GOVERNMENT OF INDIA
DEPARTMENT OF COMPANY AFFAIRS
MINISTRY OF FINANCE

# REPORT OF THE WORKING GROUP ON THE COMPANIES ACT, 1956

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NEW DELHI

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# 1
# Introduction

1.1 THE COMPANIES ACT, 1956, CAME INTO BEING IN AN ERA THAT WAS FAR REMOVED from the corporate and economic dynamism of the 1990's. Indeed, the last time when major amendments were made was in 1988, in a decade that was fundamentally different from the liberalised and competitive environment that has come to stay with the economic reforms that began from July 1991.

1.2 In the early 1990's, the Government of India recognised that many provisions of the Companies Act had become anachronistic and were not conducive to the growth of the Indian corporate sector. Consequently, it made an attempt to recast the Act, which was reflected in the Companies Bill of 1993. Unfortunately, almost every constituent of the corporate sector, as well as banks, financial institutions and capital markets, felt that the 1993 Bill did not address the substantive issues affecting corporate functioning in a rapidly changing economic environment. Not surprisingly, the 1993 Bill was withdrawn.

1.3 In his Budget Speech of July 1996, Mr. P. Chidambaram, the Union Finance Minister, announced that a Group would be set up to re-write the Companies Act, and present it for public debate by early 1997. In August 1996, a Working Group was constituted. This is the Unanimous Report of the Working Group.

1.4 Before explaining the objectives of the Report, and the economic context in which the Act is proposed to be altered,[1] it is necessary to state the composition of the Group. Unlike most Committees or Groups that are set up by the Government, this Working Group has no Chairman, and has functioned smoothly without any such titular head by pooling the Group's expertise. The members of the Working Group, in alphabetical order, are:

1. Dr K.R. Chandratre, the then President, The Institute of Company Secretaries of India.
2. Dr Omkar Goswami, Indian Statistical Institute, New Delhi.
3. Mr Rajendra S. Lodha, Senior Partner, Lodha & Co.
4. Mr D.S. Mehta, Advisor, Bajaj Auto Limited.
5. Mr S. Ramaiah, Retired Secretary (Legislative), Government of India.
6. Mr M.K. Sharma, Director (Legal and Secretarial), Hindustan Lever Limited.
7. Mr Shardul S. Shroff, Partner, Amarchand & Mangaldas & Suresh A. Shroff & Co.

[1] In this Report, "the Act" refers to the existing Act, while "new Act" refers to the proposed one.

8. Mr B.B. Tandon, the then Additional Secretary, Department of Company Affairs – Convenor.

Mr Tandon was with the Working Group (or Group) until the very last month, when he left for a new assignment in Government. The Group wishes to place on record its appreciation of Mr Tandon's signal contribution. He was replaced as the Convenor by Mr T.S. Krishna Murthy, the new Secretary of the Department of Company Affairs. Mr Krishna Murthy participated in the last six meetings of the Group. In addition, work of the Group was aided by the participation and support of Mr S.B. Mathur, Director (Inspection and Investigation), Department of Company Affairs.

1.5 The Group, which held its first meeting on 12th August, 1996, has had 34 meetings. In the process, it has interacted with, and received responses from, representatives of RBI, SEBI, banks and financial institutions, merchant bankers, capital market players, stock exchange officials, industry associations, professional bodies, and others who significantly contribute to today's corporate environment.

## Objective

1.6 The main objective of the Group was to re-write the Companies Act to facilitate a healthy growth of the Indian corporate sector under a liberalised, fast changing and highly competitive environment. The need of the day is to bring out the latent dynamism of Indian companies so that they can consolidate and grow, as also enhance shareholder value and thus become significant players in an environment that will result in even greater competitiveness with the advent of capital account convertibility.

1.7 While this objective is fine in principle, it is difficult to implement. In the past, many laws pertaining to the corporate sector, financial sector and capital markets have been characterised by a plethora of economically counter-productive controls with minimal enforcement. The Group has sought to achieve a balance that recognises an international trend: more flexibility and greater self-regulation, subject to better disclosure, more efficient enforcement and tougher penalties. Growth and flexibility are to be catalysed through many novel provisions and procedure – introducing a more appropriate re-classification of companies, expediting mergers and de-mergers, enabling fast-track restructuring, removing barriers to creating economies of scale and scope, allowing for greater flow of inter-corporate loans and investments, recognising hybrids, derivatives and options as means of corporate funds, to name a few.

1.8 These enabling facilities are accompanied by judicious checks and balances. In the last five years, there has been a distinct move towards greater corporate transparency, thanks to the Securities and Exchange Board of India (SEBI), the Public Financial Institutions, credit rating agencies, electronic stock exchanges and, most fundamentally, the quality of the financial press and research analysts. The Group

recognises this, and has proposed norms that will accelerate the trend of greater disclosure of relevant financial information.

## Plan of the Report

1.9 In most part, the Report is structured as if a company were an organic entity, and looks at it through its life cycle – from birth to eventual demise. Thus, Chapter 2 focuses on matters relating to the classification and incorporation of companies. This is followed by Chapter 3, which deals with issues that relate to raising of capital. Chapter 4 looks at the internal management of companies and non-financial disclosures to shareholders. In essence, it examines the role of management, the constitution and working of the Board of Directors, conduct of meetings and proceedings and some basic disclosures that must be made to shareholders. Chapter 5 makes important recommendations regarding accounts, audits and financial disclosures. Chapter 6 analyses issues relating to corporate restructuring of essentially viable companies, while Chapter 7 focuses on winding-up basically non-viable ones. Chapter 8 looks at monitoring and enforcement and the role of the Central Government. Chapter 9 concludes the report with a summary of major recommendations.

1.10 It should be recognised that this is only a report. By its very nature, it can neither be exhaustive nor incorporate all the changes that have been included in the draft Bill. Instead, the Report emphasises the important changes, and expects that those who are concerned about details will examine the draft Bill in its entirety.

## Three Basic Recomendations

1.11 Three basic recomendations are in order before moving on to the main body of the Report.

**a) First, the corporate scene is changing very rapidly, and will do so at an even faster pace in the future. Hence, it is essential that the Companies Act be reviewed once every five years. This will ensure that the Act retains the flexibility which is vital for sustained corporate growth.**

**b) Second, despite the best of intentions and adept drafting, laws tend to have the characteristic of being carved in stone. Laws do not change seamlessly with the times, while businesses do. Thus, desirable corporate governance and practices need legal support as well as evolution of internal standards – where the more progressive elements of the corporate sector design best practices that are constantly up-dated to complement and enhance the legal provisions. Nations that have good corporate practices do not rely exclusively upon law; conversely, those with poor records have never evolved internal codes of best practice. Keeping this in mind, the Group has sought to distinguish between legal provisions that will be incorporated in the draft Bill and recommendations which ought to be followed by Indian companies in their best interests.**

**c) Third, it is desirable that the Report be widely disseminated and discussed in the course of the next few months. The Group commits itself to consider the various suggestions and responses before finalising the Bill that is to be eventually tabled in Parliament.**

# 2

# Classification and Incorporation

2.1 COMPANIES INCORPORATED IN INDIA DESERVE TO ENJOY THE BENEFITS OF flexibility that are, more or less, at par with their international counterparts. This requires legislators as well as policy-makers to recognise that the contours of the corporate sector have changed beyond recognition from the static era of the mid-1950s. To begin with, the typology of companies has become vaster and far more complex; and retaining a classificatory system that was originally designed for 1956 may be detrimental to the interests of corporate growth as well as efficient governance. Thus, the starting point is the issue of re-classification of companies.

## Re-classification of companies

### A. Private, Public Unlisted, and Listed as a New Classification

2.2 International experience shows that a major source of growth of the industrial sector has been the small companies. They have the dynamic entrepreneurial talent to react to opportunities faster than many large corporate entities, and enjoy an innate flexibility thanks to their size and organisation. Moreover, these are typically private limited companies that do not normally access funds from the wider investing public. The Group strongly believes that such private limited companies should enjoy more freedom under the law, and be governed largely by self-regulation.

2.3 Even among public limited companies, a time has come to make an economically meaningful distinction between (i) unlisted and (ii) listed companies. Actions of the former have lesser public impact than the latter. For instance, the bankruptcy of a public non-listed company affects fewer investors and shareholders than a listed company; as a corollary, the financial distress of a listed company can have negative ripple effects on a relatively thin capital market. Keeping this in mind, the Group felt that public unlisted companies should be regulated to a lesser degree than the listed companies. Hence, the Group recommends that:

**The new Act would have a more relevant three-fold classification of companies:**

1. **Private companies – largely self-governing.**
2. **Public unlisted companies – lesser government regulations than public listed companies.**
3. **Public listed companies – greater flexibility in their operations than before, but with stricter compliance norms.**

2.4 Such a classification under the new Act will enable a neat demarcation of regulatory functions between the SEBI and the Central Government regarding capital market matters. This will not only ensure focused regulation and enforcement by SEBI, but also eliminate needless and often contradictory overlapping jurisdiction on investor protection measures.

### B. Group Resource Companies as a New Concept

2.5 In an international perspective, most of India's so-called "large" companies are really medium-sized ones. Thanks to four decades of inward orientation, many of these companies are still managed by entrepreneurs who have yet to develop the level of professional expertise and skills needed to cope with the competition of the future – especially with the global giants.

2.6 This is not to claim that Indian corporate sector does not have the intrinsic capability to face global competition. Far from it. However, it is essential to appreciate that, in an era of a freer market economy, Indian companies need to be better equipped to face international competition. To do so, they need to strengthen and develop adequate depth and expertise in a host of specialised functional areas – project implementation, cost minimisation, quality improvement, R&D, re-engineering, global marketing, financial operations, international corporate law and tax, mergers and acquisition, capital market functions, human resource development, to name a few. How can the Companies Act encourage such skill formation?

2.7 Until thirty years ago, the larger conglomerates in India used the so-called managing agency houses to develop a common pool of managers for their group companies. Unfortunately, this positive aspect of managing agencies was overshadowed by many negative features. Consequently, in 1970, the managing agency system was abolished as a form of corporate management. The Group strongly believes that there is no need to resurrect this form – either transparently or through the back-door.

2.8 Nevertheless, our companies urgently need access to managerial synergy and greater professionalism. Hence, the Group felt the need to evaluate ways and means of making available to the Indian corporate sector a pool of specialised managerial services with sufficient depth at affordable cost, without incorporating any of the exploitative elements of the old managing agency system. Keeping this in mind, the Group recommends that:

**The new Act should make an explicit provision to allow 'Group Resource Companies' to be incorporated with the objective of making available to the constituent members of the group the relevant services and expertise described above. To ensure that such a system does not become exploitative:**

**1. Group Resource Companies must operate strictly on cost sharing principles – no profit no loss – rather than on the basis of a share of the percentage of profits or turnover.**

**2. The costs incurred (if any) in using the services of a Group Resource Company must be clearly disclosed in the financial statement of the user company.**

2.9 It should be noted that there is nothing in the present law which prevents the constitution and operation of such a Group Resource Company. This system has not been used by Indian firms because of the fear of it being misconstrued as a managing agency with its attendant negatives. The explicit provision ought to remove such a fear.

### C. Foreign Companies: Existing Definition is Adequate

2.10 The Group felt that the definition of foreign companies as given in Section 592 of the present Act is adequate and should continue.

### D. Government Companies Retained

2.11 Government companies are defined under Section 617 of the Act, and relate to those enterprises which are incorporated under the Act where the Central Government and/or State Governments own 51% or more of the paid-up share capital. The Group was of the opinion that:

**1. The definition of a Government Company should continue, as it is in consonance with Article 12 of the Constitution of India.**

**2. By virtue of his fiduciary position, the Comptroller and Auditor-General (CAG) can exercise his right to appoint the statutory auditor and to conduct supplementary or test audits, if so required.**

**3. The Annual Report of such a company should continue to be placed before both Houses of Parliament.**

**4. But, no Government Company should get any concessions or privileges through special exemptions and notifications. Thus, Section 620 of the Act should be deleted.**

### E. Deemed Public Companies Omitted

2.12 One of the 1960 amendments to the Act introduced section 43A which created the concept of a "deemed public" company. By virtue of this section, private limited become public companies in certain cases. Section 43A is enormously lengthy and highly convoluted, with as many as four provisos – some of which take up over two pages of fine print. The rationale for Section 43A was opaque at the time it was introduced, and is certainly misplaced in the context of the 1990s. Various associations, chambers of commerce and professional bodies who deposed before the Group were unanimous in demanding that the section be scrapped.

**The Group recommends abolition of the concept of deemed public companies and concomitant deletion of section 43A.**

### F. Unlimited Liability Companies to be Retained

2.13 The Group recommends to retain the existing provision in the Act regarding unlimited liability companies. This is essentially a facilitating provision and, hence, there is no rationale for its deletion.

## Incorporation, Memorandum and Articles of Association

2.14 The Group believes that the 46 sections which fall under Part II of the Act (entitled "Incorporation of Company and Matters Incidental Thereto") can be significantly rationalised. Moreover, some sections can be omitted altogether. For the rest of this chapter, the Report highlights some of the significant decisions that have been taken by the Group.

### A. Form of Memorandum and Articles of Association

2.15 Sections 14, 28, and 29 of the existing Act prescribes the form in which the Memorandum and Articles of Association (Mem. & Art.) of a company should be framed. These are given in detail in Schedule I of the Act. The Group felt – as did several professional bodies – that there is no need to define the Mem. & Art. of a company in as detailed and rigid a manner as prescribed in Schedule I.

2.16 Shorn of details, a company is essentially an incorporation of the fact that at least two members (private) or at least seven members (public) have come together under the provisions of the Companies Act to do lawful business in India and abroad. If this premise is accepted, it then follows that the exact form and content of the Mem. & Art. of a company should be left to its members – and not be predetermined by the seemingly exhaustive typology as in Tables A through F in Schedule I. Besides, it is now forty-one years since the Act came into being; and there are myriad professionals who can design an appropriate Mem. & Art. without referring to Schedule I. Therefore, the Group recommends that:

**In the interest of genuine flexibility as well brevity, Schedule I be eliminated altogether from the Bill and the same may be modified and prescribed by rules.**

### B. Objects Clause of Memorandum of Association

2.17 Under Section 13 of the Act, the Memorandum must contain the objects of a company, which is sub-divided into three categories: "main objects", "incidental or ancillary objects", and "other objects". The artificiality of the three-fold categorisation has led to a situation where companies conjure up almost every possible economic activity that they can think of, and put them under one of the three objects clauses.

