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PROCESS TO REFORM THE COMPANY LAW IN INDIA : NEED TO GALVANISE AND ELECTRIFY IS IMPERATIVE

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Background

Any initiation of economic reforms should be normally accompanied by a drastic reform of the Company Law-which is the bedrock of the corporate sector- the most important component of any progressive economy. However, notwithstanding the rapid onset of reforms in India since 1992 the morbid pace at which the Companies Act, 1956, (the Act) is being reformed has not resulted in a viable or vibrant modern day company law which could be compared with the global standards and has also done no good to the millions of investors who have been left in lurch by unscrupulous promoters of companies which used the capital markets as the most convenient medium to raise funds from such investors. Instead of a one-time hurricane effort, we see amendments to the Act happening on a piece meal basis. The Working Group set up by the Government in the year 1996 made recommendations for amending the company law in totality and the basis of the report submitted by this Group the Companies Bill of 1997 was introduced in the Parliament, however the same could never become a full-fledged law to replace the archaic Companies Act, 1956, (the Act) though the Bill is still pending in the Parliament.

Thereafter there has been a spate of amendments to the Act in piece-meals in the following form :

(i) The Companies (Amendment) Ordinance 1998 which came into force w.e.f the 31st October, 1998 introduced provisions facilitating Buy Back of Shares and issuance of sweat equity shares, liberalized the provisions relating to inter-corporate loans and investments by removing the condition of government approval *in toto* and replacing the same by the shareholders approval, introduction of the nomination facility for holders of securities, mandatory compliance with the accounting standards and setting of an Investors Education and Protection Fund. The said Ordinance was validated by the Companies (Amendment) Act of 1999;

(ii) The Companies (Amendment) Act, 2000 which came into force w.e.f the 13th December, 2000 introduced the concept of

Postal Ballot, appointment of directors by small shareholders, removed the concept of deemed public companies and introduced the concept of minimum capital adequacy for public and private companies, introduced provisions for the protection of small deposits holders, defining the role of Debenture Trustees and introduced the remedy of approaching the Company Law Board for the aggrieved debenture holders, recognized the process of book building and introduced the provisions relating to issuance of Indian Depository Receipts by foreign entities , introduced the concept of secretarial audit in case of companies not required to appoint company secretaries, restricting directorships to 15 companies, disqualification of a person to act as a Director in the event of non compliance with stipulated provisions of the Act by the company on whose Board he is a director etc.

While the above stated amendments have already taken place by the passage of the respective Amendment Acts the following amendments are still pending :

(i) The Companies (Amendment) Bill, 2001. This Bill was drafted on the basis of the recommendations of the Justice Eradi Committee Report. The Central Government had appointed a High Level Committee under the Chairmanship of Justice V Balakrishna Eradi to make recommendations relating to amendment in the provisions relating to winding up of companies so as to achieve more transparency and avoid inordinate delays in the process of winding up of companies and also to make recommendations with regard to the reform of the law relating to sick companies viz., the Sick Industrial Companies (Special Provisions) Act, 1985. The said Amendment Bill of 2001 has since been introduced in the Parliament and is awaiting passage to become a full-fledged law. The core provisions of the said Bill include setting up of the National Company Law Tribunal to take over the powers of the High Court in respect of winding up of companies, to take over the powers of the Company Law Board under the Act and to exercise the powers being presently exercised by BIFR. The Bill also seeks to repeal the Sick Industrial Companies (Special Provisions) Act, 1985. The Bill has stipulated a drastic reform of the winding up process;

(ii) The Companies (Second Amendment) Bill, 2001 has also been introduced in the Parliament and is pending passage to become a full-fledged law. This Bill has been drafted on the basis of the recommendations of the Dr. Alagh Committee report and stipulates to incorporate cooperatives as companies under the Act and conversion of the existing cooperatives into companies. These cooperatives shall be producer companies with special provisions under the Act. The cooperative societies are however protected from takeovers and are not to be publicly listed. The basic objective of this Bill is to provide a more flexible regulatory framework for cooperative societies.

