of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Regulation 16 of ICDR provides that if the issue size exceeds five hundred crore rupees, the issuer shall make arrangements for the use of proceeds of the issue to be monitored by a public financial institution or by one of the scheduled commercial banks named in the offer document as bankers of the issuer. However, nothing contained in this clause shall apply to an offer for sale or an issue of specified securities made by a bank or public financial institution or an insurance company.

5.9 Forfeiture of Shares

Forfeiture may be termed as penalty for violation of terms of contract. Forfeiture of shares means taking back of shares by the company from the shareholders. If the shareholder makes default in payment of calls on shares, then

the company can use the option of forfeiting the shares. For a valid forfeiture, satisfaction of following conditions is necessary: -

1. Articles of Association must authorise the forfeiture of shares. Where power is given in the articles, it must be exercised in accordance with the regulation regarding notice, procedure and manner stated therein; otherwise the forfeiture will be void. The power of forfeiture must be exercised bona fide and in the interest of the company. It should not be collusive or fraudulent. If Articles authorise, the forfeiture shall include forfeiture of all dividends declared in respect of the forfeited shares and such dividend is not actually paid before the forfeiture of the shares.

2. Resolution for Forfeiture - Article 30 of the Table F provides that if the defaulting shareholder does not pay the amount within the specified time as required by the notice, the directors may pass a resolution forfeiting the shares.

3. Proper Notice - Before the shares of a member are forfeited, a proper notice to that effect must have been served. Regulation 29 of Table F provides that a notice shall name a further day (not less than 14 days from the date of service of the notice) on or before which the payment is to be made. The notice must also mention that in the event of non payment, the shares will be liable to be forfeited.

4. Power of forfeiture must be exercised bona fide and for the benefit of the company - The power to forfeit be exercised bona fide and for the benefit of the company. The power must be used in order to coerce reluctant shareholders into paying their calls. The power of forfeiture cannot be exercised to relieve unwilling shareholders from the liability of making the payment. Such a shareholder continues to be responsible for the unpaid part of the shares. When forfeiture of shares takes place, shareholder ceases to be a member and the forfeited shares become the property of the company. Regulation 32(ii) of Table F further provides that the liability of a person whose shares have been forfeited ceases if and when the company receives payment in full of all such monies in respect of the shares forfeited. If liquidation takes place, the original holder shall remain liable as a past member to pay calls within one year of forfeiture. However, a company cannot recover from him more than the difference between the amount payable and the amount received on forfeited shares.

In case, the defaulting shareholder approaches the Board to cancel the forfeiture, the Board is empowered to cancel such forfeiture and claim the due amount with interest.

5.10 Re-issue of Forfeited Shares

Shares forfeited by a company may either be cancelled or re-issued to another person at the discretion of the Board. This is done by a Board resolution. After the money due is received from the new member(s), the company executes a transfer deed and issues a share certificate, and if the original holder has already surrendered the share certificate, it is duly transferred, otherwise after a public notice in a newspaper, a new share certificate is issued.

If the shares are re-issued at a price more than the face value, the excess of the proceeds of sale is not payable to the former owner, if the articles provide otherwise (Calcutta Stock Exchange Assn. Ltd Re AIR 1957 Cal 438). The excess of the proceeds so retained shall constitute a premium and must therefore be transferred to the securities premium account. However, in the case of Naresh Chandra Sanyal v. Calcutta Stock Exchange Ass. Ltd., AIR 1971 SC 422, Supreme Court held that, where the articles are silent with regard to such surplus, the right of a company upon the forfeiture and sale of forfeited shares is to use the proceeds for discharging the liability for which the forfeiture was effected and if there is any balance, it belongs to the defaulter and cannot be appropriated by the company.

Where the forfeited shares are re-issued, the new shareholders will not only be liable for the balance amount remaining on the shares but he will also not be entitled to voting rights so long as calls payable by the original shareholder remain unpaid, if the company's articles so provide, as stated in Section 106.

A listed company for reissuing forfeited shares should comply with the relevant clause of the listing agreement and due approval of the regional stock exchange and others as well.

5.11 Surrender of Shares

A company cannot accept a surrender of its shares "as every surrender of shares, whether fully paid-up or not involves a reduction of capital which is unlawful...forfeiture is a statutory exception and is the only exception". [Bellerby v. Rowland and Marwood's S.S. Co. Ltd., (1902) 2 Ch 14]. But a surrender may be dealt with in the manner indicated in Re Castiglione's Willtrusts, Hunter v. Mackenzie, (1958) 1 All ER 480 viz., directing that the shares be held in the name of a nominee as trustee for the company. However, a surrender can be accepted in circumstances absolutely parallel to the requirements of a forfeiture, the only difference being that instead of going to the length of the formalities of a forfeiture, the company accepts in good faith in its own interest the shares which the shareholder is voluntarily surrendering. The other advantage to the company is that the shareholder becomes estopped from questioning the validity.

4.12 Key Concepts

- A share certificate is a certificate issued to the members by the company, specifying the number of shares held by him and the amount paid on each share.
- A split certificate means a separate certificate claimed by a shareholder for a portion of his holding.
- A call is a demand, by the company in pursuance of a Board resolution and in accordance with the articles of the company, upon its shareholders to pay the whole or part of the balance still due on each class of shares allotted or held by them made at any time during the life of the company.
- Forfeiture of shares means taking back of shares by the company from the shareholders.

5.13 Summary

- Allotment means the act of appropriation by the Board of directors of the company of a certain number of securities to persons who have made applications for securities.
- The allotment should be made by proper authority, within a reasonable time, should be absolute and unconditional, must be communicated, should be against application only and should not be in contravention of any other law.
- The Companies Act lays down certain conditions under various sections to be fulfilled before a company can proceed to allot securities such as making an application for getting the securities listed u/s 40, filing prospectus before allotment, minimum subscription,
- If the allotment is made without complying with the conditions as discussed above, allotment is said to be irregular and it will result to the consequences depending upon the nature of irregularity.
- After allotment of securities, a return of allotment in the Form PAS-3 is

required to be filed with Registrar of Companies within 30 days of allotment of securities.

- A share certificate shall be issued under the common seal, if any, of the company or signed by two directors or by a director and the company secretary, wherever, the company has appointed a company secretary, is prima facie evidence of the title of the person to the shares specified therein. Every share certificate shall be issued under the common seal, if any, of the company affixed in presence of and signed by two directors duly authorized by the Board of Directors and the secretary or any person authorized by the Board for the purpose.
- Share certificate is not an official publication within the meaning of Section 12(3)(c) of the Act.
- A call is a demand by the company upon its shareholders to pay the whole or part of the balance still due on each class of shares allotted, made at any time during the life of the company.
- If a member fails to pay a valid call within the stipulated time, the company may exercise the power to forfeit the shares.
- Shares forfeited by a company may either be cancelled or re-issued to another person at the discretion of the Board.

NOTES

CHECK YOUR PROGRESS

Define surrender of shares?

5.14 Questions and Exercise

1) A share certificate is lost. What are the provision under the Companies Act, 2013 for the issue of a duplicate share certificate?
2) What is the significance of a Share Certificate?
3) What is forfeiture of shares and the rules to be followed for the same? Can the forfeited shares be re-issued?
4) What is allotment? State the statutory provision regarding allotment? Can allotment be made on an oral application?

- **Fill in the blanks**

1. Every certificate of share or shares shall be in Form No. _____ or as near thereto as possible.
   (SH2, SH5, SH1)
2. The particulars of every share certificate issued shall be entered forthwith in a Register of Renewed and Duplicate Share Certificates maintained in Form No._____
   (SH2, SH5, SH1)
3. Whenever a company having a share capital makes any allotment of securities, it shall file with the Registrar a return of allotment in Form PAS-3 within _____ days from the date of allotment.
   (30, 40, 45)
4. A _____ is a prima facie evidence of the title of the person to the shares specified therein.
   (share certificate, prospectus, certificate of membership)
5. Every share certificate shall be issued under the common seal, if any, of the company affixed in presence of and signed by _____ directors duly authorized by the Board of Directors and the secretary or any person authorized by the Board for the purpose.
   (three, four, two)
6. If a member fails to pay a valid call within the stipulated time, the company may exercise the power to _____ the shares.
   (forfeit, surrender, discard)
7. Shares forfeited by a company may either be cancelled or re-issued to another

NOTES

person at the _____ of the Board.
(discretion, order, behalf)

8. The power to forfeit be exercised bona fide and for the benefit of the _____.
(board of directors, company, shareholder)
9. forfeiture is a statutory exception and is the only exception to the _____of shares.
(surrender, buy back, issue)
10. If the call is made for the personal benefit of directors, the call will be _____.
(invalid, valid, adjusted)

[**Ans.**1)SH1, 2)SH2, 3)thirty, 4)share certificate, 5)two, 6)forfeit, 7)discretion, 8)company, 9)surrender, 10)invalid.]

5.15 Further Reading and References

1. Dr. Avtar Singh : Company Law; Eastern Book Company, 34, Lalbagh, Lucknow - 226 001
2. C.R. Datta : Datta on the Company Law; Lexis Nexis, Butterworths Wadhwa, Nagpur
3. A. Ramaiya : Guide to the Companies Act; Lexis Nexis, Butterworths Wadhwa Nagpur
4. K.C. Garg, R.C. Chawla, Vijay Gupta: Company Law; Kalyani Publishers, 1/1, Rajinder Nagar, Civil Lines, Ludhiana - 141 001.
5. A.K. Majumdar, Dr. G.K. Kapoor, Sanjay Dhamija : Company Law and Practice; Taxmann, 59/32, New Rohtak Road, New Delhi-110 005.
6. V.S. Datey : Guide to Tax and Corporate Laws; Taxmann, 59/32, New Rohtak Road, New Delhi-110005.
7. M.C. Kuchhal : Modern Indian Company Law; Shri Mahavir Book Depot, 2603, Nai Sarak, Delhi-110006.
8. H.K. Saharay : Company Law; Universal Law Publishing Co., C-FF-1A, Dilkhush Industrial Estate, G.T. Karnal Road, Delhi. -110033.

UNIT - 6
COMPANY ACCOUNTS AND AUDIT

6.1 Introduction
6.2 Objectives
6.3 Accounts of Companies
6.4 Requirement of Keeping Books of Account (Section 128)
6.5 Financial Statements
6.6 Re-Opening of Accounts on Court's Or Tribunal's Orders
6.7 National Financial Reporting Authority (NFRA)
6.8 Internal Audit
6.8.1 Who can be an Internal Auditor
6.8.2 Appointment of Auditors
6.8.3 Powers and Duties of an Auditor
6.9 Audit Report
6.10 Cost Audit
6.11 Meaning and Definition of Dividend
6.11.1 Final dividend
6.11.2 Interim dividend
6.12 Declaration of Dividend (Section 123)
6.13 Unpaid Dividend Account (Section 124)
6.14 Investor Education and Protection Fund (Section 125)
6.15 Punishment for Failure to Distribute Dividends
6.16 Key Concepts
6.17 Summary
6.18 Questions and Exercise
6.19 Further Reading and References

6.1 Introduction

The health of a business is shown by the books of account of the company. The company is maintaining the records through the books as required by statute or as per the need of the hour. But, the maintenance of the books of account is not enough. The verification and checking is also important.

The checking of books of account is known as auditing. The auditing is also known as post mortem of books. It is helpful in the future planning. The auditing is done by the auditor. In India, the statutory audit is conducted by statutory auditor. It is mandatory in nature. Every company is required to audit its books of account. It is not only statutory audit which is in existence; now days, the cost audit, Secretarial audit, management audit etc. are also conducted by the companies. It is helpful in the formulation of the company's policies.

6.2 Objectives

After reading this lesson, you will be able to understand

- The provisions about keeping books of account, inspection of books of account and other provisions for balance sheet and profit and loss account under the Companies Act.
- Provisions for audit and auditors, their appointment, qualifications, resignation, removal, duties and liabilities.
- The legal and procedural aspects relating to distribution of dividend
- Transfer of unpaid or unclaimed dividend to Unpaid Dividend Account and transfer of unpaid dividend to Investor Education and Protection Fund (IEPF), utilization of IEPF etc.,

6.3 Accounts of Companies

The shareholders provide capital to the company for running the business. They are in a way, the owners of the company. But, all of them cannot take part in managing the affairs of the company as their number is usually much more. But they have every right to know as to how their money has been dealt with by the directors in a particular period. This is why perhaps compulsory disclosure through annual information to the shareholders by the directors about the working and financial position of the company enables them to exercise a more intelligent and purposeful control over the affairs of the company. For preparation of annual accounts the maintenance of proper books of account is a must. Section 128 of the Companies Act, 2013 contains the provisions for books of account etc. to be kept by company.

6.4 Requirement of Keeping Books of Account (Section 128)

Maintenance of books of account would mean records maintained by the company to record the specified financial transaction. It has been specifically provided that every company shall keep proper books of account. This section specifies the main features of proper books of account as under -

(i) The company must keep the books of account with respect to items specified in clauses (i) to (iv) of sub-section 2(13) of the Companies Act, 2013 hereinafter referred as Act, which defines "books of account".

(ii) The books of account must show all money received and expended, sales and purchases of goods and the assets and liabilities of the company.

(iii) The books of account must be kept on accrual basis and according to the double entry system of accounting.

(iv) The books of account must give a true and fair view of the state of the affairs of the company or its branches. "books of account" as defined in Section 2(13) includes records maintained in respect of-

(i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;

(ii) all sales and purchases of goods and services by the company;

(iii) the assets and liabilities of the company; and

(iv) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section.

Maintenance of Books of Record

The maintenance of books of account and other books and papers in electronic mode is permitted and is optional. Such books of accounts or other relevant books or papers maintained in electronic mode shall remain accessible in India so as to be usable for subsequent use (the Companies (Accounts) Rules, 2014 hereinafter referred in this Chapter as Rule) (Rule 3(1)).

The company shall intimate to the Registrar on an annual basis at the time of filing of financial statement -

(a) the name of the service provider;

(b) the internet protocol address of service provider;

(c) the location of the service provider (wherever applicable);

(d) where the books of account and other books and papers are maintained on cloud, such address as provided by the service provider.

Inspection by Directors

As provided in sub-section (3) of Section 128, any director can inspect the books of accounts and other books and papers of the company during business hours.

The expression "Books and Papers" has been defined in section 2(12) which includes accounts, deeds, vouchers, writings and documents. The company is, therefore, required to make available the aforesaid books and papers for inspection by any directors. Such inspection may be done by any type of director nominee, independent, promoter or whole time.

Period for preservation of books of Accounts

The books of accounts, together with vouchers relevant to any entry in such books, are required to be preserved in good order by the company for a period of not less than eight years immediately preceding the relevant financial year. In case of a company incorporated less than eight years before the financial year, the books of accounts for the entire period preceding the financial year together with the vouchers shall be so preserved. The provisions of Income Tax Act shall also be complied with in this regard.

Persons Responsible to maintain books

The person responsible to take all reasonable steps to secure compliance by the company with the requirement of maintenance of books of accounts etc. shall be: (sub-section 6)

(i) Managing Director,

(ii) Whole-Time Director, in charge of finance

(iii) Chief Financial Officer

(iv) Any other person of a company charged by the Board with duty of complying with provisions of section 128.

CHECK YOUR PROGRESS

Describe Requirement of Keeping Books of Account under company act?

6.5 Financial Statements

Financial Statement is defined under Section 2 (40), to include -

- Balance Sheet
- Profit and Loss account or Income and Expenditure account
- Cash flow Statement
- Statement of change in equity, if applicable
- any explanatory notes annexed to or forming part of financial statements, giving information required to be given and allowed to be given in the form of notes.

However, the financial statement with respect to one person company, small company and dormant company, may not include the cash flow statement.

Financial statements should be prepared for financial year and shall be in form as per Schedule III.

6.6 Re-Opening of Accounts on Court's Or Tribunal's Orders (This section is yet to be notified)

NOTES

Section 130 provides for provisions relating to re-opening or re- casting of books of accounts of the company. Accordingly,

(i) A company shall not re-open its books of account and shall not recast its financial statements, unless an application in this regard is made by any one or more of the following -

(a) the Central Government, or

(b) the Income-tax authorities, or

(c) the Securities and Exchange Board of India (SEBI), or

(d) any other statutory regulatory body or authority or any person concerned, and

(e) an order in this regard is made by a court of competent jurisdiction or the Tribunal.

(ii) The re- opening and recasting of financial statements is permitted only for the following reasons -

(a) the relevant earlier accounts were prepared in a fraudulent manner; or

(b) the affairs of the company were mismanaged during the relevant period, casting a doubt on the reliability of financial statements.

(iii) The Court or the Tribunal, as the case may be, shall give the notice to-

(a) the Central Government,

(b) the Income-tax authorities,

(c) the Securities and Exchange Board,

(d) any other statutory regulatory body or authority concerned and shall take into consideration the representations, if any, made by Central Government or the income tax authorities, Securities and Exchange Board or the body or authority concerned before passing any order under this section.

(iv) The accounts so revised or re-cast under this section shall be final.

It may be noted that the Tribunal will include National Company Law Tribunal (NCLT). This provision provides for both, reopening of books after accounts have been closed and recast of financial statements.

Director's report of the year in which such provisions are invoked, should provide for the reasons or circumstances in which such revisions were warranted.

6.7 National Financial Reporting Authority (NFRA) (This section is yet to be notified)

Through Section 132 of the Companies Act, 2013, the Central Government has introduced a new regulatory authority named as National Authority for Financial Reporting known as National Financial Reporting Authority (NFRA) with wide powers to recommend, enforce and monitor the compliance of accounting and auditing standards. The Companies Act, 1956 empowers the Central Government to form a Committee for recommendations on Accounting Standards which is National Advisory Committee on Accounting Standards (NACAS). This is now being renamed with enhanced independent oversight powers and authority as National Financial Reporting Authority (NFRA).

The objectives of National Financial Reporting Authority inter alia shall be as follows:

(1) Make recommendations on formulation of accounting and auditing policies and standards for adoption by companies, class of companies or their auditors;

(2) Monitor and enforce the compliance with accounting standards, monitor and enforce the compliance with auditing standards;
(3) Oversee the quality of service of professionals associated with ensuring compliance with such standards and suggest measures required for improvement in quality of service, and
(4) Perform such other functions as may be prescribed in relation to aforementioned objectives.

6.8 Internal Audit

Classes of companies requiring Internal Audit

The following class of companies shall be required to appoint an internal auditor or a firm of internal auditors:-

(a) every listed company;

(b) every unlisted public company having -

(i) paid up share capital of fifty crore rupees or more during the preceding financial year; or

(ii) turnover of two hundred crore rupees or more during the preceding financial year; or

(iii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or

(iv) outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and

(c) every private company having -

(i) turnover of two hundred crore rupees or more during the preceding financial year; or

(ii) outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

An existing company covered under any of the above criteria shall comply with the requirements of section 138 and this rule within six months of commencement of such section.

The Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit.

The company board shall be free to appoint any practicing Chartered Accountant or a Cost Accountant or any other person whom it deems fit to be appointed as its internal auditor. For this purpose, company board may consider the nature and volume of business of company; qualifications, experience and capabilities of such person being appointed as auditor and scope of internal audit.

CHECK YOUR PROGRESS

Give the provisions of internal audit?

6.8.1 Who can be an Internal Auditor

(a) a Chartered Accountant or;

(b) a Cost Accountant or;

(c) such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the Company.

For this sub-section, Chartered Accountant means a Chartered Accountant, who is a member of the Institute of Chartered Accountants of India and has a valid certificate of practice and Cost Accountant means a member of The Institute of Cost Accountants of India. Other professionals, as may be decided by the company's board, may also be appointed as an internal auditor.

Following classes of companies are required to appoint internal auditor-

6.8.2 Appointment of Auditors

The Board of Directors of a company shall appoint an individual or firm as the first auditor of a company, other than a Government company, within thirty days from the date of registration of the company. The appointment of first auditor shall be ratified by members at the first annual general meeting. The auditor so appointed shall hold the office from the conclusion of that meeting till the conclusion of sixth annual general meeting and thereafter till the conclusion of every sixth meeting. The appointment of auditors shall be ratified by members at every annual general meeting.

In the case of failure of the Board to appoint the first auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting appoint such auditor and such auditor shall hold office till the conclusion of the first annual general meeting.

Any casual vacancy (except as a result of the resignation of an auditor) in the office of an auditor of a company, other than a Government company, shall be filled by the Board of Directors within thirty days. If casual vacancy is as a result of the resignation of an auditor, the Board of Directors shall fill the vacancy within thirty days but such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting.

A retiring auditor may be re-appointed at an annual general meeting, if-

(a) he is not disqualified for re-appointment;

(b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and

(c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

If at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

Manner and procedure of selection and appointment of auditors

In case of a company that is required to constitute an Audit Committee under section 177, such committee, and, in cases where such a committee is not required to be constituted, the Board shall take into consideration the qualifications and experience of the individual or the firm proposed to be considered for appointment as auditor and whether such qualifications and experience are commensurate with the size and requirements of the company.

- Before considering the appointment of auditor, the Audit Committee or the Board, as the case may be, shall consider any pending proceeding relating to professional matters of conduct against the proposed auditor before the ICAI or any competent authority or any Court. Further they may call for such other information from the proposed auditor as it may deem fit.
- Where a company is required to constitute the Audit Committee, the committee shall recommend the name of an individual or a firm as auditor to the Board for consideration and in other cases, the Board shall consider and recommend an individual or a firm as auditor to the members in the AGM for appointment.
- If the Board agrees with the recommendation of the Audit Committee, it shall further recommend the appointment of auditor to the members in the AGM otherwise, it shall refer back the recommendation to the committee for reconsideration citing reasons for such disagreement.
- Thereafter if the Audit Committee decides not to reconsider its original recommendation, then Board shall record reasons for its disagreement with the Audit committee and send its own recommendation for consideration of the members in the AGM and if the Board agrees with the recommendations of the Audit Committee, it shall place the matter for consideration by members

in the AGM.

- The auditor appointed in the AGM meeting shall hold office from the conclusion of that meeting till the conclusion of the sixth annual general meeting, with the meeting wherein such appointment has been made being counted as the first meeting.
- Such appointment shall be subject to ratification in every AGM till the sixth AGM by way of passing of an ordinary resolution. If the appointment is not ratified by the members of the company, the Board of Directors shall appoint another individual or firm as its auditor or auditors after following the procedure laid down in this behalf under the Act.

6.8.3 Powers and Duties of an Auditor

Specific enquiries to be made by the auditor are as under-

(a) Loans and Advances made by the Company

Auditor shall inquire into "whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interest of the company or its members." It is applicable to all loans and advances made on the basis of security. The auditor should verify that the security held against the loans and advances made by the company are legally enforceable and also ascertain the valuation of securities to see whether the loan is fully secured or partly secured.

(b) Transactions represented by book entries

Auditor is required to inquire "whether the transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company ". He should verify the all book entry transactions and determine whether such transactions have actually taken place and are not prejudicial to the interest of the company.

(c) Sale of investments

Auditor should inquire, "whether so much of the assets of the company (except an investment company or a banking company) as consists of shares, debentures and other securities, have been sold at a price less than that at which they were purchased by the company". Auditor must verify the cases where securities are sold at a price less than their cost of acquisition and if he finds that such sale is bona fide and the price realised is considered to be reasonable, having regards to the circumstances of each case, no further reporting is required.

(d) Loans and Advances shown as deposits

Auditor must verify "whether loans and advances made by the company have been shown as deposits". The auditor must inquire in respect of all the deposits shown by the company and satisfy himself that the loans and advances have not been shown as deposits.

(e) Charging of Personal expenses to revenue account

Auditor should inquire as to "whether personal expenses have been charged to revenue account". Auditor must ensure that no personal expenses of directors and officers of the company have been charged to revenue account.

(f) Allotment of shares for cash

Auditor should inquire as to "whether cash has actually been received in respect of shares stated to have been allotted for cash and if no cash has actually been so received, whether the position as stated in the account books and balance sheet is correct, regular and not misleading". In this connection, auditor must ensure in respect of shares allotted in cash by the company that cash has actually been received in respect of such allotment by the company.

He should verify and report the cases where cash was not received and that the position, as stated in books of accounts and balance sheet, is correct, regular and not misleading.

NOTES

6.9 Audit Report

Section 143 (2) prescribed that auditor shall make a report to the members of the company on the accounts examined by him and on every financial statement which is required to be laid in the general meeting of the company. The Audit report should take into consideration the provisions of this Act, the Accounting and Auditing standards and matters which are required under this Act or rules made there under or under any order made u/s 143(11).

The Audit report should state that to the best of his information and knowledge, the said accounts and financial statements give a true and fair view of the state of the company's affair as at the end of the financial year and the profit or loss and the cash flow for the year and such other matters as may be prescribed.

Section 143 (3) laid down that auditor's report shall also state other details which are as under:

(a) whether he has sought and obtained all the information and explanations which were necessary and if not, the details thereof and the effect of such information on the financial statements;

(b) whether, in his opinion, proper books of account as required by law have been kept by the company and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) whether the branch audit report prepared by a person other than the company's auditor has been sent to him;

(d) whether the company 's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed as a director under section 164 (2);

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(j) Rule 11 prescribed that Auditor's Report shall also include their views and comments on the following matters, namely:-

(i) whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;

(ii) whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long term contracts including derivative contracts;

(iii) whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company.

The auditor is required to provide the reasons, where any of the matters required to be included in the Audit Report under this Clause is answered in negative or with a qualification. {Section 143 (4)}

For the financial years commencing on or after 1st April. 2015, the report of the auditor shall state about existence of adequate internal financial controls system and its operating effectiveness:

Provided that auditor of a company may voluntarily include the statement referred to in this rule for the financial year commencing on or after 1st April, 2014 and ending on or before 31st March, 2015.

6.10 Cost Audit

In a case the Central Government is of the opinion, that it is necessary to do so, it may, by order, direct that the audit of cost records of class of companies, which are covered under sub-section (1) of Section 148 and which have a net worth of such amount as may be prescribed or a turnover of such amount as may be prescribed, shall be conducted in the manner specified in the order.

Provided that the report on the audit of cost records shall be submitted by the cost accountant in practice to the Board of Directors of the company.

(a) The cost auditor shall forward his report to the Board of Directors of the company within a period of

180 days from the closure of the financial year to which the report relates and the Board of Directors shall consider and examine such report particularly any reservation or qualification contained therein.

(b) Every company covered under these rules shall, within a period of 30 days from the date of receipt of a copy of the cost audit report, furnish the Central Government with such report along with full information and explanation on every reservation or qualification contained therein, in form CRA-4.

CHECK YOUR PROGRESS

Describe audit report?

6.11 Meaning and Definition of Dividend

A dividend is a distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. A share of the after-tax profit of a company, distributed to its shareholders according to the number and class of shares held by them is called dividend. The amount and timing of the dividend is decided by the board of directors, who also determine whether it is paid out of current earnings or the past earnings kept as reserve.

Holders of equity shares are entitled to receive any amount of dividend, based on the level of profit and the company's need for cash for expansion or other purposes.

Dividend defined under section 2(35) of the Companies Act, 2013, includes any interim dividend.

The power to pay dividend is inherent in a company and is not derived from the Companies Act, 2013 or the Memorandum or Articles of Association although the Act and the Articles regulate the manner in which dividends are to be declared.

6.11.1 Final dividend

6.11.1 Final dividend

Dividend is said to be a final dividend if it is declared at the annual general meeting of the company. Final dividend once declared becomes a debt enforceable against the company. Final Dividend can be declared only if it is recommended by the Board of Directors of the Company. In accordance with Section 134(3)(k), Board of directors must state in the Directors' Report the amount of dividend, if any, which it recommends to be paid.

6.11.2 Interim dividend

Dividend is said to be an interim dividend, if it is declared by the Board of Directors between two annual general meetings of the company. All the provisions relating to the payment of dividend shall be applicable on the interim dividend also.

NOTES

6.12 Declaration of Dividend (Section 123)

Section 51 of the Act, states that a company may, if so authorized by its articles, pay dividend in proportion to the amount paid up on each share.

A. Sources of declaration of dividend: Section 123(1) of Companies Act 2013 provides that no dividend shall be declared or paid by a company for any financial year except-

(a) (i) out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of sub-section (2), or

(ii) out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with the provisions of that sub-section and remaining undistributed, or

(iii) out of both; or For the above purpose, depreciation shall be provided in accordance with the provisions of Schedule II.

(b) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government.

B. Transfer of profits to reserves: A company may, before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company.

C. Dividend in case of absence or inadequacy of profits:- Second proviso to Section 123(1) states that owing to inadequacy or absence of profits in any financial year, any company proposes to declare dividend out of the accumulated profits earned by it in previous years and transferred by the company to the reserves, such declaration of dividend shall not be made except in accordance with such rules as may be prescribed in this behalf. a company may declare dividend out of surplus subject to the fulfillment of the following conditions, namely:-

(1) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year: Provided that this sub rule shall not apply to a company which has not declared any dividend in each of preceding 3 financial years.

(2) The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(3) The amount so drawn shall first be utilized to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(a) The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid up share capital as appearing in the latest audited financial statement.

(b) No company shall declare shall declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year.

D. Dividend to be declared from free reserves only: Third proviso to Section 123(1) states that that no dividend shall be declared or paid by a company from its reserves other than free reserves.

Free reserves means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend: Provided that-

(1) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or

(2) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves;

E. Manner of providing depreciation: According to Section 123(2) for the purpose of declaration of divided by a company as per Section 123(1)(a), it shall provide depreciation in accordance with Schedule II.

F. Declaration of interim dividend: Section 123(3) of the Companies Act, 2013 provides that the Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the Profit and Loss Account as well as profit of the financial year in which the interim dividend is sought to be declared. When the company has incurred any loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding the three financial years.

G. Amount of Dividend to be deposited in Special Account of a Schedule Bank: Section 123(4) provides that the amount of the dividend, including interim dividend, shall be deposited in a scheduled bank in a separate account within five days from the date of declaration of such dividend. where if the articles of the company does not authorize so, it has to be amended accordingly.

CHECK YOUR PROGRESS

Give the provisions related to Unpaid Dividend Account?

H. Dividend only to registered shareholder: Section 123(5) explains that no dividend shall be paid by a company in respect of any share therein except to the registered shareholder of such share or to his order or to his banker and shall not be payable except in cash.

I. Capitalization of Profits: Nothing in this sub-section shall be deemed to prohibit the capitalization of profits or reserves of a company for the purpose of issuing fully paid-up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company.

J. Mode of payment: If any dividend payable in cash may be paid by cheque or warrant or in any electronic mode to the shareholder entitled to the payment of the dividend.

K. No dividend to be declared/paid in case of failure of repayment of deposits: Section 123(6) provides that a company which fails to comply with the provisions of sections 73(prohibition of acceptance of deposits except in the manner provided) and 74 (Repayment of deposits etc accepted before commencement of Companies Act 2013) shall not, so long as such failure continues, declare any dividend on its equity shares.

6.13 Unpaid Dividend Account (Section 124)

Section 124(1) states that when a dividend has been declared by a company but has not been paid or claimed within thirty days from the date of the declaration to any shareholder entitled to the payment of the dividend, the company shall, within seven days from the date of expiry of the said period of thirty days, transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in that behalf in any scheduled bank to be called the Unpaid Dividend Account.

NOTES

Section 124(4) states that any person claiming to be entitled to any money transferred under sub-section (1) to the Unpaid Dividend Account of the company may apply to the company for payment of the money claimed.

(a) Details of unpaid dividend to be placed at the website: Section 124 (2) provides that the company shall, within a period of ninety days of making any transfer of an amount under Section 124(1) to the Unpaid

Dividend Account, prepare a statement containing the names, their last known addresses and the unpaid dividend to be paid to each person and place it on the website of the company, if any, and also on any other website approved by the Central Government for this purpose, in such form, manner and other particulars as may be prescribed.

(b) Effect of Non-Transfer of the Dividend: Section 124(3) provides that if any default is made in transferring the total amount referred to in sub-section (1) or any part thereof to the Unpaid Dividend Account of the company, it shall pay, from the date of such default, interest on so much of the amount as has not been transferred to the said account, at the rate of twelve per cent. per annum and the interest accruing on such amount shall ensure to the benefit of the members of the company in proportion to the amount remaining unpaid to them.

(c) Transfer to investor education and protection fund: Section 124 (5) states that any money transferred to the Unpaid Dividend Account of a company in pursuance of this section which remains unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred by the company along with interest accrued, if any, thereon to the Fund established under sub-section (1) of section 125 (Investor Education and Protection Fund) and the company shall send a statement in the prescribed form of the details of such transfer to the authority which administers the said Fund and that authority shall issue a receipt to the company as evidence of such transfer.

(d) Shares in respect of unpaid dividend also to be transferred to IEPF: Section 124(6) provides that all shares in respect of which dividend has not been paid or claimed for seven consecutive years or more shall be transferred by the company in the name of Investor Education and Protection Fund along with a statement containing such details as may be prescribed. (As per the Companies Amendment Act, 2015)

Provided that any claimant of shares transferred above shall be entitled to claim the transfer of shares from Investor Education and Protection Fund in accordance with such procedure and on submission of such documents as may be prescribed.

It is also clarified in the Companies Amendment Act, 2015 that in case any dividend is paid or claimed for any year during the said period of seven consecutive years, the share shall not be transferred to Investor Education and Protection Fund.

(e) Offence & penalty: Section 124(7) provides that if a company fails to comply with any of the requirements of this section, 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 shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

NOTES

6.14 Investor Education and Protection Fund (Section 125)

The Central Government shall establish a Fund to be called the Investor Education and Protection Fund.

Section 125(2) prescribes that the following shall be credited to the Fund-

(a) the amount given by the Central Government by way of grants after due appropriation made by Parliament by law in this behalf for being utilised for the purposes of the Fund;
(b) donations given to the Fund by the Central Government, State Governments, companies or any other institution for the purposes of the Fund;
(c) the amount in the Unpaid Dividend Account of companies transferred to the Fund under sub section (5) of section 124;
(d) the amount in the general revenue account of the Central Government which had been transferred to that account under sub-section (5) of section 205A of the Companies Act, 1956, as it stood immediately before the commencement of the Companies (Amendment) Act, 1999, and remaining unpaid or unclaimed on the commencement of this Act;
(e) the amount lying in the Investor Education and Protection Fund under section 205C of the Companies Act, 1956;
(f) the interest or other income received out of investments made from the Fund;
(g) the amount received under sub-section (4) of section 38;
(h) the application money received by companies for allotment of any securities and due for refund;
(i) matured deposits with companies other than banking companies;
(j) matured debentures with companies;
(k) interest accrued on the amounts referred to in clauses (h) to (j);
(l) sale proceeds of fractional shares arising out of issuance of bonus shares, merger and amalgamation for seven or more years;
(m) redemption amount of preference shares remaining unpaid or unclaimed for seven or more years; and
(n) such other amount as may be prescribed.

Provided that no such amount referred to in clauses (h) to (j) shall form part of the Fund unless such amount has remained unclaimed and unpaid for a period of seven years from the date it became due for payment.

CHECK YOUR PROGRESS

What is IEPF?

Utilisation of Investor Education and Protection Fund

Section 125 (3) provides the Fund shall be utilised for-

(a) the refund in respect of unclaimed dividends, matured deposits, matured debentures, the application money due for refund and interest thereon;

(b) promotion of investors' education, awareness and protection;

(c) distribution of any disgorged amount among eligible and identifiable applicants for shares or debentures, shareholders, debenture-holders or depositors who have suffered losses due to wrong actions by any person, in accordance with the orders made by the Court which had ordered disgorgement;

6.15 Punishment for Failure to Distribute Dividends

Section 127 of Companies Act 2013 provides that when a dividend has been declared by a company but has not been paid or the warrant in respect thereof has not been posted within thirty days from the date of declaration to any

shareholder entitled to the payment of the dividend, every director of the company shall, if he is knowingly a party to the default, be punishable with imprisonment which may extend to two years and with fine which shall not be less than one thousand rupees for every day during which such default continues and the company shall be liable to pay simple interest at the rate of eighteen per cent. per annum during the period for which such default continues.

Exceptions: Proviso to section 127 has provided a list where no offence under this section shall be deemed to have been committed:-

(a) where the dividend could not be paid by reason of the operation of any law;
(b) where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with and the same has been communicated to him;
(c) where there is a dispute regarding the right to receive the dividend;
(d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or
(e) where, for any other reason, the failure to pay the dividend or to post the warrant within the period under this section was not due to any default on the part of the company.