2.18 What companies need is flexibility to move on to other lines of business, subject to shareholders' consent. Keeping this in mind, the Group recommends that:

1. **The objects should be kept as broad and flexible enough as shareholders so desire.**
2. **Altering the objects should be allowed subject to (i) the passing of a special resolution by the shareholders of a company, and (ii) the altered Memorandum being registered with the appropriate Registrar of Companies.**

## C. Change of address of registered office

2.19 Section 17 of the Act states that if a company – through a special resolution – chooses to change its registered office from one State to another, then it must seek confirmation by the Company Law Board. While this may make sense for public listed companies, it is hardly necessary for private and public unlisted companies. Therefore, the Group recommends that:

**For changing the registered office of private and public unlisted companies, passing of a special resolution to that effect should suffice.**

**This is a conscious deviation from the 1997 Companies (Amendment) Act, and is justified on the ground that the relatively limited impact of such a change in the case of small and medium sized unlisted companies does not warrant an additional approval from a quasi judicial authority.**

# 3

# Raising Capital

3.1 AT THE TIME OF INDEPENDENCE, INDIA ACCOUNTED FOR 2% OF WORLD TRADE. Today, it accounts for 0.6%. Merely re-capturing our pre-Independence share of the world market requires the corporate sector to invest in scale, quality and technology that was unheard of in the past. To make such investment, India's companies need to access the domestic and international capital markets in progressively larger doses, and as quickly as possible. Therefore, suggestions that aid our companies to garner such funds should be welcomed. It is with this frame of reference that the Group has decided to recommend a number of measures, which should eventually allow our industrial and services sector to aggressively compete in world markets.

3.2 The recommendations in this Chapter cover Parts III and IV of the Act, which consists of Sections 55 through 123. Most of the suggestions focus on public listed companies. However, unlisted companies also access investible funds. To the extent they do, some of the recommendations cover such companies.

## Capital Markets: SEBI the Sole Authority for Listed Companies

3.3 The Group had a detailed look at the provisions concerning capital markets, prospectus and issue of various securities. The present situation is unsatisfactory as far as public listed companies are concerned. Effectively, they are accountable to two authorities – the Securities and Exchange Board of India (SEBI) and the Department of Company Affairs (DCA). This has resulted in overlapping jurisdiction and conflicts in the administration of law. Time has come to cut this Gordian knot, and vest regulatory and enforcement powers upon a single authority. The Group strongly recommends that:

**The regulation and disciplinary control over *public listed companies* for the purpose of issue of securities and related matters should be unified to the extent possible, and that SEBI should be the sole authority entrusted with these monitoring regulatory and policing functions.**

Keeping this basic principle in mind, the Group also recommends that:

**Schedule II of the Act (Prospectus) should be under the domain of SEBI. Accordingly, Schedule II would be taken out of the new Bill and shifted to Rules.**

## Raising Capital: Unlisted Companies

3.4 Unlisted companies also need to raise capital. The Group recommends that if such an exercise involves accessing funds either from its members or by private placement – whether these be in the form of debt, equity, hybrids or any other security – then such regulation, policing and enforcement of unlisted companies should be under the purview of the DCA.

## Freedom to sell, purchase, transfer and acquire shares

3.5 A key feature of corporate democracy is that any shareholder has full freedom to sell, purchase, transfer and acquire shares. In the Act, there are severe constraints to this freedom. With the repeal of Chapter III of the Monopolies and Restrictive Trade Practices Act, 1969 dispensing with preentry scrutiny on the one hand, and the enactment of Depositories Act, 1996, the new Take-over Code and changes in the Securities Contracts (Regulation) Act, 1956 on the other, the Group recommends that:

**1. The provisions of Sections 108A through 108I of the Act – which require companies to obtain prior approval from the Central Government for the acquisition and transfer of shares – should be deleted.**

**a) Section 108 of the Act should be amended in respect of endorsement and validity of a share transfer instrument.**

## Hybrids, derivatives, options, and securities with differential rights

3.6 Throughout the world, corporate growth has been accompanied by the introduction of various forms of securities: debt-equity hybrids, derivatives, options, and shares with differential rights.[1] No capital market of the size of India's remains anchored to the old, three-fold classification of securities: pure debt instruments, ordinary shares and preference shares.

3.7 Alternative forms of securities have come into fore due to two fundamental reasons. First, the financing needs of companies have become far too complex to be met by only three types of securities. And, second, because markets are generally efficient enough to understand the implications and risks associated with various

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[1] These terms need a brief explanation. For simplicity, "derivatives" refer to securities that are (a) derived from a basic security such as debt paper, mortgages, equity, loans, etc., and (b) in the nature of options, futures or contracts for differences based on the primary security. Options have vintage, and go back to Holland in the 17th. century. They refer to any instrument that carries a "put" or "call" option whereby investors, instead of buying the latent security outright, can enter into a contract to either buy or sell the underlying security at a pre-specified price (the "strike price") on a pre-determined date. Options allow investors to hedge against fluctuations and, thus, ensure a much more stable market. "Hybrids" is an omnibus term that allows for any combination of securities, including their derivatives or options. "Shares with differential rights" essentially refers to equity that carry differential voting and or dividend rights. The simplest and best known example of such an instrument is the preference share.

instruments. Preventing such flexibility in India not only binds our companies to an archaic world, but also implies that authorities know best what is good for investors.

3.8 The Group felt that India's corporate sector as well as its investors should have the same flexibility as their global counterparts in terms of choice of instruments. Hence, it recommends that:

1. **Indian companies should be enabled to issue hybrids, derivatives, options, as well as shares and quasi-equity instruments with differential rights.**
2. **For private limited companies and unlisted public companies, the Department of Company Affairs (DCA) would issue guidelines regarding such securities.**
3. **For public listed companies, SEBI would issue guidelines on the norms and for protection of the interests of investors for such new instruments/securities.**
4. **Wherever applicable, the guidelines issued by DCA for private and public unlisted companies should be in consonance with SEBI's for public listed companies.**
5. **In framing such guidelines, both SEBI and the DCA should avoid trying to anticipate what the risk of a potentially new instrument may be. This is because such risks are rarely quantifiable. Instead, both authorities should insist on detailed disclosure of corporate information, and then let the potential investor decide whether or not such an investment makes portfolio sense.**

## Buy-back of shares

3.9 There is an erroneous belief that the sole reason for buy-back is to block hostile take-overs. In this connection it is pertinent to list the five reasons why the Bank of England favoured the making of law to allow companies to repurchase their shares, of which blocking take-overs was only one:

a) to return surplus cash to shareholders,

b) to increase the underlying share value;

c) to support share price during periods of temporary weakness;

d) to achieve or maintain a target capital structure;

e) to prevent or inhibit unwelcome take-over bids.

3.10 Almost all OECD countries allow companies to buy-back shares subject to certain regulations.[2] Unfortunately, Section 77 (read with Section 100) of the Act prevents buy-back. In today's context, the Group strongly believes that this section is antiquated, and goes against the long term interests of corporate sector growth and shareholder value. Hence, the Group recommends that:

[2] 'Corporate Governance Environment in OECD Countries', mimeo, OECD, Paris, February 1995.

**The new Act should provide for buy-back of shares subject to certain provisions:**

1. **Prior approval by shareholders through special resolution that clearly states (i) the amount allocated for buy-back, (ii) time period for concluding buy-back operations, and (iii) the funds allocated for buy-back are from 'free reserves' and share premium account.**
2. **In the event of buy-back, the company shall not issue any *new* shares, which includes rights issues but excludes bonus, for a period of 12 months after the buy-back is completed.**
3. **Since Buy-back is for extinguishing share capital it should not lead to an increase in debt-equity ratio in excess of 2:1.**
4. **In case of buy-back is for 'treasury operations', *such* shares will not be re-issued for 24 months after the last date of buy-back, and will be subject to the restrictions given in the table below.**

| Buy-back for treasury operations | Up-to 24 months | After 24 months but before re-issue | After re-issue |
|---|---|---|---|
| Voting rights | No | No | Yes |
| Dividend rights | No | No | Yes |
| Bonus shares | No | Yes | Yes |
| Rights issues | No | Yes | Yes |

5. **In the case of non-secondary market buy-back from specific class of share holders, the potential sellers will not vote on the special resolution;**
6. **The buy-back will be accompanied by a 'declaration of solvency' by the Board which will be signed by the Managing Director and at least one more Director, and will be in force for one year after the buy-back;**
7. **Any deviation from such compliance will be punishable by a substantial fine and/or imprisonment.**

## Full buy-out

3.11 The new Take-over Code has finally created a transparent environment for taking over the ownership and control of companies. This is to be welcomed, for take-overs play an important role in building corporate synergy, in raising shareholder value and in keeping companies on their toes. However, there is an important element that has been missed out by the new code, which ought to be rectified as soon as possible. This has to do with full buy-out.

3.12 Since the term "full buy-out" is not well understood in India, it requires some explanation. In many OECD countries, when a person, group, or body corporate acquires over 90% or 95% of the equity of a public listed company, it is incumbent

upon the residual shareholders to sell their shares to the buyer at a fair price that is set by the regulatory authority. This is not legislated for in India.

3.13 A key feature of shareholder democracy is that all shareholders who own a given class of equity are alike. Without full buy-out provisions, the residual shareholders face one of two options, both of which are inimical to this aspect of shareholder democracy. First, they may hold out for a higher offer, which is palpably unfair vis-à-vis the other shareholders who sold their stake. Or, second (and more likely if the company gets de-listed), these shareholders may get squeezed by the buyer to accept a lower price, which is unfair to them. Therefore, in the interest of shareholders and companies, the Group recomends that:

**In the event of any person, group or body corporate acquiring 95% of the shares of a public listed company – either through a take-over or otherwise – and the company getting de-listed, residual shareholders should sell their shares to the 95% owner at a price based upon SEBI guidelines.**

## Indian Depository Receipts (IDR)

3.14 Over time, India will get much more economically integrated with Southeast Asia and the SAARC countries. Keeping this in mind, and given the potential size of our capital market, the Group recommends that:

**Indian Depository Receipts should be set up, like American Depository Receipts or Global Depository Receipts. This would imply that:**

- **Foreign companies could issue IDR, where the underlying security is the equity or any other security of a foreign company.**
- **Depository and custodial activities must be encouraged to achieve international standards.**

**Provisions regarding issue of prospectus by foreign companies already existed in Part XI of the Companies Act (Section 603 to 605). Therefore, a new scheme for Indian Depository Receipts can be easily introduced with minor modifications.**

## Global Depository Receipts (GDRs) and American Depository Receipts (ADRs)

3.15 Global Depository Receipts (GDRs) and American Depository Receipts (ADRs) remain outside the pale of the Act, as foreign issues are subject to foreign laws. In the main, this is as it should be. However, the facts of the matter are that (i) the share capital is issued by domestic companies and, (ii) on conversion, the underlying securities or shares will surely have an impact on the Indian capital market. Hence, the Group recommends that:

**Issuers of GDRs or ADRs should file with the Registrar of Companies (i) the foreign offering circular or prospectus after any such issue, (ii) basic data on the issue such as the price of the depository receipt and the amount subscribed, and (ii) material details after conversion to shares.**

3.16 This recommendation has no enforcement or policing implications for the Registrar. Instead, it is simply a matter of passing some information so that the Registrar of Companies can also monitor the flow of foreign investment into India via the GDR and ADR route.

## Shelf Prospectus

3.17 It was observed by the Group that public financial institutions have sometimes accessed the capital market more than once in the course of a 365-day period. As India's infrastructural financing takes off, there may be more such instances. Under the Act, a company must issue a full-fledged prospectus each time it accesses the capital market. While this is good in principle, it certainly leads to needless repetition –more so when a company takes recourse to capital markets more than once in a given year. A way out is through a "shelf prospectus" for a specified time period. Such a prospectus has a limited life during which it remains on the "shelf", and is up-dated for any changes that have occurred between two successive offerings. The Group recommends that:

**The concept of a shelf prospectus should be incorporated in the new Act. It should have a validity of 365-days, subject to updates on material facts, material litigation and changes in financial position between the previous offering and the next one.**

**In the first instance, this shelf prospectus facility could be limited to public sector banks and financial institutions and those companies specialising in infrastructure finance. If the procedure succeeds and demonstrates that the interest of investors are protected, then the facility may be gradually extended by SEBI to other sections of corporate India.**

## Book-Building

3.18 Book-building is an international practice which refers to collecting orders from investment bankers and larger investors based on an indicative price range. In capital markets with sufficient width and depth, such a pre-issue exercise often allows the issuer to get a better idea of the demand and the final offer price of an Initial Public Offering (IPO).

3.19 The merits and de-merits of book-building – especially in thin or shallow capital markets – requires intensive examination. However, this is not the appropriate forum to evaluate its pros and cons. Irrespective of its merits, there is an issue regarding book-building that needs attention. The invitation and the building up of

the book and receiving of advance payments by the book-runner (or book-builder) has connotations that impinge upon his liability vis-à-vis the prospectus definition and prohibitions contained in the Act. Thus, the Group recommends that:

**An amendment be made to the definition of 'prospectus' in Section 2(36) of the Act which would**

**a) exclude the information memorandum that is issued prior to the prospectus at the time of book-building, but**

**b) require that, after formal closure of book-building, such a memorandum be submitted with the formal prospectus to the Registrar of Companies.**

## Employees' Stock Options

3.20 In the final analysis, sustained competitiveness by any company hinges upon the quality of its human resources. This, in turn, has much to do with employee loyalty and commitment. A widely acknowledged method of securing greater employee participation, giving the right incentive signals and rewarding loyalty as well as years of service is through Employees' Stock Options (ESOP). In today's competitive world, only the most myopic will insist on making seal-tight distinctions between employees (who should be paid only wages, salaries and bonus) and shareholders (who should get dividends). There is hardly any global corporate giant that does not have ESOP. The Group recommends that:

1. **Employee Stock Options (ESOP) should be explicitly incorporated in the new Act. These options can be in the form of warrants or other securities that have prespecified dates of conversion in the future.**
2. **This will require amending Section 81 of the Act. In order to prevent misuse, ESOP should be permitted up to 5% of the increased capital of a company (i.e. existing capital plus proposed issue).**
3. **The capital market rules for ESOP should be framed by SEBI for public listed companies, and by the Central Government for all other companies.**
4. **Such rules should allow for buy-back of options according to the principles of buy-back that have been discussed earlier in the chapter.**
5. **In addition, the Government should consider taxing these options as long term capital gains.**

## The "Tree" Companies and their Kin

3.21 The Group noted the trend in incorporating companies which engage in activities such as tree plantation, forestry, horticulture, fisheries, and the like. These are to encouraged. Often the invitation is to deposit money in "units" representing a future good, i.e. a teak tree 20-years hence. At present, these "units" are not recog-

nised as securities and, hence, do not come under the regulatory ambit of SEBI, DCA or the Reserve Bank of India. The Group felt that such units require to be treated as a form of capital market securities (since they are essentially forwards contracts); hence, provisions of the prospectus chapter in the new Act should apply to them.