Besides the above amendments in the Act what more needs to be done and how the company law in India has to meet the global standards in respect of healthy promotion of corporate business besides protecting the investors is to be guided by the following developments abroad as well as in India :

Global precedents which highlight the need for Corporate Governance and the Independent role of the Statutory Auditors

Global developments over the past 2 years have brought to fore the following two core issues that concern corporate businesses :

(i) Spirited Corporate Governance; and

(ii) Ethical & Independent Audit

Corporate America – the Mecca of business has been reeling under a spate of scams, which have exhorted the regulators to give a very serious thought to aforesaid issues. A bird's eye view of the scams reveals the following :

(i) *The Enron Collapse* : Enron which was once upon a time the seventh largest public company in the US collapsed like a pack of cards on account of unethical and illegal trade practices carried on with hand in glove support from its auditors namely Arthur

Anderson & Associates.The report of the sub-committee of the U.S Senate titled "The Role of the Board of Directors in Enron's Collapse" highlights the following major reasons contributing to the company's collapse :

— The Board of Enron knowingly allowed Enron to conduct billions of dollars in off the books activity to make its financial condition appear better than it was and failed to ensure adequate public disclosure of material off the books liabilities;

— The Board failed to ensure the independence of the company's auditors allowing Anderson to provide internal audit and consulting services while serving as Enron's outside auditor;

— The Board approved an unprecedented arrangement allowing Enron's chief Financial Officer to establish and operate private equity funds, which transacted business with Enron and profited at Enron's expense.

(ii) *The WORLD.COM Scam* : In this case involving accounting jugglery, operational expenses incurred in the day to day running of business were capitalized so that the profits were inflated by billions of dollars.

(iii) *The XEROX Scam* : In this particular case the company misstated profits for four years resulting in an overstatement of close to $3 billion. The company inflated revenue by bringing forward equipment sales thus also boosting profits for the current year. Here also the role played by KPMG as an auditor has come under scrutiny.

An overview of the scams in India and other adverse developments in corporates which necessitate a serious revamp of the provisions of the Companies Act, 1956

India has witnessed large-scale scams ever since the reforms were introduced in the year 1992, which basically involved the following *modus operandi* :

— Manipulation of the stock markets by powerful players in connivance with unscrupulous promoters of companies.

— Diversion of monies raised though public offerings to the stock markets with a view to manipulate and make quick personal gains.

— Diversion of monies raised through borrowings from banks and institutions to the stock markets with an eye on quick bargains through price manipulations.

— Raising money from the public on the basis of false statements in the offer documents and then vanishing.

— Defaults in repayment of deposits, redemption of debentures and other debt instruments.

— Raising monies through Private placements with the promise to go public and then vanishing.

While the above scams call for a serious look at the revamp of the securities laws and effective regulators, the aspect of corporate governance and independent role of the auditors as a strong preventive mechanism for the protection of the small investors hardly needs any emphasis. Further the recent debacle at Tata Finance Ltd. clearly exposes the dire need for installation of strong standards of corporate governance and maintenance of the independent status of the statutory auditors. In this case allegations have been made against the CEO for having made some dubious transactions which resulted in massive losses for the company whereas the CEO has in his reply stated that the management was always aware of the transactions. The role of the statutory auditor namely M/s A.F. Ferguson also came under a spotlight when a report prepared by one of its partners in respect of the deals of TFL was withdrawn abruptly by the firm and the concerned senior partner who had prepared the report was asked to resign. While the factual position would be known only when the court(s) before which the matter is posted, one thing that emerges is that there was lack of proper governance, lack of proper risk management systems and lack of Board control over the exposures in the stock markets. This case also illustrates the vulnerability of the auditors to management pressure.

Initiatives in India for further modification of the Companies Act

Given the said developments globally as well as in India the following initiatives have been taken up for further modification of the Act so as to further strengthen Corporate Governance and to make the provisions relating to Auditor and Accounting more stringent :

(i) The Ministry of Finance & Company Affairs, Dept. of Company Affairs vide No. 12/25/2002-IGC dated the 21-8-2002 constituted a committee under the Chairmanship of Naresh Chandra [hereinafter referred to as the Naresh Chandra Committee] to examine the Auditor-Company Relationship, Regulating the Auditors etc. This Committee is also required to examine the role of the independent directors and how their independence and effectiveness can be ensured;

(ii) The Ministry of Law, Justice & Company Affairs, Dept. of Company Affairs vide No. 11/3/2002-CLV dated the 4th April, 2002 constituted a committee under the Chairmanship of Shri RD Joshi Director General (I&R) [hereinafter referred to as the Committee on the Companies Bill, 1997] to examine the remaining provisions of the Companies (Amendment Bill, 1997) and to submit its report. This committee has since submitted its report.