6.16 Key Concepts

- A dividend is a distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders.
- Financial Statement is defined under Section 2 (40), to include -
  - Balance Sheet
  - Profit and Loss account or Income and Expenditure account
  - Cash flow Statement

6.17 Summary

- Proper books of accounts shall be deemed to have been kept by a company if such books exhibit and explain the transactions and financial position of the business of the company, including books containing sufficiently detailed entries of daily cash receipts and payments.
- As per the Act, books of account and other books and papers should be available for inspection by any director on working days during business hours.
- The Act requires that at every annual general meeting of the company, the Board of directors must lay before the shareholders of the company a balance sheet and a profit and loss account for the period as specified therein; and in the case of non-profit companies, an income and expenditure account.
- The balance sheet and profit and loss account must be approved by the Board of directors and signed by the directors before they are submitted to the auditors for their report. The Act gives other provisions also for authentication of annual accounts. The Act also requires the company to file such annual accounts with the Registrar of Companies.
- The Act provides that there shall be attached to every balance sheet laid before a company in general meeting (in practice, the annual general meeting) a report by its Board of directors, with respect to items as specified therein. The Board's Report shall also include a Directors' Responsibility Statement as required under the Act.
- The main object of audit is to ensure that the statement of accounts of the relevant financial year truly and fairly reflect the state of affairs of the company.
- Audit provides a moral check on those who are entrusted with the task of

running business and of keeping and maintaining the books of account of the company. An audit of accounts is conducted with two-fold purpose: (i) detection and prevention of errors; (ii) detection and prevention of fraud.

- The Act provides that the auditor of a Government company shall be appointed or re-appointed by the Comptroller and Auditor General of India within the limits specified.
- Dividend is the share of the company's profit distributed among the members.
- The Board may declare interim dividend during any financial year out of the surplus in the Profit and Loss Account at any time between two AGM of the company.
- Final Dividend means a Dividend which declared at the Annual General Meeting of the company.
- The amount of dividend shall be deposited in a schedule bank in a separate account within 5 days from the date of declaration.
- Dividend may be paid by cheque or warrant or in any electronic mode to the shareholders entitled to the payment of dividend.
- Where the dividend is not paid or claimed within 30 days, the company shall, within 7 days transfer the amount to Unpaid Dividend Account which shall be opened in a scheduled bank.
- In case of any default in transferring the amount, the company shall be laible to pay interest on the amount as has not been transferred.
- The amount remaining unpaid along with interest accured thereon for 7 years shall be transferred to Investor Education and Protection Fund.
- In case of non-payment of dividend declared by the company, every party in default be punishable with imprisonment of upto two years and with fine.

6.18 Questions and Exercise

1) State the procedure for transfer of unpaid or unclaimed dividend to the Investor Education and Protection Fund.
2) Explain the law relating to declaration and payment of final dividend.
3) Distinguish between 'Interim Dividend' and 'Final Dividend'.
4) Write short notes on the following:-
   (i) Investor Education and Protection Fund (IEPF).
   (ii) Punishment of failure to distribute dividend

- **Fill in the blanks**

1. The main object of audit is to ensure that the statement of accounts of the relevant financial year truly and fairly reflect the state of _____of the company.
   (affairs, transactions, purchase)
2. The expression 'annual accounts' embraces both _____ and statement of profit and loss.
   (Fund Flow Statement, Cash Flow Statement, Balance Sheet)
3. Books of account and other books and papers should be available for inspection by any director on working days _____ business hours.
   (after , before, during)
4. The Act provides that the auditor of a _____shall be appointed or re-appointed by the comptroller and auditor general of India within the specified limits.
   (Private Company, Government Company, Small Company)
5. IEPF stands for_____.
   (Investor Education Protection Fund, Investment Endurance Protection Fund, Investment Education Private Fund).

6. _____ may be declared by the board at any time between two annual general meetings.
   (Final Dividend, Interim Dividend, Preference Dividend)
7. The amount of dividend shall be deposited in a schedule bank in a separate account within_____ days from the date of declaration.
   (10 , 15, 5)
8. The amount remaining unpaid along with interest accrued thereon for _____ years shall be transferred to Investor Education and Protection Fund.
   (4, 5, 7)
9. No punishment for non-payment of dividend is liable where dividend is not paid under the provision of_____.
   (law, order, company)
10. In case of non-payment of dividend declared by the company, every party in default be punishable with imprisonment of upto _____ years and with fine.
    (three, five, two)

    [**Ans.** 1)Affairs, 2)Balance Sheet, 3)during, 4)Government Company, 5)Investor Education Protection Fund, 6)Interim Dividend, 7)5, 8)7, 9)law, 10)two.]

6.19 Further Reading and References

1. Dr. Avtar Singh : Company Law; Eastern Book Company, 34, Lalbagh, Lucknow - 226 001
2. C.R. Datta : Datta on the Company Law; Lexis Nexis, Butterworths Wadhwa, Nagpur
3. A. Ramaiya : Guide to the Companies Act; Lexis Nexis, Butterworths Wadhwa Nagpur
4. K.C. Garg, R.C. Chawla, Vijay Gupta: Company Law; Kalyani Publishers, 1/1, Rajinder Nagar, Civil Lines, Ludhiana - 141 001.
5. A.K. Majumdar, Dr. G.K. Kapoor, Sanjay Dhamija : Company Law and Practice; Taxmann, 59/32, New Rohtak Road, New Delhi-110 005.
6. V.S. Datey : Guide to Tax and Corporate Laws; Taxmann, 59/32, New Rohtak Road, New Delhi-110005.
7. M.C. Kuchhal : Modern Indian Company Law; Shri Mahavir Book Depot, 2603, Nai Sarak, Delhi-110006.
8. H.K. Saharay : Company Law; Universal Law Publishing Co., C-FF-1A, Dilkhush Industrial Estate, G.T. Karnal Road, Delhi. -110033.

UNIT - 7
REGULATORY FRAMEWORK RELATING TO SECURITIES MARKET INTERMEDIARIES

7.1 Introduction
7.2 Objectives
7.3 Role of Capital Market Intermediaries
7.4 Merchant Bankers
7.4.1 SEBI (Merchant Bankers) Regulations, 1992
7.5 Registrars and Share Transfer Agents
7.5.1 SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993
7.6 Underwriters
7.6.1 SEBI (Underwriters) Regulations, 1993
7.7 Bankers to an Issue
7.7.1 SEBI (Bankers to an Issue) Regulations, 1994
7.8 Debenture Trustees
7.8.1 SEBI (Debenture Trustees) Regulations, 1993
7.9 Syndicate Members
7.10 Key Concepts
7.11 Summary
7.12 Questions & Exercise
7.13 Further Readings & References

7.1 Introduction

Intermediaries are service providers and are an integral part of any financial system. The Market Regulator, i.e., SEBI regulates various intermediaries in the primary and secondary markets through its Regulations for these respective intermediaries. SEBI has defined the role of each of the intermediary, the eligibility criteria for granting registration, their functions and responsibilities and the code of conduct to which they are bound. These Regulations also empower SEBI to inspect the functioning of these intermediaries and to collect fees from them and to impose penalties on erring entities.

The capital market intermediaries are vital link between investor, issuer and regulator. The objective of these intermediaries is to smoothen the process of investment and to establish a link between the investors and the users of funds. Corporations and Governments do not market their securities directly to the investors. Instead, they hire the services of the market intermediaries to represent them to the investors. Investors, particularly small investors, find it difficult to make direct investment. A small investor desiring to invest may not find a willing and desirable borrower. He may not be able to diversify across borrowers to reduce risk. He may not be equipped to assess and monitor the credit risk of borrowers. Market intermediaries help investors to select investments by providing investment consultancy, market analysis and credit rating of investment instruments. In order to operate in secondary market, the investors have to transact through share brokers.

Registrars and Share Transfer Agents, Custodians and Depositories are capital market intermediaries that provide important infrastructure services for both primary and secondary markets.

The market Regulator, SEBI regulates various intermediaries in the primary and secondary markets through its Regulations for these intermediaries. SEBI has defined the role of each of the intermediary, the eligibility criteria for granting registration, their functions and responsibilities and the code of conduct to which they are bound.

These Regulations also empower SEBI to inspect the functioning of these intermediaries and to collect fees from them and to impose penalties on erring entities. As per Section 11 of SEBI Act, it is the duty of SEBI to register and regulate the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trsutees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities market in any manner.

SEBI has issued regulations in respect of each intermediary to ensure proper services to be rendered by them to the investors and the capital market which is discussed below.

7.2 Objectives

After reading this Chapter the student will able - to know about the regulatory framework of the intermediaries operating in the Primary and the

Secondary markets, Know your client norms prescribed by SEBI, SEBI (Intermediaries) Regulations and Self Regulatory Organisation etc.

7.3 Role of Capital Market Intermediaries

The role of intermediaries makes the market vibrant, and to function smoothly and continuously. Intermediaries possess professional expertise and play a promotional role in organising a perfect match between the supply and demand for capital in the market. All those, institutions or individuals, who help to bring the savers and seekers of capital and enable a regular flow of funds from supply to demand points are intermediaries. All intermediaries are service providers and are an integral part of the Securities Market.

Presently this lesson briefly covers in a nutshell the core functions of each one of the intermediaries operating in the Primary and the Secondary markets.

The following market intermediaries are involved in the Securities Market:

- Merchant Bankers
- Registrars and Share Transfer Agents
- Underwriters
- Bankers to issue
- Debenture Trustees
- Portfolio managers
- Syndicate members
- Stock-brokers and sub-brokers
- Custodians
- Investment Advisers
- Research Analysts
- Credit Rating Agencies
- Depository Participant

7.4 Merchant Bankers

'Merchant Banker' means any person engaged in the business of issue management by making arrangements regarding selling buying or subscribing to securities or acting as manager/consultant/advisor or rendering corporate advisory services in relation to such issue management.

Among the important financial intermediaries are the merchant bankers. They are the key intermediary between the company and issue of capital. It is quite common to come across reference to Merchant Banking and financial services as though they are distinct categories. The services provided by Merchant Bankers depend on their inclination and resources - technical and financial. Merchant bankers (Category I) are mandated by SEBI to manage public issues. These activities have major implications for the integrity of the market. They affect investors' interest and, therefore, transparency has to be ensured. Merchant Bankers are rendering diverse services and functions. These include organising and extending finance for investment in projects, assistance in financial management, raising Euro dollar loans and issue of foreign currency bonds. Different merchant bankers specialised in different services.

SEBI has advised that merchant Bankers shall undertake only those activities which relate to securities market.

These activities are:

(a) Managing of public issue of securities;
(b) Underwriting connected with the aforesaid public issue management business;
(c) Managing/Advising on international offerings of debt/equity i.e. GDR, ADR, bonds and other instruments;
(d) Private placement of securities;
(e) Primary or satellite dealership of government securities;
(f) Corporate advisory services related to securities market including takeovers, acquisition and disinvestment;
(g) Stock broking;
(h) Advisory services for projects;
(i) Syndication of rupee term loans;
(j) International financial advisory services.

The activities of the Merchant Bankers in the Indian capital market are regulated by SEBI (Merchant Bankers) Regulations, 1992.

7.4.1 SEBI (Merchant Bankers) Regulations, 1992

General Obligations and Responsibilities of Merchant Banker

Chapter III of the Regulations containing Regulations 13 to 28 deal with general obligations and responsibilities of Merchant Bankers.

Regulation 13 stipulates that every merchant banker shall abide by the code of conduct which has been specified in Schedule III. The code of conduct as provided in the schedule is as under:

Code of Conduct for Merchant Bankers

1. A merchant banker shall make all efforts to protect the interests of investors.
2. A merchant banker shall maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. A merchant banker shall fulfil its obligations in a prompt, ethical, and professional manner.
4. A merchant banker shall at all times exercise due diligence, ensure proper care and exercise independent professional judgement.
5. A merchant banker shall endeavour to ensure that -

NOTES

(a) inquiries from investors are adequately dealt with;
(b) grievances of investors are redressed in a timely and appropriate manner;
(c) where a complaint is not remedied promptly, the investor is advised of any further steps which may be available to the investor under the regulatory system.

6. A merchant banker shall ensure that adequate disclosures are made to the investors in a timely manner in accordance with the applicable regulations and guidelines so as to enable them to make a balanced and informed decision.
7. A merchant banker shall endeavour to ensure that the investors are provided with true and adequate information without making any misleading or exaggerated claims or any misrepresentation and are made aware of the attendant risks before taking any investment decision.
8. A merchant banker shall endeavour to ensure that copies of the prospectus, offer document, letter of offer or any other related literature is made available to the investors at the time of issue or the offer.
9. A merchant banker shall not discriminate amongst its clients, save and except on ethical and commercial considerations.
10. A merchant banker shall not make any statement, either oral or written, which would misrepresent the services that the merchant banker is capable of performing for any client or has rendered to any client.
11. A merchant banker shall avoid conflict of interest and make adequate disclosure of its interest.
12. A merchant banker shall put in place a mechanism to resolve any conflict of interest situation that may arise in the conduct of its business or where any conflict of interest arises, shall take reasonable steps to resolve the same in an equitable manner.
13. A merchant banker shall make appropriate disclosure to the client of its possible source or potential areas of conflict of duties and interest while acting as merchant banker which would impair its ability to render fair, objective and unbiased services.
14. A merchant banker shall always endeavour to render the best possible advice to the clients having regard to their needs.
15. A merchant banker shall not divulge to anybody either orally or in writing, directly or indirectly, any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.
16. A merchant banker shall ensure that any change in registration status/ any penal action taken by the SEBI or any material change in the merchant banker's financial status, which may adversely affect the interests of clients/ investors is promptly informed to the clients and any business remaining outstanding is transferred to another registered intermediary in accordance with any instructions of the affected clients.
17. A merchant banker shall not indulge in any unfair competition, such as weaning away the clients on assurance of higher premium or advantageous offer price or which is likely to harm the interests of other merchant bankers or investors or is likely to place such other merchant bankers in a disadvantageous position while competing for or executing any assignment.
18. A merchant banker shall maintain arms length relationship between its merchant banking activity and any other activity.
19. A merchant banker shall have internal control procedures and financial

and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.

20. A merchant banker shall not make untrue statement or suppress any material fact in any documents, reports or information furnished to SEBI.
21. A merchant banker shall maintain an appropriate level of knowledge and competence and abide by the provisions of the Act, regulations made thereunder, circulars and guidelines, which may be applicable and relevant to the activities carried on by it. The merchant banker shall also comply with the award of the Ombudsman passed under the SEBI (Ombudsman) Regulations, 2003.
22. A merchant banker shall ensure that SEBI is promptly informed about any action, legal proceedings,
    etc., initiated against it in respect of material breach or non-compliance by it, of any law, rules, regulations, directions of SEBI or of any other regulatory body.
23. (a) A merchant banker or any of its employees shall not render, directly or indirectly, any investment advice about any security in any publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including a long or short position, in the said security has been made, while rendering such advice.
    (b) In the event of an employee of the merchant banker rendering such advice, the merchant banker shall ensure that such employee shall also disclose the interests, if any, of himself, his dependent family members and the employer merchant banker, including their long or short position in the said security, while rendering such advice.
24. A merchant banker shall demarcate the responsibilities of the various intermediaries appointed by it clearly so as to avoid any conflict or confusion in their job description.
25. A merchant banker shall provide adequate freedom and powers to its compliance officer for the effective discharge of the compliance officer's duties.
26. A merchant banker shall develop its own internal code of conduct for governing its internal operations and laying down its standards of appropriate conduct for its employees and officers in carrying out their duties. Such a code may extend to the maintenance of professional excellence and standards, integrity, confidentiality, objectivity, avoidance or resolution of conflict of interests, disclosure of shareholdings and interests, etc.
27. A merchant banker shall ensure that good corporate policies and corporate governance are in place.
28. A merchant banker shall ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).
29. A merchant banker shall ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it in the conduct of its business, in respect of dealings in securities market.
30. A merchant banker shall be responsible for the Acts or omissions of its employes and agents in respect of the conduct of its business.
31. A merchant banker shall ensure that the senior management, particularly decision makers have access to all relevant information about the business

NOTES

on a timely basis.

32. A merchant banker shall not be a party to or instrument for-
    (a) creation of false market;
    (b) price rigging or manipulation; or
    (c) passing of unpublished price sensitive information in respect of securities which are listed and proposed to be listed in any stock exchange to any person or intermediary in the securities market.

Regulation 13A provides that no merchant banker other than a bank or a public financial institution who has been granted a certificate of registration shall carry on any business other than that of the securities market.

However, a merchant banker who has been granted certificate of registration under these regulations may ensure market making in accordance with Chapter XB of SEBI (ICDR) Regulations, 2009.

Regulations 14 to 17 deal with maintenance of books of accounts, records, submission of half-yearly results, rectifying deficiencies pointed out in the auditors report etc.

Merchant Banker Not To Act As Such For an Associate

Regulation 21 stipulates that a lead merchant banker shall not associate himself with any issue if a merchant banker not holding a certificate from SEBI is associated with the issue.

CHECK YOUR PROGRESS

What are the responsibilities Merchant Banker?

Regulation 21A provides that a merchant banker shall not lead manage any issue or be associated with any activity undertaken under any regulations made by SEBI, if he is a promoter or a director or an associate of the issuer of securities or of any person making an offer to sell or purchase securities. However, a merchant banker who is an associate of such issuer or person may be appointed, if he is involved only in the marketing of the issue or offer.

Here, a merchant banker shall be deemed to be an "associate of the issuer or person" if:

(i) either of them controls, directly or indirectly through its subsidiary or holding company, not less than 15% of the voting rights in the other; or
(ii) either of them, directly or indirectly, by itself or in combination with other persons, exercises control over the other; or
(iii) there is a common director, excluding nominee director, amongst the issuer, its subsidiary or holding company and the merchant banker.

7.5 Registrars and Share Transfer Agents

'Registrar to an Issue' means the person appointed by a body corporate or any person or group of persons to carry on the following activities on its or his or their behalf i.e.:

(i) collecting application for investor in respect of an issue;

(ii) keeping a proper record of applications and monies received from investors or paid to the seller of the securities;

(iii) (a) assisting body corporate or person or group of persons in determining the basis of allotment of the securities in consultation with the stock exchange;

(b) finalising the list of person entitled to allotment of securities;

(c) processing and despatchment of allotment letters, refund orders or certificates and other related documents in respect of the issue;

'Share Transfer Agent' means:

(i) any person who on behalf of any body corporate, maintains the records of holders of securities issued by such body corporate and deals with all matters connected with the transfer and redemption of its securities;

(ii) the department or division, by whatever name called, of a body corporate performing the activities as share transfer agents if at any time the total number of holders of its securities issued exceed one lakh.

The Registrars to an Issue and Share Transfer Agents constitute an important category of intermediaries in the primary market. They render very useful services in mobilising new capital and facilitating proper records of the details of the investors, so that the basis for allotment could be decided and allotment ensured as per SEBI Regulations.

They also render service to the existing companies in servicing the share capital contributed by the investors.

The system of share transfers gives liquidity to the investment and helps the investors to easily acquire or dispose off shares in the secondary market. The share transfer agents who have the necessary expertise, trained staff, reliable infrastructure and SEBI licence render service to the corporates by undertaking and executing the transfer and transmission work relating to the company's shares and securities. Thus they have a role to play both in the primary and the secondary markets.

Pre-issue Activities

- Sending instructions to Banks for reporting of collection figures and collection of applications.
- Providing Practical inputs to the Lead Manager and Printers regarding the design of the Bid cum- Application form.
- Facilitate and establish information flow system between clients , Banks and Managers to the issue.
- Liaison with Regulatory Authorities such as SEBI & Stock Exchanges.

Activities during the Issue

- Collection and Reporting of daily Collection figures.
- Collection of Data and Forms from Banks.
- Liaising with clients and Intermediaries to the Issue.

Post Issue Activities

- Data capturing & validation.
- Reconciliation.
- Provide Allotment Alternatives in consultation with Client / Merchant Banker and Stock Exchanges.
- Facilitating Listing.
- Filing of Return of Allotment.
- Uploading of data to the Depositories for crediting of securities electronically.
- Dispatch of Refund orders / Share Certificates / Credit Advise.
- Periodic Report submission to Regulatory Authorities.
- Reconciliation of Refund payments.
- Attending to post issue Investor queries.
- Web-based investor enquiry system for allotment / refund details.

Share Transfer Agent Services

- Processing of transfer of Securities in physical form.
- Processing Transmission / Transposition / Consolidation of holdings.
- Processing of demat requests and converting physical holding into electronic holding (dematerialization).
- Processing of remat requests and converting electronic holding into physical holding (rematerialization)
- Recording of specimen signatures in electronic media.

NOTES

- Recording of Change of address, Bank Mandates and ECS requests received from investors in physical mode.
- Accurate scanning and capturing of data.
- Issue of Duplicate/split/Consolidated Share Certificates .
- Registration of Nomination.
- Registration of Legal documents such as Power of Attorney etc.
- Dividend payout management services.
- Maintenance of Records of Inward/Outward.
- Maintain and upkeep of statutory records such as Transfer Deeds , Demat / Remat Request Form, Register of Members , Allotment Registers , undelivered returned security documents and other Registers and Returns.
- Processing of Call payments and Endorsements.
- Investor Services including providing investor related information, across counters through written communication and through telephone and via e-mail.
- Integrating electronic beneficiary positions with the physical shareholding.
- Redress Investor Complaints which appears in SEBI Complaints Redress System (SCORES).
- Assisting Client Companies in the redressing investor grievances which appears in their ID.

7.5.1 SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993

SEBI (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 were notified by SEBI on 31st May, 1993 in exercise of the powers conferred by Section 30 of SEBI Act, 1992, with the approval of Central Government.

Chapter I of the Regulations contains preliminary items and Chapter II consisting of Regulations 3 to 12 dealing with procedure for applying for initial registration as Registrar to an Issue (RTI) and Share Transfer Agents (STA), either as Category-I to carry on both the activities of RTA and STA or Category-II to carry on the activity either as Registrar to an Issue or as a Share Transfer Agent. The application should be complete and conform to the requirements otherwise it will be rejected. But an opportunity will be given to remove the objections as may be indicated by SEBI. In case of failure the application may be rejected.

Criteria for Registration

Regulation 6 lays down that SEBI shall take into account the following matters while considering the applications for initial registration. It shall assess whether the applicant:

(a) has the necessary infrastructure like adequate office space, equipments and manpower to effectively discharge his activities;
(b) has any past experience in the activities;
(c) any person directly or indirectly connected with him has been granted registration by SEBI under the Act;
(d) fulfills the capital adequacy requirement;
(e) has been subjected to any disciplinary proceedings under the Act;
(f) any of its director, partner or principal officer is or has at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence;
(g) is a fit and proper person.

Regulation 7 stipulates the capital adequacy requirement (networth) for category I as ` 50,00,000 and category II as Rs. 25,00,000.

Regulations 8 to 10 lay down the procedure for initial registration, renewal

of certificate, conditions of registration, period of validity of certificate and the procedure where registration is not granted. It is made clear that the applicant will be given due opportunity of being heard before rejection of his application.

Regulation 11 says that in case of refusal to grant or renew a certificate of permanent registration, the concerned person shall cease to carry on any activity as registrar or share transfer agent.

Regulation 12 prescribes payment of fees and indicates the consequences of failure to pay fees. In the latter case SEBI may suspend the certificate with the consequence that the RTA shall cease to carry on his activity from the date of suspension of the certificate.

General Obligations and Responsibilities

Chapter III consisting of Regulations 13 to 15 lays down the general obligations and responsibilities of RTAs. Specified in Schedule III of these regulations.

Regulation 13A prohibits an RTA from acting as such Registrar in case he or it is an associate of the body corporate issuing the securities. For the purposes of this regulation, Registrar to an Issue or the body corporate, as the case may be, shall be deemed to be an associate of other where -

(i) he or it controls directly or indirectly not less than 10% of the voting power of the body corporate or of Registrar to an issue, as the case may be or

(ii) he or any of his relative is a director or promoter of the body corporate or of the Registrar to an Issue, as the case may be. The term 'relative' shall have the same meaning as assigned to it under Section 2(77) of the Companies Act, 2013.

The RTA has to maintain proper books and records as prescribed in Regulation 14 and preserve the account books and other records for a minimum period of 3 years. Regualtion 15A provides that every Registrar to an Issue and Share Transfer Agent shall appoint a compliance officer who shall be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc. issued by SEBI or Central Government and for redressal of investor grievances. Compliance officer shall immediately and independently report to SEBI any non-compliance observed by him.

CHECK YOUR PROGRESS

State Services of Share transfer Agent?

7.6 Underwriters

Underwriter means a person who engages in the business of underwriting of an issue of securities of a body corporate.

Underwriting is an arrangement whereby certain parties assure the issuing company to take up shares, debentures or other securities to a specified extent in case the public subscription does not amount to the expected levels.

For this purpose, an arrangement (agreement) will be entered into between the issuing company and the assuring party such as a financial institution, banks, merchant banker, broker or other person.

Underwriting is compulsory for a public issue. It is necessary for a public company which invites public subscription for its securities to ensure that its issue is fully subscribed. The company cannot depend on its advertisements to bring in the full subscription. In case of any short-fall, it has to be made good by underwriting arrangements made in advance of the opening of the public issue.

It is the underwriter who agrees to take up securities which are not fully subscribed in a public issue. The underwriter makes a commitment to get the issue subscribing either by others or by themselves.

The lead managers are required to satisfy themselves about the networth

of the underwriters and their outstanding commitments and disclose the same to SEBI. In this connection each underwriter should furnish an undertaking to the lead manager about their networth and outstanding commitments. Both the lead managers and the directors are required to give a statement in the prospectus that in their opinion the underwriters have the necessary resources to discharge their liabilities, if any, in full. Penal action will be taken against underwriters for not taking up the assured amount of security in case of development and to debar them from the underwriting public issues in future.

7.6.1 SEBI (Underwriters) Regulations, 1993

These regulations were notified by SEBI in exercise of the powers conferred by Section 30 of SEBI Act, 1992 with the approval of Central Government. They came into force from 8th October, 1993.

Chapter I contains preliminary matters including definitions.

Chapter II deals with the procedure for registration of underwriters and it contains Regulations 3 to 12.

Regulation 3 lays down that the applicant seeking the certificate shall apply to SEBI in form A. Regulation 4 and 5 requires the applicant to furnish further information and clarification to SEBI regarding matters relevant to underwriting. If SEBI on receipt of further information is of the opinion that the information so furnished is not sufficient to decide on the application and seeking further information through correspondance may delay the matter, it may require the applicant or its principal officer to appear before SEBI in order to give an opportunity to the applicant to give further clarifications on the application.

Regulation 5 provides that an application not complete in all respects and not conforming to instructions specified in the form would be rejected. The applicant would be given an opportunity to remove within one month, the objections as may be indicated by SEBI. SEBI may however extend the time by another one month in order to enable the applicant to comply with the requirements of SEBI.

Regulation 6 prescribes the following conditions for consideration of the application:

1. The applicant shall have necessary infrastructure like adequate office space, equipments and manpower and past experience in underwriting, employing at least two persons with such experience. No person directly or indirectly connected with the applicant should have been granted registration by SEBI.

SEBI shall take into account whether a previous application for a certificate of any person directly or indirectly connected with the applicant has been rejected by SEBI or any disciplinary action has been taken against such person under the Act or any rules/regulations.

2. The applicant should be a fit and proper person, fulfilling the capital adequacy requirements and no director, partner or principal officer should have been at any time convicted for an offence involving moral turpitude or found guilty of any economic offence.

Regulation 7 prescribes for the following capital adequacy requirement:

1. The networth should not be less than ` 20 lakhs.

2. The stock broker who acts as a underwriter should have capital adequacy as prescribed by the stock exchange of which he is a member.

Regulations 8 and 8A, 9A, deal with grant of certificate of initial registration and permanent registration, conditions of registration.

Regulations 10 and 11 deal with the procedure where registration is not granted and the effect of refusal to grant certificate of permanent registration. Regulation 12 prescribes fees payable and consequences of failure to pay fees.

Obligations and Responsibilities of Underwriters

Chapter III consisting of Regulation 13 to 18 deals with these matters. Every underwriter shall abide by the code of conduct at all times.

Regulations 14 and 15 contain provisions regarding the matters on which every underwriter shall enter into an agreement with the body corporate and his general responsibilities.

The contents of the agreement shall include the period of agreement, the allocation of duties and responsibilities between the underwriter and the client, the amount of underwriting obligations, the period by which the underwriter should subscribe, the amount of commission/brokerage payable, and other details of arrangement for fulfilling the underwriting obligations. The general responsibilities of the underwriter are as follows:

1. The underwriter shall not derive any direct or indirect benefit from underwriting the issue other than the commission or brokerage payable under an agreement for underwriting.
2. The total underwriting obligations under all the agreements shall not exceed 20 times the networth.
3. Every underwriter, in the event of being called upon to subscribe for securities of a body corporate pursuant to an agreement shall subscribe to such securities within 45 days of the receipt of such intimation from such body corporate.

Regulation 16 to 18 relate to maintenance of proper books of account and records and their preservation for 5 years and SEBI's power call for and obtain information from the underwriter.

7.7 Bankers to an Issue

Banker to an Issue means a scheduled bank carrying on all or any of the following activities:

(i) Acceptance of application and application monies;

(ii) Acceptance of allotment or call monies;

(iii) Refund of application monies;

(iv) Payment of dividend or interest warrants.

Bankers to the issue, as the name suggests, carries out all the activities of ensuring that the funds are collected and transferred to the Escrow accounts. The Banks render crucial service in mobilisation of capital for companies.

While one or more banks may function as Bankers to the Issue as well as collection banks, others may do the limited work of collecting the applications for securities along with the remittance in their numerous branches in different centres. The banks are expected to furnish prompt information and records to the company and to the lead manager for monitoring and progressing the issue work. For this purpose, the company has to enter into an agreement with different banks specifying the conditions, terms and remuneration for services to be rendered by each such bank.

7.7.1 SEBI (Bankers to an Issue) Regulations, 1994

SEBI notified these regulations effected from 14th July, 1994 in exercise of the powers conferred by Section 30 of SEBI Act, 1994 after approval by the Central Government.

Chapter I deals with preliminary matters and definitions.

Chapter II containing Regulations 3 to 11 deals with procedure of registration for Bankers to an Issue with SEBI.

Regulations 3 to 5 prescribe that the application by a scheduled bank for

NOTES

grant of certificate of initial registration as a banker to an issue should be made to SEBI in Form A conforming to the instructions therein failing which, it shall be rejected after giving due opportunity to remove such defects within specified time. SEBI may call for and obtain further information or clarification from the applicant.

Consideration of Application

Regulation 6 prescribes the matters that are considered by SEBI in relation to the application:

(a) the applicant has the necessary infrastructure, communication and data processing facilities and manpower to effectively discharge his activities;
(b) the applicant or any of its directors is not involved in any litigation connected with the securities market and which has an adverse bearing on the business of the applicant or has not been convicted of any economic offence;
(c) the applicant is a scheduled bank;
(d) the applicant is a fit and proper person;
(e) grant of certificate to the applicant is in the interest of investors.

Procedure for Registration

Regulations 7, 7A, and 8A deals with the grant of certificate of initial registration and permanent registration and conditions of registration. Regulation 9 relates to the procedure where the registration is not granted, leading to the rejection of the application after giving an opportunity to the applicant to be heard. The applicant has right to appeal for reconsideration and SEBI shall reconsider the application and communicate its decision to the applicant in writing.

Regulation 10 lays down that the applicant whose application is refused by SEBI shall cease to carry on any activity as a banker to an issue from the date on which he receives the communication of refusal.

Regulation 11 imposes the duty on the applicant to pay the fees as prescribed. Non-payment of fees may result in suspension of the registration and the applicant shall cease to carry on the activity as a banker to the issue during the period of suspension.

General Obligations and Responsibilities

Regulation 12 requires every banker to an issue to maintain the following records with respect to:

(a) the number of applications received, the names of the investors, the dates on which the applications were received and the amounts so received from the investors;
(b) the time within which the applications received from the investors were forwarded to the body corporate or registrar to an issue as the case may be;
(c) the dates and amount of the refund monies paid to the investors;
(d) dates, names and amount of dividend/interest warrant paid to the investors.

The Banker to an issue shall intimate to SEBI about the place where these documents are kept and shall preserve them for a minimum period of 3 years.

Regulation 13 requires the banker to inform SEBI as to the number of issues for which he was engaged as banker and certain other additional information regarding the monies received, the refunds made and the dividend/ interest warrant paid.

Regulation 14 requires the banker to enter into an agreement with the body corporate for whom he is the banker to an issue with regard to the following matters:

(a) the number of centres at which the application and the application monies of an issue of a body corporate will be collected from the investors;
(b) the time within which the statements regarding the applications and the application monies received from the investors investing in an issue of a body corporate will be forwarded to the registrar to an issue of the body corporate, as the case may be;
(c) the daily statement will be sent by the designated controlling branch of the bankers to the issue to the registrar to an issue indicating the number of body corporate and the amount of application money received.

Regulation 15 requires the banker to issue to inform SEBI about disciplinary action taken, if any by the RBI against him in relation to issue payment work. If as a result of such action the banker to issue is prohibited from carrying on the activities, the certificate shall be deemed to have been cancelled or suspended as the case may be.

7.8 Debenture Trustees

'Debenture Trustee' means a trustee of a trust deed for securing any issue of debentures of a body corporate.

Debentures, Bonds and other hybrid instruments in most cases unless otherwise specified, carry securities for the investors unlike in the case of equity and preference shares. It is necessary that the company makes proper arrangements to extend assurances and comply with legal requirements in favour of the investors who are entitled to this type of security.

Intermediaries such as Trustees who are generally Banks and Financial Institutions render this service to the investors for a fee payable by the company. The issuing company has to complete the process of finalising and executing the trust deed or document and get it registered within the prescribed period and file the charge with the Registrar of Companies (ROC) in respect of the security offered.

CHECK YOUR PROGRESS

What are the general obligations of underwriters?

Role and Functions include:

- Call for periodical reports from the body corporate, i.e., issuer of debentures.
- Take possession of trust property in accordance with the provisions of the trust deed.
- Enforce security in the interest of the debenture holders.
- Ensure on a continuous basis that the property charged to the debenture is available and adequate at all times to discharge the interest and principal amount payable in respect of the debentures and that such property is free from any other encumbrances except those which are specifically agreed with the debenture trustee.
- Exercise due diligence to ensure compliance by the body corporate with the provisions of the Companies Act, the listing agreement of the stock exchange or the trust deed.
- To take appropriate measures for protecting the interest of the debenture holders as soon as any breach of the trust deed or law comes to his notice.
- To ascertain that the debentures have been converted or redeemed in accordance with the provisions and conditions under which they are offered to the debenture holders.

NOTES

- Inform the SEBI immediately of any breach of trust deed or provision of any law.
- Appoint a nominee director on the board of the body corporate when required.

7.8.1 SEBI (Debenture Trustees) Regulations, 1993

These regulations were notified by SEBI effective from 29th December, 1993 in exercise of the powers conferred by Section 30 of SEBI Act, 1992 after previous approval of the Central Government.

Chapter I contains preliminary matters and definitions.

Chapter II consisting Regulations 3 to 12 deals with the procedure for initial or permanent registration of debenture trustees.

Regulation 3 stipulates that the application for registration shall be made in Form A. Schedule II of these regulation accompanied by a non-refundable application fee as prescribed in Regulation 4 authorises SEBI to call for and obtain further information from the applicant before granting the registration. The applicant or its principal officer may, if so required, appear before SEBI for personal representation. Regulation 5 stipulates that an application which is incomplete and does not conform to instructions shall be rejected after giving an opportunity to the applicant to remove such objections within time specified.

Regulation 6 lays down that SEBI shall take into account the following matters in considering the application, namely that the applicant:

(1) has the necessary infrastructure like adequate office space, equipments, and manpower to effectively discharge his activities;
(2) has any past experience as a debenture trustee or has in his employment minimum two persons who had the experience in matters which are relevant to a debenture trustee; or
(3) any person, directly or indirectly connected with the applicant has not been granted registration by SEBI under the Act;
(4) has in his employment at least one person who possesses the professional qualification in law from an institution recognised by the Government; or
(5) any of its director or principal officer is or has at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence and is a fit and proper person;
(6) is a fit and proper person;
(7) fulfills the capital adequacy requirements specified in Regulation 7A of these Regulations.

Regulation 7 lays down that to be a debenture trustee the applicant shall be a scheduled bank carrying on commercial activity, a public financial institution, an insurance company or a body corporate.

Regulation 7A of the Regulations provide that the capital adequacy requirement of debenture trustee shall not be less than the networth of ` 2 crore.

Regulations 8 and 9A deal with the procedure for registration and the renewal thereof, conditions of registration, time period for disposal of application and period of validity of certificate.

Regulation 10 lays down that if an applicant does not fulfill the requirements of Regulation 6 above, it may be rejected after giving reasonable opportunity to the applicant for being heard. The rejection shall be conveyed in writing by SEBI and the applicant may again apply for reconsideration of SEBI. After due reconsideration SEBI shall communicate its bindings in writing to the applicant.

Regulations 11 and 12 deal with effect of refusal to grant certificate of permanent registration by SEBI and nonpayment of fees by the applicant. In the absence of a valid certificate the trustee shall cease to act as a debenture trustee.