# 4

# Internal Management and Non-Financial Disclosures

4.1 IN CORPORATE PARLANCE, THE PHRASE "INTERNAL MANAGEMENT" IS AN OMNIBUS term which deals with how the management of a company constitutes its Board of Directors, conduct of the Board in relation to the management and the shareholders, the manner in which meetings and proceedings of company are conducted, and accounting and audit procedures. In this Report, the last category is covered in Chapter 6 under "Accounts, Audits and Financial Disclosures". Thus, as far as this chapter is concerned, the phrase refers, more or less, to Sections 165 through 197 ("Meetings and Proceedings"), Sections 198 to 204A ("Managerial remuneration" and allied sections), and Sections 252 to 323 (under the head "Directors").

## Board of Directors

4.2 The Group felt that the key to desirable corporate governance is a well functioning Board of Directors that zealously performs its dual role: appreciating the issues put forward by management, and honestly discharging their fiduciary responsibilities towards shareholders.

4.3 In Anglo-American system, this objective has been sought to be attained by appointing independent professionals as non-executive directors. The success of non-executive directors in many British and some significant North American companies has led to a view that non-executive directors *per se* are the panacea to all evils. What we fail to realise is the importance of the two adjectives: "independent" and "professional". Many Anglo-American companies eventually appointed such directors in response to the pressure applied by substantial shareholders – who demanded greater disclosure from management. Moreover, such professionals have not lent their time for paltry sitting fees.

4.4 The moral of this tale is that, given our present state of corporate governance, one must not confuse form for content. No doubt, having professional non-executive directors will enhance corporate performance and maximise long term shareholder value. In order to get them to serve on Boards, we must simultaneously work on the demand side (by mandating more relevant and pointed disclosures), and on the supply side (by paying them more for their services and freeing them from unwarranted burdensome civil and criminal liabilities). These premises form the core of the Group's recommendations that follow.

## A. Disclosures of Directors

### A.1 Appointment of Relatives of Directors

4.5 Schedule IA of the existing Act gives the classification of relatives as per Section 6(c). This schedule is very important, for it can be used to ascertain whether relatives of members of the Board are employees or directors of the company. The Group believes that such information is important to shareholders. Therefore, it recommends that:

**Schedule IA be explicitly incorporated in the Act itself, and a detailed, comprehensive report on the relatives of directors – either as employees or Board members – be given as an integral part of the Directors' Report of all public limited companies.**

4.6 It is worth noting that Schedule IA is one of two schedules that is being brought into the main body of the Act. All but three (Schedule VI, XI and XIII) others are being either incorporated as Rules or eliminated altogether.

### A.2 Disclosure of interests by Directors

4.7 Section 299 of the existing Act makes it mandatory for directors to disclose their interests in any contract or arrangement of the company to the Board. Section 300 stipulates that interested directors cannot participate or vote in the Board's proceedings regarding such contracts. And, Section 301 states that every company shall keep registers of all contracts to which its directors have had interest. The Group believes that these are desirable disclosures, and that shareholders should be made more aware of them in the interest of good corporate governance. Therefore, the Group recommends that:

**The fact that such a register is maintained by the company in its registered office, and is open for inspection by any shareholder of the company should be explicitly stated in the notice of the AGM of all public limited companies.**

### A.3 Disclosure of Directors' shareholding

4.8 In a similar vein, Section 307 stipulates that every company must maintain a detailed, up-dated register showing the shares and debentures held by each director in the company, its subsidiaries, and its holding company. Moreover, sub-section (7) states that this register must be produced at all annual general meetings and be open to any person who has the right to attend the meeting. The Group endorses this disclosure and recommends that:

**The existence of the Director's share register and the fact that it can be inspected by members in any AGM should be explicitly stated in the notice of the AGM of all public limited companies.**

## B. Loans to Directors

4.9 Sections 295 and 296 of the existing Act deal with loans to directors. Section 295 basically prevents a company from making loans to its directors or to any firm or private company with which its directors are associated, except with the approval from the Department of Company Affairs (DCA). In other words, Section 295 suggests that the prohibition can be regularised by DCA approval – which vests an authority upon Government that could be better discharged by the shareholders. With this in view, the Group recommends that:

1. **Loans to Directors will be limited to only three categories namely, education for family, housing and medical assistance.**
2. **This facility will be available to only the full-time working or executive directors of companies and not to non-executive directors.**
3. **The right to grant any such loan will be subject to norms that are approved of by the shareholders in a general meeting.**
4. **The maximum loan will be five times a working director's current annual remuneration.**
5. **No full-time working director will be eligible for a second loan in any of the three categories when a previous loan remains overdue.**

## C. Appointment of sole selling agents

4.10 Since the term "sole selling agent" harks back to the days of managing agencies, it has been treated with great suspicion by the Central Government. Indeed, Section 294AA was inserted in 1975 to empower government to prohibit the appointment of sole selling agents (SSAs) in certain cases. Logically, there can be 2x2 classification of SSAs: those who operate in India and foreign SSAs on the one hand, and whether or not they are related to any director on the other. The Group recommends that:

| | Not a relative | Related to any director or director having interest |
|---|---|---|
| Sole selling agent for India | **Should require prior approval of a special resolution in a general meeting of shareholders.** | **Should require prior approval of a special resolution in a general meeting of shareholders; in addition this fact has to be fully disclosed as a separate item in the Annual Accounts.** |
| Sole selling agent for foreign markets | **May be decided by the Board, and the information be passed on to shareholders together with Annual Accounts.** | **Should require prior approval of a special resolution in a general meeting of shareholders; in addition this fact has to be fully disclosed as a separate item in the Annual Accounts.** |

4.11 In any event, the Group strongly believes that government should have no *ex ante* regulatory role to determine the tenure and terms of appointing an SSA; nor should it use questionable economic arguments to prohibit such appointment. This is a matter that must be decided upon by the Board and the shareholders.

## D. Sitting Fees and Commissions to Non-Executive Directors

4.12 India has a large pool of talented professionals – lawyers, chartered accountants, company secretaries, cost accountants, management experts, economists, scientists, financial strategists, capital market analysts, investment and merchant bankers. To attract them as non-executive directors, companies need to (i) give higher sitting fees, and (ii) design an incentive compatible package that compensates them for the opportunity cost of their time. Thus, the Group recommends that:

**The maximum fee per sitting should be increased from Rs.2,000 to Rs.5,000; and this should be revised at least once every five years to account for inflation. This change should be incorporated in the Rules.**

**Existing provisions allow for commissions to non-executive directors which vary from 1% of net profits for companies with managing or whole-time directors to 3% for others are adequate to attract talent. Hence, there seems to be no reason for revising them upwards.**

### E. Liability of Non-Executive Directors

4.13 A deterrent to securing the services of professionals as non-executive directors is the fact that they are often sought to made liable for certain offences of a company. Typically, a non-executive director has far less information about the day-to-day running of the company and whether it is complying with all the provisions of various corporate laws than a managing or whole-time director. The Group recognises this informational asymmetry, and recommends that:

**There should be an explicit proviso in Section 5 ("officer who is in default") which excludes non-executive directors, except in cases where such a person is a signatory of any declaration made by the company.**

### F. Officer who is in Default

4.14 The list under Section 5 of the Act does not recognise that defaults can, and do, occur with respect to the issuing and transfer of securities. Since capital markets will play an increasingly important role in the future, the Group recommends that:

**The list of persons who can be officers in default should**

**include the existing personae in the Act; and**

**in the case of issuing or transfer of any securities, merchant bankers, share transfer agents, registrars to the issue and bankers to the issue; but**

**exclude non-executive directors unless they happen to be signatories to any declaration made by the company.**

### G. Disqualification of Directors who Contravene the Take-over Code

4.15 If any director of an acquirer company contravenes any provision of the Take-over Code, then the Group recommends that he would be disqualified from being a director of either the acquirer or the target company for a period of two years.

### H. Managerial remuneration: amount and disclosure

4.16 Some of those who deposed before the Group were in favour of removing Central Government restrictions upon managerial remuneration as well as on managing directors and executive or whole-time directors. They argued that fixing such remuneration should be purely on the basis of shareholders' consent. After considerable internal discussion and debate, the Group recommends that:

**The present regime of managerial remuneration has worked satisfactorily. Sections 198, 309 and Schedule XIII of the Act are ample enough to give sufficient flexibility to profitable companies to attract and retain the best talents.[1] Moreover, the Act allows a company to go beyond these limits subject to approval by the DCA. Therefore, the core of these provisions should remain unaltered, at least for the next five years. However, Sections 310, 311 and 637AA are to be deleted.**

4.17 Every public limited company has to give data on the remuneration of directors (including commissions), which are treated as integral to the profit and loss account. This is a desirable practice, although such disclosure often tends to get lost in the schedules. The Group recommends that:

**The format as it exists must continue. In addition, a tabular form of directors' remuneration and commissions should form a part of the Directors' Report of all public limited companies.**

### I. Audit Committees

4.18 Some of the professional bodies and financial institutions which interacted with the Group argued in favour of compulsory Audit Committees (consisting of non-executive directors) for the large and medium sized listed companies. The Group debated this issue at great length; and the discussion centred around form versus substance. The Group felt that, in the present milieu, legislating in favour of Audit Committees would be counter-productive, and lead to such situation where such Committees would be often constituted to meet the letter – and not the spirit – of the law. Therefore, the Group recommends that:

**At this juncture, the requirement for Audit Committees and Nomination or Remuneration Committees should not be mandated by the Companies Act. Instead, it should be voluntary, with the three apex industry associations – CII, FICCI and ASSOCHAM – playing a catalytic role.**

## Secretarial Compliance Certificate

4.19 The Group felt that company secretaries have played a key role in ensuring that the working of companies is in accordance with the legal provisions of the Act and other corporate laws. Nevertheless, there were two issues that needed to be addressed. First, whether there was a need for every company to have a full-time Company Secretary? And, second, how could one ensure more effective secretarial compliance, under the Act? The Group recommends that:

[1] In the Indian context, few can argue that a ceiling of 5% of net profits if there is only one managerial person, or 10% if there are more than one is miserly. Even for an unprofitable company, Schedule XIII has a reasonable upper bound of Rs.87,500 per month.

**There should be a Secretarial Compliance Certificate forming part of the Annual Return filed with the Registrar, which would certify, in a prescribed format, that the secretarial requirements under the Companies Act have been adhered to. This would be governed by the following norms:**

1. **For listed companies having a paid-up capital of Rs.2 crores or more, it would be mandatory to have a whole-time Company Secretary. For others, it would be optional.**
2. **Since a whole-time Company Secretary falls under the category of "officer who is in default", it is presumed that he has every reason to discharge his obligations as per the Act. Therefore, companies with a whole-time Secretary would not require to submit a Separate Compliance Certificate to the Registrar.**
3. **Submitting the Secretarial Compliance Certificate to the Registrar would be mandatory for companies having a paid-up capital in excess of Rs.10 lakhs but below Rs.2 crores.**
4. **For companies having a paid-up capital of less than Rs.10 lakhs, the Secretarial Compliance Certificate would be optional.**

## Inter-corporate Loans and Investments

4.20 All over the developed world, corporate growth has been predicated upon flow of funds from one company to another. Cash rich firms have invariably used their free reserves to lend to or invest in other companies. The post-war experience of Great Britain, the U.S.A, Germany, Sweden, Japan, Korea and, more recently, Malaysia, Singapore and Indonesia clearly demonstrates the positive role of inter-corporate loans and investments.

4.21 In this respect, India lags far behind. The Dalmia-Sahu Jain Enquiry Commission of the mid-1950s seems to have fostered a belief as if all companies are fountainheads of financial dishonesty. As a consequence, Government placed severe restrictions on inter-corporate loans and investments. The current limits are 30% of paid-up capital plus free reserves for loans and a similar one for inter-corporate investments – hardly the ceilings that one should have in an era of competition and consolidation.

4.22 The Group strongly believes that the current provisions in Sections 370 and 372 of the Act have stifled industrial growth and have needlessly raised the cost of capital. Therefore, the Group recommends that:

**The provisions of Sections 370 and 372 of the Companies Act should be merged and radically altered.**

**Companies should be permitted investment of up to an aggregate limit 60% of the capital and free reserves, or 100% of the free reserves of the company, whichever is higher, as either inter-corporate investment or loans.**

**The right to investment either in equity or securities or by making loans up to the above limit should be a matter of corporate decision by the Board of Directors.**

**In case a company wishes to invest in excess of this limit prior permission should be obtained from the general body of shareholders by passing of a special resolution. In the interest of shareholder protection, such a special resolution should clearly state the amount that is to be invested and the purpose of such investment.**

4.23 The Group wishes to emphasise that increasing the limits, for inter-corporate investments and loans does not imply that all companies would opt for financing rather than manufacturing or trading. Companies work according to their comparative advantages; it is wholly unrealistic to expect a firm whose core competence is electronics to pack up its profitable manufacturing operations to become a net money-lender. And, even if a few do so, all will not – because there can be no demand for finance without adequate production of goods and services. So, the premise that increasing limits would put an end to manufacturing in favour of money lending is nothing but an irrational and unwarranted fear.