(iii) The Dept of Company Affairs has set up a working group to submit recommendations on amendments to the Companies Act for implementation of corporate governance and harmonisation of the provisions of the Act with the Listing agreement, SEBI Act, 1992, the Secretarial Standards, Accounting Standards, the Securities Contracts Regulation Act etc.

In view of the fact that many of the agendas of the said committees are overlapping it is sincerely hoped that instead of submitting varying/conflicting recommendations, a common approach is adopted on core issues like corporate governance, role of the auditors, accounting practices etc. so that the overall resultant of such a committees is not an exercise in futility.

Critical analysis of the recommendations of the Committee on the Companies Bill of 1997

We shall now critically analyze some of the important recommendations of the Committee on the Companies Bill of 1997:-

(1) *Verification of persons forming companies* : The Committee has observed that certain companies disappeared and their subscribers eloped soon after collecting funds from the public. In absence of adequate data at the helm of such companies enormous problems are being faced in locating and initiating legal action against such companies and their delinquent subscribers/promoters/directors. The Committee has therefore recommended that a subscriber to the Memorandum shall be required to furnish details of his PAN, Identity card issued by the Election Commission of India along with his address/description, occupation and proof of his identity. The Committee is of the view that this will help trace out the unscrupulous persons who disappear, elope or impersonate after cheating the public through the mode of companies formed by them for deceitful purposes.

Critical Analysis : The said recommendation is definitely a welcome step since this will at least help the regulators to trace and bring the unscrupulous promoters to book and prevent them from vanishing. However, the Committee has ignored the fact that under the Companies Act as well as under the other statutes it is always the Directors who are proceeded against for acts of omission and commission. Thus the requirement of identification should equally apply to the Directors as and when they are appointed.

(2) *Prohibiting promoters to withdraw once having subscribed to a Public Issue* : The Committee has observed that section 72(5) of the Act provides that application for shares in or debentures of a company shall not be revocable until after the time of the opening of the subscription lists. The Committee has further observed that certain unscrupulous promoters first subscribe to the issue and then purposely follow up by public announcement to this effect and enhance public confidence and then surreptitiously withdraw their application. The Committee has therefore recommended that persons described in the prospectus as promoters or directors including relatives thereof and who have applied pursuant to such prospectus shall not be entitled to revoke their applications.

Critical analysis : While the said step is welcome it should also cover those instances where the promoters/directors/their relatives put in dud cheques towards the subscription which ultimately bounce for want of funds.

(3) *Prohibition on Distribution of Gifts* : The Committee has observed that distribution of gifts at the general meetings of companies creates problems for companies since some certain unscrupulous shareholders pressurize the Board of Directors present at the meeting distribute gifts in cash or in kind and they also create unruly scenes and chaos at the general meetings. Distribution of gifts also gives leverage to unscrupulous promoters to get their resolutions passed by luring the shareholders with such gifts. The Committee has therefore recommended that a company should be prohibited from giving and a shareholder should be prohibited from demanding or accepting any gift either in cash or in kind at any general meeting or otherwise. For this purpose the term Gift will not include any discount coupon or any food or beverage offered at a general meeting by the company management.

Critical Analysis: The above recommendation is welcome since it will ensure conduct of meetings in a fair manner. However, the exclusion of 'discount coupons' offered at a general meeting from the term gifts has the effect of restoring the menace of gifts to its original position since instead of gifts, discount coupons for purchase of items will be used by unscrupulous managements to allure the shareholders and the possibility of unscrupulous shareholders demanding the same cannot be ruled out.