Responsibilities and Obligations of Debenture Trustees

Chapter III containing Regulations 13 to 18 deals with this topic. Regulation 13 lays down that no debenture trustee who has been granted a certificate by SEBI shall act as debenture trustee unless he enters into a written agreement with the body corporate before the opening of the subscription list for issue of debentures and the agreement inter alia contains that debenture trustee has agreed to act as such under the trust deed for securing an issue of debentures for the body corporate and the time limit within which the security for the debentures shall be created.

Regulation 13A stipulates that no debenture trustee shall act as such for any issue of debentures in case:

(a) it is an associate of the body corporate; or

(b) it has lent and the loan is not yet fully repaid or is proposing to lend money to the body corporate.

However, the requirement shall not be applicable in respect of debentures issued prior to the commencement of Companies (Amendment) Act, 2000 where - (i) recovery proceedings in respect of the assets charged against security has been initiated or the body corporate has been referred to Board for Industrial and Financial Reconstruction under Sick Industrial Companies (Special Provisions) Act, 1985 prior to commencement of SEBI (Debenture Trustee) Regulations, 2003.

Regulation 14 provides that every debenture trustee shall amongst other matters accept the trust deed which contains the matters specified in Schedule IV to the Regulations.

Duties of Debenture Trustees

Regulation 15 casts the following duties on the debenture trustees:

(1) call for periodical reports from the body corporate;

(2) take possession of trust property in accordance with the provisions of the trust deed;

(3) enforce security in the interest of the debenture holders;

(4) do such acts as necessary in the event the security becomes enforceable;

(5) carry out such acts as are necessary for the protection of the debenture holders and to do all things necessary in order to resolve the grievances of the debenture holders;

(6) ascertain and specify that:

(a) in case where the allotment letter has been issued and debenture certificate is to be issued after registration of charge, the debenture certificates have been despatched by the body corporate to the debenture holders within 30 days of the registration of the charge with ROC;

(b) debenture certificates have been despatched to the debenture holders in accordance with the provisions of the Companies Act;

(c) interest warrants for interest due on the debentures have been despatched to the debenture holders on or before the due dates;

(d) debentureholders have been paid the monies due to them on the date of redemption of the debentures;

(7) ensure on a continuous basis that the property charged to the debenture is available and adequate at all time to discharge the interest and principal amounts payable in respect of the debentures and that such property is free from any other encumbrances save and except those which are specifically agreed to by the debenture trustee.

(8) exercise due diligence to ensure compliance by the body corporate, with the provisions of the Companies Act, the listing agreement of the stock exchange or the trust deed;

NOTES

(9) to take appropriate measures for protecting the interest of the debenture holders as soon as any breach of the trust deed or law comes to his notice;
(10) to ascertain that the debentures have been converted or redeemed in accordance with the provisions and conditions under which they are offered to the debentureholders;
(11) inform SEBI immediately of any breach of trust deed or provision of any law;
(12) appoint a nominee director on the Board of the body corporate in the event of:
(i) two consecutive defaults in payment of interest to the debenture holders; or
(ii) default in creation of security for debenture holders; or
(iii) default in redemption of debentures.
(13) communicate to the debenture holders on half yearly basis the compliance of the terms of the issue by the body corporate, defaults, if any, in payment of interest or redemption of debentures and action taken therefor;
(14) The debenture trustee shall -
(a) obtain reports from the leading bank regarding the project.
(b) monitor utilization of funds raised in the issue.
(c) obtain a certificate from the issuer's auditors.
(i) in respect of utilization of funds during the implementation period of the project; and
(ii) in the case of debentures issued for financing working capital at the end of accounting year.
(15) A debenture trustee may call or cause to be called by the body corporate a meeting of all the debenture holders on -
(a) a requisition in writing signed by at least one-tenth of the debentureholders in value for the time being outstanding.
(b) the happening of any event, which constitutes a default or which in the opinion of the debenture trustees affects the interest of the debentureholders.
(16) No debenture trustee can relinguish its assignment in respect of the debenture issue of any body corporate, unless and until another debenture trustee is appointed in its place by the body corporate.
(17) A debenture trustee is required to maintain the networth requirements on a continuous basis. He is under an obligation to inform SEBI immediately in respect of any shortfall in the networth. He is also not entitled to undertake new assignments until it restores the networth to the level of specified requirement within the time specified by SEBI.
(18) Debenture trustee may inspect books of accounts, records, registers of the body corporate and the trust property to the extent necessary for discharging its obligations.
(19) Supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption reserve, wherever applicable.

CHECK YOUR PROGRESS

State the duties of debenture Trustees

7.9 Syndicate Members

Syndicate Member means an intermediary registered with SEBI and who is permitted to carry on the activity as an underwriter. The Book Runner(s) may appoint those intermediaries who are registered with the SEBI and who are permitted to carry on activity as an 'Underwriter' as syndicate members. The syndicate members are mainly appointed to collect the entire bid forms in a book built issue.

Syndicate Member/Broker is a member of the Stock Exchange to whom the investor has to submit the IPO Bid/ Application form. The Syndicate Member / Broker receives the bid and uploads the same on to the electronic book of the stock exchange. The Syndicate Member/Broker , then submits the bid with cheque to the bankers.

In case of online application, the Syndicate Member/Broker generates the electronic application form and submits the same to the registrar with proof of having paid the bid amount.

7.10 Key Concepts

- Portfolio A collection of securities owned by an individual or an institution (such as a mutual fund) that may include stocks, bonds and money market securities.
- Investment Profit Profit which results from the difference between the purchase and selling prices of a security. Trading profit is short term while investment profit is medium or long term.
- Institutional Investors Organisations those invest including insurance companies, depository institutions, pension funds, investment companies and endowment funds.

7.11 Summary

- The role of intermediaries makes the market vibrant, and to function smoothly and continuously. Intermediaries possess professional expertise and play a promotional role in organising a perfect match between the supply and demand for capital in the market.
- As per Section 11 of SEBI Act, it is the duty of SEBI to register and regulate 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 advisors and such other intermediaries who may be associated with securities market in any manner.
- Merchant Bankers are the key intermediaries between the company and issue of capital. The activities of the Merchant Bankers in the Indian capital market are regulated by SEBI (Merchant Bankers) Regulation, 1992.
- Underwriting is compulsory for a public issue. It is necessary for a public company which invites public subscription for its securities to ensure that its issue is fully subscribed.
- Bankers to the issue, as the name suggests, carries out all the activities of ensuring that the funds are collected and transferred to the Escrow accounts.

7.12 Questions and Exercise

1. Explain briefly the role and responsibilities of Registrar and Transfer Agent.
2. Explain general obligation and responsibilities of merchant banker.
3. Is underwriter is compulsory for a public issue. If yes, explain the role and responsibilities of underwriter in public issue.
4. Explain the norms for registration as portfolio managers.

- **Fill in the blanks**

1. Intermediaries possess professional expertise and play a promotional role in organising a perfect match between the supply and demand for _____1 in the market.
(securities, capital, funds)

2. Merchant Bankers are the key intermediaries between the _____ and issue of capital.
(company, board, shareholders)
3. _____ is necessary for a public company which invites public subscription for its securities to ensure that its issue is fully subscribed.
(bonus shares, underwriting,)
4. Bankers to the issue carry out all the activities of ensuring that the funds are collected and transferred to the _____-accounts.
(Escrow, De mat, Company)
5. Syndicate Member means an intermediary registered with SEBI and who is permitted to carry on the activity as an _____.
(underwriter, bankers to the issue, custodian)

[**Ans:** 1)Capital, 2)company, 3)underwriting, 4)Escrow, 5)underwriter]

7.13 Further Reading and References

1. E. Gordon & : Capital Market in India; Himalaya Publishing House, Ramdoot, K. Natarajan Dr. Bhalerao Marg, Girgaon, Mumbai - 400004.
2. Sanjeev Aggarwal : Guide to Indian Capital Market; Bharat Law House, 22, Tarun Enclave, Pitampura, New Delhi - 110 034.
3. V.L. Iyer : SEBI Practice Manual; Taxman Allied Service (P) Ltd., 59/32, New Rohtak Road, New Delhi-110005.
4. M.Y. Khan : Indian Financial Systems; Tata McGraw Hill, 4/12, Asaf Ali Road, New Delhi - 110 002.
5. S. Suryanarayanan & : SEBI - Law, Practice & Procedure; Commercial Law Publishers (India) V. Varadarajan Pvt. Ltd., 151, Rajindra Market, Opp. Tis Hazari Court, Delhi - 110054
6. Mamta Bhargava : Compliances and Procedures under SEBI Law; Shreeji Publishers, 8/ 294, Sunder Vihar, New Delhi - 110 087
7. Taxmann : SEBI Manual
8. Asim Kumar Mishra : Venture Capital Financing in India; Shipra Publications, 115A, Vikas Marg, Shakarpur, Delhi-110092.
9. Shashi K Gupta : Financial Institutions and Markets ; Kalyani Publishers, 4863/2B, Bharat Nishja Aggarwal Ram Road, 24, Daryaganj, New Delhi - 110002 Neeti Gupta
10. Vishal Saraogi : Capital Markets and Securities Laws simplified, Lawpoint Publication, 6C, R.N. Mukherjee Road, Kolkata-700001

UNIT - 8
REGULATORY FRAMEWORK RELATING TO SECURITIES MARKET INTERMEDIARIES- II

8.1 Introduction
8.2 Objectives
8.3 Stock Brokers & Sub-Broker
8.3.1 SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992
8.3.2 Certification by Practising Company Secretary
8.4 Portfolio Managers
8.4.1 SEBI (Portfolio Managers) Regulations, 1993
8.4.2 Obligations of Portfolio Manager
8.5 Custodians
8.5.1 SEBI (Custodian of Securities) Regulations, 1996
8.5.2 Conditions of Certificate
8.5.3 Obligations of Custodian
8.6 Investment Adviser
8.6.1 SEBI (Investment Advisers) Regulations, 2013
8.6.2 General Obligations and Responsibilities
8.7 Key Concepts
8.8 Summary
8.9 Questions & Exercise
8.10 Further Readings & References

8.1 Introduction

Intermediaries are service providers and are an integral part of any financial system. The Market Regulator, i.e., SEBI regulates various intermediaries in the primary and secondary markets through its Regulations for these respective intermediaries. SEBI has defined the role of each of the intermediary, the eligibility criteria for granting registration, their functions and responsibilities and the code of conduct to which they are bound. These Regulations also empower SEBI to inspect the functioning of these intermediaries and to collect fees from them and to impose penalties on erring entities.

The capital market intermediaries are vital link between investor, issuer and regulator. The objective of these intermediaries is to smoothen the process of investment and to establish a link between the investors and the users of funds. Corporations and Governments do not market their securities directly to the investors. Instead, they hire the services of the market intermediaries to represent them to the investors. Investors, particularly small investors, find it difficult to make direct investment. A small investor desiring to invest may not find a willing and desirable borrower. He may not be able to diversify across borrowers to reduce risk. He may not be equipped to assess and monitor the credit risk of borrowers. Market intermediaries help investors to select investments by providing investment consultancy, market analysis and credit rating of investment instruments. In order

NOTES

to operate in secondary market, the investors have to transact through share brokers. Registrars and Share Transfer Agents, Custodians and Depositories are capital market intermediaries that provide important infrastructure services for both primary and secondary markets.

The market Regulator, SEBI regulates various intermediaries in the primary and secondary markets through its Regulations for these intermediaries. SEBI has defined the role of each of the intermediary, the eligibility criteria for granting registration, their functions and responsibilities and the code of conduct to which they are bound.

These Regulations also empower SEBI to inspect the functioning of these intermediaries and to collect fees from them and to impose penalties on erring entities. As per Section 11 of SEBI Act, it is the duty of SEBI to register and regulate the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trsutees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities market in any manner.

SEBI has issued regulations in respect of each intermediary to ensure proper services to be rendered by them to the investors and the capital market which is discussed below.

8.2 Objectives

After reading this Chapter the student will able - to know about the regulatory framework of the intermediaries operating in the Primary and the

Secondary markets, Know your client norms prescribed by SEBI, SEBI (Intermediaries) Regulations and Self Regulatory Organisation etc.

8.3 Stock Brokers & Sub-Broker

Stock-broker means a member of stock exchange and they are the intermediaries who are allowed to trade in securities on the exchange of which they are members. They buy and sell on their own behalf as well as on behalf of their clients.

A sub-broker is one who works along with the main broker and is not directly registered with the stock exchange as a member. Sub-broker means any person not being a member of stock exchange who acts on behalf of a stock broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stock brokers.

A stock broker plays a very important role in the secondary market helping both the seller and the buyer of the securities to enter into a transaction. The buyer and seller may be either a broker or a client. The transaction entered cannot be annulled except in the case of fraud, willful misrepresentation or upon prima-facie evidence of a material mistake in the transaction, in the judgement of the existing authorities. If a member of the stock exchange (broker) has orders to buy and to sell the same kind of securities, he may complete the transaction between his clients concerned.

When executing an order the stock broker may on behalf of his client buy or sell securities from his own account i.e. as principal or act as an agent. For each transaction he has to issue necessary contract note indicating whether the transaction has been entered into by him as a principal or as an agent for another. While buying or selling securities as a principal, the stock broker has to obtain the consent of his client and the prices charged should be fair and justified by the conditions of the market.

8.3.1 SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992

SEBI (Stock Brokers & Sub-Brokers) Regulations, 1992 were notified by SEBI in exercise of the powers conferred by section 30 of SEBI Act, 1992 and came into effect on 23rd October, 1992.

Chapter II of the Regulations contains Regulation 3 to 10 which deals with registration of Stock Brokers. An application by a stock broker for grant of a certificate of registration shall be made through the Stock exchange, of which he is admitted as a member. The stock exchange shall forward the application form to

SEBI as early as possible but not later than 30 days from the date of its receipt. SEBI may require the applicant to furnish such further information or clarifications regarding the dealings in securities and related matters to consider the application for granting a certificate of registration. The applicant or its principal officer shall, if so required, appear before SEBI for personal representation.

SEBI shall take into account the following aspects before granting a certificate:

(a) whether the applicant is eligible to be admitted as a member of a stock exchange;
(b) whether he has the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge his activities;
(c) whether he has any past experience in the business of buying, selling or dealing in securities;
(d) whether he was subjected to disciplinary proceedings under the rules, regulations and bye-laws of a stock exchange with respect to his business as a stock broker involving either himself or any of his partners, directors or employees; and
(e) whether he is a fit and proper person.
(f) has any financial liability which is due and payable in terms of the Act, the Securities Contracts (Regulation) Act, 1956 or rules and regulations thereunder;
(g) has obtained certification in terms of SEBI (Certification of Associated Persons in the Securities Markets) Regulations, 2007 or as may be specified by SEBI;
(h) satisfies the minimum net worth and deposit requirements as specified in Schedule VI, for the segment for which membership or approval is sought.

Regulation 6 lays down that the SEBI may, after consideration of the application of registration and on being satisfied that the applicant has complied with the conditions laid down in regulation 5 grant a certificate of registration in Form D to the stock-broker, and send intimation to that effect to the stock exchange(s) of which it is a member.

Regulation 7 stipulates that where an application for grant does not fulfil the requirements as prescribed in regulations, SEBI may reject the application after giving a reasonable opportunity of being heard. The refusal to grant the registration certificate shall be communicated by the SEBI within 30 days of such refusal to the applicant and to the concerned stock exchange stating therein the grounds on which the application has been rejected.

An applicant may aggrieved by the decision of SEBI, may apply within a period of 30 days from the date of receipt of such intimation, to the SEBI for reconsideration of its decision.SEBI shall reconsider an application and communicate its decision as soon as possible in writing to the applicant and to the concerned stock exchange.

Registration of Sub-Brokers

Chapter III containing Regulations 11 to 16 deal with registration of sub-brokers. A sub-broker cannot acts as such unless he holds a certificate granted by SEBI. Where a sub-broker merely charges his affiliation from one stock broker to another stock broker being a member of the same stock exchange. There is no requirement of obtaining fresh certificate. Again there is no need of obtaining fresh certificate where a registered stock broker is affiliated to stock broker who is eligible to trade on SME platform.

Regulation 11A lays down that an application by a sub-broker for the grant of certificate shall be made in Form- B. Such application from the sub-broker applicant shall be accompanied by a recommendation letter in Form-C from a stock broker of a recognised stock exchange with whom the former is to be affiliated along with two references including one from his banker. The application form shall be submitted to the stock exchange of which the stock broker with whom he is to be affiliated is a member.

The stock exchange on receipt of an application shall verify the information contained therein and shall also certify that the applicant is eligible for registration as per criteria specified below:

(1) In the case of an individual:

(a) the applicant is not less than 21 years of age;

(b) the applicant has not been convicted of any offence involving fraud or dishonesty;

(c) the applicant has at least passed 12th standard equivalent examination from an Institution recognized by the Government. However, SEBI may relax this criterion on merits having regard to the applicant's experience;

(d) the applicant is a fit and proper person.

(2) In the case of partnership firm or a body corporate, the partners or directors as the case may be shall comply with the requirements stated above. It is also to be assessed whether the applicant has necessary infrastructure like adequate office spece, equipment and manpower to effectively discharge his activities.

The applicant should be person recognised by the stock exchange as a sub-broker affiliated to a member broker of the stock exchange.

The stock exchange shall forward the application form of such applicants, alongwith recommendation letter issued by the stock broker with whom he affiliated alongwith a recognition letter issued by the stock exchange to SEBI within 30 days from the date of its receipt.

SEBI on being satisfied that the sub-broker is eligible, shall grant a certificate in Form-E to the sub-broker and send an intimation to that affect to the stock exchange or exchanges as the case may be. SEBI may grant a certificate of registration to the applicant subject to the terms and conditions as laid down by SEBI in Regulation 12A.

Regulation 12A lays down the conditions of registration. Any registration granted by SEBI shall be subject to the following conditions: -

(a) he shall abide by the rules, regulations and bye-laws of the stock exchange which are applicable to him;

(b) he shall pay fees charged by SEBI;

(c) he shall take adequate steps for redressal of grievances, of the investors within one month of the date of receipt of the complaint and keep SEBI informed about the number, nature and other particulars of the complaints received from such investors; and

(d) he is authorized in writing by a stock-broker being a member of a stock exchange for affiliating himself in buying, selling or dealing in securities.

Where an application for grant of a certificate does not fulfil the requirements mentioned in Regulation 11A, SEBI may reject the application after

giving a reasonable opportunity of being heard. The refusal to grant the certificate shall be communicated by SEBI within 30 days of such refusal to the concerned stock exchange and to the applicant in writing stating therein the grounds on which the application has been rejected. An applicant being aggrieved by the decision of SEBI may, within a period of 30 days from the date of receipt of such intimation apply to SEBI for reconsideration of the decision.

SEBI shall reconsider an application made and communicate its decision to the applicant in writing and to the concerned stock exchange as soon as possible.

A person whose application for grant of a certificate has been refused by SEBI shall, on and from the date of communication of refusal cease to carry on any activity as a sub-broker. The sub-broker has the following general obligations:

(a) pay the fees as per Schedule III;

(b) abide by the Code of Conduct specified in Schedule II;

(c) enter into an agreement with the stock broker for specifying the scope of his authority and responsibilities;

(d) comply with the rules, regulations and bye laws of the stock exchange;

(e) not be affiliated to more than one stock broker of one stock exchange.

The sub-broker shall keep and maintain the books and documents specified in the Regulations.

No director of a stock broker can act as a sub-broker to the same stock broker.

The general obligations and responsibilities, procedure for inspection and for taking action in case of default shall be the same for both stock brokers and sub-brokers.

General Obligations and Responsibilities

Chapter IV containing Regulations 17 and 18 deal with the general obligations and responsibilities of stock brokers. It lays down that every stock broker shall keep and maintain books of accounts, records and documents namely - Register of Transactions (Sauda book); clients ledger; general ledger; journals; cash book; bank pass book; documents register including particulars of securities received and delivered in physical form and the statement of account and other records relating to receipt and delivery of securities provided by the depository participants in respect of dematerialised securities, members contract books showing details of all contracts entered into by him with other members of the same exchange or counterfoils or duplicates of memos of confirmation issued to such other members; counterfoils or duplicates of contract notes issued to clients; written consents of clients in respect of contracts entered into as principals; margin deposit book; registers of accounts of sub-brokers; an agreement with sub-broker specifying scope of authority, and responsibilities of the stock brokers as well as sub-brokers and client account opening Form in the format as specified by SEBI.

Every stock broker shall intimate to SEBI the place where the books of accounts, records and documents are maintained. He shall, after the close of each accounting period, furnish to SEBI if so required, as soon as possible but not later than 6 months from the close of the said period, a copy of the audited balance sheet and profit and loss account for the said accounting period.

If this is not possible, the stock broker shall keep SEBI informed of the same together with the reasons for the delay and the period of time by which such documents would be furnished to SEBI. Every stock broker shall preserve the books of accounts and other records for a minimum period of 5 years.

The stock broker shall not deal with any person as sub-broker unless such person has been granted certificate of registration by SEBI.

NOTES

8.3.2 Certification by Practising Company Secretary

Internal Audit for Stock Brokers/Trading Members/ Clearing Members

SEBI has authorized the Practicing Company Secretary to carry out complete internal audit of stock brokers/ trading members/clearing members on a half yearly basis. The circular states that stock brokers/trading members/ clearing members shall carry out complete internal audit on a half yearly basis by chartered accountants, company secretaries or cost and management accountants who are in practice and who do not have any conflict of interest. The scope of such audit covers, interalia, the existence, scope and efficiency of the internal control system, compliance with the provisions of the SEBI Act, 1992, Securities Contracts (Regulation) Act 1956, SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992, circulars issued by SEBI, agreements, KYC requirements, Bye Laws of the Exchanges, data security and insurance in respect of the operations of stock brokers/ clearing members. The objective of internal audit is -

(i) to ensure that the books of account, records (including telephone records and electronic records) and documents are being maintained in the manner required under SEBI Act, 1992, SCR Act, 1956 and SEBI (Stock brokers and Sub-brokers) Regulations, 1992.

(ii) to ascertain as to whether adequate internal control systems, procedures and safeguards have been established and are being followed by the intermediary to fulfill its obligations within the scope of the audit.

(iii) to ascertain as to whether any circumstances exist which would render the intermediary unfit or ineligible.

(iv) to ascertain whether the provisions of the securities laws and the directions or circulars issued thereunder are being complied with.

(v) to ascertain whether the provision of stock exchange bye-laws, notices, circulars, instructions or orders issued by stock exchanges are being complied with.

(vi) to inquire into the complaints received from investors, clients, other market participants or any other person on any matter having a bearing on the activities of the stock broker.

CHECK YOUR PROGRESS

State thee provisions for registration of Sub-brokers.

8.4 Portfolio Managers

Portfolio manager means any person who pursuant to contract or arrangement with the client, advises or directs or undertakes on behalf of the client (whether as a discretionary portfolio manager or otherwise) the management or administration of a portfolio of securities or the funds of the clients as the case may be.

"Discretionary portfolio manager" is defined as one who exercises or may exercise, under a contract relating to portfolio management, any degree of discretion as to the investment or the management of the portfolio of the securities or the funds of the client. "Portfolio" means the total holdings of securities belonging to any person.

A portfolio manager plays a pivotal role in deciding the best investment plan for an individual as per his income, age as well as ability to undertake risks. A portfolio manager is responsible for making an individual aware of the various investment tools available in the market and benefits associated with each plan. Make an individual realize why he actually needs to invest and which plan would be the best for him. A portfolio manager is responsible for designing customized investment solutions for the clients according to their financial needs.

8.4.1 SEBI (Portfolio Managers) Regulations, 1993

Norms for Registration as Portfolio Managers

The requirements to be satisfied by the applicant for getting the certificate of registration as mentioned in Regulation 6 are as follows:

(a) the applicant is a body corporate;
(b) the applicant has the necessary infrastructure like adequate office space, equipments and the manpower to effectively discharge the activities of a portfolio manager;
(c) the principal officer of the applicant has either professional qualifications in finance, law, accountancy or business management from an institution recognised by the Government or a foreign university or an experience of at least 10 years in related activities in the securities market including in a portfolio manager, stock broker or as a fund manager;
(d) the applicant has in its employment minimum of two persons who, between them, have at least five years experience as portfolio manager or stock broker or investment manager or in the areas related to fund management;
(e) any previous application for grant of certificate made by any person directly or indirectly connected with the applicant has been rejected by SEBI;
(f) any disciplinary action has been taken by SEBI against a person directly or indirectly connected with the applicant under the Act or the Rules or the Regulations made thereunder.
(g) the applicant fulfils the capital adequacy requirements;
(h) the applicant, its director, principal officer or the employee as specified in Clause (d) is involved in any litigation connected with the securities market which has an adverse bearing on the business of the applicant;
(i) the applicant, its director, principal officer or the employee as specified in Clause (d) has at any time been convicted for any offence involving moral turpitude or has been found guilty of any economic offence;
(j) the applicant is a fit and proper person;
(k) grant of certificate to the applicant is in the interests of investors.

Capital Adequacy Requirement

Regulation 7 lays down that portfolio manager must have capital adequacy requirement of not less than networth of two crore rupees. However the portfolio manager shall fulfill capital adequacy requirement under these regulations, separately and independently, of capital adequacy requirements if any for each activity undertaken by it under the relevant regulations. Networth for the purpose means the aggregate value of paidup equity capital plus free reserves (excluding reserves created out of revaluation) reduced by the aggregate value of accumulated looses and deferred expenditure not written off, including miscellaneous expenses not written off.

Conditions of Registration

Any registration granted or any renewal granted under these regulation shall be subject to the following conditions, namely:

(a) where the portfolio manager proposes to change its status or constitution, it shall obtain prior approval of SEBI for continuing to act as such after the change;

(b) it shall pay the fees for registration or renewal, as the case may be, in the manner provided in these regulations;

(c) it shall take adequate steps for redressal of grievances of the investors within one month of the date of the receipt of the complaint and keep SEBI informed about the number, nature and other particulars of the complaints received;

(d) it shall maintain capital adequacy requirements specified in these

NOTES

regulation at all times during the period of the certificate or renewal thereof;

(e) it shall abide by the regulations made under the Act in respect of the activities carried on by it as portfolio manager.

Period of Validity of Certificate

The certificate of registration granted and its renewal granted under these regulation shall be valid for a period of three years from the date of its issue to the applicant.

Procedure Where Registration Is Not Granted

Where the applicant does not satisfy the requirement of registration, SEBI may reject the application after giving an opportunity of being heard. The refusal shall be communicated by SEBI within 30 days of such refusal indicating the grounds for rejection. An applicant if aggrieved by SEBI's rejection may apply within a period of 30 days from the date of receipt of rejection letter to SEBI for reconsideration. SEBI shall reconsider the matter and communicate its final decision as soon as possible in writing to the applicant. The applicant shall cease to carry on activity as portfolio manager on receipt of rejection of his application. If the portfolio manager fails to pay the fees as provided in Schedule II, SEBI may suspend the certificate and during the period of suspension the portfolio manager shall not carry on activity as such portfolio manager

Responsibilities of a Portfolio Manager

Regulation 15 lays down that the discretionary portfolio manager shall individually and independently manage the funds of each client in accordance with the needs of a client in a manner which does not partake character of a mutual fund, whereas the non discretionary portfolio manager shall manage the funds in accordance with the directions of the client. The portfolio manager shall not accept from the client, funds or securities worth less than twenty five lacs rupees. The portfolio manager shall act in a fiduciary capacity with regard to the clients funds. The portfolio manager shall keep the funds of all clients in a separate account to be maintained by it in a Scheduled Commercial Bank. He shall transact in securities within the limitation placed by the client for dealing in securities under the provisions of RBI Act, 1934. He shall not derive any direct or indirect benefit out of the clients funds or securities. The portfolio manager shall not borrow funds or securities for behalf of the client. The portfolio manager shall not lend securities held on behalf of clients to a third person except as provided under these regulation.

Accounting by Portfolio Managers

Regulations 17 to 20 deal with books of accounts, records, accounts and audit.

Regulation 17 lays down that every portfolio manager shall keep and maintain the following books of accounts, records and documents, namely - a) a copy each of balance sheet, profit and loss account and the auditor's account in respect of each accounting period b) a statement of financial position and c) records in support of every investment transaction or recommendation which will indicate the data, facts and opinions leading to that investment decision. Every portfolio manager shall intimate to SEBI where the books of accounts, records or documents are maintained. Every portfolio manager shall after the end of each accounting period furnish to SEBI copies of the balance sheet, profit and loss account and such other documents as are required under these regulations for any other preceeding five accounting years. Regulation 18 provides that portfolio manager shall furnish to SEBI half-yearly unaudited financial results when required by SEBI with a view to assist in monitoring the capital adequacy of the portfolio manager.

The portfolio manager shall preserve the books of account and other records and documents mentioned in any of the regulations mentioned under Chapter III for a minimum period of five years.

Regulation 20 lays down that the portfolio manager shall maintain separate client-wise accounts. The funds received from the clients, investments or disinvestments and all the credits to the account of the client like interest, dividend, bonus or any other beneficial interest received on the investment and debits for expenses if any shall be properly accounted for and details thereof shall be reflected correctly in the clients accounts. The tax deducted at source as required under the Income Tax Act, 1961 shall be recorded in the portfolio account. The books of account will be audited by a qualified auditor to ensure that portfolio manager has followed proper accounting methods and procedures and that he has performed the duties in accordance with the law. A certificate to this effect shall, if so specified be submitted to SEBI within 6 months of the close of the portfolio managers accounting period.

The portfolio accounts of the portfolio manager shall be audited annually by an independent chartered accountant and a copy of the certificate issued by the chartered accountant shall be given to the client.

The client may appoint a chartered accountant to audit the books and accounts of the portfolio manager relating to his transactions and the portfolio manager shall co-operate with such chartered accountant in course of the audit.

8.4.2 Obligations of Portfolio Manager

It shall be the duty of every director, proprietor, partner, officer and employee of the portfolio manager who is being inspected, to produce to the inspecting authority such books of accounts and documents in his custody or control and furnish him with the statements and information relating to these activities within such time as the inspecting authority may require. The portfolio manager shall allow the inspecting authority to have reasonable access to the premises occupied by the former or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in his possession or in the possession of any other person and also provide copies of documents or other material which in the opinion of the inspecting authority are relevant for the purposes of the inspection. In the course of inspection, the inspecting authority shall be entitled to examine or record statements of any principal officer, director, partner, proprietor and employee of the portfolio manager. It shall be the duty of each such person to give to the inspecting authority all assistance in connection with the inspection which the portfolio manager may reasonably be expected to give.

The inspecting authority shall submit an inspection report to SEBI as soon as it is possible. SEBI or the chairman shall after consideration of the inspection or investigation report take such action as SEBI or its chairman may deem fit and appropriate including action under Chapter V of SEBI (Intermediaries) Regulations, 2008.

Liability for Action In Case Of Default

A portfolio manager who contravenes any of the provisions of the Act, Rules or Regulations framed there under shall be liable for one or more action specified therein including the action under Chapter V of SEBI (Intermediaries) Regulations, 2008.

Appointment of Auditor

SEBI may appoint a qualified auditor to investigate into the books of account or the affairs of the portfolio manager.

The auditor so appointed shall have the same powers of the inspecting

NOTES

authority as are mentioned in regulation and the obligation of the portfolio manager and his employees in regulation 26 shall be applicable to the investigation under this regulation.

Internal Audit of Portfolio Manager

Every Portfolio manager is required to appoint a Practising Company Secretary or a Practising Chartered Accountant for conducting the internal audit. The Portfolio manager is required to report the compliance of the aforesaid requirement to SEBI while submitting the half yearly report.

The report is to be submitted twice a year, as on 31st of March and 30th of September. The report should reach SEBI within thirty days of the period to which it relates.

No precise period has been prescribed for the PCS to submit his report to the Board of the company. However, it would be advisable for the PCS to give the audit report to the Portfolio Manager sufficiently well in advance to enable the Company to report the compliance of the same to SEBI.

The scope of the internal audit would comprise the checking of compliance of SEBI (Portfolio Managers)

Regulations 1993 and circulars notifications or guidelines issued by SEBI and internal procedures followed by the Portfolio Manager.

CHECK YOUR PROGRESS

What are the provisions for portfolio managers?

8.5 Custodians

A custodian is a person who carries on the business of providing custodial services to the client. The custodian keeps the custody of the securities of the client. The custodian also provides incidental services such as maintaining the accounts of securities of the client, collecting the benefits or rights accruing to the client in respect of securities.

Every custodian should have adequate facilities, sufficient capital and financial strength to manage the custodial services.

The SEBI (Custodian of Securities) Regulations, 1996 prescribe the roles and responsibilities of the custodians.

According to the SEBI the roles and responsibilities of the custodians are to:

- Administrate and protect the assets of the clients.
- Open a separate custody account and deposit account in the name of each client.
- Record assets.
- Conduct registration of securities.

Custodial services refer to the safeguarding of securities of a client. The activities relating to custodial services involve collecting the rights benefiting the client in respect to securities, maintaining the securities' account of the client, informing the clients about the actions taken or to be taken, and maintaining records of the services.

The term "custodial services" in relation to securities of a client or gold or gold related instruments held by a mutual fund in accordance with the SEBI (Mutual Funds) Regulations, 1996 means safekeeping of securities or gold or gold related instruments or title deed of real estate assets and providing services incidental thereto, and includes -

(i) maintaining accounts of securities or gold or gold related instruments or title deeds of real estate assets of a client;
(ii) undertaking activities as a Domestic Depository in terms of the Companies (Issue of Indian Depository Receipts) Rules, 2004.
(iii) collecting the benefits or rights accruing to the client in respect of

securities or gold or gold related instruments or title deeds of real estate assets;

(iv) keeping the client informed of the actions taken or to be taken by the issuer of securities, having a bearing on the benefits or rights accruing to the client; and

(v) maintaining and reconciling records of the services referred to in points (i) to (iii).

8.5.1 SEBI (Custodian of Securities) Regulations, 1996

In exercise of the powers conferred by section 30 of SEBI Act, 1992 SEBI notifed the SEBI (Custodian of

Securities) Regulations, 1996 on May 16, 1996.

Chapter I contains preliminary matter and definitions. Chapter II consisting Regulation 3 to 11 relating to procedure for registration of custodian

Application for Grant of Certificate

Regulation 3(1) provides that any person proposing to carry on business as custodian of securities on or after the commencement of these regulations shall make an application to SEBI for grant of a certificate. SEBI may, however in special cases, where it is of the opinion that it is necessary to do so for reasons to be recorded in writing, may extend the period upto a maximum of six months from the date of such commencement.

Any person who fails to make an application for grant of certificate within the period or the extended period specified therein, shall cease to carry on any activity as custodian of securities and shall be subject to the directions of SEBI with regard to the transfer of records, documents or securities relating to his activities as custodian of securities.

Application to Conform To Requirements

An application which is not complete in all respects or which does not conform to the instructions specified therein will be rejected. However before rejecting any such application, SEBI would give the applicant an opportunity to remove the objection, within such time as may be specified.

Furnishing of Information

SEBI may require the applicant to furnish such further information or clarification regarding matters relevant to the activities of a custodian of securities for the purpose of consideration of the application. The applicant or his authorised representative may, if so required, appear before SEBI for personal representation, in connection with the grant of certificate.

Consideration of Application for Grant of Certificate

SEBI, while granting the Certificate shall take into account following matters which are relevant to the activities of a custodian of securities:

(a) the applicant fulfils the capital requirement;

(b) the applicant has the necessary infrastructure, including adequate office space, vaults for safe custody of securities and computer systems capability, required to effectively discharge his activities as custodian of securities;

(c) the applicant has the requisite approvals under any law for the time being in force, in connection with providing custodial services in respect of gold or gold related instruments of a mutual fund, or title deeds of real estate assets held by a real estate mutual funds scheme where applicable;

(d) the applicant has in his employment adequate and competent persons

NOTES

who have the experience, capacity and ability of managing the business of the custodian of securities;

(e) the applicant has prepared a complete manual, setting out the systems and procedures to be followed by him for the effective and efficient discharge of his functions and the arms length relationships to be maintained with the other businesses, if any, of the applicant;

(f) the applicant is a person who has been refused a certificate by SEBI or whose certificate has been cancelled by SEBI;

(g) the applicant, his director, his principal officer or any of his employees is involved in any litigation connected with the securities market;

(h) the applicant, his director, his principal officer or any of his employees has at any time been convicted of any offence involving moral turpitude or of any economic offence;

(i) the applicant is a fit and proper person; and

(j) the grant of certificate is in the interest of investors.

Also SEBI shall not consider an application unless the applicant is a body corporate.