## Registration of Charges

4.24 Registration of charges is presently covered under Part V of the Act. This is an important function which needs to be streamlined through accountable delegation. Keeping this in mind, the Group recommends that:

**The registration of charges and the delegation of the function of certifying the creation of charges should be empowered to the statutory auditor, who would be liable in the event of false certification. Moreover, the Registrar of Companies would be empowered to grant extensions of time for registration of charges, according to prescribed guidelines.**

## Shareholder Matters

### A. Nomination facilities

4.25 The absence of nomination facilities for securities in the Act has needlessly created hardship to the survivors or successors of deceased security holders. The Companies Bill, 1993, had recognised this problem. The Group recommends that:

**Section 82 of the Act would be amended on the lines of the Companies Bill, 1993, and would provide for nomination facilities for such securities.**

## B. Proxies versus Postal Ballot

4.26 The Group debated about postal ballot. Although there are arguments in its favour, the Group concluded that postal ballot was not feasible in the present context. The basic reason is the state of postal infrastructure in India. To ensure that every shareholder can exercise his or her ballot rights, the notice of the meeting and the resolutions must reach at least a month before the date of the general meeting. Even so, one cannot guarantee that shareholders in small towns will receive the papers in time, if at all. The logistics of postal ballot in today's scenario are quite horrendous. Ballots will have to be sent by registered post, which is costly. Even that will not ensure that the ballots reach in time. The upshot is bound to be needless altercations between the shareholders and management.

4.27 Feasibility is not the only issue. At present, management can – and often does – introduce amendments to a motion after hearing the views of shareholders at the general meeting. Under postal ballots, this will not be possible. Hence, a seemingly better system may actually turn out to be more inflexible than proxies.

4.28 However, the Group also felt that the system of proxies could be improved upon to give more say to shareholders. Taking everything into consideration, the Group recommends that:

**Given the present state of postal services, postal ballots should not be introduced as a substitute to the current system. At the same time, the role of proxies should be strengthened by permitting two rights: to vote in show of hands and to speak at general meetings.**

## C. Voting According to Financial Stake

4.29 The cornerstone of corporate democracy is that members vote according to financial stake. This principle is followed in the existing Act for all but one situation. The exception is to be found in sub-section (2) of Section 391. For mergers, amalgamation and any other compromise between a company and its shareholders, there is a provision that allows voting not according to stake but according to type or value. What it means is that someone owning, say, 50,000 shares has the same voting power in a special resolution as another owning 10 shares. Since shareholders are the ultimate risk-takers, their ownership signifies the extent of their commitment to a company. Section 391(2) denies this basic fact. Therefore, the Group recommends that:

**There should be no deviation from the principle of voting according to stake. Consequently, the existing provision of Section 391(2), i.e. "if a majority *in number* representing three-fourths in value" be substituted by the usual mode of voting on any special resolution.**

## D. Oppression of majority shareholders by a strategic minority

4.30 Just as the management and the Board of Directors have duties towards the shareholders, so too do shareholders towards their company. The Group noted with dismay a few practices that have vitiated the concept of shareholder's duties towards good governance. The first has to do with the manner in which a few shareholders try to use a provision of the existing Act to extract personal concessions from management. By this, the Group refers to the use of Section 257.

4.31 Section 257 states that any member of a public limited company who is not a retiring director is eligible for appointment as a director provided that (i) he is proposed by himself or any other member not less than 14 days before the AGM, and (ii) the proposal is in writing and accompanied by a deposit of Rs.500, which is refundable if elected. In such an event, the company has to inform all its shareholders of the candidature by serving individual notices not less than 7 days before the AGM, or by advertising the fact in an English and a regional language newspaper of the city where the company has its registered office.

4.32 In the last few years, this provision has been misused by a handful of shareholders. Typically, they approach a company with a large and dispersed shareholder base a day or two before the 14-days deadline and propose themselves or someone else as director. The company faces two costly options: (i) to send notices to individual shareholders, which can cost several lakhs of rupees, (ii) to advertise, which is also costly. Since these people know the cost implications, their purpose is to misuse Section 257. To prevent this, the Group strongly recommends that:

1. **Section 257 of the Act should be amended so that any member must have the consent of 100 shareholders or of 1% of the voting rights before he can suggest his or someone else's candidature as director.**
2. **The candidature should be accompanied by a deposit of Rs.50,000, which would be forfeited only in the event of the candidate not getting the votes of even 1% of the voting shareholders present in the AGM.**

4.33 The Group also recommends that :

1. **There should be restriction with respect to removal of directors, removal or re-appointment of statutory auditors.**
2. **The demand for poll at the General Meeting would be permissible by one or more shareholders holding shares of the Face Value of Rs. 5,00,000 or holding of 1% of the paid up capital of the company whichever is lessor.**
3. **Petition for injunctions on the holding of Annual or Extraordinary General Meetings/or issue of securities of by a company should be heard only in the High Court which has jurisdiction over the registered office of a company.**

## E. Gifts at AGM

4.34 In the 1970s, some companies began the practice of giving gifts to shareholders at the AGM. Now it has assumed cancerous proportions. It is virtually impossible to conduct an AGM of many companies without giving increasingly valuable gifts to appease shareholders who attend meetings. Without such presents, shareholders have been known to heckle and continuously disrupt proceedings, ask for poll on every resolution, and have even turned violent.

4.35 The ideal way to put an end to this is for chambers of commerce and industry associations to persuade their members to put an end to it, even at the cost of having one or two disruptive and contentious meetings. Powerful companies have indeed put their foot down and sent a message. But for many medium sized companies, taking a hard line is easier said than done. To give support to the management of these companies, the Group recommends that:

**There should be a section in Part VI, Chapter 1 of the Companies Act ("Meetings and Proceedings") that debars companies from giving gifts and presents to shareholders attending general meetings or otherwise.**

# 5

# Accounts, Audit and Financial Disclosures

5.1 INTEGRITY OF ACCOUNTING AND AUDITING PROCEDURES AND THE QUALITY of financial disclosures are fundamental to corporate transparency and long term shareholder support. In this, the Group feels that India's financial press and electronic media have played a key role during the last five years. They have not only brought economic news to the fore, but have also induced a level of disclosure that was inconceivable even a decade ago. Today, the half-yearly and annual results of all significant companies are carefully examined, analysed and reported in the major dailies, internal governance issues have become *de facto* public domain, and very few company can cut corners without the risk of catching the attention of either an investigative reporter or a financial analyst. This, more than anything else, has created a healthier environment to foster good corporate practices.

5.2 The Group is grateful to the community of financial reporters, analysts and researchers, for they have made its task easier. Thanks to them, it is far more feasible to recommend more relevant disclosure norms in the new Act than it would have been in the 1970s and 1980s. It is appropriate, therefore, that the Chapter begins with financial disclosures before moving on to other matters such as depreciation.

## Financial Disclosures

5.3 In the earlier Chapters of the Report, the Group has recommended a couple of disclosures that are essentially financial in nature. These need re-stating.

1. Costs incurred, if any, in using the services of a Group Resource Company must be clearly and separately disclosed in the financial statement of the user company.
2. The present format of reporting directors' remuneration must continue. In addition, a tabular form of directors' remuneration and commissions should form a part of the Directors' Report of all public limited companies.

5.4 We now move on to other important financial disclosures.[1] Some of these are new, and others exist in Schedule VI of the Act. One point needs to be emphasised. Contrary to populist opinion, the disclosure requirements in Schedule VI are very

[1] It should be noted that the Report only emphasises the more important financial disclosures. Schedule VI to the Act contains very many disclosures – many of which are being made more effective. However, it would be difficult and tedious to note all of them in the Report. For a full understanding of all financial disclosures and accounting practices, the reader will need to refer to the draft Bill.

stringent. Keeping the best of these and adding a few more relevant ones can create a more than adequate disclosure environment in the law.

### A. Business Segments and Divisions

5.5 For a multi-division or multi-segment listed public company, the Group felt that there should be some qualitatively relevant information on these segments or divisions without necessarily exposing detailed data to potential competitors. Keeping this in mind, the Group recommends that:

**A listed public limited company must give certain key information on its divisions or business segments as a part of the Directors' Report in the Annual Report. This should encompass (i) the share in total turnover, (ii) review of operations during the year in question, (iii) market conditions, and (iv) future prospects. For the present, the cut-off may be 10% of total turnover.**

### B. End-Use of Funds Raised from the Capital Market

5.6 Shareholders have the right to know – and companies the duty to disclose – how they have utilised funds raised through a fresh capital issue. Therefore, the Group recommends that:

**1. Where a company has raised funds from the public by issuing shares, debentures or other securities, it shall be required to give a separate statement showing the end-use of such funds, namely:**

**a) how much was raised versus the stated and actual project cost;**

**b) how much has been utilised in the project upto the end of the financial year; and**

**c) where are the residual funds, if any, invested and in what form.**

**1. This disclosure would be in the balance sheet of the company as a separate note forming a part of accounts.**

### C. Debt Exposure

5.7 At present, Schedule VI of the Act provides for fairly detailed disclosure on debt. Nevertheless, it was felt that this area needs to be strengthened further. Thus, the Group recommends that:

**In the schedule, there should be clear demarcation between "long term loans" (falling due at least after 12 months from the date obtained) and others. In addition to giving the aggregate amount of long term and short term loans, certain important sub-heads should be categorised as:**

| | Long Term Loans | Short Term Loans |
|---|---|---|
| Secured (giving nature of security) | Banks and financial institutions, debentures (with rate of interest, date of issue, and date and term of redemption or conversion), subsidiaries and others sources (specifying nature) | Banks and other financial institutions, subsidiaries and others (specifying nature) |
| Unsecured | Fixed deposits, banks, subsidiaries and others | Banks and other financial institutions, subsidiaries, others (specifying nature) |

## D. Interest on Debt Exposure

5.8 Schedule VI of the Act clearly specifies that a company must disclose the amount of interest on its debentures, with disclosure on any such interest if paid or payable to the managing director and the manager. In addition, it must separately give full details on interest on debentures, loans and other liabilities that have been outstanding for six months or more. **The Group recommends that this disclosure be retained in the new Act.**

## E. Foreign Exchange

5.9 With more Indian companies accessing foreign exchange for trade as well as investment, it is necessary to give a more comprehensive break-down of foreign exchange exposure and use. The Group recommends that:

1. **At present, paragraph 4.D of Part II of Schedule VI requires companies to comply with considerable disclosure on foreign exchange earning and outflow. This should continue.**
2. **In addition, there should also be a note containing separate data on of foreign currency transactions that are germane in today's context: (i) foreign holding in the share capital of the company, and (ii) loans, debentures, or other securities raised by the company in foreign exchange.**

## F. Investment

5.10 Under Schedule VI, the balance sheet category "investment" is classified under four broad heads: (i) in Government or Trust securities, (ii) in shares, debentures, bonds and other such security, (iii) in immovable property, and (iv) in capital of partnership firms. Moreover, such outlays – irrespective of whether it be "investment" (i.e. long term) or as a part of current assets – are expected to be separately segregated as trade related and other investments. The Group felt that such disclosures were quite detailed and satisfactory. In other words, the Group recommends that:

> **1. The 2x2 classification of investment and current assets in Schedule VI (i.e. trade versus non-trade, and quoted versus unquoted) be retained in the new Act.**
>
> **2. While the cell totals are important, it is not necessary to give details of every single small investment – sometimes as low as Rs.1000 – in the note. Instead, there should be the total under the four heads, and details of those investments that account for 5% or more of each total. This is an example of focusing on the quality of disclosures, which is sometimes forgotten in order to maximise quantity.**

## G. Commission and Brokerage to Sole Selling and Other Agents

5.11 Schedule VI provides for giving detailed data on commission and brokerage to selling agents. **The Group recommends that this disclosure should continue in the new Act.**

## H. Adjustment Between end of Financial Year and Board Approval

5.12 There are often differences in assets and liabilities between the end of the financial year and the date on which the Board approves the balance sheet and profit and loss account. In addition to such disclosures appearing in the Directors' Report [Sec 217], **the Group recommends that these differences should be clearly stated under the relevant sub-heads, and presented as a note forming a part of the accounts.**

## I. Fixed Assets through Leasing

5.13 Leasing has become an important manner of financing fixed asset formation. Unfortunately, it is sometimes subject to under-reporting. The Group recommends that:

> **If any fixed asset acquired through or given out on lease is not reported under appropriate sub-heads, full disclosure would need to be made as a note to the balance sheet. This should give details of the type of asset, its total value, and the future obligations of the company under the lease agreement.**

## J. Inappropriate treatment in Accounts

5.14 The Group recommends that:

**Any inappropriate treatment of an item in the balance sheet or profit and loss account should not be allowed to be explained away either through disclosure of accounting policies or via notes forming a part of accounts.**

### K. Cash Flow Statement

5.15 Under Clause 32 of the Listing Agreement, listed companies have to append a cash flow statement under three broad heads: (i) from operating activities, (ii) from investing activities, and (iii) from financing activities. The Group felt that the present form of the statement gives very little relevant information and is more an object of form than substance. Therefore, the Group recommends that:

**A new, more informative and user-friendly cash flow statement should be designed in consultation with the Institute of Chartered Accountants of India (ICAI) and would form a part of Schedule VI for listed companies alone.**

### L. Earnings per Share (EPS) and Cash EPS

5.16 With the capital market becoming more important, listed public companies have a duty to disclose to their shareholders the EPS and cash EPS (gross, of depreciation). EPS disclosure has recently come into being.

**The Group recommends that EPS as well as cash EPS should form a part of the disclosure in the Annual Report.**

### M. List of employees under Section 217(2A)

5.17 At present, companies have to prepare, as a part of the Director' Report, a list of employees who earn above Rs.3 lakhs per year, with a list of attributes such as years of employment, position, previous employment etc. Two points need to be noted. For several large and even medium sized companies, this is a very long list that has no great disclosure value to a shareholder.[2] Moreover, in today's context, the threshold is quite low. Ideally, this requirement ought to be eliminated. However, the Group felt that this should evolve out of the public debate and recommends that, at the very least:

1. **The threshold should be raised to Rs.5 lakhs per year, and that it should only be submitted to the Registrar of Companies and not form a part of the Directors' Report. The statement should be made available for inspection of shareholders at the AGM.**
2. **However, if there are any director relatives who receive remuneration full details of such cases should be given.**

[2] It has a negative value insofar as it gives free information to head hunting firms.