(4) *Powers of the Board* : The Committee has recommended that section 292 of the Act be amended to provide that the following powers be exercised by the Board only by means of resolutions passed at meetings of the Board and not by circular resolutions or by way of delegation to committees :

(i) The power to issue securities whether in India or outside;

(ii) The power to approve the annual reports, the profit and loss account and the directors' report or wherever required the half yearly accounts;

(iii) The power to approve amalgamation, merger, reconstruction; and

(iv) The power to make contributions to charitable or other funds.

The Committee has observed that the aforesaid matters are very important and need face to face interactions before approval.

Critical Analysis : Pvt. Ltd. companies need to be exempted from the said provisions since in such companies the degree of public interest is minimal.

(5) *Retiring age of Directors* : The Committee has recommended that a person shall not be eligible to be appointed as a Managing Director, whole-time director or other director if he has attained the age of 75 years. This restriction shall however not apply to the directors currently holding the position as such. The Committee has observed that keeping in view the present day complex business environment only persons with sound health need to occupy position as Directors, Managing Directors etc. and hence the need to fix the retirement age. Pvt. Ltd. companies are however sought to be exempted from the said provision.

Critical Analysis : While the proposed provision will definitely lead to infusion of young professionals on Boards, it has the effect of increasing the retirement age of Managing Directors/Whole-time Directors from 70 (as prescribed by schedule xiii) to 75. Under the existing provisions appointment is required to be approved by a special resolution if the proposed appointee has crossed 70 years. A differentiation must be made between the full time role of the Managing Director/ Whole-time Director and a Non-Executive Director since the former has many important functions to perform. It would have been appropriate to fix the retirement age of the Managing Director/Whole-time director to 70 years.

(6) *Service of Notice by Courier and Electronic means*: The committee has recommended that speed

post, courier, and e-mail be allowed as acceptable modes of service of notice/ documents on the company, on the Registrar and on the members.

Critical Analysis : The recommendation may sound simple but its implications are phenomenal particularly in view of the fact that electronic mail is proposed to be allowed as a means of service. Once the usage of digital signatures is established legally in India in terms of the Information Technology Act of 2000 then this practice of service of documents through the electronic means can achieve wonders. The Govt. would need to frame separate rules after amending sections 51, 52 & 53 of the Act to provide for the mechanism of electronic filing of notices/ documents. This will definitely reduce the cost, paper work and time consumed in serving of documents. However, safeguards need to be put in to prevent manipulation the electronic records.

(7) *Enlarging the scope of Explanatory Statement to be annexed to the notice* : The Committee has recommended that in the interest of proper governance a company is required to disclose the financial implications and specific nature of interest of any director/manager and/or his relative in any item of special business, in the Explanatory Statement annexed to the notice under section 173(2) of the Companies Act.The Committee has also recommended that company should also be required to give particulars of the shareholding interest of the director's relative in that other company. It has also been recommended that a liability is cast on the director or manager for non-disclosure or insufficient disclosure to hold in trust the benefits received by him directly or indirectly and reimburse or compensate the company.

Critical Analysis : Even presently a director's interest is required to be disclosed in the Explanatory Statement and that *ipso facto* includes indirect interest through a relative. Thus though interest may exist in an item if a relative is interested (by virtue of being a director or otherwise) it would be difficult to quantify the exact financial implications of the interest. Also disclosure of shareholding should be required to be made if it exceeds 2% of the paid up share capital {as provided in section 299(6)}. The said recommendation may not serve any fruitful purpose and may only add to the paper work. The emphasis should have been on the quality of explanation and justification of the agenda item.

(8) *Amending the definition of an Officer in default so as to include independent directors and the Chief Accounts Officer* :The Committee has recommended that the scope and ambit of "Officer in default" be amplified so as to include independent directors in respect of any contravention of the provisions of the Companies Act, 1956 which has taken place with his consent or connivance or is attributable to neglect on his part. It is also proposed to include "Chief Accounts Officer" in the definition of "an Officer in default" to make him responsible in respect of financial reporting and other accounts related matters. It is also the recommendation of the Committee that in case of a company having a paid up share capital of Rs 5 crores or more the company shall appoint a Chief Accounts Officer (CAO) who shall be a member of the Institute of Chartered Accountants of India or a member of the Institute of Costs & Works Accountants of India and who would be specifically made responsible for the preparation and maintenance of proper accounts and management of finance of the company.