8.5.2 Conditions of Certificate

The certificate granted to the custodian of securities may be subject to the following conditions, namely:

(a) it shall not commence any activities as custodian of securities unless it fulfils the capital requirement;

(b) it shall abide by the provisions of the Act and these regulations in the discharge of its functions as custodian of securities;

(c) it shall enter into a valid agreement with its client for the purpose of providing custodial services;

(d) it shall pay annual fees as specified in these regulation;

(e) if any information previously submitted by it to SEBI is found by it to be false or misleading in any material particular, or if there is any change in such information, it shall forthwith inform SEBI in writing; and

(f) besides providing custodial services, it shall not carry on any activity other than activities relating to rendering of financial services.

Period of Validity

Regulation 9A of the Regulations provide that every certificate granted under these regulation shall be valid for a period of three years from the date of grant.

Renewal of Certificate

Regulation 9B provides that a custodian of securities, desirous of having its certificate renewed shall make an application to SEBI for renewal of the certificate in Form A, not less than three months before the expiry of its period of validity under Regulation 9A. The application for renewal of certificate shall be dealt with, as far as may be, as if it were an application for the grant of a fresh certificate and shall be accompanied with the application fee as specified in Schedule II.

Effect of Refusal to Grant Certificate

Any custodian of securities whose application for grant of certificate has been rejected by SEBI shall, on and the date of the receipt of the communication ceases to carry on any activity as custodian of securities and shall be subject to the directions of SEBI with regard to the transfer of records, documents or securities that may be in its custody or control relating to its activity as custodian of securities.

Appointment of Compliance Officer

Regulation 19A(1) provides that every custodian of securities would appoint a compliance officer responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions etc. issued by SEBI or the Central Government. He is under an obligation for redressal of investors' grievances.

The compliance officer is required to immediately and independently report to SEBI any non-compliance observed by him.

Information to SEBI

SEBI may, at any time, call for any information from a custodian of securities with respect to any matter relating to its activity as custodian of securities. Where any information is called for by SEBI, it shall be the duty of the custodian of securities to furnish such information, within such reasonable period as SEBI may specify.

Inspection and Audit

SEBI may appoint one or more persons as inspecting officer to undertake inspection of the books of accounts, records and documents of the custodian of securities for any of the following purposes, namely:-

(a) to ensure that the books of account, records and documents are being maintained by the custodian of securities in the manner specified in these regulations;
(b) to investigate into complaints received from investors, clients or any other person, on any matter having a bearing on the activities of the custodian of securities;
(c) to ascertain whether the provisions of the Act and these regulations are being complied with by the custodian of securities; and
(d) to investigate suo motu into the affairs of the custodian of securities, in the interest of the securities market or in the interest of investors.

The custodian of securities against whom the inspection is being carried out is under an obligation to discharge his obligations.

8.5.3 Obligations of Custodian

It is the duty of the custodian of securities whose affairs are being inspected, and of every director, officer and employee thereof, to produce to the inspecting officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to his activities of the custodian of securities, as the inspecting officer may require, within such reasonable period as the inspecting officer may specify.

The custodian of securities is required to allow the inspecting officer to have reasonable access to the premises occupied by such custodian or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the custodian of securities or such other person and also provide copies of documents or other materials which, in the opinion of the inspecting officer are relevant for the purposes of the inspection.

The inspecting officer, in the course of inspection, is entitled to examine or to record the statements of any director, officer or employee of the custodian of securities. It is the duty of every director, officer or employee of the custodian of securities to give to the inspecting officer all assistance in connection with the inspection, which the inspecting officer may reasonably require.

Liability for Action In Case Of Default

A custodian of securities who contravenes any of the provisions of the Act, the rules framed there under or these regulations or fails to furnish any information relating to his activity as custodian of securities as required by SEBI or furnishes to SEBI information which is false and misleading in any material particular or does not submit periodic returns or reports as required by SEBI or does not co-operate in any enquiry or inspection conducted by SEBI or fails to update its systems and procedures as recommended by SEBI or fails to resolve the complaints of clients or fails to give a satisfactory reply to SEBI in this behalf or is guilty of misconduct or makes a breach of the Code of Conduct specified in the Third Schedule or fails to pay annual fees, shall be dealt with in the manner provided under Chapter V of SEBI (Intermediaries) Regulations, 2008.

8.6 Investment Adviser

CHECK YOUR PROGRESS

State the conditions for grant of certificate to the custodian.

"Investment Adviser" means any person, who for consideration, is engaged in the business of providing investment advice to clients or other persons or group of persons and includes any person who holds out himself as an investment adviser, by whatever name called. Investment advisers are those, who guide one about his or her financial dealings and investments.

"Investment Adviser" means advice relating to investing in, purchasing, selling or otherwise dealing in securities or investment products, and advice on investment portfolio containing securities or investment products, whether written, oral or through any other means of communication for the benefits of the client and shall include financial planning. However, investment advice given through newspaper, magazines, any electronic or broadcasting or telecommunication medium, which is widely available to the public shall not be considered as investment advice for the purpose of these regulation.

The globalization of the capital markets, the proliferation of asset classes and the bewildering variety of risks that the average institutional investor is confronted which have increased the need for the specialized expertise that investment advisers provide. The role of investment adviser has got a lot of significance in the present time.

Investment adviser serve as facilitators, making sure that all clients have many opportunities to express their financial concerns and issues. Basically Investment adviser give advice and provide services related to the investment management process. The rapid change of market conditions as well as the availability of numerous options for financial investments necessitates the existence of knowledgeable investment adviser. In order to add value, the investment adviser is called upon to apply specialized knowledge, experience and analytical resources to create and deliver focused advice to client and works to increase the investment knowledge of clients and thereby support the fiduciary obligations clients face in the management of their plan.

8.6.1 SEBI (Investment Advisers) Regulations, 2013

In exercise of the powers conferred by sub-section (1) of Section 30 read with clause (b) of sub-section\ (2) of Section 11 of SEBI Act, 1992, SEBI made these regulations.

Registration of Investment Advisers

Regulation 3 deals with the application for grant of certificate by SEBI. A person shall not act as an investment adviser or hold itself out as an investment adviser unless he has obtained a certificate of registration from SEBI.

An application for grant of certificate of registration shall be made in Prescribed Form and shall be accompanied by a non refundable application fee to be paid in the manner specified in these regulations.

Exemption from Registration

Regulation 4 provides that certain persons are exempted from the requirement of registration under regulation 3 subject to the fulfillment of the conditions stipulated therefor, -

(a) Any person who gives general comments in good faith in regard to trends in the financial or securities market or the economic situation where such comments do not specify any particular securities or investment product;

(b) Any insurance agent or insurance broker who offers investment advice solely in insurance products and is registered with Insurance Regulatory and Development Authority for such activity;

(c) Any pension advisor who offers investment advice solely on pension products and is registered with Pension Fund Regulatory and Development Authority for such activity;

(d) Any distributor of mutual funds, who is a member of a self regulatory organisation recognised by SEBI or is registered with an association of asset management companies of mutual funds, providing any investment advice to its clients incidental to its primary activity;

(e) Any advocate, solicitor or law firm, who provides investment advice to their clients, incidental to their legal practise;

(f) Any member of Institute of Chartered Accountants of India, Institute of Company Secretaries of India,
Institute of Cost and Works Accountants of India, Actuarial Society of India or any other professional body as may be specified by SEBI, who provides investment advice to their clients, incidental to his professional service;

(g) Any stock broker or sub-broker registered under SEBI (Stock Broker and Sub-Broker) Regulations,
1992, portfolio manager registered under SEBI (Portfolio Managers) Regulations, 1993 or merchant banker registered under SEBI (Merchant Bankers) Regulations, 1992, who provides any investment advice to its clients incidental to their primary activity:
However, such intermediaries shall comply with the general obligation(s) and responsibilities as specified in Chapter III of these regulations. Further the existing portfolio manager offering only investment advisery services may apply for registration under these regulations after expiry of his current certificate of registration as a portfolio manager;

(h) Any fund manager, by whatever name called of a mutual fund, alternative investment fund or any other intermediary or entity registered with SEBI;

(i) Any person who provides investment advice exclusively to clients based out of India: However, persons providing investment advice to Non-Resident Indian or Person of Indian Origin shall fall within the purview of these regulations;

(j) Any representative and partner of an investment adviser which is registered under these regulations.
However, such representative and partner shall comply with these regulations;

(k) Any other person as may be specified by SEBI.

Qualification & Certification

- Investment Advisers are required to hold a professional qualification or post-graduate degree or post graduate diploma in finance, accountancy, business management, commerce, economics, capital market, banking, insurance or actuarial science from a university or an institution recognized by the Central Government or any State Government or a recognized foreign university or institution or association.
  Alternatively, advisers having a graduate in any discipline with experience of at least five years in activities relating to advice in financial products or securities or fund or asset or portfolio management are also qualified.
- Investment Advisers, their partners and their representatives should have a certification on financial planning or fund or asset or portfolio management or investment advisory services from NISM or from any other organization or institution including Financial Planning Standards Board India (FPSB) or stock exchange in India provided that such certification is accredited by NISM.
- Existing investment advisers and their representatives seeking registration under these regulations will have to obtain certification within two years from the date of commencement of these regulations.

Investment advisers whose existing certificates which are due for expiry need to also obtain the above mentioned certification to continue their practice.

Capital Adequacy

SEBI has also laid down capital adequacy requirements for corporate and individual distributors. Corporate distributors will require a minimum net worth of Rs. 25 lakh while individuals and partnership firms will require to posses tangible assets worth at least Rs. 1 lakh.

Registration

After complying with the investment advisers regulations, Investment advisers would need to register with SEBI by paying a non-refundable application fee of Rs. 5,000. Individual advisors will have to shell out a registration fee of Rs. 10,000 while corporate will have to cough up Rs.1 lakh in addition to the application fee. This certificate will be valid for a period of five years.

8.6.2 General Obligations and Responsibilities

Regulation 15 deals with the general obligation of Investment Advisers which are as follows :

(1) An investment adviser shall act in a fiduciary capacity towards its clients and shall disclose all conflicts of interests as and when they arise.

(2) An investment adviser shall not receive any consideration by way of remuneration or compensation or in any other form from any person other than the client being advised, in respect of the underlying products or securities for which advice is provided.

(3) An investment adviser shall maintain an arms-length relationship between its activities as an investment adviser and other activities.

(4) An investment adviser which is also engaged in activities other than investment advisory services shall ensure that its investment advisory services are clearly segregated from all its other activities.

(5) An investment adviser shall ensure that in case of any conflict of interest of the investment advisory activities with other activities, such conflict of interest shall be disclosed to the client.

(6) An investment adviser shall not divulge any confidential information about its client, which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.

(7) An investment advisor shall not enter into transactions on its own account which is contrary to its advice given to clients for a period of fifteen days from the day of such advice.
However, during the period of such fifteen days, if the investment adviser is of the opinion that the situation has changed, then it may enter into such a transaction on its own account after giving such revised assessment to the client at least 24 hours in advance of entering into such transaction.
(8) An investment adviser shall follow Know Your Client procedure as specified by SEBI from time to time.
(9) An investment adviser shall abide by Code of Conduct as specified in Third Schedule.
(10) An investment adviser shall not act on its own account, knowingly to sell securities or investment products to or purchase securities or investment product from a client.
(11) In case of change in control of the investment adviser, prior approval from SEBI shall be taken.
(12) Investment advisers shall furnish to SEBI information and reports as may be specified by SEBI from time to time.
(13) It shall be the responsibility of the Investment Adviser to ensure that its representatives and partners, as applicable, comply with the certification and qualification requirements under these Regulation at all times.

CHECK YOUR PROGRESS

What are the provisions for qualification & certification of investment advisor

Maintenance of Records

Regulation 19 provides that an investment adviser shall maintain the following records,-

(a) Know Your Client records of the client;
(b) Risk profiling and risk assessment of the client;
(c) Suitability assessment of the advice being provided;
(d) Copies of agreements with clients, if any;
(e) Investment advice provided, whether written or oral;
(f) Rationale for arriving at investment advice, duly signed and dated;
(g) A register or record containing list of the clients, the date of advice, nature of the advice, the products/ securities in which advice was rendered and fee, if any charged for such advice.

All records shall be maintained either in physical or electronic form and preserved for a minimum period of five years. However, where records are required to be duly signed and are maintained in electronic form, such records shall be digitally signed.

Liability for Action In Case of Default

Regulation 28 provides that an investment adviser who -

(a) contravenes any of the provisions of the Act or any regulations or circulars issued thereunder;
(b) fails to furnish any information relating to its activity as an investment adviser as required by SEBI;
(c) furnishes to SEBI information which is false or misleading in any material particular;
(d) does not submit periodic returns or reports as required by SEBI;
(e) does not co-operate in any enquiry, inspection or investigation conducted by the SEBI;
(f) fails to resolve the complaints of investors or fails to give a satisfactory reply to SEBI in this behalf, shall be dealt with in the manner provided under the Securities and Exchange Board of India (Intermediaries) Regulations, 2008.

NOTES

8.7 Key Concepts

- A **portfolio manager** with professional experience and expertise in the field, studies the market and adjusts the investment mix for his client on a continuing basis to ensure safety of investment and reasonable returns therefrom.
- **Stock-broker** means a member of stock exchange and they are the intermediaries who are allowed to trade in securities on the exchange of which they are members.
- A **sub-broker** is one who works along with the main broker and is not directly registered with the stock exchange as a member.
- **Portfolio manager** means any person who pursuant to contract or arrangement with the client, advises or directs or undertakes on behalf of the client (whether as a discretionary portfolio manager or otherwise) the management or administration of a portfolio of securities or the funds of the clients as the case may be.

8.8 Summary

- A stock broker plays a very important role in the secondary market helping both the seller and the buyer of the securities to enter into a transaction.
- A portfolio manager with professional experience and expertise in the field, studies the market and adjusts the investment mix for his client on a continuing basis to ensure safety of investment and reasonable returns therefrom.
- Every Portfolio manager is required to appoint a Practising Company Secretary or a Practising Chartered Accountant for conducting the internal audit.
- Custodian of securities means any person who carries on or proposes to carry on the business of providing custodial services.
- Investment adviser means any person, who for consideration is engaged in the business of providing investment advice to clients or other group of persons and includes any person who holds out himself as an investment adviser, by whatever name called.

8.9 Questions and Exercise

1. What are the Obligations of stock-broker in case of inspection by SEBI and liability in case of default made by stock broker?
2. What is the regulation 4 of SEBI (Investment Advisers) Regulations, 2013? Explain
3. Short note on additional disclosure by Proxy advisor of SEBI (Research analyst) Regulation, 2014.

- **Fill in the blanks**

1. Custodian of securities means any person who carries on or proposes to carry on the business of providing custodial services.
   (stock broker, custodian, portfolio manager)
2. A portfolio manager with professional experience and expertise in the field, studies the market and adjusts the investment mix for his client on a continuing basis to ensure safety of investment and reasonable returns therefrom.
   (sotck broker, custodian, portfolio manager)
3. A stock broker plays a very important role in the _____ market helping both the seller and the buyer of the securities to enter into a transaction.
   (primary, secondary, capital)

4. The _____ also provides incidental services such as maintaining the accounts of securities of the client, collecting the benefits or rights accruing to the client in respect of securities.
(custodian, investment advisor, sub- broker)
5. All records shall be maintained either in physical or electronic form and preserved for a minimum period of _____years.
(six, ten, five)

[**Ans:** 1) Custodian, 2) portfolio manager, 3) secondary, 4) custodian, 5) five.]

8.10 Further Reading and References

1. E. Gordon & : Capital Market in India; Himalaya Publishing House, Ramdoot, K. Natarajan Dr. Bhalerao Marg, Girgaon, Mumbai - 400004.
2. Sanjeev Aggarwal : Guide to Indian Capital Market; Bharat Law House, 22, Tarun Enclave, Pitampura, New Delhi - 110 034.
3. V.L. Iyer : SEBI Practice Manual; Taxman Allied Service (P) Ltd., 59/32, New Rohtak Road, New Delhi-110005.
4. M.Y. Khan : Indian Financial Systems; Tata McGraw Hill, 4/12, Asaf Ali Road, New Delhi - 110 002.
5. S. Suryanarayanan & : SEBI - Law, Practice & Procedure; Commercial Law Publishers (India) V. Varadarajan Pvt. Ltd., 151, Rajindra Market, Opp. Tis Hazari Court, Delhi - 110054
6. Mamta Bhargava : Compliances and Procedures under SEBI Law; Shreeji Publishers, 8/ 294, Sunder Vihar, New Delhi - 110 087
7. Taxmann : SEBI Manual
8. Asim Kumar Mishra : Venture Capital Financing in India; Shipra Publications, 115A, Vikas Marg, Shakarpur, Delhi-110092.
9. Shashi K Gupta : Financial Institutions and Markets ; Kalyani Publishers, 4863/2B, Bharat Nishja Aggarwal Ram Road, 24, Daryaganj, New Delhi - 110002 Neeti Gupta
10. Vishal Saraogi : Capital Markets and Securities Laws simplified, Lawpoint Publication, 6C, R.N. Mukherjee Road, Kolkata-700001

NOTES

UNIT - 9
CORPORATE FINANCE

9.1 Introduction
9.2 Objectives
9.3 Corporate Finance
9.4 Concept of Corporate Financial Decisions
9.4.1 Nature of Financial Decisions
9.4.2 Types of Corporate Financial Decisions
9.4.3 Objectives of Corporate Financial Decisions
9.4.4 Factors Influencing Corporate Financial Decisions
9.5 Key Concepts
9.6 Summary
9.7 Questions & Exercise
9.8 Further Readings & References

9.1 Introduction

Corporations invest in real assets, which generate cash inflows and income. Some of the assets are tangible assets such as plant and machinery; others are intangible assets such as brand names and patents.

Corporations finance these assets by borrowing, by retaining and reinvesting cash flow, and by selling additional shares of stock to the corporation's shareholders.

A large corporation may have hundreds of thousands of shareholders. These shareholders differ in many ways, such as their wealth, risk tolerance, and investment horizon. They usually endorse the same financial goal: they want the financial manager to increase the value of the corporation and its current stock price.

The corporation can either invest in new assets or it can give the cash back to the shareholders, who can then invest that cash in the financial markets. Financial managers add value whenever the company can earn a higher return than shareholders can earn for themselves. The shareholders' investment opportunities outside the corporation set the standard for investments inside the corporation. Financial managers therefore refer to the opportunity cost of the capital that shareholders contribute to the firm.

9.2 Objectives

After reading this chapter, the students will able to understand,

-The concept and meaning of corporate finance.

-Nature, scope and objectives of corporate finance.

9.3 Corporate Finance

Every decision made in a business has financial implications, and any decision that involves the use of money is a corporate financial decision. Defined broadly, everything that a business does fits under the rubric of corporate finance.

A) Meaning:

Finance plays a very important role in making an organisation successful and it is a starting point of every business activity. Finance is regarded as science as well as an art. It is the soul of every business and basic requirement for starting and running business. Business finance is the lifeblood of business. There must be continuous flow of funds in and out of a business enterprise. Finance makes the wheels of business to run smoothly.

B) Definitions:

Bonneville and Deway :

"Business finance consists of the raising, providing, managing of all the money, capital or funds of any kind to be used in connection with the finance".

Guthmann and Dougall :

"Business finance can be broadly defined as the activity concerned with planning, raising and administering of funds used in the business".

C) Scope of Corporate Finance

Corporate finance is the area of finance dealing with the sources of funding and the capital structure of corporations, the actions that managers take to increase the value of the firm to the shareholders, and the tools and analysis used to allocate financial resources. The primary goal of corporate finance is to maximize or increase shareholder value. Although it is in principle different from managerial finance which studies the financial management of all firms, rather than corporations alone, the main concepts in the study of corporate finance are applicable to the financial problems of all kinds of firms.

Investment analysis (or capital budgeting) is concerned with the setting of criteria about which value-adding projects should receive investment funding, and whether to finance that investment with equity or debt capital. Working capital management is the management of the company's monetary funds that deal with the short-term operating balance of current assets and current liabilities; the focus here is on managing cash, inventories, and short-term borrowing and lending (such as the terms on credit extended to customers).

The terms corporate finance and corporate financier are also associated with investment banking. The typical role of an investment bank is to evaluate the company's financial needs and raise the appropriate type of capital that best fits those needs. Thus, the terms "corporate finance" and "corporate financier" may be associated with transactions in which capital is raised in order to create, develop, grow or acquire businesses. Recent legal and regulatory developments in the U.S. will likely alter the makeup of the group of arrangers and financiers willing to arrange and provide financing for certain highly leveraged transactions.

Financial management overlaps with the financial function of the Accounting profession. However, financial accounting is the reporting of historical financial information, while financial management is concerned with the allocation of capital resources to increase a firm's value to the shareholders.

The primary goal of financial management is to maximize or to continually increase shareholder value. Maximizing shareholder value requires managers to be able to balance capital funding between investments in projects that increase the firm's long term profitability and sustainability, along with paying excess cash in the form of dividends to shareholders. Managers of growth companies (i.e. firms that earn high rates of return on invested capital) will use most of the firm's capital resources and surplus cash on investments and projects so the company can continue to expand its business operations into the future. When companies reach maturity levels within their industry (i.e. companies that earn approximately average or lower returns on invested capital), managers of these companies will use surplus

NOTES

cash to payout dividends to shareholders. Managers must do an analysis to determine the appropriate allocation of the firm's capital resources and cash surplus between projects and payouts of dividends to shareholders, as well as paying back creditor related debt.

Choosing between investment projects will be based upon several inter-related criteria. (1) Corporate management seeks to maximize the value of the firm by investing in projects which yield a positive net present value when valued using an appropriate discount rate in consideration of risk. (2) These projects must also be financed appropriately. (3) If no growth is possible by the company and excess cash surplus is not needed to the firm, then financial theory suggests that management should return some or all of the excess cash to shareholders (i.e., distribution via dividends).

This "capital budgeting" is the planning of value-adding, long-term corporate financial projects relating to investments funded through and affecting the firm's capital structure. Management must allocate the firm's limited resources between competing opportunities (projects).

Capital budgeting is also concerned with the setting of criteria about which projects should receive investment funding to increase the value of the firm, and whether to finance that investment with equity or debt capital. Investments should be made on the basis of value-added to the future of the corporation. Projects that increase a firm's value may include a wide variety of different types of investments, including but not limited to, expansion policies, or mergers and acquisitions. When no growth or expansion is possible by a corporation and excess cash surplus exists and is not needed, then management is expected to pay out some or all of those surplus earnings in the form of cash dividends or to repurchase the company's stock through a share buyback program.

D) Features of Corporate Finance:

1) Financial Activity :

Corporate finance is a financial activity. It includes planning, raising, investing and monitoring the finance of the company. It includes all the financial aspects of the company. This work is done by the financial department headed by the finance manager.

2) Raising the Finance :

Corporate finance includes raising (collecting) finance for the company. Finance can be collected through shares, debentures, bank loans, etc. It is very difficult for new companies to collect finance because the investors do not have confidence in new companies. However it is easy for the reputed companies to collect finance due to their well established goodwill in the market.

3) Investing the Finance :

Corporate finance also includes investing (using) the finance. The finance is used to achieve the objectives of the company. It is used to purchase fixed assets. It is used for running the company. The finance must be used profitably.

4) Objective Oriented :

Corporate finance is objective oriented. That is, it is used to achieve the objectives of the company. (i) to earn maximum profit , (ii) to give a proper dividend to the shareholders, (iii) to create a proper reserve for future growth and expansion. Etc.

5) Types of Finance :

There are two types of corporate Finance, viz., fixed capital and working capital. Fixed capital is also called long term finance. Working capital is also called short term finance.

6) Relationship with other Departments :

Corporate finance has a close relationship with all other departments in

the company, i.e. Production Department, Marketing Department, etc..

7) Dynamic in Nature :

Corporate finance is dynamic in nature. It goes on changing according to the changes in environment, circumstances, times, etc. so the finance manager must use new and innovative ideas for collecting and investing money.

8) Requires proper Planning and Control :

Corporate finance requires proper planning and control. Planning is required to collect finance from the investors. It is also required for investing the finance. Control is required to find out whether the finance is invested properly or not. By that corrective measures can be taken.

9) Managing Finance is an Art and Science :

Managing finance is an Art because it requires human skills and judgement. It is a Science because it follows a systematic approach.

10) Legal Requirements :

There are many legal requirements for corporate finance. The company has to take permission, from the Controller of Capital Issues, for collecting finance from the public. The company also has to follow all the rules of SEBI.

11) Important part of Business Management :

Finance is required for all business activities. It is required for promoting business. It is required for conducting the business smoothly. It is required for expansion, diversification, modernization, replacement of assets, etc.

NOTES

CHECK YOUR PROGRESS

What are the features of corporate finance?

9.4 Concept of Corporate Financial Decisions:

To carry on business, a corporation needs an almost endless variety of real assets. These assets do not drop free from a blue sky; they need to be paid for. To pay for real assets, the corporation sells claims on the assets and on the cash flow that they will generate. These claims are called financial assets or securities. Take a bank loan as an example. The bank provides the corporation with cash in exchange for a financial asset, which is the corporation's promise to repay the loan with interest. An ordinary bank loan is not a security, however, because it is held by the bank and not sold or traded in financial markets. Take a corporate bond as a second example. The corporation sells the bond to investors in exchange for the promise to pay interest on the bond and to pay off the bond at its maturity. The bond is a financial asset, and also a security, because it can be held by and traded among many investors in financial markets. Securities include bonds, shares of stock, and a dizzying variety of specialized instruments.

The investment decision also involves managing assets already in place and deciding when to shut down and dispose of assets if profits decline. The corporation also has to manage and control the risks of its investments. The financing decision includes not just raising cash today but also meeting obligations to banks, bondholders, and stockholders that contributed financing in the past. For example, the corporation has to repay its debts when they become due. If it cannot do so, it ends up insolvent and bankrupt. Sooner or later the corporation will also want to pay out cash to its shareholders.

9.4.1 Nature of Financial Decisions:

The nature of financial decisions would be clear while understanding the operation of a firm. At the very outset, the promoter makes an appraisal of various investment proposals and selects one or more of them, depending upon the net benefit derived from each as well as on the availability of funds. When a particular project is selected or the area of operation is finalised, the requirements for long-term assets as well as current assets are determined, and accordingly, the quantum

NOTES

and the sources of finance are sorted out. The firm raises funds to finance fixed assets like land and building, plant & machinery etc. the operation starts. An optimum trade-off between profitability and liquidity is maintained throughout the operations so as to ensure smooth operations.

1) Selection of investment proposals, known as the investment decision;
2) Determination of working capital requirements, known as the working capital decision;
3) Raising of funds to finance the assets, known as the financing decision;
4) Allocation of profits for dividend payment, known as the dividend decision.

These four decisions form the subject matter of corporate finance, although financial tools, such as financial analysis, planning and control instruments that facilitate the above decisions are also an integral part of the theme of corporate financial management.

9.4.2 Types of Corporate Financial Decisions:

1) Investment Decision/ Capital Budgeting Decision:

The investment decision, which is also known as capital budgeting, is concerned with the selection of an investment proposal / proposals and the investment of funds in the selected proposal or proposals.

2) Financing Decision:

All functions of a company need to be paid for one way or another. It is up to the finance department to figure out how to pay for them through the process of financing. There are two ways to finance an investment: using a company's own money or by raising money from external funders.

3) Dividend Decision:

Dividend decision is the third major financial decision. The financial manager must decide whether the firm should distribute all profits, or retain them, or distribute a portion and retain the balance. Like the debt policy, the dividend policy should be determined in terms of its impact on the shareholders' value.

4) Working Capital Decision:

The working capital decision takes into account the management of current asses and current liabilities. The management of current assets involves a couple of issues. The first being the size of current assets, or in other words, what the size of cash holdings, short-term marketable securities, account receivables and inventory should be.

9.4.3 Objectives of Corporate Financial Decisions:

1) Long-term Decisions:

This includes capital investment decisions like viability assessment of projects, financing it through equity and/or debt, pay dividend or reinvest the profit.

2) Short-term Decisions:

These are also called working capital management decisions which try to strike a balance between current assets such as cash, inventories, etc and current liabilities i.e. a company's debts/obligations impending for less than a year.

9.4.4 Factors Influencing Corporate Financial Decisions:

a) Microeconomic Factors:

1) Nature and Size of the Enterprise:

If a firm is engaged in manufacturing operations or in the provision of public utility services, its investment in fixed assets is large and hence the capital structure has a large share of long-term capital.

2) Risk:

Risk is another important factor that influences financial decisions. The

greater the risk, the higher the discount factor and this in turn considerably influences the investment decision.

3) Liquidity Position;

The third factor influencing financial decisions is the liquidity position. Since dividend is normally paid out of cash, firms with a sound liquidity position adopt a liberal dividend policy.

4) Attitude of the Management:

Last factor is the management's attitude. A conservative finance manager will attach greater importance to liquidity rather than to the profitability.

b) Macroeconomic Factors:

1) The State of the Economy:

The state of the economy changes from time to time and the financial decisions of a firm conform to these changes. When the economy is growing or proceeding towards recovery, the finance manager should be eager to avail of investment opportunities. But when the economy is facing a slump, the finance manager should proceed with care. For example, in such a situation, it would not be advisable to go for an expansion programme. Similarly, when the economy is experiencing an uptrend, the finance manager can opt for trading on equity as larger profits are asuured. But in times of a downtrend, the stress should be on internal financing. Again during an uptrend, higher dividends can be declared, but a during a downtrend, conservation of cash is necessary and therefore a strict dividend policy should be followed. The state of economy is also donated by the structure of capital and money markets. If the capital market is well developed having a multitude of financial institutions and venturesome investors, the finance manager will find it easy to select the proportion mix of capital structure.

2) Governmental Policy:

Apart from the state of economy, governmental policy is no less significant in influencing corporate financial decisions. State intervention or state regulation is found in almost all countries, although its degree varies. In India where economic policies become more liberal since the 1990s, entrepreneurs are comparatively free to take up any venture that pleases them. Thus corporate investment decisions are governed by the nature and extent of the state regulations.

NOTES

CHECK YOUR PROGRESS

State types of Financial Decisions

9.5 Key Concepts

- **Corporate finance** is the area of finance dealing with the sources of funding and the capital structure of corporations, the actions that managers take to increase the value of the firm to the shareholders, and the tools and analysis used to allocate financial resources.
- **Business finance** consists of the raising, providing, managing of all the money, capital or funds of any kind to be used in connection with the finance.

9.6 Summary

- Finance plays a very important role in making an organisation successful and it is a starting point of every business activity.
- Business finance is the lifeblood of business.
- Finance is regarded as science as well as an art. It is the soul of every business and basic requirement for starting and running business.
- Corporate finance is the area of finance dealing with the sources of funding and the capital structure of corporations, the actions that managers take to increase the value of the firm to the shareholders, and the tools and analysis used to allocate financial resources.

- Investment analysis (or capital budgeting) is concerned with the setting of criteria about which value-adding projects should receive investment funding, and whether to finance that investment with equity or debt capital.
- Investment Decision/ Capital Budgeting Decision, Financing Decision, Dividend Decision, and Working Capital Decision are the types of Corporate Financial Decisions.
- Microeconomic factors and Macroeconomic factors influence the financial decisions.
- Capital budgeting is the planning of value-adding, long-term corporate financial projects relating to investments funded through and affecting the firm's capital structure.

9.7 Questions and Exercise

1. Explain the concept of Corporate Finance.
2. What are the types of Financing Decisions?

- **Fill in the blanks**

1. _____ consists of the raising, providing, managing of all the money, capital or funds of any kind to be used in connection with the finance.
(Business Finance, Finance, Capital Finance)
2. Investment Decision/ Capital Budgeting Decision, Financing Decision, Dividend Decision, and Working Capital Decision are the types of _____.
(working capital, cost of capital, corporate financial decision)
3. _____ is the planning of value-adding, long-term corporate financial projects relating to investments funded through and affecting the firm's capital structure.
(cost of capital, capital budgeting, capital structure)
[**Ans:** 1) Business Finance, 2) corporate financial decision, 3) capital budgeting]

9.8 Further Reading and References

1. M.Y. Khan & P.K. Jain : Financial Management - Text and Problems; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
2. Prasanna Chandra : Financial Management - Theory & Practice; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
3. I.M. Pandey : Financial Management (2005); Vikas Publishing House Pvt. Ltd., New Delhi.
4. R.P. Rustagi : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
5. R. Charles Moyer, : Contemporary Financial Management; West Publishing Company. James R. McGuign & William J. Kretlow
6. Rajiv Srivastava & : Financial Management, Oxford University Press Anil Mishra
7. J.B. Gupta : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
8. Ravi M. Kishore : Strategic Financial Management - Taxmann Publication Pvt. Ltd.

UNIT - 10
SOURCES OF FINANCE

NOTES

10.1 Introduction
10.2 Objectives
10.3 Sources of funds
10.3.1 Shares/ Securities
10.3.2 Loan stock
10.3.3 Retained earnings
10.3.4 Bank lending
10.3.5 Leasing
10.3.6 Hire purchase
10.3.7 Government assistance
10.3.8 Venture capital
10.4 Key Concepts
10.5 Summary
10.6 Questions & Exercise
10.7 Further Readings & References

10.1 Introduction

Sourcing money may be done for a variety of reasons. Traditional areas of need may be for capital asset acquirement - new machinery or the construction of a new building or depot. The development of new products can be enormously costly and here again capital may be required. Normally, such developments are financed internally, whereas capital for the acquisition of machinery may come from external sources. In this day and age of tight liquidity, many organisations have to look for short term capital in the way of overdraft or loans in order to provide a cash flow cushion. Interest rates can vary from organisation to organisation and also according to purpose.

10.2 Objectives

This chapter is intended to provide:

- An introduction to the different sources of finance available to management, both internal and external
- An overview of the advantages and disadvantages of the different sources of funds
- An understanding of the factors governing the choice between different sources of funds.

10.3 Sources of funds

A company might raise new funds from the following sources:

The capital markets:

i) new share issues, for example, by companies acquiring a stock market listing for the first time

ii) rights issues

NOTES

-Loan stock
-Retained earnings
-Bank borrowing
-Government sources
-Business expansion scheme funds
-Venture capital
-Franchising.

10.3.1 Shares/ Securities

1. Ordinary (equity) shares

Ordinary shares are issued to the owners of a company. They have a nominal or 'face' value. The market value of a quoted company's shares bears no relationship to their nominal value, except that when ordinary shares are issued for cash, the issue price must be equal to or be more than the nominal value of the shares.

Deferred ordinary shares are a form of ordinary shares, which are entitled to a dividend only after a certain date or if profits rise above a certain amount. Voting rights might also differ from those attached to other ordinary shares. Ordinary shareholders put funds into their company:

a) by paying for a new issue of shares

b) through retained profits.

Simply retaining profits, instead of paying them out in the form of dividends, offers an important, simple low-cost source of finance, although this method may not provide enough funds, for example, if the firm is seeking to grow.

A new issue of shares might be made in a variety of different circumstances:

a) The company might want to raise more cash. If it issues ordinary shares for cash, should the shares be issued pro rata to existing shareholders, so that control or ownership of the company is not affected? If, for example, a company with 200,000 ordinary shares in issue decides to issue 50,000 new shares to raise cash, should it offer the new shares to existing shareholders, or should it sell them to new shareholders instead?

i) If a company sells the new shares to existing shareholders in proportion to their existing shareholding in the company, we have a rights issue. In the example above, the 50,000 shares would be issued as a one-in-four rights issue, by offering shareholders one new share for every four shares they currently hold.

ii) If the number of new shares being issued is small compared to the number of shares already in issue, it might be decided instead to sell them to new shareholders, since ownership of the company would only be minimally affected.

b) The company might want to issue shares partly to raise cash, but more importantly to float' its shares on a stick exchange.

c) The company might issue new shares to the shareholders of another company, in order to take it over.

New shares issues

A company seeking to obtain additional equity funds may be:

a) an unquoted company wishing to obtain a Stock Exchange quotation

b) an unquoted company wishing to issue new shares, but without obtaining a Stock Exchange quotation

c) a company which is already listed on the Stock Exchange wishing to issue additional new shares.

The methods by which an unquoted company can obtain a quotation on the stock market are:

a) an offer for sale

b) a prospectus issue
c) a placing
d) an introduction.

Offers for sale:

NOTES

An offer for sale is a means of selling the shares of a company to the public.

a) An unquoted company may issue shares, and then sell them on the Stock Exchange, to raise cash for the company. All the shares in the company, not just the new ones, would then become marketable.

b) Shareholders in an unquoted company may sell some of their existing shares to the general public. When this occurs, the company is not raising any new funds, but just providing a wider market for its existing shares (all of which would become marketable), and giving existing shareholders the chance to cash in some or all of their investment in their company.

When companies 'go public' for the first time, a 'large' issue will probably take the form of an offer for sale. A smaller issue is more likely to be a placing, since the amount to be raised can be obtained more cheaply if the issuing house or other sponsoring firm approaches selected institutional investors privately.

Rights issues

A rights issue provides a way of raising new share capital by means of an offer to existing shareholders, inviting them to subscribe cash for new shares in proportion to their existing holdings.