## N. One Deletion

5.18 Even after the dismantling of the licensing regime, companies are expected to give details of irrelevant concepts such as licensed and installed capacity. The Group recommends that:

**The requirement to give licensed and installed capacity should be eliminated from Schedule VI of the new Act.**

## Directors' Statement of Responsibility

5.19 For some time, there has been a demand for framing a model code of corporate governance. The Group discussed this issue at great length and concluded that there is a need to define the scope of the Directors' responsibilities. This is sought to be achieved by recommending that there should be a specific statement of the responsibilities of the Directors of a company. A model of the Directors' Responsibility Statement (DRS), which should be published in its Annual Accounts, is recommended below:

**Companies Act requires the directors to prepare financial statements for each financial year, which give a true and fair view of the state of affairs of the company at the end of the year and of the profit or loss of the company for that period. In preparing these annual accounts, the directors are required to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent.**

**The directors must also specify whether applicable accounting standards have been followed and, if not, disclose and explain any material departures in the financial statements. The annual accounts must be prepared on the going concern basis, unless it is inappropriate to presume that the Company will continue in business.**

**The directors are also responsible for the maintenance of adequate accounting records in compliance with the Companies Act, 1997, for safeguarding the assets of the Company, and for preventing and detecting fraud and other irregularities.**

5.20 The key point is that the code of corporate governance should not be limited to the DRS. As mentioned earlier, governance standards need to be recommended by industry associations and other professional bodies; and, if required, such standards may need to go beyond the scope of their legal or regulatory codes of conduct. Professionals like company secretaries, chartered accountants, lawyers, consultants, as well as financial institutions and their nominee directors could also be covered by the concept of a code of corporate governance, as their actions impinge upon corporate functioning. The actions of the shareholders and the representative bodies at general meeting, and the manner in which corporate meetings are conducted, are also matters of good corporate governance.

## Accounting Standards

5.21 As a matter of corporate policy, the Group strongly felt that **accounting standards as well as financial and audit statements have to be consistent with those published by Institute of Chartered Accountants of India (ICAI) from time to time. No less importantly, the Income Tax standards should also be those prescribed by ICAI.** In the event that there is any deviation from the accounting standards, the Director's explanatory notes included in the Annual Accounts must give a justification and the rationale of deviating from the standard.

5.22 On the matter of standards, the Group was particularly concerned about a serious matter, which has been communicated to the Working Group on the Income Tax Act. This has to do with the difference in accounting standards on interest income during the construction period. The deviation in accounting procedures has been introduced by the Income Tax Department; and, if it continues, will have serious repercussions for infrastructure projects. It needs some explanation.

5.23 By its very nature, infrastructure projects have long construction periods which, in turn, sometimes creates an asymmetry between fund inflow and immediate needs. Given the "lumpiness" of construction activity, it is reasonable to assume that finance raised at the commencement of a project may need to be temporarily employed elsewhere.[3] The Group strongly believes that any interest income earned in the interim during the construction period should be set off against interest outgo and other expenditure during construction. In this, it has followed ICAI's guidance note as well as the decision in the Maharashtra Electrosmelt case. However, the Income Tax authorities consider it otherwise, and treat it as "taxable income from other sources". This is one of several instances where accounting standards need to be reconciled through consultation between the Income Tax Department and ICAI.

## Protection to Holders of Company Deposits

5.24 Since company deposits are in the nature of unsecured loans, deposit-holders are more prone to corporate defaults. The 1997 Amendment Act has provided for two types of protection: defaulting companies are no longer permitted to accept further deposit, advance inter-corporate loans and investments. To further protect their interest, the Group recommends that:

**Section 58A of the Act should be modified so that companies who fail to repay the principal or pay interest would be banned from declaring dividends until the default is made good.**

[3] Presumably, no one will argue that it should be kept idle between two bursts of construction activity.

## Consolidation of Group Accounts

5.25 Consolidation of accounts of companies within a group has become the norm in most OECD countries. It is also the case that the countries which permit such consolidation simultaneously allow the consolidated group entity two key facilities:

a) leveraging funds on the basis of the group's assets, market value or net worth; and

b) making tax provisions and set-offs applicable for the group as a whole.

Unfortunately, neither happens to be true in India. Banks and financial institutions do not treat a group as a borrowing entity;[4] and, until date, there is no indication that the Income Tax Department will accept the concept of a group for tax purposes. In such a context, mandatory consolidation will only have a severe asymmetric impact. Keeping this in mind, the Group recommends that:

1. **For the present, consolidation of accounts of the holding and subsidiary companies should be optional.**
2. **Before consolidation is made mandatory for holding and subsidiary companies, the banks and financial institutions should agree to lend on the basis of group leverage, and the Income Tax Act should recognise consolidation for tax purposes.**
3. **If a group chooses to consolidate on a voluntary basis, then it should not be required to annex the accounts of its subsidiary companies under Section 212 of the Act.**

## Chief Financial Officer (CFO)

5.26 It is international best practice for listed companies above a certain size to have a CFO who is fully responsible for the financial accounts of a company's operations. The Group felt that this is a good practice and ought to be in law. Therefore, it recommends that:

**A listed company having issued capital of Rs.3 crores and above should have a CFO, who may be a chartered accountant or a cost accountant. A CFO would be legally responsible for proper maintenance of the Books of Account, and should ensure disclosure of all required information in the Offer Documents and Annual Financial Statements of the Company.**

## Cost Audit

5.27 No one can deny that appropriate costing is a key management function of manufacturing companies. However, there is a difference between costing on the one hand, and mandatory cost audits as given in Section 233B of the Act. The former

[4] Which they should, if they wish to monitor their funds better.

is an internal management tool; the latter is a mandatory audit and has little to do with *ex ante* management decisions. Moreover, it needs to be recognised that the provision was introduced in 1965. That was an era of relative autarky, massive quantitative controls, and a plethora of administrative prices. These do not make economic sense in a flexible competitive world, where all that matters is the changing structure of demand. Either the costs are compatible with demand, or they are not. Neither states alter through a mandatory cost audit as prescribed in Section 233B. Therefore, the Group recommends that:

**The provisions under Section 233B concerning mandatory cost audit at the directives of the Department of Company Affairs should be removed. However, the requirement to maintain cost records should continue as before.**

## Depreciation under the Companies Act

5.28 In the course of the current fiscal year, the issue of depreciation under the Companies Act and the Income Tax Act has again attained prominence. Before outlining the logic behind the Group's recommendation, it is necessary to give an analytical overview as well as a bit of history.

5.29 First the analysis. The depreciation rates under the Companies Act and the Income Tax Act serve very different objectives. The former uses the rates to reflect a "true and fair view" of the affairs of the company in the interests of shareholders, creditors and other stake-holders. Therefore, its objective is to create long term corporate value for the shareholders. To do so, the Act recognises the need to gradually write off assets over a number of years.[5] The Income Tax Act uses depreciation to calculate net taxable income. Equally importantly, tax depreciation rates are universally recognised as fiscal instruments to promote investment in desirable areas.

5.30 The depreciation rates under the Income Tax Act are not just deductions for fall in value of fixed assets due to their "productive use" and "obsolescence". These are also designed to provide funds for replenishment and replacement of assets. As competition increases, the need for such funds will be greater than ever before. There is also an incentive aspect. The depreciation rates under Income Tax have often been designed to encourage core and priority sector industries, facilitate funding of such projects through appropriate debt-equity ratios, and to generate cash flows for timely debt servicing.

[5] In fact, the rates under the Companies Act implicitly take into account the fact that in a capital scarce economy such as India, companies tend to use fixed assets throughout their "useful life" – which is often beyond their "economic life". No doubt this increases marginal cost of the use of machinery, but its impact on total cost is generally negligible. In any case, such inefficiency at the margin has to be evaluated against higher interest cost incurred for new machinery. The overall results are inconclusive.

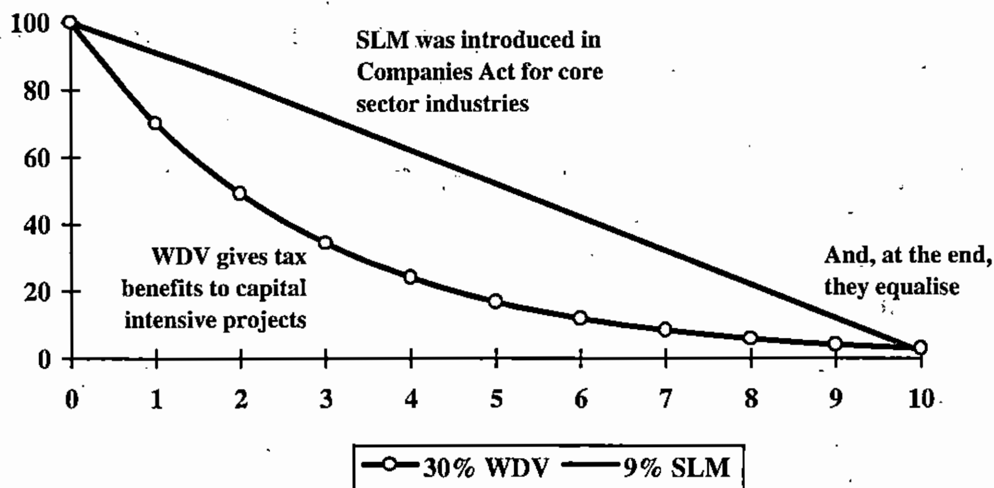
5.31 This incentive aspect of depreciation in is particularly important in the Indian context. Despite living in an age of inflation and high technological obsolescence, our tax laws do not allow for depreciation of fixed assets on the basis of replacement cost basis.

5.32 Given this basic difference, **the Group believes that it is logical to maintain a distinction between the two sets of rates**. This is also in line with the view of the *Tax Reform Committee* (*Chelliah Committee*).

5.33 The issue is not merely one of logic. It has to do with reality. At present, the primary and secondary capital markets are in doldrums. Any increase in depreciation rates under the Companies Act will have the immediate consequence of reducing profits, dividends, and hence, share prices and market capitalisation. Conversely, any reduction in depreciation rates under the Income Tax Act will immediately erode cash flow and trigger debt defaults – which, in turn, will raise the proportion of non-performing assets held by banks and financial institutions. It is, not surprising that no constituent corporate India – companies, industry associations, SEBI, capital market intermediaries, banks or financial institutions professional bodies – has wanted any aligning of the depreciation rates under the Companies Act and the Income Tax Act. Clearly, both the suppliers and the users of public fund know the consequences only too well.

5.34 There is a historical aspect that needs to be mentioned. The last change in these rates under the Companies Act took place in March 1995, after almost a year's deliberation involving the DCA, industry associations and various all-India level professional bodies. It is now February 1997. The Group does not recognise the rationale to alter these rates in the course of two years.

5.35 As far as the two methods of calculating depreciation are concerned, it must be stressed that "written down value" (WDV) method of depreciation under the Income Tax Act and the "straight line method" (SLM) under Section 205(2)(b) of the Companies Act converge over a period of time. This becomes clear from a hypothetical example given in the chart below for a fixed asset costing Rs.100 crores.




5.36 Under WDV, a company gets high initial benefits which reduce with every passing year. SLM was introduced in the Companies Act by an amendment in 1960 to foster investment in priority, core and infrastructure projects. The Group felt that both methods should continue under the provisions of the new Act.

5.37 Another issue needs to be brought into focus. There is sound economic rationale for the Companies Act to have shift-based depreciation rates under WDV and SLM. Both economic and useful life vary according to shifts, and there is no merit whatsoever in forcing a single rate for each category irrespective of the shift worked.

5.38 Taking all these factors into account, the Group recommends that:

**The existing practice of having different rates and methods of providing for depreciation under the Income Tax Act and the Companies Act has served a useful purpose and needs to continue.**

**Any attempt to align the two sets of rates will have severely detrimental consequences for companies, share prices, capital markets, shareholders, small investors, banks as well as financial institutions. Our economy may be spared from such shocks.**

5.39 The Group reiterates that while there is no need *per se* to change the basic structure of the rates under the Companies Act, there could be discussions on fine tuning and rounding off the existing rates of depreciation, and the possibility of reducing the number of categories/slabs. A model suggested putting up the minimum rate of depreciation on SLM for generating a debate on this key aspect is setout below:

| Machinery | SLM (Minimum) Rate | | |
|---|---|---|---|
| | Single Shift | Double Shift | Triple Shift |
| New | 5 % | 7.5 % | 10 % |
| *(Second Hand | 10 % | 15 % | 20% |
| Building including } Factory Building } | | - | 2.5% |
| *Ships | | - | 5% |
| Other assets including Cars, Office Equipments etc. | | - | 10% |

Note 1 *Suitable definition of second hand machinery/ships (i.e. resident life of less than 10 years) and appropriate rates for the same to be incorporated.

Note 2 In this model, companies will of course be at liberty to provide for a higher depreciation in their discretion on either SLM basis or WDV basis.

# 6

# Mergers, De-mergers And Corporate Restructuring

6.1 In the western world, mergers and de-mergers have been very important instruments for corporate restructuring since early 1960s. This trend has now come into being in India. Firstly, in current de-regulatory environment, group companies are organizing into sharply focussed segments. Secondly, in joint ventures, the foreign partners insist upon segmentation of the activity from divisions/activities of company other than joint venture activities into a separate company. Thirdly, there is a trend in family-owned businesses to divide and restructure the ownership so as to entrust management of specific parts to different branches of the families.

6.2 Accordingly, the Group decided to discuss these points in a joint meeting with the Working Group on The Income Tax Act. It was prompted by the belief that a unified approach in the matter of de-mergers and restructuring would go a long way in the expeditious reconstruction of business entities in India.

Such a meeting was held on 5th January, 1997 in which it was noted that the need for providing specifically for the concept of de-mergers was first recognized by the Chelliah Committee which had set out the areas for amendments that are necessary in clause (i) section 2 (22) of the Income Tax Act regarding the definition of "dividend", clause (ii) section 49 of that Act providing for non-taxability of capital gains on account of sub-division or de-merger and (iii) exemption from levy of gift tax by modifying section 45B of the Gift Tax Act.

6.3 In the light of the discusssions, the Group recommend that

**De-mergers and Sub-Divisions be recognised and made tax neutral under the Income Tax Act subject to satisfaction of the following criteria:**

**(1) There is substantial identity between persons owning various parts of the business both before and after the restructuring.**

**(2) The restructuring is for <u>bonafide</u> business reasons.**

**(3) That none of the original company's/former shareholders is contemplating the sale or cessation of business in post restructuring period.**

**(4) New owners are only a sub divided part of the old owners and the old owners should have substantially held their shares for a minimum period of immediately preceding two/three years.**

For expediting restructuring, it would be desirable to allow losses to be carried forward in a merger to any company subject to the tax shield available being transferred to a separate Restructure Reserve such a reserve to be used and redeployed entirely and exclusively for reconstruction and rehabilitation of old sick units.

6.4 In his Budget Speech, the Finance Minister promised change in SICA and in BIFR procedures, and a new draft is expected to be placed before Parliament in the first quarter of 1997. For the amended SICA to fall in line with international practices and for it to be more meaningful in the Indian context, it may ensure the following:

- **eliminate the notion of net worth erosion and make the trigger debt default for 365-days;**
- **make the reference to BIFR voluntary for the firm as well as creditors – and so encourage both parties to settle outside court;**
- **ensure that if a firm chooses to come to BIFR, it cannot use the body to create further delays, which can be implemented by a process that:**
  - **eliminates debtor-in-possession;**
  - **immediately puts up the company for sale under the supervision of an independent professional who acts as an administrator on behalf of BIFR;**
  - **the sale process is preceded by transparent, strictly time-bound due diligence procedures and an independent, though confidential, assessment of liquidation value;**
  - **the sale is conducted publicly through a sealed bid Vickerey auction under supervision of independent administrator, where the existing promoter is also allowed to bid;**

**if the winning bid is less than the liquidation value then the firm is liquidated; if it is equal to or more than the liquidation value then the shares of the promoter are transferred to the winner, and the proceeds of the sale go to satisfy creditors according to APR.**

6.6 While SICA provides for a comprehensive code for dealing with revival, rehabilitation and winding up of sick or potentially sick companies, it is limited in its application to companies engaged in industries included in First Schedule to the Industries (Development and Regulation) Act 1951 (IDRA). The Group therefore, recomends that:

| **In respect of companies engaged in the activities outside the purview of IDRA, a regime for rehabilitation and revival, similar to that of SICA may be provided for Act. Such a step will go a long way in effectively dealing with the problems of sickness of such companies.** |
|---|

# 7

# Winding Up of Companies

7.1 THIS CHAPTER FOCUSES ON EXPEDITING THE WINDING UP OR LIQUIDATION OF companies. This is a key area which can make or mar the possibility of rapid re-use of productive assets lying dormant across the length and breadth of the country.

7.2 Major delays in High Courts to wind-up companies that are beyond redemption have been proven by evidence. The table below gives the data as of 1992-93 for 1,859 companies which were under winding up in courts.

**Delays in Winding up in Court**

| 0-10 yrs | 10-20 yrs | 20-30 yrs | 30-40 yrs | 40-50 yrs | > 50 yrs |
|---|---|---|---|---|---|
| 774<br>(41%) | 506<br>(27%) | 346<br>(19%) | 186<br>(10%) | 44<br>(2%) | 3<br>(1%) |

Source: Ajeet N. Mathur, 'Industrial restructuring and the National Renewal Fund', mimeo, Asian Development Bank, 1993.

7.3 The contrast between Indian winding up and the Barings case cannot be starker. Here was a company that suddenly became insolvent thanks to the activities of a single rogue trader. The Bank of England immediately launched an investigation. But, what was remarkable was a universal appreciation of the fact that a quick settlement had to be reached with the creditors, so that the firm could be quickly liquidated and "re-born" under new management. The entire Baring affair was settled within two weeks, and a new body corporate was back in operation within a month. Under the present laws and procedures, such speed would be inconceivable in India.

7.4 The Indian economy has borne huge costs because of delays in winding up. The delays reflect two factors of the law and legal administration:

- lack of appreciation that it is of prime importance to preserve the value of the assets of a company that is being wound up – which is best achieved by ensuring that these assets are quickly re-allocated to productive use by more efficient entrepreneurs;
- failure to realise that the parties who are worst affected by delays in winding up are workers and secured creditors.

7.5 The Group strongly believes that winding-up procedures must radically expedite the sale of assets whether in the corporate form or as individual properties. It

has, therefore, recognised the international trend in the law relating to corporate bankruptcy: sell assets first as quickly as possible, and adjudicate and distribute later. The Group believes that this principle will also facilitate the process of distribution of sale proceeds and substitution of security to such proceeds, for the simple reason that if the money is in the kitty quickly, parties will negotiate and acquiesce faster for disposal. Keeping these in mind, the Group recommends an entirely new, and strictly time-bound approach to winding up, whose key features are:

1. **High Courts will have exclusive jurisdiction in the matter of liquidation of company.**
2. **Encouragement of voluntary winding-up, which is generally a more cost- and time-efficient manner of liquidation.**
3. **Distinct separation of the two aspects of liquidation: (i) first, asset sale and (ii) then, distribution of the proceeds.**
4. **Clarity in winding-up order – which should coherently describe the steps that have to be taken along with time frames for each action.**
5. **Clear enunciation of the manner in which the Act shall catalyse rapid, transparent, market-determined sale of assets which would not only allow for their profitable re-use, but also increase the pool for distribution to claimants, including workers.**
6. **Well-defined and non-subjective norms to ascertain whether a company's assets should be sold in totality as a going concern, or in parts as individual asset sale.**
7. **Permitting professionals such as chartered accountants, lawyers or company secretaries to be empanelled by the High Court as liquidators who may be selected as Official Liquidators.**

7.6 The basic guideline has been that the assets of a company that is being wound up should be sold within a period of six months of the winding up order. The manner in which this is sought to be implemented is by giving clear time-bound schedules to complete various processes prior to sale, and by making most of these processes concurrent rather than sequential. It is hoped that such provisions would empower the High Courts to reduce stays and dispose the cases much faster.

7.7 The Group also recommends that the High Court must distinguish between asset sale on the one hand, and misfeasance or malfeasance on the other. The latter certainly needs to be detected and punished. But this should not be at the expense of delaying the sale and re-use of valuable productive assets.

7.8 Penultimately, the success of the new winding-up procedure recommended by the Group hinges upon judicial expertise on commercial matters and the will to expeditiously dispose off the cases in the interest of the nation's economy. For both, it is vital to differentiate between when procedure is being used with the intent of creating strategic delays, and when it is justified. The Group believes that such an

ability comes with sound commercial knowledge. It is only then that judgements will bear the imprimatur of enlightened impartiality.

7.9 Finally, it may be asked why are High Courts being given exclusive jurisdiction under winding by Court – the more so given the past record. This is prompted by a reason and a fervent hope. The CLT should not be burdened with winding up, at least during the first five years of its existence. It would have neither the experience of the procedures, nor the stamp of authority that history has bestowed on High Courts. Besides, High Courts can, if they so desire, expedite procedures. The Group hopes that they will do so.

# 8

# Monitoring and Enforcement

8.1 THIS CHAPTER DEALS WITH THE WAYS IN WHICH THE REPORT PROPOSES TO restructure the regulatory mechanism for monitoring and enforcing the different aspects of the new Act. It covers four substantive issues: (i) the constitution and jurisdiction of the Company Law Tribunal vis-a-vis company court, (ii) licensing of Registrars, (iii) penalties and fines, and (iv) the need for financial commitment to develop a quick response monitoring and enforcement infrastructure .

## Company Law Tribunal (CLT)

8.2 The Group felt that while the Company Law Board has fulfilled a role, it needs to be restructured and strengthened at all levels if it is to achieve the status of an effective and expeditious enforcer of the law. A necessary condition for meeting this objective is to elevate the Company Law Board to the status of a Tribunal. Therefore, the Group recommends that:

1. **The new Act shall provide for establishment of the Company Law Tribunal (CLT) as a Quasi-Judicial Tribunal.**
2. **It shall be mandatory for the CLT to have a judicial member and a technical member of each Bench. This would be on the familiar lines of the Income Tax Appellate Tribunal.**
3. **The CLT shall have multiple Benches set up in five zones.**
4. **The CLT shall be empowered to function with much greater administrative, financial and judicial independence compared to the existing Company Law Board.**
5. **The CLT shall be under the Ministry of Law, as is the case with the Income Tax Appellate Tribunal.**
6. **In order to give concrete shape to independence, the Group recommends that the Tribunal Benches should be housed in separate premises independent of the Department of Company Affairs**
7. **The orders and judgement of the CLT shall be reported and published. These shall have precedent value irrespective of the zoning. Close co-ordination between separate zones is to be achieved in order to create uniformity.**
8. **Although it is desirable to have fresh appointments for filling the Benches of CLT, in the interegnum and for continuity, the existing Chairman and members of the Company Law Board may constitute the CLT.**

8.3 The Group also felt that introduction of experts to assist the CLT would expedite the process of adjudication and build a reservoir of skills. This recommendation is equally true for Company Courts.

8.4 The new Act would set out the selection procedures, confer rule making power for appointment of Presidents or Vice-Presidents of the CLT, and enable rules to be made for selection, recruitment, appointment, removal and other conditions of members of the CLT. It would also specify the rules for creating a panel of experts to assist the Court or the CLT in company law matters.

## Jurisdiction of Court and CLT

8.5 Multiple fora for adjudication and enforcement of corporate rights, liabilities and obligation have been the bane of Indian companies. Therefore, the Group has attempted to clearly delineate the dispute resolution mechanism available to the corporate investor, and for corporate resolution of disputes or for mergers, winding up, reconstructions, amalgamations, de-mergers and revivals. The Group recommends that:

**1. Matters concerning mergers, acquisitions, de-mergers, re-structuring and schemes of arrangement or reconstruction, and winding up shall be exclusively dealt with by the Court, with the assistance of a panel of experts acting as a Commission under Order XXVI of the Code of Civil Procedure.**

**2. The CLT shall have jurisdiction in relation to all other matters, so long as these are not within the original jurisdiction of the Company Court.**

**3. The CLT would have powers of contempt, review and power to condone delay under Section 5 of the Limitation Act, 1963.**

**4. The jurisdiction of the District Court as a Company Court would be removed. Thus, no Civil Court would have jurisdiction in any matter relating to the Companies Act, unless specifically stated otherwise in the Act.**

**5. In cases of take-overs –**

- **Neither any Civil Court nor the Company Court shall have jurisdiction to entertain or try any proceedings arising out the SEBI Takeover Code.**
- **SEBI will have a right to be heard in all matters of Takeover of Listed Public Companies.**
- **SEBI would retain its right to issue clarifications, circulars and directions from the judgements of CLT. This should help in keeping the Code in tune with the adjudicated decisions of the CLT.**

**6. The jurisdiction for buy-back of shares and disputes arising from solvency certificates or failure of companies in a buy-back will lie with the CLT.**

7. **The changes in the registered office of listed companies would be procedurally made by applying to the CLT.**
8. **All matters and disputes concerning shares or other securities or other issues provided for in the Companies Act would be taken away from the Courts, the MRTP Commission, the Consumer Courts and other fora, and would be vested in the CLT. Thus, CLT's jurisdiction would be considerably enhanced.**
9. **Appeals from the CLT would lie to the Division Bench of the High Court where the Company Court has jurisdiction over the company. Appeals from the Company Court would lie to the Division Bench of the same Court. On matters where no appeal is permitted from decisions, orders or judgements of the CLT, a direct appeal could be made to the Supreme Court of India on questions of law.**
10. **There would be a panel of experts to assist the Company Court for mergers, acquisitions, de-mergers or winding-up. These would be selected from lawyers, chartered accountants, cost accountants, company secretaries, valuers, merchant bankers, warehouse keepers, auctioneers. Appropriate guidelines as to how this panel of experts would be selected, and how they could assist the Court or the CLT would be provided for in the new Act.**

## Licensed Registrars

8.6 There are a many functions that are carried out by the Registrar of Companies (ROC) which are unrelated to enquiries, inspection and prosecution. Until date, all ROC functions are vested upon the Central Government. This need not be so.

8.7 Few would deny that Great Britain and Singapore provide excellent Registrar services. The fact of the matter is that many of these services have been licensed to efficient companies, subject to strict regulatory checks and balances.

8.8 International success is not the only reason why we should seriously consider licensing of selected Registrar services to the private sector. As of 31st of March, 1995, there were 353,292 companies registered under the Act [1]. In Maharashtra alone there are 77,560 such companies. Their affairs are being monitored by two offices located in Mumbai, whose total staff strength is not more than 200. The problem of inadequate staffing are heightened by a desperate lack of physical resources. Most Registrar's offices are woefully ill-equipped in terms of computing facilities, scanners, document handling and storage facilities and yet they are expected to handle over 1,000,000 documents in the course of a year.

8.9 The Group was in favour of two pronged strategy regarding registration: (i) the Government Registrars have to be allocated far larger funding to create

[1] Note: These are the companies limited by shares

minimal infrastructure, (ii) the Central Government must create offices of Licensed registrars, Regarding the latter, the Group recomends that:

1. **Government must permit the setting up of private licensed Registrars.**
2. **The selection of a licensee will be based on:**
- **Transparent licensing procedure**
- **Well defined capital adequacy**
- **Minimal computing, imaging, data processing, storage and on-line capability.**
- **Strong confidentiality guarantees**
- **A licensed Registrar would not handle the affairs of any of its group companies.**
- **Clear provision that all material pertaining to the Companies Act are the property of the Central Government and that the Registrar is performing a fiduciary and custodial service on its behalf.**
3. **Commitment to on-line all information for name availability and registration as well as breaches between licensed Registrar and his Government counter-parts on a daily basis.**
4. **In the event of termination of license, all property will be handed over to the Government.**

## GOVERNMENT OWNED COMPANY PROVIDING COMPANY LAW SERVICES

8.10 In addition to Licensed Registrars, the Group believes that further efficiency can be fostered by setting up a company under Government to provide registration services on commercial basis. By virtue of being a company, it will have the power to re-utilise its profits into expanding its capabilities and providing better services. Therefore, the Group recommends that:

**The Government should corporatise company law services with an adequate equity base to modernise the registration functions.**

## STRENGTHENING OF GOVERNMENT ROCs

8.11 Given the stellar contribution of the offices of the ROC, it is only fair that they be far better equipped. In 1994-95 the ROC collected a total revenue of Rs.236.6 crores. Against this its expenditure was a paltry Rs.13.9 crores. The Group recommends that:

**The funds allocated to the Government ROCs should be increased many fold. A rough estimate suggest an one-shot investment of around Rs.60 crores and annual budget of no less than 25 crores is a must to purchase and maintain the kind of facilities that are needed to state of the art registration functions. These amounts should be made available as soon as possible. In the first instance such financing will have to come from the Consolidated Fund of India. Thereafter, the proceeds of the license fee can be allocated to strengthen the office of the Government Registrars.**

Future vision: Modernised players

8.12 The Group believes that the quality of registration functions will improve dramatically, if morethan two players – Licensed Registrars, Public Sector Company and/or Government Registrars compete in terms of quality of services. The enforcement functions will however continue to vest with the Government The Table below indicates the broad classification of functions between these persons.