For example, a rights issue on a one-for-four basis at 280c per share would mean that a company is inviting its existing shareholders to subscribe for one new share for every four shares they hold, at a price of 280c per new share.

A company making a rights issue must set a price which is low enough to secure the acceptance of shareholders, who are being asked to provide extra funds, but not too low, so as to avoid excessive dilution of the earnings per share.

Preference shares

Preference shares have a fixed percentage dividend before any dividend is paid to the ordinary shareholders. As with ordinary shares a preference dividend can only be paid if sufficient distributable profits are available, although with 'cumulative' preference shares the right to an unpaid dividend is carried forward to later years. The arrears of dividend on cumulative preference shares must be paid before any dividend is paid to the ordinary shareholders.

From the company's point of view, preference shares are advantageous in that:

- Dividends do not have to be paid in a year in which profits are poor, while this is not the case with interest payments on long term debt (loans or debentures).
- Since they do not carry voting rights, preference shares avoid diluting the control of existing shareholders while an issue of equity shares would not.
- Unless they are redeemable, issuing preference shares will lower the company's gearing. Redeemable preference shares are normally treated as debt when gearing is calculated.
- The issue of preference shares does not restrict the company's borrowing power, at least in the sense that preference share capital is not secured against assets in the business.
- The non-payment of dividend does not give the preference shareholders the right to appoint a receiver, a right which is normally given to debenture

NOTES

holders.

However, dividend payments on preference shares are not tax deductible in the way that interest payments on debt are. Furthermore, for preference shares to be attractive to investors, the level of payment needs to be higher than for interest on debt to compensate for the additional risks.

For the investor, preference shares are less attractive than loan stock because:

- they cannot be secured on the company's assets
- the dividend yield traditionally offered on preference dividends has been much too low to provide an attractive investment compared with the interest yields on loan stock in view of the additional risk involved.

10.3.2 Loan stock

Loan stock is long-term debt capital raised by a company for which interest is paid, usually half yearly and at a fixed rate. Holders of loan stock are therefore long-term creditors of the company.

CHECK YOUR PROGRESS

Difference between Preference shares and ordinary equity shares

Loan stock has a nominal value, which is the debt owed by the company, and interest is paid at a stated "coupon yield" on this amount. For example, if a company issues 10% loan stocky the coupon yield will be 10% of the nominal value of the stock, so that Rs. 100 of stock will receive Rs.10 interest each year. The rate quoted is the gross rate, before tax.

Debentures are a form of loan stock, legally defined as the written acknowledgement of a debt incurred by a company, normally containing provisions about the payment of interest and the eventual repayment of capital.

Debentures with a floating rate of interest

These are debentures for which the coupon rate of interest can be changed by the issuer, in accordance with changes in market rates of interest. They may be attractive to both lenders and borrowers when interest rates are volatile.

Security

Loan stock and debentures will often be secured. Security may take the form of either a fixed charge or a floating charge.

a) Fixed charge; Security would be related to a specific asset or group of assets, typically land and buildings. The company would be unable to dispose of the asset without providing a substitute asset for security, or without the lender's consent.

b) Floating charge; With a floating charge on certain assets of the company (for example, stocks and debtors), the lender's security in the event of a default payment is whatever assets of the appropriate class the company then owns (provided that another lender does not have a prior charge on the assets). The company would be able, however, to dispose of its assets as it chose until a default took place. In the event of a default, the lender would probably appoint a receiver to run the company rather than lay claim to a particular asset.

The redemption of loan stock

Loan stock and debentures are usually redeemable. They are issued for a term of ten years or more, and perhaps 25 to 30 years. At the end of this period, they will "mature" and become redeemable (at par or possibly at a value above par).

Most redeemable stocks have an earliest and latest redemption date. For example, 18% Debenture Stock 2007/09 is redeemable, at any time between the earliest specified date (in 2007) and the latest date (in 2009). The issuing company can choose the date. The decision by a company when to redeem a debt will depend on:

a) how much cash is available to the company to repay the debt

b) the nominal rate of interest on the debt. If the debentures pay 18% nominal interest and the current rate of interest is lower, say 10%, the company may try to raise a new loan at 10% to redeem the debt which costs 18%. On the other hand, if current interest rates are 20%, the company is unlikely to redeem the debt until the latest date possible, because the debentures would be a cheap source of funds.

NOTES

There is no guarantee that a company will be able to raise a new loan to pay off a maturing debt, and one item to look for in a company's balance sheet is the redemption date of current loans, to establish how much new finance is likely to be needed by the company, and when.

Mortgages are a specific type of secured loan. Companies place the title deeds of freehold or long leasehold property as security with an insurance company or mortgage broker and receive cash on loan, usually repayable over a specified period. Most organisations owning property which is unencumbered by any charge should be able to obtain a mortgage up to two thirds of the value of the property.

As far as companies are concerned, debt capital is a potentially attractive source of finance because interest charges reduce the profits chargeable to corporation tax.

CHECK YOUR PROGRESS

Explain the concept of retained earnings

10.3.3 Retained earnings

For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends. Profit re-invested as retained earnings is profit that could have been paid as a dividend. The major reasons for using retained earnings to finance new investments, rather than to pay higher dividends and then raise new equity for the new investments, are as follows:

a) The management of many companies believes that retained earnings are funds which do not cost anything, although this is not true. However, it is true that the use of retained earnings as a source of funds does not lead to a payment of cash.

b) The dividend policy of the company is in practice determined by the directors. From their standpoint, retained earnings are an attractive source of finance because investment projects can be undertaken without involving either the shareholders or any outsiders.

c) The use of retained earnings as opposed to new shares or debentures avoids issue costs.

d) The use of retained earnings avoids the possibility of a change in control resulting from an issue of new shares.

Another factor that may be of importance is the financial and taxation position of the company's shareholders. If, for example, because of taxation considerations, they would rather make a capital profit (which will only be taxed when shares are sold) than receive current income, then finance through retained earnings would be preferred to other methods.

A company must restrict its self-financing through retained profits because shareholders should be paid a reasonable dividend, in line with realistic expectations, even if the directors would rather keep the funds for re-investing. At the same time, a company that is looking for extra funds will not be expected by investors (such as banks) to pay generous dividends, nor over-generous salaries to owner-directors.

10.3.4 Bank lending

Borrowings from banks are an important source of finance to companies. Bank lending is still mainly short term, although medium-term lending is quite common these days.

Short term lending may be in the form of:

a) an overdraft, which a company should keep within a limit set by the bank. Interest is charged (at a variable rate) on the amount by which the company is overdrawn from day to day;

b) a short-term loan, for up to three years.

Medium-term loans are loans for a period of from three to ten years. The rate of interest charged on medium-term bank lending to large companies will be a set margin, with the size of the margin depending on the credit standing and riskiness of the borrower. A loan may have a fixed rate of interest or a variable interest rate, so that the rate of interest charged will be adjusted every three, six, nine or twelve months in line with recent movements in the Base Lending Rate.

Lending to smaller companies will be at a margin above the bank's base rate and at either a variable or fixed rate of interest. Lending on overdraft is always at a variable rate. A loan at a variable rate of interest is sometimes referred to as a floating rate loan. Longer-term bank loans will sometimes be available, usually for the purchase of property, where the loan takes the form of a mortgage. When a banker is asked by a business customer for a loan or overdraft facility, he will consider several factors, known commonly by the mnemonic **PARTS**.

- **P**urpose
- **A**mount
- **R**epayment
- **T**erm
- **S**ecurity

P- The purpose of the loan A loan request will be refused if the purpose of the loan is not acceptable to the bank.

A- The amount of the loan. The customer must state exactly how much he wants to borrow. The banker must verify, as far as he is able to do so, that the amount required to make the proposed investment has been estimated correctly.

R- How will the loan be repaid? Will the customer be able to obtain sufficient income to make the necessary repayments?

T- What would be the duration of the loan? Traditionally, banks have offered short-term loans and overdrafts, although medium-term loans are now quite common.

S- Does the loan require security? If so, is the proposed security adequate?

10.3.5 Leasing

A lease is an agreement between two parties, the "lessor" and the "lessee". The lessor owns a capital asset, but allows the lessee to use it. The lessee makes payments under the terms of the lease to the lessor, for a specified period of time.

Leasing is, therefore, a form of rental. Leased assets have usually been plant and machinery, cars and commercial vehicles, but might also be computers and office equipment. There are two basic forms of lease: "operating leases" and "finance leases".

Operating leases

Operating leases are rental agreements between the lessor and the lessee whereby:

a) the lessor supplies the equipment to the lessee
b) the lessor is responsible for servicing and maintaining the leased equipment
c) the period of the lease is fairly short, less than the economic life of the asset, so that at the end of the lease agreement, the lessor can either
   i) lease the equipment to someone else, and obtain a good rent for it, or
   ii) sell the equipment secondhand.

Finance leases

Finance leases are lease agreements between the user of the leased asset (the lessee) and a provider of finance (the lessor) for most, or all, of the asset's expected useful life.

Suppose that a company decides to obtain a company car and finance the acquisition by means of a finance lease. A car dealer will supply the car. A finance house will agree to act as lessor in a finance leasing arrangement, and so will purchase the car from the dealer and lease it to the company. The company will take possession of the car from the car dealer, and make regular payments (monthly, quarterly, six monthly or annually) to the finance house under the terms of the lease.

Other important characteristics of a finance lease:

a) The lessee is responsible for the upkeep, servicing and maintenance of the asset. The lessor is not involved in this at all.

b) The lease has a primary period, which covers all or most of the economic life of the asset. At the end of the lease, the lessor would not be able to lease the asset to someone else, as the asset would be worn out. The lessor must, therefore, ensure that the lease payments during the primary period pay for the full cost of the asset as well as providing the lessor with a suitable return on his investment.

c) It is usual at the end of the primary lease period to allow the lessee to continue to lease the asset for an indefinite secondary period, in return for a very low nominal rent. Alternatively, the lessee might be allowed to sell the asset on the lessor's behalf (since the lessor is the owner) and to keep most of the sale proceeds, paying only a small percentage (perhaps 10%) to the lessor.

Why might leasing be popular

The attractions of leases to the supplier of the equipment, the lessee and the lessor are as follows:

- The supplier of the equipment is paid in full at the beginning. The equipment is sold to the lessor, and apart from obligations under guarantees or warranties, the supplier has no further financial concern about the asset.
- The lessor invests finance by purchasing assets from suppliers and makes a return out of the lease payments from the lessee. Provided that a lessor can find lessees willing to pay the amounts he wants to make his return, the lessor can make good profits. He will also get capital allowances on his purchase of the equipment.
- Leasing might be attractive to the lessee:
  i) if the lessee does not have enough cash to pay for the asset, and would have difficulty obtaining a bank loan to buy it, and so has to rent it in one way or another if he is to have the use of it at all; or
  ii) if finance leasing is cheaper than a bank loan. The cost of payments under a loan might exceed the cost of a lease.

Operating leases have further advantages:

- The leased equipment does not need to be shown in the lessee's published balance sheet, and so the lessee's balance sheet shows no increase in its gearing ratio.
- The equipment is leased for a shorter period than its expected useful life. In the case of high-technology equipment, if the equipment becomes out-of-date before the end of its expected life, the lessee does not have

NOTES

to keep on using it, and it is the lessor who must bear the risk of having to sell obsolete equipment secondhand.

The lessee will be able to deduct the lease payments in computing his taxable profits.

10.3.6 Hire purchase

Hire purchase is a form of instalment credit. Hire purchase is similar to leasing, with the exception that ownership of the goods passes to the hire purchase customer on payment of the final credit instalment, whereas a lessee never becomes the owner of the goods.

Hire purchase agreements usually involve a finance house.

i) The supplier sells the goods to the finance house.

ii) The supplier delivers the goods to the customer who will eventually purchase them.

iii) The hire purchase arrangement exists between the finance house and the customer.

The finance house will always insist that the hirer should pay a deposit towards the purchase price. The size of the deposit will depend on the finance company's policy and its assessment of the hirer. This is in contrast to a finance lease, where the lessee might not be required to make any large initial payment.

An industrial or commercial business can use hire purchase as a source of finance. With industrial hire purchase, a business customer obtains hire purchase finance from a finance house in order to purchase the fixed asset. Goods bought by businesses on hire purchase include company vehicles, plant and machinery, office equipment and farming machinery.

CHECK YOUR PROGRESS

What are different types of leasing?

10.3.7 Government assistance

The government provides finance to companies in cash grants and other forms of direct assistance, as part of its policy of helping to develop the national economy, especially in high technology industries and in areas of high unemployment. For example, the Indigenous Business Development Corporation of Zimbabwe (IBDC) was set up by the government to assist small indigenous businesses in that country.

10.3.8 Venture capital

Venture capital is money put into an enterprise which may all be lost if the enterprise fails. A businessman starting up a new business will invest venture capital of his own, but he will probably need extra funding from a source other than his own pocket. However, the term 'venture capital' is more specifically associated with putting money, usually in return for an equity stake, into a new business, a management buy-out or a major expansion scheme.

The institution that puts in the money recognises the gamble inherent in the funding. There is a serious risk of losing the entire investment, and it might take a long time before any profits and returns materialise. But there is also the prospect of very high profits and a substantial return on the investment. A venture capitalist will require a high expected rate of return on investments, to compensate for the high risk.

A venture capital organisation will not want to retain its investment in a business indefinitely, and when it considers putting money into a business venture, it will also consider its "exit", that is, how it will be able to pull out of the business eventually (after five to seven years, say) and realise its profits. Examples of venture capital organisations are: Merchant Bank of Central Africa Ltd and Anglo

American Corporation Services Ltd.

When a company's directors look for help from a venture capital institution, they must recognise that:

-the institution will want an equity stake in the company

-it will need convincing that the company can be successful

-it may want to have a representative appointed to the company's board, to look after its interests.

The directors of the company must then contact venture capital organisations, to try and find one or more which would be willing to offer finance. A venture capital organisation will only give funds to a company that it believes can succeed, and before it will make any definite offer, it will want from the company management:

a) a business plan
b) details of how much finance is needed and how it will be used
c) the most recent trading figures of the company, a balance sheet, a cash flow forecast and a profit forecast
d) details of the management team, with evidence of a wide range of management skills
e) details of major shareholders
f) details of the company's current banking arrangements and any other sources of finance
g) any sales literature or publicity material that the company has issued.

A high percentage of requests for venture capital are rejected on an initial screening, and only a small percentage of all requests survive both this screening and further investigation and result in actual investments.

NOTES

CHECK YOUR PROGRESS

Define Venture Capital

10.4 Key Concepts

Bank lending
Capital markets
Debentures
Deferred ordinary shares
Franchising
Government assistance
Hire purchase
Loan stocks
New share issue
Ordinary shares
PARTS
Preference shares
Retained earnings
Rights issue
Sources of funds
Venture capital

10.5 Summary

- Deferred ordinary shares are a form of ordinary shares, which are entitled to a dividend only after a certain date or if profits rise above a certain amount.
- Loan stock and debentures will often be secured. Security may take the form of either a fixed charge or a floating charge.

- For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends. Profit re-invested as retained earnings is profit that could have been paid as a dividend.
- A company must restrict its self-financing through retained profits because shareholders should be paid a reasonable dividend, in line with realistic expectations, even if the directors would rather keep the funds for re-investing.
- Bank lending is still mainly short term, although medium-term lending is quite common these days.
- A lease is an agreement between two parties, the "lessor" and the "lessee". The lessor owns a capital asset, but allows the lessee to use it.
- Finance leases are lease agreements between the user of the leased asset (the lessee) and a provider of finance (the lessor) for most, or all, of the asset's expected useful life.
- The supplier of the equipment is paid in full at the beginning. The equipment is sold to the lessor, and apart from obligations under guarantees or warranties, the supplier has no further financial concern about the asset.
- Hire purchase is a form of instalment credit. Hire purchase is similar to leasing, with the exception that ownership of the goods passes to the hire purchase customer on payment of the final credit instalment, whereas a lessee never becomes the owner of the goods.
- Venture capital is money put into an enterprise which may all be lost if the enterprise fails. A businessman starting up a new business will invest venture capital of his own, but he will probably need extra funding from a source other than his own pocket.

10.6 Questions and Exercise

1. State different types of Sources of finance.
2. Explain Leasing.

- **Fill in the blanks**

1. Deferred ordinary shares are a form of ordinary shares, which are entitled to a dividend only after a certain date or if profits rise above a certain amount.

   (Equity shares, preference shares, deferred ordinary shares)
2. For any company, the amount of earnings retained within the business has a direct impact on the amount of dividends.

   (Profit, Dividends, Share value)
3. Profit re-invested as retained earnings is profit that could have been paid as a dividend.

   (Profit, Dividends, Share value)
4. Finance leases are lease agreements between the user of the leased asset (the lessee) and a provider of finance (the lessor) for most, or all, of the asset's expected useful life.

   (Finance, operating, combined)
5. Venture capital is money put into an enterprise which may all be lost if the enterprise fails.

   (New Capital, Primary, Venture)

   [**Ans:** 1)Deferred ordinary shares, 2)Dividends, 3)dividend, 4)Finance, 5)Venture Capital]

10.7 Further Reading and References

1. M.Y. Khan & P.K. Jain : Financial Management - Text and Problems; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
2. Prasanna Chandra : Financial Management - Theory & Practice; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
3. I.M. Pandey : Financial Management (2005); Vikas Publishing House Pvt. Ltd., New Delhi.
4. R.P. Rustagi : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
5. R. Charles Moyer, : Contemporary Financial Management; West Publishing Company. James R. McGuign & William J. Kretlow
6. Rajiv Srivastava & : Financial Management, Oxford University Press Anil Mishra
7. J.B. Gupta : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
8. Ravi M. Kishore : Strategic Financial Management - Taxmann Publication Pvt. Ltd.

NOTES

UNIT - 11
FINANCING DECISION- COST OF CAPITAL

11.1 Introduction
11.2 Objective
11.3 Cost of Capital
11.4 Classification of Cost of Capital
11.5 Importance of Cost of Capital
11.6 Factors Determining the Firm's Cost of Capital
11.7 Controllable Factors Affecting Cost of Capital
11.8 Measurement of Cost of Capital
11.8.1 Cost of Debt (Kd)
11.9 Cost of Preference Share Capital
11.10 Cost of Equity Capital
11.11 Weighted Average Cost of Capital
11.12 Cost of Capital and Its Implications in Budgeting Decisions
11.13 Key Concepts
11.14 Summary
11.15 Exercise & Questions
11.16 Further Readings & References

11.1 Introduction

Cost of capital is a very important which decides the fate of various investment decisions. Cost of capital is an integral part of investment decision as it is used to measure the worth of investment proposal provided by the business concern. It is used as a discount rate in determining the present value of future cash flows associated with capital projects. Cost of capital is also called as cut-off rate, target rate, hurdle rate and required rate of return. When the firms are using different sources of finance, the finance manager must take careful decision with regard to the cost of capital; because it is closely associated with the value of the firm and the earning capacity of the firm.

11.2 Objectives

The objective of this lesson is to enable the students to learn about

- The factors affecting the cost of capital of accompany
- Calculation of cost of capital of for different sources of finance
- Calculation of Weighted Cost of Capital
- Calculation of Marginal cost of Capital

11.3 Cost of Capital

The cost of capital is the required rate of return that a firm must achieve in order to cover the cost of generating funds in the marketplace. It is used to evaluate

new projects of a company as it is the minimum return that investors expect for providing capital to the company, thus setting a benchmark that a new project has to meet.

Meaning of Cost of Capital

Cost of capital is the rate of return that a firm must earn on its project investments to maintain its market value and attract funds.

Cost of capital is the required rate of return on its investments which belongs to equity, debt and retained earnings. If a firm fails to earn return at the expected rate, the market value of the shares will fall and it will result in the reduction of overall wealth of the shareholders.

Definitions of the term cost of Capital

The following important definitions are commonly used to understand the meaning and concept of the cost of capital.

According to the definition of John J. Hampton "Cost of capital is the rate of return the firm required from investment in order to increase the value of the firm in the market place"

According to the definition of William and Donaldson, "Cost of capital may be defined as the rate that must be earned on the net proceeds to provide the cost elements of the burden at the time they are due".

Assumption of Cost of Capital

Cost of capital is based on certain assumptions which are closely associated while calculating and measuring the cost of capital. It is to be considered that there are three basic concepts:

1. It is not a cost as such. It is merely a hurdle rate.
2. It is the minimum rate of return.
3. It consists of three important risks such as zero risk level, business risk and financial risk. Cost of capital can be measured with the help of the following equation.

$K = rj + b + f.$

Where,

K = Cost of capital.

rj = The riskless cost of the particular type of finance. b = The business risk premium.

f = The financial risk premium.

11.4 Classification of Cost of Capital

Cost of capital may be classified into the following types on the basis of nature and usage:

A. Explicit and Implicit Cost.

B. Average and Marginal Cost.

C. Historical and Future Cost.

D. Specific and Combined Cost.

Explicit and Implicit Cost

The cost of capital may be explicit or implicit cost on the basis of the computation of cost of capital.

Explicit cost is the rate that the firm pays to procure financing. This may be calculated with the help of the following equation;

$$CIo = \sum_{t+1}^{n} \frac{COt}{(t + C)t}$$

Where,

CIo = initial cash inflow

NOTES

C = outflow in the period concerned
N = duration for which the funds are provided
T = tax rate

Implicit cost is the rate of return associated with the best investment opportunity for the firm and its shareholders that will be forgone if the projects presently under consideration by the firm were accepted.

Average and Marginal Cost

Average cost of capital is the weighted average cost of each component of capital employed by the company. It considers weighted average cost of all kinds of financing such as equity, debt, retained earnings etc. Marginal cost is the weighted average cost of new finance raised by the company. It is the additional cost of capital when the company goes for further raising of finance.

Historical and Future Cost

Historical cost is the cost which has already been incurred for financing a particular project. It is based on the actual cost incurred in the previous project.

Future cost is the expected cost of financing in the proposed project. Expected cost is calculated on the basis of previous experience.

Specific and Combine Cost

The cost of each sources of capital such as equity, debt, retained earnings and loans is called as specific cost of capital. It is very useful to determine the each and every specific source of capital.

The composite or combined cost of capital is the combination of all sources of capital. It is also called as overall cost of capital. It is used to understand the total cost associated with the total finance of the firm.

11.5 Importance of Cost of Capital

Computation of cost of capital is a very important part of the financial management to decide the capital structure of the business concern.

1. Capital Budgeting Decision; Capital budget decision largely depends on the cost of capital of each source. According to net present value method, present value of cash inflow must be more than the present value of cash outflow. Hence, cost of capital is used to capital budgeting decision.

2. Structure Decision: Capital structure is the mix or proportion of the different kinds of long term securities. A firm uses particular type of sources if the cost of capital is suitable. Hence, cost of capital helps to take decision regarding structure.

3. Evolution of Financial Performance: Cost of capital is one of the important determining which affects the capital budgeting, capital structure and value of the firm. Hence, it helps to evaluate the financial performance of the firm.

4. Other Financial Decisions: Apart from the above points, cost of capital is also used in some other areas such as, market value of share, earning capacity of securities etc. hence; it plays a major part in the financial management.

11.6 Factors Determining the Firm's Cost of Capital

Cost of capital, like all other costs, is a variable term, subject to changes in a number of factors. The various factors that play a part in determination of cost of capital are described below: There are four main factors which mainly determine the cost of Capital of a firm.

General economic conditions, the marketability of the firm's securities (market conditions), operating and financing conditions within the company, and the amount of financing needed for new investments. Now we will discuss each one of them.

1: General Economic Conditions

General economic conditions determine the demand for and supply of capital within the economy, as well as the level of expected inflation. This economic variable is reflected in the risk less rate of return. This rate represents the rate of return on risk- free investments, such as the interest rate on short-term government securities. In principle, as the demand for money in the economy changes relative to the supply, investors alter their required rate of return. For example, if the demand for money increases without an equivalent increase in the supply, lenders will raise their required interest rate. At the same time, if inflation is expected to deteriorate the purchasing power of the euro, investors require a higher rate of return to compensate for this anticipated loss.

2: Market Conditions

When an investor purchases a security with significant risk, an opportunity for additional returns is necessary to make the investment attractive. Essentially, as risk increases, the investor requires a higher rate of return. This increase is called a risk premium. When investors increase their required rate of return, the cost of capital rises simultaneously. If the security is not readily marketable when the investor wants to sell, or even if a continuous demand for the security exists but the price varies significantly, an investor will require a relatively high rate of return. Conversely, if a security is readily marketable and its price is reasonably stable, the investor will require a lower rate of return and the company's cost of capital will be lower.

3: Operating and Financing Decisions

Risk, or the variability of returns, also results from decisions made within the company. Risk resulting from these decisions is generally divided into two types: business risk and financial risk. Business risk is the variability in returns on assets and is affected by the company's investment decisions. Financial risk is the increased variability in returns to common stockholders as a result of financing with debt or preferred stock. As business risk and financial risk increase or decrease, the investor's required rate of return (and the cost of capital) will move in the same direction.

4: Amount of Financing

The last factor determining the corporation's cost of funds is the level of financing that the firm requires. As the financing requirements of the firm become larger, the weighted cost of capital increases for several reasons. For instance, as more securities are issued, additional flotation costs, or the cost incurred by the firm from issuing securities, will affect the percentage cost of the funds to the firm. Also, as management approaches the market for large amounts of capital relative to the firm's size, the investors' required rate of return may rise. Suppliers of capital become hesitant to grant relatively large sums without evidence of management's capability to absorb this capital into the business. This is typically "too much too soon". Also, as the size of the issue increases, there is greater difficulty in placing it in the market without reducing the price of the security, which also increases the firm's cost of capital.

NOTES

11.7 Controllable Factors Affecting Cost of Capital

These are the factors affecting cost of capital that the company has control over

(1) Capital Structure Policy

A firm has control over its capital structure, and it targets an optimal capital structure. As more debt is issued, the cost of debt increases, and as more equity is issued, the cost of equity increases.

(2) Dividend Policy

Given that the firm has control over its payout ratio, the breakpoint of the marginal cost of capital schedule can be changed. For example, as the payout ratio of the company increases, the breakpoint between lower-cost internally generated equity and newly issued equity is lowered.

(3) Investment Policy

It is assumed that, when making investment decisions, the company is making investments with similar degrees of risk. If a company changes its investment policy relative to its risk, both the cost of debt and cost of equity change.

CHECK YOUR PROGRESS

Explain the concept of Cost of Capital

Uncontrollable Factors Affecting the Cost of Capital

These are the factors affecting cost of capital that the company has no control over:

(1) Level of Interest Rates

The level of interest rates will affect the cost of debt and, potentially, the cost of equity. For example, when interest rates increase the cost of debt increases, which increases the cost of capital.

(2) Tax Rates

Tax rates affect the after-tax cost of debt. As tax rates increase, the cost of debt decreases, decreasing the cost of capital.

11.8 Measurement of Cost of Capital

11.8.1 Cost of Debt (Kd)

Cost of Debt refers to the cost of long Term debentures/bond. Short term debts are ignored in calculating the cost of debt assuming that either short term debt plays insignificant part in determining the cost of debt or that the interest on short term debt is balanced by interest on short term receivables

Cost of Debt is calculated after tax because interest payments are tax deductible for the firm. Cost of capital is denoted by the term Kd

Kd after taxes = Kd (1 - tax rate)

Example

If the cost of debt for Cowboy Energy Services is 10% (effective rate) and its tax rate is 40% then:

Kd after taxes =Kd (1 - tax rate)

= 10 (1 - 0.4) = 6.0 %

Example

Jain & Co sells a new issue of 6% irredeemable debentures to raise ` 100,000 and realizes the full face value of Rs.100. The company falls in 40% tax bracket. Debts are issued at par. Find Cost of Capital

Solution

Before tax cost of debt = Interest / Sale value or Interest /Principal being issued at par

6,000 / 1,00,000 * 100 = 6%

Cost of debt after tax = (1 - T) * before tax cost of debt

= (1 - 0.40) * 6%
= 0.036 or 3.6%
Cost of debt which are issued at premium
Cost of debt which are issued at Discount

NOTES

Example

Jain & Co sells a new issue of 6% 1000 irredeemable debentures of ` 100 each @ 10 % Discount. The company falls in 40% tax bracket. Find Cost of Capital

Solution

Sale value or net proceeds from sale of Debentures (SV)
= Rs (1,000*100- 1,000*100*10%)
= Rs 90,000
Kd = I (1 - T) / SV
Cost of debt = 6,000 / 90,000 * (1 - 0.40) = 4%
Cost of Bond/Debentures redeemable after certain period

Cost of Redeemable debt:

In case of debentures redeemable after a certain period of time, cost of debt is calculated taking the average of sale value and redemption value. It is calculated by under given formula

Kd (before tax) = (I + [RV - SV] / n) / (RV + SV) / 2
Where:
I = Annual fixed interest
RV = Redeemable Value of debenture net of commission and floatation costs, if any.
SV= Sale Value of debentures net of discount or premium.
N = Term of debt till maturity
After tax cost of Redeemable debt :-
Kd (after tax) = Kd (before tax) * (1 - T)

Example

A firm issues debentures worth ` 1,00,000 and realizes ` 98,000 after allowing 2% commission to brokers. They carry an interest rate of 10% and are due for maturity at the end of 10th year. The company has 40% tax bracket.

Solution

Redeemable value = `1,00,000; Sale value = ` 98,000. Annual interest (I) = ` 10,000
Cost of debt = ((10,000 + [1,00,000 - 98,000] / 10) / [(1,00,000 + 98,000) / 2)]
Cost of debt (after tax) = 6.18%

Example

X Limited issues its Bond at par @ `1,000 per bond. These bonds will mature after 20 years at part and bear coupon rate of 10%. Coupons are annual. The bond will sell for par but flotation costs amount to ` 50 per bond. What is the pre-tax and after-tax cost of debt for X Limited?

Solution

Present realization from sale of 1 Bond = ` 950
Annual Interest = ` 100
Maturity value after 20 Years = Rs 1000
Let Pre tax cost of debt is Kd
Present Value of realization from Bond= P. V. of interest for 20 Years @ kd + P.V of Redemption Value @ Kd
950 = 100(PVIFA 20, Kd) + 1000(PVIF 20, Kd)
Using a financial calculator:
Kd = 10.61%

NOTES

After-tax cost of debt:
Kd = Kd (1 - T)
Kd = .1061 (1 - .34)
Kd = .07 = 7%

11.9 Cost of Preference Share Capital

Preference shares represent a special type of ownership interest in the firm. They are entitled to a fixed dividend, but subject to availability of profit for distribution. The preference share holders have to be paid their fixed dividends before any distribution of dividends to the equity shareholders. Their dividends are not allowed as an expense for the purpose of taxation. In fact, the preference dividend is a distribution of profits of the business.

Dividends are paid out of profits after taxes so the cost of preference shareholder is after tax only.

Preference shares can be divided into:

1. Irredeemable preference shares
2. Redeemable preference shares

(1) Cost of Irredeemable preference shares

Irredeemable preference shares are those shares issuing by which the company has no obligation to pay back the principal amount of the shares during its lifetime. The only liability of the company is to pay the annual dividends. The cost of irredeemable preference shares is:

Kp (cost of pref. share) = Annual dividend of preference shares
Market price of the preference stock

Example

Calculate the cost of 10% preference capital of 10,000 preference shares whose face value is `100. The market price of the share is currently ` 115.

Solution

Annual dividend = 10% of ` 100 = `10 per share
Kp = ` 10/` 115 = 8.7%

Cumulative preference shares:

In case of cumulative preference shares, the market price of the preference stock will be increased by such amount of dividend in arrears. Cumulative preference shares are those shares whose dividends will get accumulated if they are not paid periodically. All the arrears of cumulative preference shares must be paid before paying anything to the equity share holders.

Non-cumulative preference shares:

These are preference shares whose dividends do not get carried forward to the next year if they are not paid during a year.

If the company issues new preference shares,
The cost of preference capital would be:
Kp = Annual dividend / Net proceeds after floatation costs, if any.

Example:

A limited company issues 8% preference shares which are irredeemable. The face value of share is `100 but they are issued at `105. The floatation cost is `3 per share, calculate case of capital.

Solution

Net proceed = `(105-3)= ` 102
Lesson 4 Cost of Capital 123
Kp = (8/102) *100= 7.84%

(2) Cost of Redeemable preference shares

Redeemable preference shares are those shares which have a fixed maturity date at which they would be redeemed.

Cost of Redeemable preference shares = Kp = D + (RV - SV) / N
(RV + SV) / 2

Where Kp= Cost of preference Shares
RV- Redemption value
SV= Sale value
N= No of years to Maturity
D= Annual Dividend

Example:

A company issues 10,000, 8% preference shares of `100 each redeemable after 20 years at face value. The floatation costs are `3 per share find case of capital.

Solution

Redeemable value = `100;
Sale value = `100-`3 = `97
Annual dividend = `8 per share.
Kp = 8 + (100 - 97) / 20 = 8.27%
(100 + 97) / 2

11.10 Cost of Equity Capital

Equity Capital is the money invested by the promoters in the firm. The return which promoters get is of two kinds:

- Periodic Payments in the form of dividends. This is an explicit return.
- The capital appreciation which they might get by selling the shares at the increase in the market value of the shares. This return is an implicit return. The market value is an indicative measure of the return to the investors when they wish to redeem their investment

The cost of equity capital is the minimum rate of return that a company must earn on the equity financed portion of its investments in order to maintain the market price of the equity share at the current level. The cost of equity capital is rather difficult to estimate because there is no definite commitment on the part of the company to pay dividends. However, there are various approaches for computing the cost of equity capital. They are:

1. CAPM model

This is a popular approach to estimate the cost of equity. According to the SML, the cost of equity capital is:

Ke = Krf + ß (Km - Krf)

Where:

Ke = Cost of equity
Krf = Risk-free rate
Km = Equity market required return (expected return on the market portfolio)
ß = beta - Systematic Risk Coefficient.

Example:

Calculate the cost of equity capital for a company whose Risk-free rate =10%, equity market required return =18% with a beta of 0.5.

Solution

Ke = 0.10 + 0.5(0.18 - 0.10)= 0.14 or 14%.

2. Bond Yield Plus Risk Premium Approach

This approach is a subjective procedure to estimate the cost of equity. In this approach, a judgmental risk premium to the observed yield on the long-term bonds of the firm is added to get the cost of equity.

Cost of equity = Yield on long-term bonds + Risk Premium.

Example

Given, the yield on debt is 10% and the risk premium as 5%, calculate the cost of equity.

Solution

Cost of equity = 0.10 + 0.05 = 0.15 or 15%.

Firms that have risky and consequently high cost of debt will also have risky and consequently high cost equity.

Thus it makes sense to base the cost of equity on a readily observable cost of debt. The disadvantage or a challenge to this approach is the determination of the risk premium. There is no objective way to determine it and hence many financial analysts look at the operating and financial risks of the business and arrive at a subjectively determined risk premium that ranges between 2 percent and 6 percent.

3. Dividend Growth Model Approach

The price of an equity stock depends ultimately on the dividends expected from it. It can be represented as follows:

P0 = D1/ (1+R) 1 + D2/ (1+R) 2 +D3/ (1+R) 3 +----------

Where:

P0 = Current price of the stock

D1 = Expected dividend at the end of year 1

D2 = Expected dividend at the end of year 2 and so on..

t = Year t

r = Equity shareholders' required rate of return

If the dividends are expected to grow at a constant rate of g% per year, then the equation becomes:

P0 = D1(1+G) / (1+R) 1 + D2(1+G) / (1+R) 2 +D3(1+G) / (1+R) 3 +---

Simplifying this equation, we get: P0 =D1/(r-g) and solving for r, we get

r = D1/P0+ g

Example

A company has issued 5,000 equity shares of ` 100 each. Its current market price is ` 95 per Share and the current dividend is Rs, 4.5 per share. The dividends are expected to grow at the rate of 6%. Compute the cost of equity capital.

Solution

Here, D1 = 4.5 + growth rate 6% = 4.77 per share

P0 = 95

Ke = 4.77 + 6% = 0.11 or 11%

95

4. Earnings-Price Ratio approach

According to this approach, the cost of equity capital is:

$$Ke = \frac{E1}{P0}$$

Where:

E1 = Expected earnings per share for the next year

P0 = Current market price per share

E1 = (Current EPS) * (1 + growth rate of EPS)

Example

A company has currently 10,000 equity shares of `100 each and its' earnings are ` 150,000. Its' current market price is `112 and the growth rate of EPS is

expected to be 5%. Calculate the cost of equity.

Solution

Current EPS = Earnings available for equity shareholders /
Number of equity shares
= `150,000 / 10,000 shares = `15 per share.

E1 = `15 + 5% = `15.75 per share

Ke = `15.75 / `112 = 0.14 or 14%.