## Licensed Registrars

| | Government ROC | Licensed ROC | Government owned Law Services Company |
|---|---|---|---|
| Acceptance of documents | ✓ | ✓ | ✓ |
| Incorporation of companies | ✓ | ✓ | ✓ |
| Registration of prospectus | ✓ | ✓ | ✓ |
| Inspection of documents by public | ✓ | ✓ | ✓ |
| Power to make enquiries | ✓ | ✗ | ✗ |
| Power to carry out inspection | ✓ | ✗ | ✗ |
| Prosecution | ✓ | ✗ | ✗ |
| Assisting Court or CLT (producing evidence) | ✓ | ✓ | ✓ |
| Furnishing data for Company Law and DCA reports | ✓ | ✓ | ✓ |

## PENALTIES AND FINES

8.13 An significant feature of the Companies Act is how the penalties have remained mired in the 1950s.

These are out of date and do not provide for any deterrence at all. The Group recommends that :

- **Penalties would be raised by a factor of ten.**
- **Monetory fines can be imposed by the Regional Director of the Department of Company Affairs. Appeal should lie with the CLT.**
- **Continuing penalty would also rise ten times.**
- **Imprisonment with or without fine will continue to remain under the jurisdiction of the Magistrates.**

# 9

# Summary of Recommendations

## Chapter I Introduction

**Basic recommendations**

a) First, the corporate scene is changing very rapidly, and will do so at an even faster pace in the future. Hence, it is essential that the Companies Act be reviewed once every five years. This will ensure that the Act retains the flexibility which is vital for sustained corporate growth.

b) Second, despite the best of intentions and adept drafting, laws tend to have the characteristic of being carved in stone. Laws do not change seamlessly with the times, while businesses do. Thus, desirable corporate governance and practices need legal support as well as evolution of internal standards – where the more progressive elements of the corporate sector design best practices that are constantly up-dated to complement and enhance the legal provisions. Nations that have good corporate practices do not rely exclusively upon law; conversely, those with poor records have never evolved internal codes of best practice. Keeping this in mind, the Group has sought to distinguish between legal provisions that will be incorporated in the draft Bill and recommendations which ought to be followed by Indian companies in their best interests.

c) Third, it is desirable that the Report be widely disseminated and discussed in the course of the next few months. The Group commits itself to consider the various suggestions and responses before finalising the Bill that is to be eventually tabled in Parliament.

# Chapter II Classification of Companies

**Classifications of companies.**

The new Act would have a more relevant three-fold classification of companies:

1. Private companies – largely self-governing.
2. Public unlisted companies – lesser government regulations than public listed companies.
3. Public listed companies – greater flexibility in their operations than before, but with stricter compliance norms.

The new Act should make an explicit provision to allow 'Group Resource Companies' to be incorporated with the objective of making available to the constituent members of the group the relevant services and expertise described above. To ensure that such a system does not become exploitative:

1. Group Resource Companies must operate strictly on cost sharing principles – no profit no loss – rather than on the basis of a share of the percentage of profits or turnover.
2. The costs incurred (if any) in using the services of a Group Resource Company must be clearly disclosed in the financial statement of the user company.
3. The definition of a Government Company should continue, as it is in consonance with Article 12 of the Constitution of India.
4. By virtue of his fiduciary position, the Comptroller and Auditor-General (CAG) can exercise his right to appoint the statutory auditor and to conduct supplementary or test audits, if so required.
5. The Annual Report of such a company should continue to be placed before both Houses of Parliament.
6. But, no Government Company should get any concessions or privileges through special exemptions and notifications. Thus, Section 620 of the Act should be deleted.

**Deemed Public Companies Eliminated**

The Group recommends that the concept of deemed public companies the abolish and recommends concomitant deletion of section 43A.

**Memorandum & Articles of Association.**

In the interest of genuine flexibility as well brevity, Schedule I be eliminated altogether from the Bill and the same may be modified and prescribed by rules.

1. The objects should be kept as broad and flexible enough as shareholders so desire.
2. Altering the objects should be allowed subject to (i) the passing of a special resolution by the shareholders of a company, and (ii) the altered Memorandum being registered with the appropriate Registrar of Companies.

**Change of Registered Office simplified.**

For changing the registered office of private and public unlisted companies, passing of a special resolution to that effect should suffice.

This is a conscious deviation from the 1997 Companies (Amendment) Act, and is justified on the ground that the relatively limited impact of such a change in the case of small and medium sized unlisted companies does not warrant an additional approval from a quasi judicial authority.

# Chapter III Raising Capital

**SEBI sole authority for listed companies**

The regulation and disciplinary control over *public listed companies* for the purpose of issue of securities and related matters should be unified to the extent possible, and that SEBI should be the sole authority entrusted with these monitoring regulatory and policing functions.

Schedule II of the Act (Prospectus) should be under the domain of SEBI. Accordingly, Schedule II would be taken out of the new Bill and shifted to Rules.

**Freedom to transfer and acquire shares**

1. The provisions of Sections 108A through 108I of the Act – which require companies to obtain prior approval from the Central Government for the acquisition and transfer of shares – should be deleted.

a) Section 108 of the Act should be amended in respect of endorsement and validity of a share transfer instrument.

**Hybrids derivatives and options introduced**

1. Indian companies should be enabled to issue hybrids, derivatives, options, as well as shares and quasi-equity instruments with differential rights.
2. For private limited companies and unlisted public companies, the Department of Company Affairs (DCA) would issue guidelines regarding such securities.
3. For public listed companies, SEBI would issue guidelines on the norms and for protection of the interests of investors for such new instruments/securities.
4. Wherever applicable, the guidelines issued by DCA for private and public unlisted companies should be in consonance with SEBI's for public listed companies.
5. In framing such guidelines, both SEBI and the DCA should avoid trying to anticipate what the risk of a potentially new instrument may be. This is because such risks are rarely quantifiable. Instead, both authorities should insist on detailed disclosure of corporate information, and then let the potential investor decide whether or not such an investment makes portfolio sense.

**Buy-back of shares permitted.**

The new Act should provide for buy-back of shares subject to certain provisions:

1. Prior approval by shareholders through special resolution that clearly states (i) the amount allocated for buy-back, (ii) time period for concluding buy-back operations, and (iii) the funds allocated for buy-back are from 'free reserves' and share premium account.
2. In the event of buy-back, the company shall not issue any *new* shares, which includes rights issues but excludes bonus, for a period of 12 months after the buy-back is completed.
3. Since Buy-back is for extinguishing share capital it should not lead to an increase in debt-equity ratio in excess of 2:1.
4. In the case of buy-back is for 'treasury operations', *such* shares will not be re-issued for 24 months after the last date of buy-back, and will be subject to the restrictions given in the table below.

| Buy-back for treasury operations | Up-to 24 months | After 24 months but before re-issue | After re-issue |
|---|---|---|---|
| Voting rights | No | No | Yes |
| Dividend rights | No | No | Yes |
| Bonus shares | No | Yes | Yes |
| Rights issues | No | Yes | Yes |

5. In the case of non-secondary market buy-back from specific class of share holders, the potential sellers will not vote on the special resolution;
6. The buy-back will be accompanied by a 'declaration of solvency' by the Board which will be signed by the Managing Director and at least one more Director, and will be in force for one year after the buy-back;
7. Any deviation from such compliance will be punishable by a substantial fine and/or imprisonment.

In the event of any person, group or body corporate acquiring 95% of the shares of a public listed company – either through a take-over or otherwise – and the company getting de-listed, residual shareholders should sell their shares to the 95% owner at a price based upon SEBI guidelines.

**Indian Depository Receipts.**

Indian Depository Receipts should be set up, like American Depository Receipts or Global Depository Receipts. This would imply that:

- Foreign companies could issue IDR, where the underlying security is the equity or any other security of a foreign company.
- Depository and custodial activities must be encouraged to achieve international standards.

Provisions regarding issue of prospectus by foreign companies already existed in Part XI of the Companies Act (Section 603 to 605). Therefore, a new scheme for Indian Depository Receipts can be easily introduced with minor modifications.

**Issue of ADRs and GDRs to be recorded with ROC.**

Issuers of GDRs or ADRs should file with the Registrar of Companies (i) the foreign offering circular or prospectus after any such issue, (ii) basic data on the issue such as the price of the depository receipt and the amount subscribed, and (ii) material details after conversion to shares.

**Shelf prospectus.**

The concept of a shelf prospectus should be incorporated in the new Act. It should have a validity of 365-days, subject to updates on material facts, material litigation and changes in financial position between the previous offering and the next one.

In the first instance, this shelf prospectus facility could be limited to public sector banks and financial institutions and those companies specialising in infrastructure finance. If the procedure succeeds and demonstrates that the interest of investors are protected, then the facility may be gradually extended by SEBI to other sections of corporate India.

**Book building.**

An amendment be made to the definition of 'prospectus' in Section 2(36) of the Act which would

a) exclude the information memorandum that is issued prior to the prospectus at the time of book-building, but

b) require that, after formal closure of book-building, such a memorandum be submitted with the formal prospectus to the Registrar of Companies.

**Employee Stock Options.**

1. Employee Stock Options (ESOP) should be explicitly incorporated in the new Act. These options can be in the form of warrants or other securities that have pre-specified dates of conversion in the future.
2. This will require amending Section 81 of the Act. In order to prevent misuse, ESOP should be permitted up to 5% of the increased capital of a company (i.e. existing capital plus proposed issue).
3. The capital market rules for ESOP should be framed by SEBI for public listed companies, and by the Central Government for all other companies.
4. Such rules should allow for buy-back of options according to the principles of buy-back that have been discussed earlier in the chapter.
5. In addition, the Government should consider taxing these options as long term capital gains.

# Chapter IV Internal Management and Non Financial Disclosures

**Disclosure of remuneration to Directors relative**

Schedule IA be explicitly incorporated in the Act itself, and a detailed, comprehensive report on the relatives of directors – either as employees or Board members – be given as an integral part of the Directors' Report of all public limited companies.

**Disclosure of interest by Directors.**

The fact that such a register is maintained by the company in its registered office, and is open for inspection by any shareholder of the company should be explicitly stated in the notice of the AGM of all public limited companies.

**Disclosure of Directors shareholders at AGM**

The existence of the Director's share register and the fact that it can be inspected by members in any AGM should be explicitly stated in the notice of the AGM of all public limited companies.

**Loans to Directors.**

1. Loans to Directors will be limited to only three categories namely, education for family, housing and medical assistance.
2. This facility will be available to only the full-time working or executive directors of companies and not to non-executive directors.
3. The right to grant any such loan will be subject to norms that are approved of by the shareholders in a general meeting.
4. The maximum loan will be five times a working director's current annual remuneration.
5. No full-time working director will be eligible for a second loan in any of the three categories when a previous loan remains overdue.

**Appointment of sole selling agent without government approval provided.**

| | Not a relative | Related to any director or director having interest |
|---|---|---|
| Sole selling agent for India | Should require prior | Should require prior |

| | | |
|---|---|---|
| | approval of a special resolution in a general meeting of shareholders. | approval of a special resolution in a general meeting of shareholders; in addition this fact has to be fully disclosed as a separate item in the Annual Accounts. |
| Sole selling agent for foreign markets | May be decided by the Board, and the information be passed on to shareholders together with Annual Accounts. | Should require prior approval of a special resolution in a general meeting of shareholders; in addition this fact has to be fully disclosed as a separate item in the Annual Accounts. |

The maximum fee per sitting should be increased from Rs.2,000 to Rs.5,000; and this should be revised at least once every five years to account for inflation. This change should be incorporated in the Rules.

**Sitting fee and commission to non executive directors retained at present level.**

**Officer in default clearly defined.**

There should be an explicit proviso in Section 5 ("officer who is in default") which excludes non-executive directors, except in cases where such a person is a signatory of any declaration made by the company.

The list of persons who can be officers in default should include the existing personae in the Act; and in the case of issuing or transfer of any securities, merchant bankers, share transfer agents, registrars to the issue and bankers to the issue; but exclude non-executive directors unless they happen to be signatories to any declaration made by the company.

**Disqualification of Directors who contravene Takeover Code.**

Such Directors should be disqualify from being Director of acquiror or target company for a period of two years.

**Managerial remuneration and its disclosures.**

The present regime of managerial remuneration has worked satisfactorily. Sections 198, 309 and Schedule XIII of the Act are ample enough to give sufficient flexibility to profitable companies to attract and retain the best talents.[1] Moreover, the Act allows a company to go beyond these limits subject to approval by the DCA. Therefore, the core of these provisions should remain unaltered, at least for the next five years. However, Sections 310, 311 and 637AA are to be deleted.

The format as it exists must continue. In addition, a tabular form of directors' remuneration and commissions should form a part of the Directors' Report of all public limited companies.

**Voluntary appointments of audit committees.**

At this juncture, the requirement for Audit Committees and Nomination or Remuneration Committees should not be mandated by the Companies Act. Instead, it should be voluntary, with the three apex industry associations – CII, FICCI and ASSOCHAM – playing a catalytic role.

**Secretarial Compliance Certificate.**

There should be a Secretarial Compliance Certificate forming part of the Annual Return filed with the Registrar, which would certify, in a prescribed format, that the secretarial requirements under the Companies Act have been adhered to. This would be governed by the following norms:

1. For listed companies having a paid-up capital of Rs.2 crores or more, it would be mandatory to have a whole-time Company Secretary. For others, it would be optional.
2. Since a whole-time Company Secretary falls under the category of "officer who is in default", it is presumed that he has every reason to discharge his obligations as per the Act. Therefore, companies with a whole-time Secretary would not require to submit a Separate Compliance Certificate to the Registrar.

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3. Submitting the Secretarial Compliance Certificate to the Registrar would be mandatory for companies having a paid-up capital in excess of Rs.10 lakhs but below Rs.2 crores.
4. For companies having a paid-up capital of less than Rs.10 lakhs, the Secretarial Compliance Certificate would be optional.

**Inter-corporate loans and investments procedure.**

The provisions of Sections 370 and 372 of the Companies Act should be merged and radically altered.