11.11 Weighted Average Cost of Capital

The weighted average cost of capital (WACC), as the name implies, is the weighted average of the costs of different components of the capital structure of a firm. WACC is calculated after assigning different weights to the components according to the proportion of that component in the capital structure.

Example

Kritika Limited is currently financed with `1, 000,000 of 7% bonds, and `2, 000,000 of common stock. The stock has a beta of 1.5, and the risk free rate is 4%, and the market risk premium is 3.5%. The marginal tax rate for a corporation of AKL's size is 35%. What is Kritika Limited WACC?

Solution

Ration of Debt to Total Capital = 10,00,000/ (10,00,000+ 20,00,000) = 1/3

Ration of Common stock to total capital = 20,00,000/ (10,00,000+ 20,00,000) = 2/3

Cost of Equity:

E(Ri)= Ri + ßim = x (E(Rm) - Rf) ? 4% + 1.5 x 3.5 ? 9.25

Cost of debt = 0.07(1-0.35) = 0.455 or 4.55%

WACC = (4.55%*1/3) + (9.25%*2/3)
= 0.076833

11.12 Cost of Capital and Its Implications in Budgeting Decisions

Investment decisions are directly related to financial decisions influenced by cost of capital. Management of a company is always anxious to maximise return on investments with a view to ensure that cost of capital is covered although management may alternatively decide to minimise investment which may yield highest returns for reasons of high risk involved or it may decide to maximise investments for obtaining highest growth through expansion of the productive processes. Management is guided by such considerations as:

(1) Opportunities created by technological change requiring replacements, necessitating expansion or taking up new activities.

(2) Competition strategies to avail of economic opportunities, investment being planned by them and the threat which may arise to the existing or proposed market shares of the firm;

(3) Short-term and long-term market forecasts with reference to sales, revenue proceeds, net profits etc.;

(4) Incentives offered by the state to promote investment in particular areas of production required for meeting urgent local needs of the nation or for exporting to earn foreign exchange etc. Nevertheless, the management of a corporate enterprise while preparing capital outlays prepares the particulars of the expected receipts (cash inflows) generated from the activity through such investment. Both are compared over-time and for optimum decision receipts should cover cost of financing the capital outlays. As such investment or capital budgeting

NOTES

decisions are directly linked with the cost of capital.

Before dealing with the application of cost of capital budgeting decisions, it is considered necessary to apprise the readers of the sources of capital and the cost of capital and its significance in investment decisions in the following paragraphs:

Implications in Budgeting Decisions

Despite the above objections, cost of capital is used as the basis to evaluate investments whose cash flows are perfectly correlated with the cash flows from the company's present assets. With perfect co-relation between the two sets of cash flows risk is the same. But if the timing of the cash flows is not also the same, the same discount rate cannot be used for both investments. But weighted average cost of capital represents an averaging of all risks of the company and can be used to evaluate investments in much the same manner that the pay-back method. It gives some insight and guidance and to that extent it is good to be used. Present value of an investment can be computed using a weighted average cost of capital and this can be compared with present values calculated using the other discount rates. It may be that an investment with a positive present value should be rejected because of its risk characteristics or that an investment with a negative present value using the weighted average cost of capital should be accepted. All this will differ from situation to situation and case to case.

Nevertheless, evaluation of capital investment projects requires some basis which could serve as the minimum rate of return which a project should generate. In such cases, weighted cost of capital could serve as an accepted discounting rate for evaluating investment decisions as no project will be acceptable which does not generate funds equal or greater to the cut-off rate represented by weighted cost.

CHECK YOUR PROGRESS

Explain Cost of Capital and Its Implications in Budgeting Decisions

11.13 Key Concepts

- Average cost of capital is the weighted average cost of each component of capital employed by the company.
- Marginal cost is the weighted average cost of new finance raised by the company.
- Historical cost is the cost which has already been incurred for financing a particular project.
- Future cost is the expected cost of financing in the proposed project.
- Cost of Debt Cost of Debt refers to the cost of long Term debentures/bond.
- Cost of Equity Capital Equity Capital is the money invested by the promoters in the firm.

11.14 Summary

- The cost of capital is a term used in the field of financial investment to refer to the cost of a company's funds (both debt and equity), or, from an investor's point of view "the shareholder's required return on a portfolio company's existing securities"
- Cost of capital is used to evaluate new projects of a company and it is the minimum return that investors expect for providing capital to the company.
- For an investment to be worthwhile, the expected return on capital must be greater than the cost of capital. The cost of capital is the rate of return that capital could be expected to earn in an alternative investment of equivalent risk.
- Cost of capital may be classified into the following types on the basis of nature and usage:
  (a) Explicit and Implicit Cost.

(b) Average and Marginal Cost.
(c) Historical and Future Cost.
(d) Specific and Combined Cost.

NOTES

- There are four main factors which mainly determine the cost of Capital of a firm. General economic conditions, the marketability of the firm's securities (market conditions), operating and financing conditions within the company, and the amount of financing needed for new investments.
- There are factors affecting cost of capital that the company has control over and includes Capital Structure Policy, Dividend Policy, Investment Policy etc.
- There are some factors affecting cost of capital that the company has not control over and these factors includes Level of Interest Rates, Tax Rates.
- Cost of Debt is calculated after tax because interest payments are tax deductible for the firm. Cost of capital is denoted by the term Kd.
  Kd after taxes = Kd (1 - tax rate)
- Irredeemable preference shares are those shares issuing by which the company has no obligation to pay back the principal amount of the shares during its lifetime. The only liability of the company is to pay the annual dividends. The cost of irredeemable preference shares is:
  Kp (cost of pref. share) = Annual dividend of preference shares
  Market price of the preference stock
- Redeemable preference shares are those shares which have a fixed maturity date at which they would be redeemed. The cost of redeemable preference shares is calculated by under given formulae.
  Cost of Redeemable preference shares = $Kp = \frac{D + (RV - SV) / N}{(RV + SV) / 2}$
  Where Kp= Cost of preference Shares
  RV- Redemption value
  SV= Sale value
  N= No of years to Maturity
  D= Annual Dividend
- The cost of equity capital is the minimum rate of return that a company must earn on the equity financed portion of its investments in order to maintain the market price of the equity share at the current level. The cost of equity capital is rather difficult to estimate because there is no definite commitment on the part of the company to pay dividends. However, there are various approaches for computing the cost of equity capital. They are:
- CAPM model : This is a popular approach to estimate the cost of equity. According to the SML, the cost of equity capital is:
  Ke = Krf + ß (Km - Krf)
  Where:
  Ke = Cost of equity
  Krf = Risk-free rate
  Km = Equity market required return (expected return on the market portfolio)
  ß = beta- Systematic Risk Coefficient.
- Bond Yield Plus Risk Premium Approach
  This approach is a subjective procedure to estimate the cost of equity. In this approach, a judgmental risk premium to the observed yield on the long-term bonds of the firm is added to get the cost of equity.
  Cost of equity = Yield on long-term bonds + Risk Premium.
- Dividend Growth Model Approach
  The price of an equity stock depends ultimately on the dividends expected from it. According to this approach P0 =D1/(r-g) and r = D1/P0+ g. here
  P0 = Current price of the stock
  D1= Expected dividend at the end of year 1

NOTES

r = Equity shareholders' required rate of return
g = Growth rate

- Earnings-Price Ratio approach

According to this approach, the cost of equity capital is:

$$Ke = \frac{E1}{P0}$$

Where:
E1 = Expected earnings per share for the next year
P0 = Current market price per share
E1 = (Current EPS) * (1 + growth rate of EPS)

- The weighted average cost of capital (WACC), as the name implies, is the weighted average of the costs of different components of the capital structure of a firm. WACC is calculated after assigning different weights to the components according to the proportion of that component in the capital structure.
- Marginal Cost of Capital (MCC) can be defined as the cost of additional capital introduced in the capital structure since we have assumed that the capital structure can vary according to changing requirements of the firm.

11.15 Questions and Exercise

1. What is cost of capital? Define cost of capital.
2. Cost of capital computation based on certain assumptions. Discuss. Explain the classification of cost.
3. Mention the importance of cost of capital. Explain the computation of specific sources of cost of capital.
4. How overall cost of capital is calculated? Explain various approaches for calculation of cost of equity.

- **Fill in the blanks**

1. _____ is the rate of return that a firm must earn on its project investments to maintain its market value and attract funds.

   (Cost of Capital, Expense of Capital, Value of Capital)
2. _____can be defined as the cost of additional capital introduced in the capital structure since we have assumed that the capital structure can vary according to changing requirements of the firm.

   (Average Cost of Capital, Marginal Cost of Capital (MCC), Historical Cost of Capital)
3. WACC is calculated after assigning different weights to the components according to the proportion of that component in the _____.

   (Capital, Liability, Capital Structure)
4. According to _____, the price of an equity stock depends ultimately on the dividends expected from it.

   (Dividend Growth Model Approach, Net Operating Method, Operating Method)
5. _____preference shares are those shares which have a fixed maturity date at which they would be redeemed.

   (Redeemable, Irredeemable, Ordianry)

6. The only liability of the company in case of Irredeemable preference shares is to pay the _____.
   (Quarterly Dividend, Bonus, Annual Dividend)

[**Ans:** 1) Cost of capital, 2) Marginal Cost of Capital (MCC), 3) capital structure, 4) Dividend Growth Model Approach, 5) Redeemable, 6) Annual dividends.]

11.16 Further Reading and References

1. M.Y. Khan & P.K. Jain : Financial Management - Text and Problems; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
2. Prasanna Chandra : Financial Management - Theory & Practice; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
3. I.M. Pandey : Financial Management (2005); Vikas Publishing House Pvt. Ltd., New Delhi.
4. R.P. Rustagi : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
5. R. Charles Moyer, : Contemporary Financial Management; West Publishing Company. James R. McGuign & William J. Kretlow
6. Rajiv Srivastava & : Financial Management, Oxford University Press Anil Mishra
7. J.B. Gupta : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
8. Ravi M. Kishore : Strategic Financial Management - Taxmann Publication Pvt. Ltd.

NOTES

UNIT - 12
FINANCING DECISION-CAPITAL STRUCTURE

12.1 Introduction
12.2 Objective
12.3 Meaning of Capital Structure
12.4 Significant of capital structure
12.5 Capital Structure Vis-A-Vis Financial Structure
12.6 Planning and Designing of Capital Structure
12.7 Optimal Capital Structure
12.8 Factors Influencing Capital Structure
12.9 Determinants of Capital Structure
12.10 Capital Structure and Valuation
12.11 Capital Structure Theories
12.12 EBIT - EPS Analysis
12.13 Measures of Operating and Financial Leverage
12.13.1 Operating Leverage
12.13.2 Financial Leverage
12.13.3 Distinguish Between Operating Leverage and Financial Leverage
12.13.4 Combined Leverage
12.14 Risk and Leverage
12.15 Key Concepts
12.16 Summary
12.17 Questions & Exercise
12.18 Further Readings & References

12.1 Introduction

Capital Structure of a company is very important for company survival. If the capital structure of a company is not optimized, then it becomes difficult for a company to get sustain i.e. sometime it have to face the lack of capital, sometime it has to bear the high interest. So in view of above, it becomes very important for a finance manager to ensure that the firm's capital structure is as per the market and organisation condition.

12.2 Objectives

The object of the Lesson is to enable the students to understand:

- Nature, scope and significance of capital structure
- Factors influencing Capital Structure
- Capital structure vis a vis Financial structure
- Planning and designing of capital structure

- Optimal Capital Structure
- Capital Structure & Valuation
- Capital Structure theories
- Leverage - Operating leverage, financial leverage, combined leverage
- EBIT-EPS Analysis
- Effect of leverages on return on equity

12.3 Meaning of Capital Structure

By the term capital structure we mean the structure or constitution or break-up of the capital employed by a firm.

The capital employed consists of both the owners' capital and the debt capital provided by the lenders. Debt capital is understood here to mean the long term debt which has been deployed to build long term assets. Apart from the elements of equity and debt in the capital structure, a firm could have quasi equity in the form of convertible debt.

Capital Structure of a firm is a reflection of the overall investment and financing strategy of the firm. It shows how much reliance is being placed by the firm on external sources of finance and how much internal accruals are being used to finance expansions etc. Capital structure can be of various kinds as described below:

1. Horizontal Capital Structure

In a Horizontal capital structure, the firm has zero debt components in the structure mix. The structure is quite stable. Expansion of the firm takes in a lateral manner, i.e. through equity or retained earning only. The absence of debt results in the lack of financial leverage. Probability of disturbance of the structure is remote.

2. Vertical Capital Structure

In a vertical capital structure, the base of the structure is formed by a small amount of equity share capital. This base serves as the foundation on which the super structure of preference share capital and debt is built. The incremental addition in the capital structure is almost entirely in the form of debt. Quantum of retained earnings is low and the dividend pay-out ratio is quite high. In such a structure, the cost of equity capital is usually higher than the cost of debt. The high component of debt in the capital structure increases the financial risk of the firm and renders the structure unstable. The firm, because of the relatively lesser component of equity capital, is vulnerable to hostile takeovers.

3. Pyramid shaped Capital structure

A pyramid shaped capital structure has a large proportion consisting of equity capital and retained earnings which have been ploughed back into the firm over a considerably large period of time. The cost of share capital and the retained earnings of the firm is usually lower than the cost of debt. This structure is indicative of risk averse conservative firms.

4. Inverted Pyramid shaped Capital Structure

Such a capital structure has a small component of equity capital, reasonable level of retained earnings but an ever increasing component of debt. All the increases in the capital structure in the recent past have been made through debt only. Chances are that the retained earnings of the firm are shrinking due to accumulating losses.

Such a capital structure is highly vulnerable to collapse.

NOTES

12.4 Significant of capital structure

Capital structure is significant for a firm because the long term profitability and solvency of the firm is sustained by an optimal capital structure consisting of an appropriate mix of debt and equity. The capital structure also is significant for the overall ranking of the firm in the industry group. The significance of the capital structure is discussed below:

1. It reflects the firm's strategy

The capital structure reflects the overall strategy of the firm. The strategy includes the pace of growth of the firm.

In case the firm wants to grow at a faster pace, it would be required to incorporate debt in its capital structure to a greater extent. Further, in case of growth through acquisitions or the inorganic mode of growth as it is called, the firm would find that financial leverage is an important tool in funding the acquisitions.

2. It is an indicator of the risk profile of the firm

One can get a reasonably accurate broad idea about the risk profile of the firm from its capital structure. If the debt component in the capital structure is predominant, the fixed interest cost of the firm increases thereby increasing its risk. If the firm has no long term debt in its capital structure, it means that either it is risk averse or it has cost of equity capital or cost of retained earnings less than the cost of debt.

3. It acts as a tax management tool

The capital structure acts as a tax management tool also. Since the interest on borrowings is tax deductible, a firm having healthy growth in operating profits would find it worthwhile to incorporate debt in the capital structure in a greater measure.

4. It helps to brighten the image of the firm

A firm can build on the retained earnings component of the capital structure by issuing equity capital at a premium to a spread out base of small investors. Such an act has two benefits. On the one hand, it helps the firm to improve its image in the eyes of the investors. At the same time, it reduces chances of hostile take-over of the firm.

12.5 Capital Structure Vis-A-Vis Financial Structure

In engineering, structure refers to different parts of a building and thus in financial terms, financial structure refers to all the components of finance in an organization. In simple terms, financial structure consists of all assets, all liabilities and the capital. The manner in which an organization's assets are financed is referred to as its financial structure. There are some similarities between capital structure and financial structure. However, there are many differences also that will be highlighted in this article.

If you take a look at the balance sheet of a company, the entire left hand side which includes liabilities plus equity is called the financial structure of the company. It contains all the long term and short term sources of capital. On the other hand, capital structure is the sum total of all long term sources of capital and thus is a part of the financial structure. It includes debentures, long term debt, preference share capital, equity share capital and retained earnings. In the simplest of terms, capital structure of a company is that part of financial structure that reflects long term sources of capital.

12.6 Planning and Designing of Capital Structure

Just as planning and design of a physical structure is important, the same holds true for capital structure as well.

A well thought out plan for the capital structure supplemented by a careful design ensures that prime goal of the firm, i.e. maximisation of the shareholder wealth is easily achieved.

Planning of the capital structure is a preliminary activity and it might commence as early at the time of incorporation of the firm. Once the firm is established, the next logical step is to move in the direction of implementation of the project. For meeting the cost of the project, the means of finance are to be arranged. Hence the need for timely and early planning of the capital structure.

Attributes of a Well Planned Capital Structure

A well-planned capital structure should have the following attributes:

1. Long Tenure: The plan should be for a fairly long tenure and should cover the working of at least five to seven years of the project. Expansion of the capacity, addition of product lines etc. should be accounted for in the plan.

2. Consistency: The planned capital structure should be consistent with the over all financing philosophy of the firm. If the firm has a risk averse philosophy, then the plan should have minimum component of debt.

3. Feasibility: The planned capital structure should have feasibility, i.e. it should not be impractical. Feasibility also means that it should be workable within the amount of share capital, debt and retained earnings expected to be available to the firm.

Designing a Capital Structure

After planning the capital structure, we are faced with the issue of its design. Design takes off from where the plan ends. Planning establishes the broad parameters of the structure. It is left for the design to fill in the minor details. While designing a capital structure, following points need to be kept in view:

1. Design should be functional: The design should create synergy with the long term strategy of the firm and should not be dysfunctional. It should facilitate the day to day working of the firm rather than create systematic bottlenecks.

2. Design should be flexible: The capital structure should be designed to incorporate a reasonable amount of flexibility in order to allow for temporary expansion or contraction of the share of each component.

3. Design should be conforming statutory guidelines: The design should conform to the statutory guidelines, if any, regarding the proportion and amount of each component. The limits imposed by lenders regarding the minimum level of owners' equity required in the firm should be complied with.

12.7 Optimal Capital Structure

Is there an optimal capital structure for a firm? By the term optimal capital structure we mean a particular arrangement of various components of the structure which is just in tune with the both the long term and short term objectives of the firm. A combination less or more than the optimal combination would be less than satisfying.

Hence a sub-optimal combination would affect the achievement of the goal of maximisation of the shareholders'\ wealth.

But can we plan and design an optimal capital structure? For designing such a structure, one would need the following information:

NOTES

- The requirement of capital of the firm
- Availability of different components
- Cost of these components
- Rate of return from investment

It has to be further kept in mind that the above information should be exact information. In reality it is not possible to have the exact information on all the above four parameters. Secondly whatever information is available is for a particular period. Thus we have to design the structure in a static set-up which makes the design devoid of all flexibility.

The real world of business, however, is a dynamic world with ever changing demand and supply of various components of the capital structure. Hence we can not formulate the optimal capital structure in a static framework.

The process has to be carried out in a dynamic framework of interdependent investment and financing decisions that yield optimal values within the constraints at the time and place when the decisions were made. We can, therefore, say that the optimal capital structure is an ideal situation which can function as the benchmark of performance for a firm. But this benchmark is invincible and the firm can expect to achieve moderated or toned down versions of this benchmark depending upon dynamics of each project.

12.8 Factors Influencing Capital Structure

Normally a company wishes to raise capital by way of both equity and debt. In the real world, deciding on the capital structure is not so easy. In deciding the capital structure of a firm, following points need to be considered.

(a) Corporate Strategy

It is the main factor determining the financial structure of a company. The company has to determine the overall Capital Intensity Ratio (Debt/Equity) in line with its overall strategy. The company has to look at various options of debt equity mix, the cost of each option, the consequences of increase in equity on its valuation, capability to service both debt and equity etc. Other strategic decisions like management control level, risk averseness or risk taking nature of the management have also to be considered. Ultimately, the most appropriate capital structure will be the one, which most closely supports the strategic direction of the business with the least cost and at a reasonably acceptable risk level.

(b) Nature of the Industry

The nature of the industry plays on important role in capital structure decisions. If the firm is capital intensive, it would rely more on debt than equity. Generally speaking, long term assets should be financed by a balance between term debt and equity and short term assets should be financed by long term sources and more by short term debt. The current assets (short term assets) and fixed assets (long term assets) are determined by the nature of the business itself. A trading firm might have more current assets than fixed assets. In business like construction, capital and higher consumer goods their volumes and hence requirements of funds are affected by the changes in national and global scene. Business subject to such variations need a capital structure that can buffer the risks associated with such savings. The degree of competition is also a major factor to be considered in deciding the capital structure. In highly competitive industry with low entry barriers companies need to be well capitalized.

(c) Current and past capital structure

Current capital structure of a firm is determined largely by past decisions. Investment decision of the past, acquisition, takeovers financing policy, dividends

etc. go into forming the current capital structure which is difficult to change overnight. However, alterations in the structure are possible by raising capital, retiring debts, buying back shares, taking on debts, altering dividend pay-out policies, alteration in earning capacity etc. Also, as past decisions determine current capital structure, current changes in the capital structure decide the future capital structure. Hence, utmost care has to be exercised in decision and implementation of changes in the capital structure.

While deciding upon the capital structure the firm has to consider the different life cycle stages which are:

- The pioneering stage
- The expansion stage
- The stagnation/stabilization stage

The pioneering stage is one of rapid increase in demand for the products/ services at the starting stage of the life cycle of the company and the efficient companies are the one to survive. The financial cost of borrowing is very high at this stage, due to risk perception about the company. To survive this stage, the capital structure should orient more towards equity and avail more soft loans.

The expansion stage is the next stage, during which the strong companies survive the competition struggle and aim to expand their market share and volumes. During this stage, huge investments are made to expand production/service capacity. Requirement of funds is high during this stage. Subject to the corporate strategy of funding projects and market conditions, the company may raise capital at the lowest possible cost. As the earnings stabilize the company will be in a position to weather any small variations in business, then it can seek to financially leverage itself within a pre-fixed ceiling, by bank loans.

Stabilization/stagnation stage is the last and final stage. A dynamic management will always be on the lookout for expansion/diversification into new projects. It could again, depending on corporate strategy, go in for green-field projects or takeover existing units, seek mergers, acquisitions and strategic alliances etc. Usually a recession in economy opens up a vast number of such opportunities which cash rich companies can take advantage of. In case of lack of such opportunity, the company could reduce the financial leverage and save on interest.

12.9 Determinants of Capital Structure

We have seen above that there is no optimal capital structure for a firm and with the best of efforts, the firm can hope to attain an approximation to it. Now let us discuss the factors which determine the formation of the capital structure:

1. Minimisation of risk: The capital structure should aim at minimisation of risk of the firm. The term risk here means financial risk. The term excludes the normal financial risk and concentrates on the abnormal financial risk that might arise from a particular capital structure decision. The normal risk has already been factored in the projections while matching with the expected returns. It is the abnormal financial risk which should be minimised.

2. Maximisation of profit: The capital structure is formulated with a view to achieve the goal of maximization of firm's profits. These profits are after tax profits which add to shareholder wealth. Thus if the debt obligations of the firm entail tax breaks, it would be advisable for the firm to enlarge the debt component of the structure.

3. Nature of the project: Formulation of the structure is also determined by the nature of the investment project. If the project is a capital intensive, long gestation project then it should be financed by debt of matching maturity.

4. Control of the firm: This aspect of the firm also plays a part in the determination of the capital structure. Since the key to control of the firm is ownership of the equity capital, the promoters would like to part with only that proportion of equity capital as is necessary for execution of the project. Spreading of equity among the public investors exposes the firm to risk of take over. Hence a capital structure which makes the firm vulnerable in this respect is discouraged.

12.10 Capital Structure and Valuation

There is a theme that the capital structure should be conducive to increase in valuation of the firm. By valuation, we mean that the market value or the realisable value of the owners' equity should increase. This can happen in case value of both components of the shareholders' equity, i.e. share capital and retained earnings increases.

Value of the share capital is reflected in the market value of the firm in case the shares are traded on the stock exchange. This market value, under ideal conditions, is indicative of the inherent value and is different from both the face value and the book value. The capital structure should be such as maximises the inherent value of the firm.

Retained earnings also have a book value, i.e. the value at which these earnings are carried in the books of the firm. The inherent value of the retained earnings depends upon the future returns which these earnings can generate for the owners. As earnings of the firm increase, its valuation also increases. Earnings can increase either directly through increased level of operations of the firm or indirectly through decrease in cost of capital of the firm. The direct increase in earnings is dependent upon the investment decisions and the changes in capital structure have no explicit bearing upon these earnings. Capital structure plays an important part in increase in earnings brought about by change in cost of different components of the structure.

12.11 Capital Structure Theories

There are basically three approaches to capital structure decision:

1. Net Income Approach
2. Net Operating Income Approach
3. Modigliani Miller Approach

1. Net Income Approach

According to this approach, the cost of debt capital, Kd and the cost of equity capital Ke remains unchanged when D/S, the degree of leverage, varies. Here S stands for total capital employed (= D + E). The constancy of Kd and Ke with respect to the degree of leverage means that K the average cost of capital, measured by the following formula declines as the degree of leverage increases.

$$K = Kd \times \frac{D}{D+E} + Ke \times \frac{E}{D+E}$$

This happens because when the degree of leverage increases, Kd which is lower than Ke receives a higher weight in the calculation of K.

As our assumption is that the cost of debt and equity capital would not change with the change in the level of leverage, K is seen to go down with the increasing proportion of debt in the capital.

Let us take a company that has an investment of Rs.2,00,000 and a net operating income of Rs.50,000. It is considering two scenarios: (1) no debt and (2)

equal levels of debt and equity of Rs. 1,00,000 each. Let us say that the company finds out that the cost of equity is 12% and the cost of debt is 8%.

Calculations show that equity earnings would be Rs. 50,000 and Rs. 42,000 respectively in the two scenarios and shown below. As the return expected on equity is 12%, we can say that this profit is 12% and therefore the market value of equity would be such that this return becomes 12% on the same. This means that the market value of equity would be Rs. 4,16,667 and Rs. 4,50,000 respectively in the two scenarios. Adding the market value of debt and the market value of equity gives us the total value of the firm in the market.

Equity	**Scenario 'A'**	**Scenario 'B'**
Equity	2,00,000	1,00,000
Debt	0	1,00,000
Cost of Equity	12%	12%
Cost of Debt	8%	8%
Net operating income	50,000	50,000
Interest on debt	0	8,000
Equity Earnings	**50,000**	**42,000**
Market value of equity	4,16,667	3,50,000
Market value of debt	0	1,00,000
Total Value of Firm	**4,16,667**	**4,50,000**

Average cost of capital Scenario A: 8% x (0/2,00,000) + 12% x (2,00,000/ 2,00,000) = 12%

Scenario B: 8% x (1,00,000/4,50,000) + 12% x (3,50,000/4,50,000) = 11.10%

There are two points to be noted here

1. As the cost of capital decreases the value of the firm would go up as it is dependent upon the return expected and the cost of capital. Inverse relationship exists between the value of the firm and cost of capital for any given level of return.

2. This means that as we increase the level of debt in the company, the value of the firm would go up even further. This would mean that the companies would like to employ as much debt as possible.

2. Net Operating Income Theory

Taking an opposite view from the view taken in the net income approach, this approach states that the cost of capital for the whole firm remains constant, irrespective of the leverage employed in the firm. We can express the cost of equity as:

$$Ke = Ko \times \frac{(Ko+Kd) \times D}{D+E}$$

Let us repeat the example we discussed earlier in net income approach. Let us take a company that has an investment of Rs. 2,00,000 and net operating income of Rs. 50,000. It is considering two scenarios: 1) no debt and 2) equal levels of debt and equity of Rs. 100,000 each. Let us assume that the company finds out that the overall cost of capital is 10% and the cost of debt is 8%.

As the return expected on total capital is 10 per cent, therefore the market value of total capital would be such that this return becomes 10 per cent on the same. This means that the market value of capital would be Rs.5,00,000 in both the scenarios as our assumption in this case is that the total market value remains constant.

Also the value of debt would also remain constant as the cost of debt

NOTES

remains constant. This means that the equity capitalization can be calculated by subtracting the market value of debt from the total market value of the firm. Then the return on equity divided by the market capitalization of equity would give us the cost of equity.

Equity	Scenario 'A'	Scenario 'B'
Equity	2,00,000	1,00,000
Debt	0	1,00,000
Cost of Debt	8%	8%
Net operating income	50,000	50,000
Overall Capitalization rate	10%	10%
Total market value	5,00,000	5,00,000
Interest on debt	0	8,000
Debt capitalization rate	0.08	0.08
Market value of debt	0	1,00,000
Market value of equity	5,00,000	4,00,000

There are two points to be noted here :

- As the cost of total capital and debt is constant, the cost of equity would go up or down with increasing or decreasing leverage, i.e., the amount of debt in the capital structure.

- This means that as we increase the level of debt in the company, the value of the firm doesn't change and the company does not benefit by taking on debt. This would mean that the companies would like to employ as much equity as possible so as to reduce the risk of the company.

3. Modigliani - Miller Theory

In 1958, Franco Modigliani and Merton Miller (MM) published a theory of modern financial management - they concluded that the value of a firm depends solely on its future earnings stream, and hence its value is unaffected by its debt/equity mix. In short, they concluded that a firm's value stems from its assets, regardless of how those assets are financed. In other words, a variant of the net operating income approach discussed above.

In their paper, MM began with a very restrictive set of assumptions, including perfect capital markets (which implies zero taxes). And then they used an arbitrage proof to demonstrate that capital structure is irrelevant. Under their assumptions, if debt financing resulted in a higher value for the firm than equity financing, then investors who owned shares in a leveraged (debt-financed) firm could increase their income by selling those shares and using the proceeds, plus borrowed funds, to buy shares in an unleveraged (all equity financed) firm. The simultaneous selling of shares in the leveraged firm and buying of shares in the unleveraged firm would drive the prices of the stocks to the point where the values of the two firms would be identical. Thus, according to MM Hypothesis, a firm's stock price is not related to its mix of debt and equity financing.

Modigliani and Miller have restated and amplified the net operating income position in terms of three basic propositions. These are as follows:

Proposition - I

The total value of a firm is equal to its expected operating income (PBIT when tax = 0) divided by the discount rate appropriate to its risk class. It is independent of the degree of leverage.

NOTES

$$Vl = Vu = \frac{EBIT}{Kol} = \frac{EBIT}{Kou}$$

Here the subscript l is used to denote leveraged firm and subscript u is used to denote unleveraged firm.

Since the V (Value of the firm) as established by the above equation is a constant, then under the MM model, when there are no taxes, the value of the firm is independent of its leverage. This implies that the weighted average cost of capital to any firm is completely independent of its capital structure and the WACC for any firm, regardless of the amount of debt it uses, is equal to the cost of equity of unleveraged firm employing no debt.

Proposition - II

The expected yield on equity, Ke is equal to Ko plus a premium. This premium is equal to the debt - equity ratio times the difference between Ko and the yield on debt, Kd. This means that as the firm's use of debt increases its cost of equity also rises, and in a mathematically precise manner.

Proposition - III

The cut-off rate for investment decision making for a firm in a given risk class is not affected by the manner in which the investment is financed. It emphasizes the point that investment and financing decisions are independent because the average cost of capital is not affected by the financing decision.

Criticism of MM Hypothesis

If the MM theory was correct, managers would not need to concern themselves with capital structure decisions, because such decisions would have no impact on stock prices. However, like most theories, MM's results would hold true only under a particular set of assumptions. Still, by showing the conditions under which capital structure is irrelevant, MM provided important insights into when and how debt financing can affect the value of a firm.

MM Hypothesis with Corporate Taxes

In 1963, MM added corporate taxes to their model. With corporate taxes considered, a firm's stock price was shown to be directly related to its use to debt financing - higher the percentage of debt financing, the higher the stock price. Under the MM with tax theory, firms should use virtually 100% debt financing. The reason for this result is the corporate tax structure - returns to stockholders come from after-tax earnings, but returns to creditors are paid before tax. The effect of this tax treatment is that more of a company's operating income is left for investors when more debt financing is used.

Empirical evidence Against MM Hypothesis

In spite of the MM arguments, firms do not usually use anywhere close to 100% debt financing. In an attempt to modify MM's model to make it more consistent with actual behaviour, many of their assumptions were relaxed in papers by other authors. In particular, the possibility of financial distress drastically changed the MM results. In the modified model, tax savings cause the value of a firm to rise as more and more debt is used, but at some point (the optimal structure), the value of the firm begins to fall with additional debt because the tax benefits are more than offset by the increasing costs of potential financial distress.

The MM model as modified to include financial distress suggests to managers.

- that a certain amount of debt is good

NOTES

- that too much debt is bad, and
- that there is an optimal amount of debt for every firm.

Thus, the modified MM theory, which is called the trade-off theory of capital structure, provides useful insights into the factors that affect a firm's optimal capital structure. Here the marginal costs and benefits of debt financing are balanced against one another, and the result is an optimal capital structure that falls somewhere between zero and 100% debt.

12.12 EBIT - EPS Analysis

One widely used means of examining the effect of leverage is to analyse the relationship between earnings before interest and taxes (EBIT) and earnings per share (EPS). The use of EBIT - EPS analysis indicates to management the projected EPS for different financial plans. Generally, management wants to maximise EPS if doing so also satisfies the primary goal of financial management - maximisation of the owner's wealth as represented by the value of business, i.e. the value of firm's equity. If the firm attempts to use excessive amounts of debt, shareholders (who are risk - averters) may sell their shares, and thus its price will fall. While the use of large amount of debt may result in higher EPS, it may also result in a reduction in the price of the firm's equity.

The optimum financial structure for a firm (that is, the use of debt in relationship of equity and retained earnings as sources of financing) should be the one which maximises the price of the equity.

Given the importance of earnings per share (EPS) as a measure of a firm performance, analysis of the impact of financing alternatives on EPS is an important first step. Essentially, the method involves the comparison of alternative methods of financing under various assumptions as to EBIT.

EBITDA Analysis (Earnings Before Interest, Tax, Depreciation and Amortization),

EBITDA, an acronym for "earnings before interest, taxes, depreciation and amortization," is an often-used measure of the value of a business. EBITDA is calculated by taking net income and adding interest, taxes, depreciation and amortization expenses back to it. EBITDA is used to analyze a company's operating profitability before non operating expenses (such as interest and "other" non-core expenses) and non-cash charges (depreciation and amortization).

Analysis with EBITDA

EBIDTA enables analysts to exclude the impacts of non-operating activities and focus on the outcome of operating decisions. Non-operating activities include interest expenses, tax rates, and large non-cash items such as depreciation and amortization.

By removing the non-operating effects, EBITDA gives investors the ability to focus on the profitability of their operations. This type of analysis is particularly important when comparing similar companies across a single industry for example.

Limitations of EBITDA

Factoring out interest, taxes, depreciation and amortization can make even completely unprofitable firms appear to be fiscally healthy. The use of EBITDA as measure of financial health made these firms look attractive.

EBITDA numbers are easy to manipulate. If fraudulent accounting techniques are used to inflate revenues and interest, taxes, depreciation and amortization are factored out of the equation, almost any company may appears to be profitable and great.

Operating cash flow is a better measure of how much cash a company is generating because it adds non-cash charges (depreciation and amortization) back to net income and includes the changes in working capital that also use or provide cash (such as changes in receivables, payables and inventories). These working capital factors are the key to determining how much cash a company is generating. If investors do not include changes in working capital in their analysis and rely solely on EBITDA, they will miss clues that indicate whether a company is losing money because it isn't making any sales.

Despite various shortcomings, there are some good reasons for using EBITDA.

1. The first factor to consider is that EBITDA can be used as a shortcut to estimate the cash flow available to pay debt on long-term assets, such as equipment and other items with a lifespan measured in decades rather than years. Dividing EBITDA by the amount of required debt payments yields a debt coverage ratio. Factoring out the "ITDA" of EBITDA was designed to account for the cost of the long-term assets and provide a look at the profits that would be left after the cost of these tools was taken into consideration

2. Another factor is that EBITDA estimate to be reasonably accurate, the company under evaluation must have legitimate profitability. Using EBITDA to evaluate old-line industrial firms is likely to produce useful results. This idea was lost during the 1980s, when leveraged buyouts were fashionable, and EBITDA began to be used as a proxy for cash flow. This evolved into the more recent practice of using EBITDA to evaluate unprofitable dotcoms as well as firms such as telecoms, where technology upgrades are a constant expense.

3. EBITDA can also be used to compare companies against each other and against industry averages. In addition, EBITDA is a good measure of core profit trends because it eliminates some of the extraneous factors and allows a more "apples-to-apples" comparison.

Ultimately, EBITDA should not replace the measure of cash flow, which includes the significant factor of changes in working capital. Remember "cash is king" because it shows "true" profitability and a company's ability to continue operations.

12.13 Measures of Operating and Financial Leverage

The term leverage refers to an increased means of accomplishing some purpose. Leverage is used to lifting heavy objects, which may not be otherwise possible. In the financial point of view, leverage refers to furnish the ability to use fixed cost assets or funds to increase the return to its shareholders.

Definition of Leverage

James Horne has defined leverage as, "the employment of an asset or fund for which the firm pays a fixed cost or fixed return.

Types of Leverage

Leverage can be classified into three major headings according to the nature of the finance mix of the company.

12.13.1 Operating Leverage

The leverage associated with investment activities is called as operating leverage. It is caused due to fixed operating expenses in the company. Operating leverage may be defined as the company's ability to use fixed operating costs to magnify the effects of changes in sales on its earnings before interest and taxes. Operating leverage consists of two important costs viz., fixed cost and variable

cost. When the company is said to have a high degree of operating leverage if it employs a great amount of fixed cost and smaller amount of variable cost. Thus, the degree of operating leverage depends upon the amount of various cost structure. Operating leverage can be determined with the help of a break even analysis.

Operating leverage can be calculated with the help of the following formula:

Uses of Operating Leverage

Operating leverage is one of the techniques to measure the impact of changes in sales which lead for change in the profits of the company. If any change in the sales, it will lead to corresponding changes in profit. Operating leverage helps to identify the position of fixed cost and variable cost.

Operating leverage measures the relationship between the sales and revenue of the company during a particular period. Operating leverage helps to understand the level of fixed cost which is invested in the operating expenses of business activities. Operating leverage describes the overall position of the fixed operating cost.

12.13.2 Financial Leverage

A leverage activity with financing activities is called financial leverage. Financial leverage represents the relationship between the company's earnings before interest and taxes (EBIT) or operating profit and the earning available to equity shareholders.

Financial leverage is defined as "the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on the earnings per share". It involves the use of funds obtained at a fixed cost in the hope of increasing the return to the shareholders. "The use of long-term fixed interest bearing debt and preference share capital along with share capital is called financial leverage or trading on equity".

Financial leverage may be favourable or unfavourable depends upon the use of fixed cost funds.

Favourable financial leverage occurs when the company earns more on the assets purchased with the funds, then the fixed cost of their use. Hence, it is also called as positive financial leverage.

Unfavourable financial leverage occurs when the company does not earn as much as the funds cost. Hence, it is also called as negative financial leverage.

Financial leverage can be calculated with the help of the following formula:

$$FL = \frac{OP}{PBT}$$

Where

FL = Financial leverage

OP = Operating profit (EBIT) PBT = Profit before tax.

Uses of Financial Leverage

Financial leverage helps to examine the relationship between EBIT and EPS.

Financial leverage measures the percentage of change in taxable income to the percentage change in EBIT.

Financial leverage locates the correct profitable financial decision regarding capital structure of the company.

Financial leverage is one of the important devices which is used to measure the fixed cost proportion with the total capital of the company. If the firm acquires fixed cost funds at a higher cost, then the earnings from those assets, the earning per share and return on equity capital will decrease.

12.13.3 Distinguish Between Operating Leverage and Financial Leverage

No.	Operating Leverage	Financial Leverage
1	Operating leverage is associated with investment activities of the company.	Financial leverage is associated with financing activities of the company.
2	Operating leverage consists of fixed operating expenses of the company.	Financial leverage consists of operating profit of the company.
3	It represents the ability to use fixed operating cost.	It represents the relationship between EBIT and EPS
4	Operating leverage can be calculated by	Financial leverage can be calculated by
5	A percentage change in the profits resulting from a percentage change in the sales is called as degree of operating leverage.	A percentage change in taxable profit is the result of percentage change in EBIT.
6	Trading on equity is not possible while the company is operating leverage.	Trading on equity is possible only when the company uses financial leverage.
7	Operating leverage depends upon fixed cost and variable cost..	Financial leverage depends upon the operating profits.
8	Tax rate and interest rate will not affect the operating leverage.	Financial leverage will change due to tax rate and interest rate.

Financial BEP

It is the level of EBIT which covers all fixed financing costs of the company. It is the level of EBIT at which EPS is zero.

Indifference Point

It is the point at which different sets of debt ratios (percentage of debt to total capital employed in the company) gives the same EPS.

12.13.4 Combined Leverage

When the company uses both financial and operating leverage to magnification of any change in sales into a larger relative changes in earning per share. Combined leverage is also called as composite leverage or total leverage.

Combined leverage expresses the relationship between the revenue in the account of sales and the taxable income.

Combined leverage can be calculated with the help of the following formulas:

$$CL = OL \times FL$$

Degree of Combined Leverage

The percentage change in a firm's earning per share (EPS) results from one percent change in sales. This is also equal to the firm's degree of operating leverage (DOL) times its degree of financial leverage (DFL) at a particular level of sales.

$$\text{Degree of contributed coverage} = \frac{\text{Percentage change in EPS}}{\text{Percentage change in sales}}$$

EFFECTS OF LEVERAGE ON SHAREHOLDERS' RETURNS

Financial plan is one of the vital decisions of a firm because a financial

plan affects the market value, cost of capital and shareholders return of a firm. The Proportion of Debt to Equity in the financial plan of a firm is called leverage. Since optimal debt ratio influences a firm's market value and shareholder's return, different firms use different debt ratio at different levels to maximize market value and shareholders return. Leverage has statistically significant effect on the shareholders' return and proper management of leverage can maximize the value of EPS

1. Operating Leverage Effect : % Change of EBIT is more than % Change in Sale

If % change of earning before interest and tax is more than % change in sale, this operating leverage will effect ROE positively because at this level, per unit fixed cost will decrease and small increase in sale will boost EBIT.

If EBIT will increase, ROE will also increase. After dividing % Change of EBIT with % changes in sales. We can take ratio of it and it indicates, how will change EBIT if changes will be done in sales. 2:1 of operating leverage means if 100% sales will increase 200% EBIT will increase. As interest is fixed cost, so with this ROE will increase.

A. Situation: High Operating Leverage:

Too high operating leverage is not good, it may be high risky.

B. Situation: Low Operating Leverage:

Low operating leverage may be useful when sale market is fluctuating.

2. Operating Leverage Effect : % Change of EBIT is less than % Change in Sale

Now see also second face when % changes of EBIT is less than % changes in sales, it means 200% sale will increase, 100% EBIT will increase if operating leverage is 1:2. This situation is less effective for enhancing ROE.

3. Effect of Financial Leverage on ROE

If we have to check real effect of leverage on ROE, we have to study financial leverage. Financial leverage refers to the use of debt to acquire additional assets. Financial leverage may decrease or increase return on equity in different conditions.

A. Situation: High Financial Leverage:

Financial over-leveraging means incurring a huge debt by borrowing funds at a lower rate of interest and utilizing the excess funds in high risk investments in order to maximize returns.

B. Situation: Low Financial Leverage:

Financial low-leveraging means incurring a low debt by borrowing funds. It may affect positively, if decrease the value of bought asset with this low debt.

4. Effect of High Operating leverage and High Financial Leverage

It will increase ROE but it is high risky also.

5. Effect of Low Operating leverage and High Financial Leverage

It is optimum combination for bringing optimum return on equity.

12.14 Risk and Leverage

Risk is the probability that the future revenue streams of a firm shall show a variation from the expected figures. The variation is normally on the negative or the lower side because a positive variation reduces the investment risk and a reduction of risk is always welcome.

For linkage with leverage, we can divide risk into two broad categories, i.e. business risk and financial risk. Business risk pertains to risks associated with day to day operations of the firm. For example, decisions made regarding purchase of raw materials, manufacturing expenses and administrative expenses change the business risk profile of the firm. These decisions have an impact upon the operational profitability of the firm, i.e. the profits before interest and taxes. Financial risk, on the other hand, is associated with introduction of fixed interest bearing debt obligations in the capital structure of the firm. These obligations create a prior charge on EBIT before distribution of post tax profits among the owners.

Relationship between Financial Risk and Financial Leverage

As the financial leverage increases, the breakeven point of the company increases and the company now has to sell more of its product (or service) in order to break even. High financial leverage increases the risk to banks and other lenders because of the higher probability of bankruptcy and the risk to stockholders because greater losses may be incurred if the company goes bankrupt. Increase in financial leverage increases, the risk to stockholders. because the higher leverage will cause greater volatility in earnings and greater volatility in the stock price.

12.15 Key Concepts

- Leverage: leverage refers to relationship between two variables as reflected in a unit change in one variable consequent upon a unit change in another variable.
- Capital Structure of a firm is a reflection of the overall investment and financing strategy of the firm.

12.16 Summary

- Capital Structure of a firm is a reflection of the overall investment and financing strategy of the firm. It shows how much reliance is being placed by the firm on external sources of finance and how much internal accruals are being used to finance expansions.
- Optimal capital structure means arrangement of various components of the structure in tune with both the long-term and short term objectives of the firm.
- The three Capital Structure Theories are-Net Income Approach, Net Operating Income Approach and Modigliani Millar Approach.
- Net income approach provides that the cost of debt capital, Kd and the cost of equity capital Ke remains unchanged when the degree of leverage, varies.
- Net Operating Income approach states that cost of the capital for the whole firm remains constant, irrespective of the leverage employed in the firm.
- Modigliani and Miller have restated the net operating income position in terms of three basic propositions:
  Proposition I - The total value of a firm is equal to its expected operating income divided by the discount rate appropriate to its risk class.
  Proposition II - The expected yield on equity, Ke is equal to Ko plus a premium.
  Proposition III - The cut off rate for investment decision making for a firm in a given risk class is not affected by the manner in which the investment is financed.
- Leverage: leverage refers to relationship between two variables as reflected in a unit change in one variable consequent upon a unit change in another variable.
  Leverage = Unit change in desired result
  Unit change in chosen variable

- Two major types of Leverages are: Financial leverage and operating leverage.
- Financial leverage measures the extent to which the cost of project has been funded by borrowed money as compared to owner's equity.
- EBIT -EPS Analysis indicates the projected EPS for different financial plans.

12.17 Questions and Exercise

1. What is the significance of capital structure? Describe its various kinds.
2. What points need to be kept in mind while deciding the capital structure of a firm?
3. Illustrate the difference between operating leverage and financial leverage.

- **Fill in the blanks**

1. _____ measures the extent to which the cost of project has been funded by borrowed money as compared to owner's equity.
   (Financial Leaverage, Operating Leaverage, Combined Leaverage)
2. _____ states that cost of the capital for the whole firm remains constant, irrespective of the leverage employed in the firm.
   (Net Income approach, Net operating Income approach, MM approach)
3. _____ provides that the cost of debt capital, Kd and the cost of equity capital Ke remains unchanged when the degree of leverage, varies.
   (Net Income approach, Net operating approach, MM approach)
4. According to the prepositions of MM Approach, The expected yield on equity, Ke is equal to Ko plus a _____.
   (Discount, Premium, Profit)
5. _____ may be defined as the company's ability to use fixed operating costs to magnify the effects of changes in sales on its earnings before interest and taxes.
   (Financial Leaverage, Operating Leaverage, Combined Leaverage)

[**Ans.** 1) Financial leverage, 2) Net Operating Income approach, 3) Net income approach, 4) Premium, 5) Operating leverage]

12.18 Further Reading and References

1. M.Y. Khan & P.K. Jain : Financial Management - Text and Problems; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
2. Prasanna Chandra : Financial Management - Theory & Practice; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
3. I.M. Pandey : Financial Management (2005); Vikas Publishing House Pvt. Ltd., New Delhi.
4. R.P. Rustagi : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
5. R. Charles Moyer, : Contemporary Financial Management; West Publishing Company. James R. McGuign & William J. Kretlow
6. Rajiv Srivastava & : Financial Management, Oxford University Press Anil Mishra
7. J.B. Gupta : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
8. Ravi M. Kishore : Strategic Financial Management - Taxmann Publication Pvt. Ltd.

UNIT - 13
CORPORATE TREASURY MANAGEMENT

13.1 Introduction
13.2 Objective
13.3 Objectives of Treasury Management
13.4 Role of Treasury Management and Benefits
13.5 Significance of Treasury Management Function
13.6 Functions and Scope of Treasury Management
13.7 Relationship between Treasury Management and Financial Management
13.8 Difference between Financial Management and Treasury Management
13.9 Treasury Organization: Picking The Right Model
13.10 Role and Responsibilities of Treasury Manager
13.11 Tools of Treasury Management
13.12 Environment for Treasury Management
13.13 Role of Information Technology in Treasury Management
13.14 Liquidity Management Vis-A-Vis Treasury Management
13.15 Regulation & Supervision of Treasury Operation
13.16 Treasury Control Mechanism
13.17 Treasury Operations in Banking
13.18 Key Concepts
13.19 Summary
13.20 Questions & Exercise
13.21 Further Readings & References

13.1 Introduction

Treasury Management is an activity associated with managements of cash and funds in an organisation. It is one of the core and most important activity of financial management and a finance manager should be aware about core aspects of treasury management.

Treasure management means "To plan, organise and control cash and borrowings so as to optimise interest and currency flows, and minimise the cost of funds " or in other words "the handling of all financial matters, the generation of external and internal funds for business, the management of currencies and cash flows, and the complex strategies, policies, and procedures of corporate finance" It involves ensuring that proper funds are available with the company at the time of outflow required & also that funds are not kept untilised for a good long time...this requires investing/disinvesting funds in open ended mutual fund schemes. The scope of Treasury management includes the management of cash flows, banking, money-market and capital-market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

NOTES

13.2 Objectives

The object of the study is enable the students understand -

- Objectives of Treasury Management
- Function and scope of Treasury Management
- Unit level
- Domestic level
- International level
- Treasury Management vis-a-vis Financial Management
- Role and responsibilities of Treasury Managers
- Tools of Treasury Management
- Zero based Budgeting
- Financial Statement Analysis
- Internal Treasury Control
- Environment for Treasury Management

13.3 Objectives of Treasury Management

We have noted above that the main function of a treasury manager is the management of funds. While managing these funds, the treasury manager seeks to fulfill the under-noted objectives:

1. Availability of funds in right quantity

The treasury manager arranges funds for the unit. It is the duty of the treasury manager to ensure that after the funds have been arranged in required quantity. The term quantity refers to the amount of funds required for day to day functioning of the unit. This quantity is available to the firm either as external loans or as internal generation.

The loans quantity is arranged in the form of working capital treasury against the security of inventory and trade receivables.

Availability of funds in the right quantity is the core objectives of treasury management. Alongside, the treasury manager has also to ensure that the funds are just adequate for the requirements, neither more nor less. In case funds are kept in excess of the requirement, the excess portion imposes an opportunity cost over the system, i.e. the cost represented by the earnings which these funds would have obtained instead of being left idle. Again, the adequacy of funds has to be determined carefully. For this purpose, the cash flows for the relevant period have to be accurately charted out. Cash flows are the actual cash flows in this case as there can be a lag in terms of less realization of the projected flows. Thus actual cash flows only have to be considered while determining adequacy. Further, while actual inflows should be ascertained, as regards outflows a margin of contingency should be maintained to take care of the uncertainties. Cash is understood here to include both cash and bank balances plus that portion of highly liquid securities that can be converted into cash within a stipulated time period.

2. Availability of funds at right time

The requisite funds for day-to-day working of the firm should be available in time. Timely availability of funds smoothens the operations of the firm and brings about certainty to the quantum of inflows that would be available at a particular point in time. What is timely is a relative matter dependent upon the situation of each case. Again the inflows have to be actual inflows at the determined time and not projected or anticipated flows. This is because the element of uncertainty has

to be accorded due consideration. In case of a firm having a large number of transactions, timely availability of funds is extremely important because the execution of many transactions would be dependent upon funds position. This is relevant also for transactions involving foreign exchange. For the purpose of treasury operations, we consider foreign currencies at par with the domestic currency. It is assumed that the regulatory mechanism for holding foreign currency and domestic currency is the same and there is no constraint on holding or converting currencies. For foreign exchange transactions, funds have to be made available for meeting many critical situations. The treasury manager ensures that all the receipts of funds are credited to the account of the firm well in time. Another way of ensuring timely availability of funds is to park short-time surplus funds in liquid securities which can be sold conveniently and quickly to realize cash. In this way, availability can be ensured without straining other resources.

3. Deployment of Funds in right quantity

Just as procurement of funds in right quantity is important for a treasury manager, equally important is to ensure that the right quantity of funds is deployed. By deployment of funds, we mean earmarking of funds for various expense heads, parking of short-term funds and investing surplus funds.

The expense heads can be capital expenditure and revenue expenditure. Capital expenditure involves allocation of funds for acquisition of fixed assets. The amount involved per transaction in capital expenditure is large and such expenditure is usually known well in advance. Revenue expenditure on the other hand is routine expenditure for purchase of raw materials and making payment for utilities, wages and other miscellaneous items. The number of transactions for revenue expenditure is large and the amount involved per transaction is smaller as compared to the capital expenditure. Some items of revenue expenditure are in the form of cash payment but the capital expenditure is mainly through bank account.

For deploying the right amount of funds, the treasury manager has to keep track of all receipts of funds.

Simultaneously, the time table of deployment of funds is to be drawn up. In this time table, the payees are prioritized according to the urgency of their payments. There are certain expenses like important raw material payments, utility payments etc. which have to be accorded top priority over others. Other payments like payment to capital goods suppliers and financiers have also to be arranged in the right quantity. Apart from these payments, some extra funds have to be kept available for meeting contingencies. The sum of all these deployments makes the right quantum of funds to be deployed. For making the right development of funds at right time, it is necessary to have a close tie-up with different department i.e. Purchase department, HR Department. Without this type of tie-up, right quantity of funds cannot be deployed.

If the deployment is not in right quantity, the result can either be under deployment resulting in higher cost of funds or over deployment resulting in funds remaining idle. In case all the requirements of deployment of funds have been met and procurement of funds has been done in the right quantity, there is a possibility that some amount of funds would remain in surplus with the treasury department. This surplus would be in excess of the contingency requirements and as such can be deployed further on short term or long term basis depending upon the quantum of funds. If the quantum of surplus is large enough, some amount from this can be earmarked for long term deployment in investments etc. otherwise the entire surplus can be parked in short term securities.

Deployment of the right quantity of funds cannot be achieved in case the procurement of funds has not been done in right quantity in the first place. This is because ultimately the inflows of funds shall be utilized for feeding the outflows on

NOTES

whatsoever account. If the deployment has been done rightly, there shall be no bottlenecks in the funds flow of the firm. The allocation and use of funds follow each other in a cyclical manner and both have to be done in the right quantity for optimal use of the funds.

4. Deployment of funds at right time

A logical corollary of sourcing funds at the right time is that the funds should be deployed at the right time. The description of the right time is a relative term and what amount of time is appropriate varies from firm to firm. The span of time varies from a week to a month in case of purchase of fixed assets. However, in working capital deployment, the range of time allowed may be quite narrow - say 2-3 days only. The treasury manager has to honour the outstanding commitments on working capital account within this short span of time. Payment for wages and utilities etc. has to be made in time to avoid any defaults. Similarly, payment to trade creditors, domestic and overseas, has to be made within a stipulated short period of time for avoiding interest payments etc.

Timely disbursement ensures that the funds are not left idle for the shortest span of time. In case the sourcing and deployment of funds is well organized, surplus of funds shall soon start emerging which can be deployed in short term liquid investments. However, if the inflow and outflow of funds is not evenly matched in the time dimension, bottlenecks and mismatch of funds are sure to emerge. Apart from causing administrative problems and rationing of funds, such a situation also leads to increase in cost of funds. Thus the treasury manager seeks to avoid such situations. Timely deployment of funds is a well planned activity requiring intra-organisation coordination and liaison with banks and financial institutions apart from forex dealers.

5. Profiting from availability and deployment

One of the prime objectives of a treasury manager is to ensure timely procurement of right amount of funds and timely deployment of right amount of funds. This objective results in administrative smoothening and paves way for easier achievement of performance targets of the firm. Modern day treasury manager has another objective, which is to profit from such sourcing and deployment. Profit from this function is derived as under:

Sourcing of funds at the right time and in right quantity is a result of realization of debtors and financing of borrowings. Realisation of debtors in time has a direct impact upon profitability of the firm through decrease in cost of holding debtors. Financing of borrowings is a capital structure decision but the actual availment of these borrowings is the domain of the treasury manager. Adequate and timely utilization of the borrowed funds results in the avoidance of strain on other sources of funds.

Once the funds have been sourced in correct measure, the deployment adds further to the profitability of the firm it has been done in tandem with the pace of sourcing. Correct deployment ensures that there is no unnecessary accumulation of funds in the firm at any point in time. Needs of every department are met as per schedule. This action results in avoidance of special and extraordinary costs, interests and the like. With costs being in control, surplus funds emerge from the system which is deployed profitably either as long term investments or as short term parking tools. Both ways, the net result for the firm is an addition to profits.

13.4 Role of Treasury Management and Benefits

In its broadest sense Treasury covers cash management, corporate finance and financial risk management. Closer inspection reveals that the Treasury function undertakes a range of complex and skilled tasks; liaises with internal and external

stakeholders and plays a key role in the smooth functioning and value creation of an organization.

13.5 Significance of Treasury Management Function

NOTES

The Treasury function in any corporate has always been important in making sure that the business has sufficient liquidity to meet its obligations, whilst managing payments, receipts and financial risks effectively. With the ever increasing pace of change to regulation, compliance and technology in the financial sector, Treasury has increasingly become a strategic business partner across all areas of the business, adding value to the operating divisions of the company: for example, working with the sales department to establish good financial contract terms so that any trade discounts offered and the payment method agreed are beneficial to the business.

Current market conditions also reinforce the need for corporates to ensure that their financial position is managed as efficiently as possible, with no excess working capital tied up in the business - the old adage 'cash is king' is certainly as relevant today as it has always been.

Treasury departments need to cover the complete financial environment; from capital structure and long term investments to liquidity and working capital management. If Treasury can drive improvements in the Purchase To-Pay and Order-To Cash cycles, there can be a direct effect on the overall debt and investment requirements and thus on the capital structure required in the business.

CHECK YOUR PROGRESS

What are the objectives of Treasury Management?

The question then is: if the Treasury function is becoming more of a business partner, how can the department manage its time to ensure that day to day administration, processing and transaction execution is completed using the minimum of resource? The answer is that larger companies automate the majority of their daily financial processing and administration tasks, supported by policy standards, control and monitoring processes, embedding financial best practices across the whole business. Integrating corporate systems with those of their banks can achieve significant levels of automation, reducing the amount of time that needs to be spent on tasks such as calculating the daily cash position.

At the same time, the efficient use of secure systems can minimise operational risk, increase operational security and maximise straight through processing. Add to this automatic reconciliation of bank account data and Treasury can then manage exceptions rather than every item, giving them the time to devote to delivering value-added services across the company.

13.6 Functions and Scope of Treasury Management

Government sector, business sector and the foreign sector are the major sectors of country's economy. For macro operations of these sectors, there is requirement of cash, currency and credit. In broader terms, all financial resources including foreign exchange are to be made available to the industrial or business units.

Similarly, at the macro level return flow of funds in the form of taxes and repayment of loans is needed. Such to and from movement of funds is part of the financial functioning.

Any business enterprise requires finance to start business operations. The first requirement is in the form of capital for setting up of the project. Project finance needs long term funds. These funds can be obtained from equity and debt both. Equity and internal accruals are considered the owners' contribution whereas debt is treated as the outsiders' stake in the project. Once the company starts operations of production and manufacture, it needs working capital funds also.

NOTES

These funds are required to meet the payments for raw materials and other inputs, spares, utilities etc. The quantum of funds needed for working capital depends upon nature of the company's business and nature of its products or services.

The function of treasury management is concerned with both macro and micro facets of the economy. At the macro level, the pumping in and out of cash, credit and other financial instruments are the functions of the government and business sectors, which borrow from the public. These two sectors spend more than their means and have to borrow in order to finance their ever-growing operations. They accordingly issue securities in the form of equity or debt instruments. The latter are securities including promissory notes and treasury bills which are redeemable after a stipulated time period. Such borrowings for financing the needs of the government and the business sector are met by surplus funds and savings of the household sector and the external sector.

These two sectors have a surplus of incomes over expenditure. The micro units utilize these surpluses and build up their capacities for production of output and this leads to the productive system and distribution and consumption systems.

No company can operate in a vacuum. Its assets are both financial and human. As such, there are both quantifiable and non-quantifiable factors involved in financial performance, forecasting and achievement of targets. The company's treasury manager is the pivot around which day to day operations of the company revolve. His operations and performance have an impact on the company itself and the financial system and the economy in the broad sense. An analysis of the sources of funds of business units reveals that broadly there are three categories of resources - internal accruals of the unit, external sources from the capital and the money market and the external sources. The same analysis holds good at the sectoral and national level. In fact, the emergence of international financial markets can be traced to this sectoral inter-dependence, including the foreign sector and intra-national dependence. Basically, as no country is self-sufficient, international economic and economic relations emerge.

In a similar fashion, it would be appropriate to set out the pattern of use of funds of any company into various sectors of the economy, including the foreign sector. Dispensation of funds for current or capital expenditures in domestic and international markets can be separately set out. Such an analysis is particularly more relevant to multinational corporations and branches or subsidiaries of foreign companies in whose case foreign markets and foreign sources of supply play an important part. The head office or the holding company may spend apart of its funds in investment in the host country, make inward remittances for working capital or investment purposes and outward remittances for royalty and dividend payments or technical fees.

International financial markets emerged out of the need to facilitate operations of nations arising out of commercial and financial transactions with the rest of the world. This emergence can be attributed logically to the interrelations of the economic unit with the corporate sector and of the latter with the other sectors of the economy, including the foreign sector. It would be apt to set out here the inter-relations between micro level operations of a treasury manager with the macro level working of the corporate sector and foreign sector. A treasury manager is a micro unit in the financial sector. The environment he faces is competition from other similar units in the corporate sector. Besides this, the corporate sector, in turn, is inter-linked with all other sectors of the economy.

The treasury manager is thus faced with a total environment of the economy which includes foreign sector and it is thus necessary for him to be familiar with the international financial system, as much as to the domestic financial system.

(1) Scope of Treasury Management of Unit Level

At the unit level, the treasury manager's activities encompass all other

management functions. The performance of production, marketing and HRD functions is dependent upon the performance of the treasury department. The lubricant for day-to-day functioning of a unit is money or funds and these funds are arranged by the treasury manager. The treasury is involved in all the budgeting activities of the unit, whether these are financial budget, costing budget, the marketing budget or the HRD budget. The feedback available from interactions with the various departments of the company is utilized by the treasury department to fine tune the overall performance targets of the company within the constraints of availability of currency, cash and cash equivalents.

Treasury manager also monitors the cash flows of the unit on a continual basis. It is ensured by him that adequate funds are made available for day-to-day working of the unit. In case there is genuine shortfall in cash flows, the outflows are made in an order of priority with the more urgent payments being made first. The treasury manager has two duties of taking decisions both in the areas of cash inflows and outflows. He has to integrate the treasury function with with the production and marketing functions. The scope of the treasury management function at the unit level can be better described in the following routine duties of the treasury manager:

1. Keeping a track, on monthly, fortnightly or weekly basis, of all cash inflows and outflows and their variance with budget projections.
2. Maintaining a record of all receivables and payables, credit instruments, credit sales, deposits, loans and advances etc.
3. Study regularly the quantity and quality of current assets and liabilities and position of current liquidity.
4. Assess from time to time the long-term and short-term solvency of the company and its overall solvency position.
5. Keep liaison with stock exchanges, where the shares of the company are listed for a study of the share price movements.
6. Keep liaison with banks and financial institutions for ant change in borrowing limits or to inform them of any imminent changes in company's financial position or policies. Payments of interest and instalment of principal are to be arranged at the right times.
7. Keep liaison with Registrar of Companies and government departments concerned with the investment and financing decisions for any information regarding policy changes.
8. Keep abreast with all legal and procedural requirements for raising funds and investment decisions.
9. Keep the top management or the board informed of any likely changes in the financial position of the company due to internal factors.

(2) Scope of Treasury Management of Domestic Level

At the domestic or national level, the scope of treasury management function is to channelise the savings of the community into profitable investment avenues. This job is performed by the commercial banks. Treasury management is a crucial activity in banks and financial institutions as they deal with the funds, borrowing and lending and investments. By nature of their activity, they earn their profits through operations in money or near money claims. They borrow from the public in the form of deposits which along with other borrowings constitute their liabilities. Their assets are mostly in the form of loans, advances and investments. As their liabilities are mostly of short and medium term nature, funds management becomes critical for ensuring a proper matching of assets and liabilities according to the maturity of each and their costing. Commercial banks being the creators of

NOTES

credit have an additional responsibility of maintaining their image of creditworthiness, safety and integrity.

Commercial banks are also required to observe capital adequacy norms and provide for non-performing assets on a strict basis. Thus there are limits to which the banks can expand their credit portfolio. Banks are also enjoined by regulations to maintain Cash Reserve Ratio (CRR) of a minimum of 3% and Statutory Liquid Ratio (SLR) of 25% of their net demand and time liabilities. While the CRR is required to be maintained with the RBI in the form of cash balances, the SLR is to be maintained in the form of investment in central and state government securities. It has been observed that during times of slack credit demand, banks invest in govt. securities to a higher extent than the statutory requirement of 25% of net DTL. This activity is more pronounced when the interest rates are falling because the yields on govt. securities fall in such a period, driving up their prices. Banks, which do their treasury management astutely, stand to gain tremendously during such periods.

The gilt edged market has two forms-primary and secondary. The primary market is a wholesale market where RBI is the underwriter and allots the securities to applicants on behalf of the government. On the same basis, the RBI sells the repos (or repurchase agreements) of government securities to the institutions, banks, etc. to meet the market demands. The interest rates are decided by the discounts quoted in these bids and these are market related rates. In the primary market, RBI sells securities to banks, FIs, PF trusts, etc. RBI as the underwriter of of government securities, makes up for any shortfall in subscription for them. But in the case of state government securities, it only arranges for subscription.

The main features of the primary market are listed below:

- New borrowings to be made on behalf of govt. is decided by RBI and terms such as tenor and coupon rates are announced.
- The RBI acts as underwriter and contributes to the loans unsubscribed by the public. Work of the RBI is shared with a class of primary dealers.
- The timing and conditions, and the amounts involved are discussed by RBI with banks and FIs and sometimes prior commitments are enlisted.
- The floatation of bonds is effected throughout the year depending on the conditions of the market and requirements of the government.
- The timing and quantum is also adjusted having regard to overall liquidity in the market.
- The subscription to the loans can be in cash as also in the form of rolling over of existing securities which have fallen due for repayment.

In the secondary market, which is a retail market, trading is over the counter. Main operators in the secondary market are the Discount and Finance House of India (DFHI), banks, FIs, PFs etc. This market is an over-the counter (OTC) market where trading is done through phones, fax etc.

The concept of yields is important for understanding of the government securities market. Yield, as we know, is the rate of return on an investment. In case of lending made by the banks, they stipulate a rate of interest per annum which becomes the benchmark for their return. The actual yield may vary from the benchmark depending upon whether the periodicity of interest is monthly, quarterly or half yearly basis. In case of government securities, however, the yields are determined on the basis of the price at which the security is auctioned in the primary market or the prices determined in the secondary market through sale and purchase.

Nominal Yield

Coupon rate is the rate of interest payable per annum per Rs. 100/- or the face value. If the purchase price is different from the face value then the return is equal to (coupon rate/purchase price) x 100. This return is called the normal yield.

Real Yield

Nominal yields deflated by the index of inflation rate, such as WPI or CPI will give real yields, which reflect the true purchasing power of the return on these securities.

Net Yield

Nominal yields adjusted for the tax rate or payment of relevant taxes at which deduction of tax at source takes place are called the net yield.

Current Yield

Coupon rate is the rate at which the bond carries interest. This is the nominal yield payable on on the face value of the bond regularly and remains unaltered, say, for example 7.75% loan 2005. Current yield is equal to (coupon rate x face value)/ cost or market price.

Redemption yield or yield to maturity

This takes into account the price paid for the bond, length of time to maturity and the coupon rate of the bond.

This is the yield which the holder gets per annum if he holds it until maturity and is the same as current yield if the bond is purchased at par. Redemption yield is equal to current yield +/- average annual capital gain or loss (for the bond purchased at a discount or premium as the case may be).

RBI is responsible for public debt management of the government. It does this by underwriting and subscription to new issues not subscribed by public, by use of Open Market Operations (OMO) as a technique of sale and purchase of government securities to control the liquidity and the interest rate structure and by use of SLR and CRR as the method of controlling the liquidity of banking system and their contributions to government debt.

(3) Scope of Treasury Management of International Level

At the international level, the function of treasury management is concerned with management of funds in the foreign currencies. Foreign exchange as a subject refers to the means and methods by which the rights to income and wealth in one currency are converted into similar rights in terms of another country's currency. Such exchanges may be in the form of one currency to another or of conversion of credit instruments denominated in different currencies such as cheques, drafts, telegraphic transfers, bills of exchange, trade bills or promissory notes. Exchange is done through dealers in foreign exchange regulated by the central bank of a country. Banks are usually the dealers apart from other specialized agencies.

One of the important components of the international financial system is the foreign exchange market. The various trade and commercial transactions between countries result in receipts and payments between them.

These transactions are carried out in the currencies of the concerned countries? any one of them or in a mutually agreed common currency. Either way, the transactions involve the conversion of one currency to the other. The foreign exchange market facilitates such operations. The demand for goods and services from one country to another is the basis for demand for currencies in the market. Thus basically, demand for and supply of foreign currencies arises from exporters or importers or the public having some transactions with foreign countries.

NOTES

Companies having an import or export component in their business profile have to frequently deal in forex operations. Forex operations in a country being supervised by the central bank, reference to the central bank in one form or the other is necessary to use foreign exchange. If the country on the whole is a net exporter of goods and services, it would have a surplus of foreign exchange. If, on the other hand, it is a net importer then it would have a shortage of foreign exchange. The extent of regulation of the forex market depends upon the availability of foreign exchange in a country. If the forex is scarce, then holding and using it would be subject to a lot of regulatory control. It also matters whether international trade forms a significant percentage of the GDP of a nation. If it is so, then the awareness about forex regulations would be much more widespread as compared to a situation when foreign trade forms an insignificant portion of GDP. Presently, however, with increasing globalisation, forex dealing has become a normal part of treasury operations.

Every foreign exchange transaction involves a two-way conversion - a purchase and sale. Conversion of domestic currency into foreign currency involves purchase of the latter and sale of the former and vice versa. These transactions are routed through the banks. The transactions take the shape of either outright release of foreign currency for meeting travel and related requirements or payments to outside parties in the denominated currency via the medium of correspondent banks. For effecting payment, following instruments are generally used:

CHECK YOUR PROGRESS

What are the functions of treasury management?

Telegraphic transfers (TT)

A TT is a transfer of money by telegram or cable or telex or fax from one center to another in a foreign currency. It is a method used by banks with their own codes and correspondent relations with banks and abroad for transmission of funds. It involves payment of funds on the same day, it is the quickest means of transmission of funds. As there is no loss of interest or capital risk in this mode, it enjoys the best rate for the value of receipts.

Mail Transfers (MT)

It is an order to pay cash to a third party sent by mail by a bank to its correspondent or branch abroad. It is issued in duplicate, one to the party buying it and the other to the correspondent bank. The amount is paid by the correspondent bank to the third party mentioned therein in the transferee country by its own cheque or by crediting the party's account. As the payment is made after the mail advice is received at the other end, which will take a few days, the rate charged to the purchaser is cheaper to the extent of the interest gain to the seller bank.

Drafts and cheques

Draft is a pay order issued by a bank on its own branch or correspondent bank abroad. It is payable on sight but there is always a time lapse in the transit or in post between the payment by the purchaser of the draft to his bank and the receipt of the money by the seller in the foreign center. As in the case of MT, there is risk of loss of draft in transit or delay in release of payment to the beneficiary and loss of interest in the intervening period.

Bills of exchange

It is an unconditional order in writing addressed by one person to another, requiring the person to whom the order is addressed, to pay certain sum on demand or within a specified time period. If it is payable on demand, it is called a sight bill. If it is payable after a gap of some time, it is called a usance bill. Such bills can be bankers' bills or trade bills. Bankers' bills are drawn on banks abroad while trade bills are made between individual parties.

There are four major components of the forex markets, depending upon the level at which the transactions are put through. These can be either

- Banks with public
- Inter-bank deals
- Deals with correspondents and branches abroad
- Deals with RBI.

In the market, there is no physical exchange of currencies except in small denominations when travelers and tourists carry them across national borders. The medium of exchange is credit instruments or book entries in the books of concerned banks.

Exchange rates can be spot rates or forward rates. If an importer is paying on receipt of documents, then he can buy a foreign currency say dollars on spot basis. It means that the exchange of Indian Rupee and Dollars is proceeding on current basis. But if the importer agrees to pay three or six months hence, his demand for dollars might arise only after three or six months. In such a situation, the transaction is carried out through forward transaction. The exchange of Rupee and Dollar is to take place after the stipulated time period, though the exchange price has been pre-decided.