Companies should be permitted investment of up to an aggregate limit 60% of the capital and free reserves, or 100% of the free reserves of the company, whichever is higher, as either inter-corporate investment or loans.

The right to investment either in equity or securities or by making loans up to the above limit should be a matter of corporate decision by the Board of Directors.

In case a company wishes to invest in excess of this limit prior permission should be obtained from the general body of shareholders by passing of a special resolution. In the interest of shareholder protection, such a special resolution should clearly state the amount that is to be invested and the purpose of such investment.

**Registrars to grant extension for registration of charges.**

The registration of charges and the delegation of the function of certifying the creation of charges should be empowered to the statutory auditor, who would be liable in the event of false certification. Moreover, the Registrar of Companies would be empowered to grant extensions of time for registration of charges, according to prescribed guidelines.

**Nominations facility for security holders**

Section 82 of the Act would be amended according to the lines of the Companies Bill, 1993, and would provide for nomination facilities for such securities.

**Proxy holders permitted to speak and vote at meetings.**

Given the present state of postal services, postal ballots should not be introduced as a substitute to the current system. At the same time, the role of proxies should be strengthened by permitting two rights: to vote in show of hands and to speak at general meetings.

**Voting according to financial stake.**

There should be no deviation from the principle of voting according to stake. Consequently, the existing provision of Section 391(2), i.e. "if a majority *in number* representing three-fourths in value" be substituted by the usual mode of voting on any special resolution.

**Operation of majority shareholders by strategic minority prevented.**

1. Section 257 of the Act should be amended so that any member must have the consent of 100 shareholders or of 1% of the voting rights before he can suggest his or someone else's candidature as director.
2. The candidature should be accompanied by a deposit of Rs.50,000, which would be forfeited only in the event of the candidate not getting the votes of even 1% of the voting shareholders present in the AGM.
3. There should be restriction with respect to removal of directors, removal or re-appointment of statutory auditors.
4. The demand for poll at the General Meeting would be permissible by one or more shareholders holding shares of the Face Value of Rs. 5,00,000 or holding of 1% of the paid up capital of the company whichever is lessor.
5. Petition for injunctions on the holding of Annual or Extraordinary General Meetings/or issue of securities of by a company should be heard only in the High Court which has jurisdiction over the registered office of a company.

**Gifts at AGMs**

There should be a section in Part VI, Chapter 1 of the Companies Act ("Meetings and Proceedings") that debars companies from giving gifts and presents to shareholders attending general meetings or otherwise.

# Chapter V Accounts Audit and Financial disclosure.

**Reporting of Business Segements and divisions by listed companies.**

A listed public limited company must give certain key information on its divisions or business segments as a part of the Directors' Report in the Annual Report. This should encompass (i) the share in total turnover, (ii) review of operations during the year in question, (iii) market conditions, and (iv) future prospects. For the present, the cut-off may be 10% of total turnover.

**End use of funds raised from the capital market to be disclosed.**

1. Where a company has raised funds from the public by issuing shares, debentures or other securities, it shall be required to give a separate statement showing the end-use of such funds, namely:

a) how much was raised versus the stated and actual project cost;

b) how much has been utilised in the project upto the end of the financial year; and

c) where are the residual funds, if any, invested and in what form.

1. This disclosure would be in the balance sheet of the company as a separate note forming a part of accounts.

**Debt disclosure in balancesheet**

In the schedule, there should be clear demarcation between "long term loans" (falling due at least after 12 months from the date obtained) and others. In addition to giving the aggregate amount of long term and short term loans, certain important sub-heads should be categorised as:

| | Long Term Loans | Short Term Loans |
|---|---|---|
| Secured (giving nature of security) | Banks and financial institutions, debentures (with rate of interest, date of issue, and date and term of redemption or conversion), subsidiaries and others sources (specifying nature) | Banks and other financial institutions, subsidiaries and others (specifying nature) |
| | | |

| | Long Term Loans | Short Term Loans |
|---|---|---|
| | | |
| Unsecured | Fixed deposits, banks, subsidiaries and others | Banks and other financial institutions, subsidiaries, others (specifying nature) |

**Foreign Exchange information disclosure.**

1. At present, paragraph 4.D of Part II of Schedule VI requires companies to comply with considerable disclosure on foreign exchange earning and outflow. This should continue.
2. In addition, there should also be a note containing separate data on of foreign currency transactions that are germane in today's context: (i) foreign holding in the share capital of the company, and (ii) loans, debentures, or other securities raised by the company in foreign exchange.

**Investment classification in balance sheet.**

1. The 2x2 classification of investment and current assets in Schedule VI (i.e. trade versus non-trade, and quoted versus unquoted) be retained in the new Act.
2. While the cell totals are important, it is not necessary to give details of every single small investment – sometimes as low as Rs.1000 – in the note. Instead, there should be the total under the four heads, and details of those investments that account for 5% or more of each total. This is an example of focusing on the quality of disclosures, which is sometimes forgotten in order to maximise quantity.

**Information regarding lease asset by companies.**

If any fixed asset acquired through or given out on lease is not reported under appropriate sub-heads, full disclosure would need to be made as a note to the balance sheet. This should give details of the type of asset, its total value, and the future obligations of the company under the lease agreement.

**Inappropriate treatment in Account**

Any inappropriate treatment of an item in annual accounts of the company should not be allow to be explained through notes forming part of account or accounting policies.

**User Friendly cash flow statements.**

A new, more informative and user-friendly cash flow statement should be designed in consultation with the Institute of Chartered Accountants of India (ICAI) and would form a part of Schedule VI for listed companies alone.

SECTION 217(2A)

1. The threshold should be raised to Rs.5 lakhs per year, and that it should only be submitted to the Registrar of Companies and not form a part of the Directors' Report. The statement should be made available for inspection of shareholders at the AGM.
2. However, if there are any director relatives who receive remuneration full details of such cases should be given

**Requirement to give licensed capacity information abolished in balance sheet.**

The requirement to give licensed and installed capacity should be eliminated from Schedule VI of the new Act.

**Directors Responsibility Statement**

Companies Act requires the directors to prepare financial statements for each financial year, which give a true and fair view of the state of affairs of the company at the end of the year and of the profit or loss of the company for that period. In preparing these annual accounts, the directors are required to select suitable accounting policies, apply them consistently and make judgements and estimates that are reasonable and prudent.

The directors must also specify whether applicable accounting standards have been followed and, if not, disclose and explain any material departures in the financial statements. The annual accounts must be prepared on the going concern basis, unless it is inappropriate to presume that the Company will continue in business.

The directors are also responsible for the maintenance of adequate accounting records in compliance with the Companies Act, 1997, for safeguarding the assets of the Company, and for preventing and detecting fraud and other irregularities.

**Protection to holder of company deposit strengthened**

Section 58A of the Act should be modified so that companies who fail to repay the principal or pay interest would be banned from declaring dividends until the default is made good.

**Consolidation of Group Accounts Optional**

1. For the present, consolidation of accounts of the holding and subsidiary companies should be optional.
2. Before consolidation is made mandatory for holding and subsidiary companies, the banks and financial institutions should agree to lend on the basis of group leverage, and the Income Tax Act should recognise consolidation for tax purposes.
3. If a group chooses to consolidate on a voluntary basis, then it should not be required to annex the accounts of its subsidiary companies under Section 212 of the Act.

**Chief Financial Officer appointment in Companies**

A listed company having issued capital of Rs.3 crores and above should have a CFO, who may be a chartered accountant or a cost accountant. A CFO would be legally responsible for proper maintenance of the Books of Account, and should ensure disclosure of all required information in the Offer Documents and Annual Financial Statements of the Company.

**Cost audit.**

The provisions under Section 233B concerning mandatory cost audit at the directives of the Department of Company Affairs should be removed. However, the requirement to maintain cost records should continue as before.

**Depreciation**

The existing practice of having different rates and methods of providing for depreciation under the Income Tax Act and the Companies Act has served a useful purpose and needs to continue.

Any attempt to align the two sets of rates will have severely detrimental consequences for companies, share prices, capital markets, shareholders, small investors, banks as well as financial institutions. Our economy may be spared from such shocks.

| Machinery | SLM (Minimum) Rate | | |
|---|---|---|---|
| | Single Shift | Double Shift | Triple Shift |
| New | 5 % | 7.5 % | 10 % |
| *(Second Hand | 10 % | 15 % | 20% |
| Building including Factory Building } | | - | 2.5 % |
| Ships | | - | 5% |
| Other assets including Cars, Office Equipments etc. | | - | 10% |

Note 1 *Suitable definition of second hand machinery (i.e. resident life of less than 10 years) and appropriate rates for the same to be incorporated.

Note 2 In this model, companies will of course be at liberty to provide for a higher depreciation in their discretion on either SLM basis or WDV basis.

## Chapter VI Mergers, De-mergers And Corporate Restructuring

**Safe guards for recognition of de-mergers and sub-divisions by Income Tax Law recommended and to be made tax neutral.**

(1) There is substantial identity between persons owning various parts of the business both before and after the restructuring.

(2) The restructuring is for bonafide business reasons.

(3) That none of the original company's/former shareholders is contemplating the sale or cessation of business in post restructuring period.

(4) New owners are only a sub divided part of the old owners and the old owners should have substantially held their shares for a minimum period of immediately preceding two/three years.

## Chapter VII Winding up of Companies.

**Winding up of companies outside purview of IDRA provided.**
In respect of companies engaged in the activities outside the purview of IDRA, a regime for rehabilitation and revival, similar to that of SICA may be provided for Act. Such a step will go a long way in effectively dealing with the problems of sickness of such companies.

**Time Bound winding up of Companies**

1. High Courts will have exclusive jurisdiction in the matter of liquidation of company.
2. Encouragement of voluntary winding-up, which is generally a more cost- and time-efficient manner of liquidation.
3. Distinct separation of the two aspects of liquidation: (i) first, asset sale and (ii) then, distribution of the proceeds.
4. Clarity in winding-up order – which should coherently describe the steps that have to be taken along with time frames for each action.
5. Clear enunciation of the manner in which the Act shall catalyse rapid, transparent, market-determined sale of assets which would not only allow for their profitable re-use, but also increase the pool for distribution to claimants, including workers.
6. Well-defined and non-subjective norms to ascertain whether a company's assets should be sold in totality as a going concern, or in parts as individual asset sale.
7. Permitting professionals such as chartered accountants, lawyers or company secretaries to be empanelled by the High Court as liquidators who may be selected as Official Liquidators.

# Chapter VIII Monitoring and Enforcement

**Jurisdiction of Court and Company Law Tribunal.**

1. The new Act shall provide for establishment of the Company Law Tribunal (CLT) as a Quasi-Judicial Tribunal.
2. It shall be mandatory for the CLT to have a judicial member and a technical member of each Bench. This would be on the familiar lines of the Income Tax Appellate Tribunal.
3. The CLT shall have multiple Benches set up in five zones.
4. The CLT shall be empowered to function with much greater administrative, financial and judicial independence compared to the existing Company Law Board.
5. The CLT shall be under the Ministry of Law, as is the case with the Income Tax Appellate Tribunal.
6. In order to give concrete shape to independence, the Group recommends that the Tribunal Benches should be housed in separate premises independent of the Department of Company Affairs
7. The orders and judgement of the CLT shall be reported and published. These shall have precedent value irrespective of the zoning. Close co-ordination between separate zones is to be achieved in order to create uniformity.
8. Although it is desirable to have fresh appointments for filling the Benches of CLT, in the interegnum and for continuity, the existing Chairman and members of the Company Law Board may constitute the CLT.

**Carved out jurisdiction of Courts and Company Law Tribunal**

1. Matters concerning mergers, acquisitions, de-mergers, re-structuring and schemes of arrangement or reconstruction, and winding up shall be exclusively dealt with by the Court, with the assistance of a panel of experts acting as a Commission under Order XXVI of the Code of Civil Procedure.
2. The CLT shall have jurisdiction in relation to all other matters, so long as these are not within the original jurisdiction of the Company Court.
3. The CLT would have powers of contempt, review and power to condone delay under Section 5 of the Limitation Act, 1963.

4. The jurisdiction of the District Court as a Company Court would be removed. Thus, no Civil Court would have jurisdiction in any matter relating to the Companies Act, unless specifically stated otherwise in the Act.

5. In cases of take-overs –

- Neither any Civil Court nor the Company Court shall have jurisdiction to entertain or try any proceedings arising out the SEBI Takeover Code.
- SEBI will have a right to be heard in all matters of Takeover of Listed Public Companies.
- SEBI would retain its right to issue clarifications, circulars and directions from the judgements of CLT. This should help in keeping the Code in tune with the adjudicated decisions of the CLT.

6. The jurisdiction for buy-back of shares and disputes arising from solvency certificates or failure of companies in a buy-back will lie with the CLT.

**Licensed registrar subject to safe guards.**

1. Government must permit the setting up of private licensed Registrars.
2. The selection of a licensee will be based on:
   - Transparent licensing procedure
   - Well defined capital adequacy
   - Minimal computing, imaging, data processing, storage and on-line capability.
   - Strong confidentiality guarantees
   - A licensed Registrar would not handle the affairs of any of its group companies.
   - Clear provision that all material pertaining to the Companies Act are the property of the Central Government and that the Registrar is performing a fiduciary and custodial service on its behalf.
3. Commitment to on-line all information for name availability and registration as well as breaches between licensed Registrar and his Government counter-parts on a daily basis.
4. In the event of termination of license, all property will be handed over to the Government.

**Corporatisation of Company Law Services.**

The Government should corporatise company law services with an adequate equity base to modernise the registration functions.

**ROC offices to be provided more funds.**

The funds allocated to the Government ROCs should be increased many fold. A rough estimate suggest an one-shot investment of around Rs.60 crores and annual budget of no less than 25 crores is a must to purchase and maintain the kind of facilities that are needed to state of the art registration functions. These amounts should be made available as soon as possible. In the first instance such financing will have to come from the Consolidated Fund of India. Thereafter, the proceeds of the license fee can be allocated to strengthen the office of the Government Registrars.

**Prosecution of companies in some cases delegated to regional directors.**

- Penalties would be raised by a factor of ten.
- Monetary fines can be imposed by the Regional Director of the Department of Company Affairs. Appeal should lie with the CLT.
- Continuing penalty would also rise ten times.
- Imprisonment with or without fine will continue to remain under the jurisdiction of the Magistrates.