Just as the banks are buying and selling spot, they also do business in forward currencies. Corresponding to the spot rate of exchange, there is a forward rate for various periods. Currencies sold or bought in forward are subject to the influences of interest rates? both domestic and international. Forward rates also depend upon the relative position of currencies vis-à-vis other currencies. Hence there is an implicit risk that the forward rates contracted today may be different from actual spot rates that would prevail three or six months hence. If any bank succeeds in forward purchases with forward sales of the same currency, it avoids exposure to the exchange rate risk. If the forward sales and purchases do not match, the bank may have an uncovered position which it may cover with another bank which has a contrary position. If it fails to cover with a bank, it may still do so with the central bank of the country or with a correspondent bank abroad. If a bank takes a position uncovered, it may take a calculated risk in the hope that the rate may move in its favour or else it may have to bear the exchange rate differential.

When foreign exchange markets operate in a free manner, the assumption is that the exchange rates between various currencies would be quoted at the same level at all the trading centers throughout the world. But it seldom happens and at the best of times, there are discernible differences in exchange values across centers.

Banks and other dealers take advantage of these differences and profit from the rate difference. This operation is called arbitrage. For example, if the Dollar-Euro parity is 1.00 in New York and 1.05 in Frankfurt, then a dealer can sell Euros in Frankfurt, purchase Dollars and with the Dollars, buy Euros again in New York thereby profiting from the deal.

Operations in the forex market are exposed to a number of risks. These risks are as follows:

- Credit risk arising out of lending to a foreign borrower whose credit rating is not known for certainty.
- Currency risk of trading in a currency whose stability and strength is known to fluctuate.
- Country risks involved in dealing in the currency of a country whose political and economic stability is uncertain.
- Solvency risks due to mismatch between current assets and liabilities of

dealers and resultant default in meeting forward commitments.

In India, commercial and most of the co-operative banks have been authorized to deal in foreign exchange.

Banks finance huge amount of foreign trade. This trade is conducted on daily basis through purchase and sale of foreign currencies. The demand and supply of active currencies is matched by the banks from their own stock. There are cases when the bank needs some currencies or has a surplus of such currencies. These needs are met by buying or selling such currencies to the RBI.

The foreign exchange department of every bank draws up a position sheet for each currency daily in which purchases and sales of the currency are recorded. The banks generally avoid taking any exchange risk by covering uncovered balances at the end of the day. When the purchases exceed sales, the credit balance is plus and the position is overbought. This is to be covered by equal sales of that currency. When the sales exceed purchases, it is a situation of overselling and the same is covered by purchases of that currency.

A typical dealer in Forex may be a bank having the controlling and supervisory authority and the head office. Actual dealings in forex would take place through authorized branches. At these branches, there are dealing dooms and back office operations. Dealing room would perform the following functions normally:

- Quoting, negotiating and fixing rates of exchange for larger sized customer transactions involving purchase or sale of foreign currencies.
- Arranging cover against purchase and sale of foreign currencies.
- Trading on own account, i.e. purchase/sale of foreign currencies for profit.
- Mobilisation of required foreign currency funds by swapping arrangements or purchases from other dealers.
- Accepting customer forward contracts for purchase/sale of foreign currency and arranging cover against the same.

The back office operations would comprise of the following:

- Consolidation of all exchange deals and provide cover operations
- Analysis of the structure of the deals for determining the future rates.
- Processing of inter-bank deals, sending or receiving contract notes or confirmation of deals.
- Follow-up work on contracts
- Transfer of funds to correspondents and their branches.

13.7 Relationship between Treasury Management and Financial Management

Finance function is a key element in the corporate activity. Its main objective is to keep the firm in good financial health. To secure financial health, the finance manager has to perform the following functions:

- Investment functions and decisions
- Financing function and decisions

Investment function elates to the efficient use of funds in alternate activities. The aim is to allocate funds to each activity so as to obtain optimal returns from such allocation. The short-term and long-term investment strategy has to be planned in line with the objective of maximization of wealth of shareholders. The utilization

of funds, as and when they accrue, should take care of two prime considerations. The first consideration is that there should not be any idle funds and second consideration is that there should be no threat of liquidity crisis. Idle funds have their 1own cost and it results in lowering of profitability. Extreme tightness of funds, on the other hand, raises the specter of default and loss of commercial reputation. So a delicate balance between these two conflicting objectives has to be maintained by the finance manager. It is in this context that the function of finance becomes crucial to the survival and growth of a firm.

The financing function refers to the securing of right resources of funds at an appropriate cost and at the right time. Here the decision is to be taken about the least cost combination of funds for capital requirements and for working capital needs. Whether owners' equity should be used for financing or should the firm resort to external financing? If owners' equity is to be arranged, what returns are to be assured? If borrowing has to be done, then what rate of interest is to be paid?

In line with the twin objectives of investment and financing, the finance manager has to take responsibility for all decisions pertaining to these areas. In the finance function, a macro view of the requirements and uses of funds is to be taken. The finance manager has to arrange the funds within the approved capital structure of the firm.

The funds may be debt or equity. Once the funds have been arranged, it is left to the treasury function to utilize these funds according to the approved parameters. Financial management is also concerned with the overall solvency and profitability of the firm. By overall solvency, we mean that the funds should be able at all times to meet its liabilities. The liabilities can be short-term or long-term. The long-term liabilities pertain to payment of long-term borrowings. Internal liabilities like payment to shareholders are a matter of consideration once external solvency has been attained by the firm. Profitability means that the firm should run its affairs profitably. It may be possible that some segments of the firm may at times face strain upon their profitability due to macro-economic or internal causes. But the firm should be in a position to earn reasonable return on its investment on the capital employed. Capital employed, as we know, is the sum of own funds and borrowed funds. Profitability of operations of the firm means that both the own funds and borrowed funds generate adequate surpluses for the firm. This can be ensured by investing the funds in such projects which provide optimal returns.

The treasury function is concerned with management of funds at the micro level. It means that once the funds have been arranged and investments identified, handling of the funds generated from the activities of the firm should be monitored with a view to carry out the operations smoothly. Since funds or cash is the lubricant of all business activity, availability of funds on day to day basis is to be ensured by the treasury manager. The role of treasury management is to manage funds in an efficient manner, so that the operations in the area of finance are facilitated in relation to the business profile of the firm. The treasury function is thus supplemental and complemental to the finance function. As a supplemental function, it reinforces the activities of the finance function by taking care of the finer points while the latter delineates the broad contours. As a complementary function, the treasury manager takes care of even those areas which the finance function does not touch. Looked at from this point of view, the treasury function integrates better with manufacturing and marketing functions than the finance function.

This is because the treasury department of a firm is involved in more frequent interaction with other departments.

For the purpose of performing this role, the treasury manager operates in various financial markets including the inter-corporate market, money market, G-sec market, forex market etc.

NOTES

13.8 Difference between Financial Management and Treasury Management

Following differences can be observed between financial management and treasury management:

1. Control Aspects

The objective of financial management is to establish, coordinate and administer as an integral part of the management, an adequate plan for control of operations. Such a plan should provide for capital investment programs, profit budgets, sales forecasts, expenses budgets and cost standards.

The objective of treasury management is to execute the plan of finance function. Execution of the plan takes care of the issues arising in routine operations of the firm which have a bearing upon the funds position.

Thus the finance function of a firm would fix the limit for investment in short term instruments for a firm for example. It is the treasury function that would decide which particular instruments are to be invested in within the overall limit having regard to safety, liquidity and profitability. Again, the finance function would arrange the borrowed funds for the firm but the treasury function would take care of day-to-day monitoring of the funds.

2. Reporting Aspects

Financial management is concerned with the preparation of overall financial reports of the firm such as Profit and Loss account and the Balance Sheet. It also takes care of the taxation aspects and external audit. Based upon the performance of the firm, budgets for the ensuing years are fixed. The reports are submitted to the top management of the firm.

Treasury management is concerned with monitoring the income and expense budgets on a periodic basis visà-a-vis the budgets. The budgets are fixed department/ segment wise so as to dovetail with the overall corporate budgets. Variances from the budgets are analysed by the treasury department on a continual basis for taking corrective measures. The corrective measures that can be taken are pointing out of discrepancies to departmental heads and refuse payments that are not according to approved procedures and guidelines. The treasury department is also involved in the internal audit of the firm.

3. Strategic Aspects

The finance function is involved in formulating overall financial strategy for the firm. The top management chooses the line of activity for the firm. The finance function firms up the investment and financing plans for the activity.

The strategic choices before the financial manager are the options of investment and financing. While making these choices, the finance manager is taking a long-term view of the state of affairs. It is just possible that the business of a firm may not be profitable in the initial years but it does not mean that the choice regarding investing has been strategically incorrect. In fact, there are many mega projects where the gestation period is even upto seven years. But given the correctness of the original assumptions, performance of the finance function would be measured by the number of years that gets reduced in breaking even.

Strategy for treasury management is more short-term in nature. The treasury manager has to decide about the tools of accounting and development of systems for generation of controlling reports. The maintenance of proper systems of accounting is one of the objectives of treasury management. Another strategic objective for treasury management would be maintenance of short-term liquidity. This is done through regulation of payments and speedy realization of receivables.

4. Nature of assets

The finance manager is concerned with creation of fixed assets for the firm. Fixed assets are those assets which yield benefit to the firm over a longer period of time. It can be said that the time span of a project coincides with the span of the fixed assets. In case the fixed assets have depreciated physically by a significant measure, then a decision has to be taken for upgradation and replacement of the assets.

The treasury manager is concerned with the net current assets of the firm. Net current assets are the difference between the current assets and current liabilities of the firm, both normally realizable within a period of one year.

Current assets should always be more than the current liabilities for ensuring liquidity of the firm. Current assets are the inventory, receivables and cash balances. Current liabilities are the trade creditors, statutory payables and loan repayables within one year. To ensure a healthy level of net current assets, the treasury manager is to ensure that the quality of the assets does not deteriorate.

As regards investments, the finance manager is concerned with long-term and strategic investments. These investments could be funded from borrowed funds or from internal accruals. The investments are expected to be held over a longer period of time as such day-to-day monitoring of the investments is not required. The treasury manager is concerned with short-term investments. The tenor and quality of these investments has to be constantly monitored by the treasury manager for ensuring safety and profitability.

13.9 Treasury Organization: Picking The Right Model

Organisations have extended debates on the kind of treasury they should have. The common themes include services that the treasury should offer, the right size or structure, and the right spread of management control There are many dimensions to the structure of a treasury organisation. Two key dimensions - range of services and extent of centralisation of management control - define resultant organisation models. The relationship between organisation models and factors that influence decisions on the right model to adopt.

There are various definitions of the word treasury. In its strictest sense, it refers to one function: asset liability management, especially when used in the context of banks. In a wider sense, treasury includes a whole range of activities encompassing various markets. A few significant activities are:

Asset liability management:

- Maturity mismatch;
- Interest rate and type mismatch; and
- Currency mismatch.

Sales and trading:

- Currency, interest rate, and credit products;
- Money market and long-tenure instruments; and
- Derivative products.

Risk management

- Back office processing, settlement, and accounting; and
- Customer and regulatory reporting.

Organisation Models: Dimensions

Any organisation can exercise its choice on the scope of the treasury functions it undertakes. In doing this, it may be governed by a variety of

considerations:

- It may choose to handle only those needs driven by utilitarian motives such as liquidity support or, on the other hand, it may consider treasury as a "core" organisational process and hence handle the full range of services.
- It may choose to outsource portions of the activities required or it may choose to foster these capabilities in-house.

Independently, an organisation can also decide on the extent of centralisation of treasury management:

- It may be efficient to centralise back office processing, while the front office may need to be decentralized to aid speedy local decision-making.
- It may be important to have a common risk management strategy, while execution may be decentralised.

A study of common practices relating to the two key influencers - the range of activities supported and the degree of centralization or decentralisation - at treasury organisations globally suggests four models.

1. Full Service Global

Full service refers to a treasury that undertakes most, if not all, of the activities of treasury management. Global treasury refers to one that either operates as the only treasury for all markets across the globe, or ultimately combines all regional or local treasuries (that may exist due to legal or regulatory reasons) into a central treasury for pooling risks, for policies or strategies, or for both these. In this sense, management of the treasury function in this model is very much centralised. Although this model readily lends itself to global organisations, it could also be used by local businesses that need to access global markets.

2. Full Service Local

In this model, each treasury is a self-contained local unit dictated purely by the needs of the local business.

Thus, the treasury management function is, by and large, decentralised. While this sort of treasury is usually the norm for a business with a local or regional spread, it may be adopted for a global organisation that operates as a collection of highly independent business units. Again, the range of services offered is the full gamut, as described in the full service global model above.

3. Limited Service Global

This model is different from the full service global model in that the range of services offered is limited. This could largely be due to the fact that certain activities are kept outside the purview of treasury and are handled directly by business units because the scale of these activities is not large enough to warrant the attention of the central treasury. Examples are treasuries with limited or no foreign exchange trading activities, with the exposure being either managed directly by the concerned export or import department or not managed at all. For those activities that are included in the treasury in such a model, pooling is at a central level.

4. Limited Service Local

This model is akin to having virtually little or no treasury activities, beyond local cash and liquidity management.

These are very small decentralised treasuries where the concerned managers may also have other responsibilities in the finance department.

13.10 Role and Responsibilities of Treasury Manager

The overall finance function starts with capital structuring, scouting for the least cost combination of internal and external capital for financing of the project and forecasting the sources and uses of funds. In this function, one has to coordinate with production and marketing functions and all others that constitute the management team.

The inflows and the outflows and their coordination and synchronization and meeting any gaps are the functions of the finance manager. The treasury manager has a larger role of coordinating the apparently routine, yet significant activities of the firm. The activities are apparently routine because a sense of repetition is involved in these activities. Nevertheless, the activities are significant because smooth functioning of these activities paves the way for eventual solvency and profitability of the firm. The role and responsibilities of the treasury manager may be described as follows:

Role of a treasury manager

A treasury manager has a significant part to play in the overall functioning of the firm. At any point of time he is engaged in a number of roles played. While the production manager or the marketing manager may be involved in limited roles pertaining to their own fields, the roles of treasury manager intermingle with and overlap other role sets. In any business entity which is engaged in marketing, a treasury manager could be performing a variety of roles. The expected roles to be carried out by him would be slightly less in number in case the firm is engaged in service activity but that does not deride the importance of treasury manager for a services organization.

The treasury manager has the following roles:

(a) Originating roles

The treasury manager inducts and originates system of accounting for the firm. Routine accounting of the firm is then carried out along these established systems. These systems are the pivot around which the functioning of the unit revolves. For operations of these systems, the treasury manager compiles exhaustive operations manual for the guidance of the users. It is expected that all the users shall comply with all important disclosure requirements for endorsing the integrity and validity of the systems.

(b) Supportive Roles

The second role expected from a treasury manager is a supportive role. In this role, the treasury manager supports the activities of other departments like manufacturing, marketing and HRD. The support is evidenced through a meaningful and constructive coordination with the other departments. While doing this, the treasury manager is acting as an extended arm of the finance manager. Allocation for expenses for every department is made by the finance manager in the annual budget. It is the duty of treasury manager to ensure that each department is able to spend the earmarked amount subject to completion of disclosure and documentation formalities.

(c) Leadership Roles

The treasury manager also has a leadership role to play. This role comes into play during times of exigency. An exigency could occur during times of systems

break-down. During such periods, the treasury manager has to make alternative arrangements for transaction processing. While doing this, he has to act like a leader and carry the team along with him. Another example of exigency could be a situation when the firm is face to face with a sudden and unexpected liquidity crunch. During such an eventuality, the treasury manager has to use his ingenuity and leadership skills for tiding over the crunch. These skills could take the shape of postponing and prioritizing payments and expediting recoveries.

(d) Watchdog Roles

The treasury department is the eyes and ears of the management. Every financial transaction passes through his accounting system. As a processor of all the financial transactions, he keeps a watch on suspected bungling and frauds in the firm. He sets an example for other departments of the firm by adhering to sound accounting practices and transparent dealings.

(e) Learning Roles

The accounting practices all over the world are in a state of constant flux due to evolution of new accounting concepts and technological changes. The treasury manager accepts these changes with an open mind and adopts the changes best suited to the organization. Simultaneously, he educates the other departments of the firm also about the changes.

(f) Informative Roles

The treasury manager is the source of information for the top management regarding performance of the firm vis-à-vis the budgets. For conveying this information, he develops a management information system suited for the organization. This system provides concise and timely information on all the relevant parameters which enable the top management to take decisions.

Apart from the above roles, the treasury manager has the under-mentioned responsibilities which he is expected to shoulder along with his roles:

1. Compliance with statutory guidelines

While establishing operational systems for the firm, the treasury manager has a duty to ensure that the systems comply with all statutory and regulatory guidelines. Particularly, he has to take care of provision regarding taxation and other government dues. He must ensure that the system should be simple and not cumbersome.

The system should be transparent and it should protect the integrity of the transactions. Moreover, it should be impersonal and capable of being operated on the basis of pre-established guidelines. It should be flexible also to incorporate any subsequent changes in accounting and taxation norms.

2. Equal treatment to all departments

While playing the supportive role, the treasury manager has a responsibility of professionalism and impartiality. In accepting the demands for expenditure from various departments, the treasury manager has to ensure that the role is carried out without any undue favour or bias. He has to keep the interest of the organization in mind and not to promote intra-organisation conflicts. The support that he provides must be detached and objective.

3. Ability to network

While playing the leadership role in case of systems break-down or during periods of cash crunch, the treasury manager should be able to exhibit traits of public relationship and networking. A crisis situation requires level headedness and ability to think straight. What it also requires is the ability to provide comfort to all users of the system. This can be done by exercising PR skills of a high order. Apart from this, the treasury manager should have networking abilities for outsourcing some of the accounting work to outside agencies during the period of interruption.

4. Integrity and impartial dealings

Since the treasury manager is the watchdog of the management regarding honest and straight dealings, he has to be impartial in his dealings. He must highlight the true state of affairs of the finances to the management. In case of any inadvertent shortcoming on the part of his department, the same should be admitted and the whole matter should be looked at in an impartial manner.

5. Willingness to learn and to teach

The treasury manager is required to keep himself of all the developments in the field. He should be able to pick out the latest developments that are likely to help his organization. He must accept new ideas in an open minded state rather than treating new ideas as a threat to his fiefdom. Simultaneously, he should be willing to teach and inculcate the latest developments among his colleagues.

13.11 Tools of Treasury Management

Treasury manager is required to work in a fast changing and competitive environment. For carrying out his activities, he has resort to certain tools and techniques. Most of the tools originate from the finance department and as such can not be considered to be an exclusive prerogative of the treasury department. Yet it is the treasury manager which is using these tools most extensively. The tools are being described below:

1. Analytic and planning tools

In treasury function, planning and budgeting are essential to achieve targets and to keep effective control on costs. Analysis of the data and information is necessary for planning and budgeting. Performance budgeting is referred to as setting of physical targets for each line of activity. The financial outlay or expenditure needed for each is earmarked to choose the least cost mode of activity to achieve the targets. Productivity and efficiency improves by decentralization of responsibility and that is achieved by performance budgeting, where each department or section is made a profit center and is accountable for its targets, financial involvement and profits in financial terms, relative to the targets in physical terms.

This type of planning involving performance budgeting is best suited for service industry say a financial services company or bank where every department can function in a decentralized manner and achieve the targets.

2. Zero Based Budgeting (ZBB)

Another tool of analysis and performance is ZBB wherein each manager establishes objectives for his function and gain agreement on them with top management. Then alternate ways for achieving these targets are defined and most practical way for achieving the targets is selected. This alternative is then

broken into incremental levels of effort required to achieve the objective. For each incremental level of activity, costs and benefits are assessed. The alternative with the least cost is then selected.

NOTES

3. Financial Statement Analysis

Financial analysis of a company is necessary to help the treasury manager to decide whether to invest in the company. Such analysis also helps the company in internal controls. The soundness and intrinsic worth of a company is known only by such analysis. The market price of a share depends, among other things on the sound fundamentals of the company, the financial and operational efficiency and the profitability of that company.

These factors can be known by a study of financial statements of the company.

4. Internal Treasury Control

All economic units have the goal of profit maximization or wealth maximization. This objective is achieved by short-term and long-term planning for funds. The plans are incorporated in the budget in the form of activities and corresponding targets are fixed accordingly. The next step in the process is the control function to see that the budgets are being implemented as per plans. Control is thus part of planning and budgeting in any organization.

Control is a process of constant monitoring to ensure that the activities are being carried out as per plans. It is also noticed whether there is any divergence from the plans, what are the reasons for the divergence and what remedial action can be suggested.

Internal treasury control is a process of self improvement. It is concerned with all flows of funds, cash and credit and all financial aspects of operations. From time to time and on regular basis, the internal treasury control is exercised on financial targets. The financial aspects of operations include procuring of inputs, paying creditors, making arrangement for finance against inventory and receivables. The gaps between inflows and outflows are met by planned recourse to low cost mix of financing.

The control aims at operational efficiency and removal of wastages and inefficiencies and promotion of cost effectiveness in the firm. The control is exercised under phases of planning and budgeting. These phases include setting up of targets, laying down financial standards, evaluation of performance as per these norms and reporting in a standard format.

The quarterly and annual budgets would set the targets for each department and financial standards are set out for each activity. Monthly budgets are evaluated by the performance sheets maintained daily and regular reports go to the financial controller. Reporting and evaluation go together and on the basis of information system built in the past, plans are prepared for the next period.

Following principles of internal control need to be mentioned here:

1. Control should be at all levels of management and participation should be from all cadres of personnel. More important are specific levels of operations. The top management should concern itself with strategic controls. The middle management is more concerned with segmental controls whereas the lower management concerns itself with operational controls.

2. The management control can be decentralized or decentralized. In a decentralized form of control, responsibility is given to lower managers to achieve

the targets. A margin of deviation from the targets is allowed but the basic objective of control is to see that activities are in the direction of the plan and the budgetary targets are a guide.

3. For effective control, there has to be a system of building up of effective communication from top to bottom and bottom to the top.

NOTES

4. The control should be built upon the management information system. This function involves the collection of data from all departments on their operations, analysis of operations and suggesting the methods of improving the efficiency and productivity.

13.12 Environment for Treasury Management

Treasury management is carried out in the real corporate world and the corporate functioning is carried out in the overall corporate environment. Environment for treasury operations can broadly be classified as under:

(a) Legal environment

By legal environment we refer to the legislations which govern corporate functioning. These legislations are the one pertaining to company law, taxation, industrial regulation etc.

(b) Regulatory environment

The regulatory environment encompasses regulations regarding employment, wages, land laws, promotion of units and closure of units etc.

(c) Financial environment

Financial environment pertains to policies regarding monetary and fiscal control, financial supervision, exchange control etc.

13.13 Role of Information Technology in Treasury Management

With the ever increasing pace of change to regulation, compliance and technology in the financial sector, treasury has increasingly become a strategic business partner across all areas of the business, adding value to the operating divisions of the company: for example, working with the sales department to establish good financial contract terms so that any trade discounts offered and the payment method agreed are beneficial to the business.

The major role the information technology is playing in effective treasury management is as follows:

1. Automate repetitive tasks

Technology today is being leveraged to automate repetitive tasks such as data gathering, accounting, bank polling, portfolio tracking and reporting. By automating these processes, the delays and the possibility of human error may be minimized. Automation also facilitate information sharing across departments, offices and geographies, and provide an accurate audit trail. Furthermore, automating these processes enable to focus on more value added tasks, critical to providing effective decision support to management team.

2. Implement internal controls

To ensure compliance with rule and regulations, sound and effective internal

NOTES

controls must be implemented. The focus should not only on system-related controls, but also on clear cut segregation of duties. In treasury workstation, sophisticated rules must be implemented to ensure policy compliance. The solution that has obtained a Internal audit and other compliance activities must be implemented.

3. Time saver and fraud & error detection Methodology

This best practice is a great time saver, especially when it's time to close the books. On the first day of the accounting close, there is a need to balance that day's transactions, not the entire months. In treasury management system, the source of cash transactions is the previous day's bank data. Through the treasury management system, all repetitive transactions are automatically tagged with the correct instructions. Most companies using a treasury management system get 90-95% of their transactions automatically tagged accurately without any manual intervention.

4. Forecast cash flows

Effective forecasting helps manage financial risk by enabling to predict a cash shortfall or liquidity crisis, taking into account interest rate changes and foreign exchange fluctuations. Forecasting also helps to enhance financial returns, enabling to make more effective decisions regarding investments and borrowing needs. Finally, forecasting helps maintain financial control by identifying unexpected occurrences for further review and action.

5. Communicate with operating units

Operating units must be involved while building your forecasts to ensure incorporation of all the necessary and up-to-date information. The past may not be indicative of the present so it's important to have the latest and updated information. There must be benchmarking resulted at the operating unit level, and the cash forecasting results must be published. It's important to keep a two-way flow of information by providing feedback to the operating units based on how the actuals compare to the forecasts. The treasury forecast performance matters must be compared to forecasts generated by other groups and/ or divisions. Significant variances may be indicators that treasury is not yet aware of all the information that should be included in the forecast.

6. Choose a Web-based treasury management system

The full benefits of technology without unnecessary costs or delays may be achieved by selecting a web-based treasury management system. Web-based solutions significantly reduce implementation costs and timeframes, and enable to access the system from anywhere at any time. Furthermore, any enhancements to the system are automatically deployed to all users, thus eliminating the need to spend internal resources on hardware or software acquisition, testing or downloads. To ensure the security of your information, select a system with two factor authentication and encryption technology must be selected.

7. Rethink treasury processes

There should be reassessing of the treasury workstation at transparent intervals to evaluate processes and identify how they can/should be revised to maximize efficiencies. While reevaluating treasury management system, the focus should not only be on data, but on experience and knowledge.

8. Pay for performance

To reinforce the importance of forecasting, portfolio management, cash consolidation, and other value added activities across treasury department, benchmarks should be defined. The proper and effective use of information technology in treasury operation increases the efficiency and effectiveness of corporate officers across the treasury, investor relations, corporate finance and corporate communication function.

13.14 Liquidity Management Vis-A-Vis Treasury Management

Liquidity management ensures that the right amount of cash is available, at the right time and in the right place, is firmly positioned as a pivotal task for every treasurer. Over the past few years, many treasurers have made substantial progress towards increasing the visibility of their cash flow and centralising cash within countries or regions. However, industry surveys indicate year on year that liquidity management and particularly cash flow forecasting remain the greatest challenges facing treasurers. With credit more expensive and elusive for many companies, it is now imperative to tackle these challenges effectively. Working capital management of a financial institution or bank or company is somehow different to that of other trading units, the process starts with tapping of funds at lower rate in shape of deposits/borrowing and ends with investing the same in higher rate to earn profit out of business with a margin of small portion of cash-in-hand kept to meet day to day operation.

Efficient account and cash pooling structures are key to efficient and cost-effective liquidity management. Every investment has a cost to the company even the shares tapped from the share holders. Deposits are tapped in exchange of payment of interest. Borrowing has cost of payment of interest to creditors. So every fund has dividend/interest payment risks for the banks/company. So if funds tapped are not properly utilized, the banks/ company should suffer loss. Idle cash balance in hand has no yield. On the other hand if we do not keep balanced liquid cash-in-hand, we may not be able to pay the demand withdrawal of depositors, as well as, installment of creditors and untimely payment for other contingent liabilities. These will lead overtrading position to the company. So there must be a scientific liquidity management policy for the company/bank/financial institution.

Proper liquidity management can increase the turnover of business and also creates additional profit to the company/banks. Liquidity management has great significance in modern days to the company/bankers/financial institution, because they engage not only in retail business, but also deal in wholesale banking and investment banking business.

Over liquidity on the other hand implies excess idle cash balance in hand. So every company should avoid both the position and should manage the company without less/excess funds in hand i.e. just liquid position.

13.15 Regulation & Supervision of Treasury Operation

The Treasury Operations Department is responsible for treasury's middle and back office functions, all systems services, and particularly cash management and banking relations services. Treasury operation's cross-functional staffs provide pricing and valuation, performance measurement, transaction and securities

NOTES

processing and compliance support functions. The middle office provides quantitative analytics support and operational risk reporting and coordinates treasury's control risk assessments related to internal corporate governance and risk management functions.

Treasury Operations implements and manages information systems in support of treasury's asset management, funding, pension investment, and cash operations functions.

The role of Treasury Manager, is to manage, mitigate and monitor financial risks arising due to differences in currency basis and timing of pledges from donors, disbursements and debt service. The risk management tools that are used include, among others, currency swaps and currency forwards, interest rate swaps and forward rate agreements .Treasury Manager enters into a master derivatives agreement and hedges risk positions using its counterparties in the market.

Risk management generally incorporates:

- a prudent approach to balance sheet management, with the aim of mitigating and controlling financial risks;
- suitable risk limits and policies and procedures formulated to ensure that the limits are not breached; and
- appropriate systems, controls and reporting mechanisms for measuring and monitoring residual risks.

In this context, the role of treasury manager typically includes:

(a) Policy Analysis: develop the risk management framework, taking into account Board's risk preferences, balance sheet dynamics and market limitations, as well as credit, interest rate, operational and foreign currency risks, and the different instruments available for risk transfer.

(b) Strategy Design: advise on optimal risk transfer through a broad-based suit of risks to be hedged out and the instruments available, based on modeling and evaluation of risk management options.

(c) Structuring, Negotiating and Executing transactions: The treasury manager is responsible to efficiently remove interest rate and foreign currency exposure based on board-approved risk management strategy; tactical decision-making on overall execution strategy and timing for transacting on the different currencies to accommodate to market and liquidity limitations; benchmark counterpart market quotes based on in-house models to negotiate prices and ensure best execution.

13.16 Treasury Control Mechanism

Treasury management relates to most of the highly volatile instrument's market dealing. The volume of transactions involved in the dealings are usually heavy and risk in operation are also heavy. So any unorganisation operation will create heavy loss for the institution. Generally control system may be related to :

(a) Internal control of different, dealing rooms, settlement offices and control offices.

(b) Checking of unhealthy insider trading system.

(c) Mutual and ammicable solution of different conflicts of interest in dealing operation.

Internal Control System: It relates to forming policies to check leakage of profit for the institution. In treasury operation, the role of Central Offices are vital.

They should form suitable guidelines for the institution in respect of various treasury dealing operations. There are advice dealing offices to bifract all treasury items into different classes according to risk involvement. As treasury business is a risky business responsible positioned persons should be delegated powers to deal in treasury operation with imposition of different limits on their discretionary power.

Some important area should be taken (i) fixation of rates for each treasury items and (ii) fixing limits for dealers to deal with different counterparties, with proper observation of confidentiality and adherance to best market practice. Treasury executive should be ensured that the transactions were carried in correct manner by cross checking during each dealing day.

For above facts the central offices should develop proper policies and guidelines for treasury operation and should advice the dealers to deal according to policies of the following :

(i) restriction on deal in one's own account.

(ii) timely advice to dealing offices in respect of any adverse transactions received or excess reporting.

(iii) timely submission of returns to different statutory authorities.

(iv) review of security and contingency arrangement of different offices.

(v) proper verification of compliance given by lower offices for irregularities.

Insider Dealings

Insiders are those who are in management including near and dear; and their dealings means-taking advantages of unpublished internal informations of the corporate body. These may create price sensex situation. So these advantages dealings should properly efficient internal control system should be taken by the management to eliminate insider dealing by fixing penalties for insider dealers.

13.17 Treasury Operations in Banking

All banks/financial institution (core principals and brokers) should ensure that they should try to serve for giving best service in the market operation within code of conduct issued for time to time. Core principals should be conducted non-investment business with private individuals should segregate them into retail or wholesale for smooth function of business within sound guidelines. It is essential that all staff should be familiar to code of conducts, in professional manner while entering into dealing transactions. Banks/financial institution will be responsible for dealing actions of the staff members. So it should be segregated work for the staff members such as no staff member control the full operation. Banks/financial institution should identify any potential or actual conflict of interest that might arise when undertaking wholesale market transactions; and take measures either to eliminate these practices and provide fair treatment to counter parties. Banks/ financial institution should know their counter party and their credit worthiness before entering into contract. It is good practice for principals, subject to their own legal advice, to alert counter party to any legal or tax uncertainty which they know are relevant to a proposed relationship or transaction. All principals have the responsibility to assessing the credit worthiness of their counter parties, or potential counter parties whether dealing directly or through a brokers/ firms. Bank/financial institution should take measure of risk control and meet proper legal obligation for each contract to minimize the loss. It is better to prepare a dealing mandate for each transaction. The mandate will be helpful to clarify the extent of a relationship between core principals and their customers with responsibility.

NOTES

Banks/financial institutions should observe confidentiality. It is essential for the preservation of reputable and efficient market place for bank/financial institution. The transactions should not be dealt in non-market rates. So this practice should be avoided. Adequate safeguards should be established to prevent abuse of informations by staff members with respect to non-public price-sensitive informations.

13.18 Key Concepts

Treasury management is the science of managing treasury operations of a firm.

Treasury in its literal sense refers to treasure or valuables of the Government.

13.19 Summary

- Treasury management is the science of managing treasury operations of a firm. Treasury in its literal sense refers to treasure or valuables of the Government.
- Macro level: It is the inflows and outflows of cash, credit and other financial instruments are the functions of the government and the business sectors. These inflows are arranged by them as borrowing from the public. In these sectors, the ratio of savings to investments is less than one, i.e. the savings are inadequate to fund the investments.
- At micro level, the finance manger aims at optimizing the value of his assets or wealth and minimizing the burden of his liabilities. He may seek to maximise his operational profits and seek to maximise the wealth of stakeholders of the micro unit.
- The availability of funds in right quantity, Availability in right time, Deployment in right quantity, Deployment in right time and Profiting from availability and deployment are the main objective of the Treasury Management.
- At unit level, treasury manager's activities encompass all other management functions.
- Treasury manager monitors the cash flows of the unit on a continual basis. It is ensured by him that adequate funds are made available for day-to-day working of the unit. In case there is genuine shortfall in cash flows, the outflows are made in an order of priority with the more urgent payments being made.
- At domestic level or national level treasury management function is to channelise the savings of the community into profitable investment avenues.
- At the international level, the function of treasury management is concerned with management of funds in the foreign currencies
- Analytic and planning tools, Zero Based Budgeting and Financial Statement Analysis are the various Tools of treasury management.
- Internal treasury control is a process of self improvement which is concerned with all flows of funds, cash and credit and all financial aspects of operations.
- Environment for treasury management can be broadly classified as Legal environment, Regulatory environment and Financial environment

13.20 Questions and Exercise

1. What do you understand by treasury management? What are its main objectives?
2. What is the significant of treasury management for the top management of a company?
3. Bring out the importance of control in the treasury function.

● **Fill in the blanks**

1. _____ of funds means earmarking of funds for various expense heads, parking of short-term funds and investing surplus funds.
   (Deployment, Employment, Supply)
2. At _____ level, the finance manger aims at optimizing the value of his assets or wealth and minimizing the burden of his liabilities.
   (unit, domestic, micro)
3. Deployment in right time and Profiting from availability and deployment are the main objective of the _____ Management.
   (treasury, financial, capital)
4. At _____ level or national level treasury management function is to channelise the savings of the community into profitable investment avenues.
   (domestic, international, local)
5. At the _____ level, the function of treasury management is concerned with management of funds in the foreign currencies.
   (domestic, international, local)
6. Analytic and planning tools, Zero Based Budgeting and Financial Statement Analysis are the various _____ of treasury management.
   (techniques, Methods, Tools)
7. _____ treasury control is a process of self improvement which is concerned with all flows of funds, cash and credit and all financial aspects of operations.
   (external, internal, other)
8. Treasury manager monitors the cash flows of the unit on a _____ basis.
   (daily, continual, alternate)
9. _____ are those who are in management including near and dear; and their dealings means-taking advantages of unpublished internal information of the corporate body.
   (neighbours,insiders,outsiders)
10. In _____, each manager establishes objectives for his function and gain agreement on them with top management. Then alternate ways for achieving these targets are defined and most practical way for achieving the targets is selected.
    (Analytical tool, ZBB, Financial Statement Analysis)

[**Ans:** 1)Deployment, 2)micro, 3)Treasury 4)Domestic, 5)International, 6)Tools, 7)Internal, 8)Continual, 9)Insiders, 10)ZBB]

NOTES

13.21 Further Reading and References

1. M.Y. Khan & P.K. Jain : Financial Management - Text and Problems; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
2. Prasanna Chandra : Financial Management - Theory & Practice; Tata McGraw Hill Publishing Co. Ltd., New Delhi.
3. I.M. Pandey : Financial Management (2005); Vikas Publishing House Pvt. Ltd., New Delhi.
4. R.P. Rustagi : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
5. R. Charles Moyer, : Contemporary Financial Management; West Publishing Company. James R. McGuign & William J. Kretlow
6. Rajiv Srivastava & : Financial Management, Oxford University Press Anil Mishra
7. J.B. Gupta : Strategic Financial Management - Taxmann Publication Pvt. Ltd.
8. Ravi M. Kishore : Strategic Financial Management - Taxmann Publication Pvt. Ltd.