Critical Analysis : At a time when we are talking about an active participation and enhanced role of the independent directors in Board functioning it is a draconian recommendation that such directors should be held liable as officers in default. Such a provision would prevent professionally qualified directors from participating in Boards for the fear of prosecution. In fact, such directors are not involved in the day to day functioning of a company and hence would find it extremely bothersome to fight long drawn criminal prosecutions. If at all such a provision is to be introduced then the law should also make an exemption to the effect that "Provided, however, that no prosecution shall be launched against an independent director if he is able to furnish a compliance certificate from the management duly placed at a Board meeting on which he relied and believed to be true that the company has complied with the provisions of the Companies Act, 1956." Such a provision will also make it incumbent upon the management to obtain compliance certificates from its officers and place them before the Board. Such a provision will in fact go a long way to recognize the system of proper compliance in the company.

The provision relating to the appointment of a CAO is indeed welcome since it will ensure that a competent professional oversees compliance with the provisions relating to accounts with the fear of prosecution.

(9) *Rotation of Auditors* : The Committee has remarked that there are cases where corporate houses or corporate groups get associated with certain accounting firms and the same firms are employed to audit companies in these groups year after year. This over a period time leads to a nexus between the management and the auditors. There have been cases where the auditors collude with the management by adopting malpractices in reporting facts to the shareholders. In order to stop this unhealthy practice it is felt that there should be break in their re-appointment. Therefore, it is proposed that no company shall appoint or re-appoint the same auditor for more than five consecutive accounting years. However, such an auditor may be considered for appointment after the expiry of five years from the last term of appointment.

Critical Comments : After the Enron debacle and many other cases as cited in the above paras the role of the auditors has come under a microscope and laws are being amended world wide to prevent a repeat of such debacles. In India the situation is that many big firms have monopolized audits and as a result young professionals are not being able to practise though they may be equally competent as their big brothers. This has also led to complacency and as a result the quality of audit suffers. The ultimate losers in the process are the investors and creditors who place reliance upon the audit reports as the x-ray report of the company's affairs. Another advantage of the concept of rotation of auditors is that the quality of services will improve since there is always a scope for re-appointment after five years of his last appointment. Also this will introduce a peer level review which in turn helps to bring out deficiencies and undertaking steps to improve further.

(10) *Auditors to report diversion of funds* : The Committee has remarked that presently there is no specific duty on the auditors to check and report on such diversion of funds to the shareholders in their report. It is, therefore, proposed to cast a responsibility on the auditors to check and report diversion, misutilisation and misappropriation of funds by companies in the Auditor's report by including this in MAOCARO.

(11) *Falsification of Accounts* : The Committee has recommended that there should be a provision in the Act for providing deterrent punishment for falsification of books of accounts. The Committee has recommended that a provision be inserted in the Act providing for imprisonment of not less than one year and upto ten years for the management and the statutory auditors of the company, if they are found to have been involved in or engaged in fraudulent accounting practices including their involvement in any manner as a direct participant or as an aider or an abettor or as a co-conspirator in fraudulent acts or in omission and commission of such schemes.

Critical Analysis : Though the above step is a drastic move to curb the process of accounting jugglery which may involve inflation of profits, overstating income or suppressing expenditure and many other means it would be difficult to prove *mala fides* since the defence of prudent estimation or reasonable exercise of judgement in preparing the financial statements may be used by the management and/or the auditors. Also while drafting the provision the words "falsification" should be used as against the words "fraudulent" since in criminal law fraud has to be proved specifically and a company may escape prosecution on the ground that though there was a misstatement in the accounts it was not used specifically against a particular person or that no specific gain accrued to the company as a result of the said misstatement. Any auditor who certifies as correct any falsified books is bound to be caught in the words - "an aider or abettor".

(12) *Professional Firms* : The Committee has remarked that under sub-section (2) of section 11 of the Act no company, association or partnership consisting of more than 20 persons can be formed for the purpose of carrying on any business or gain unless it is registered as a company under the Companies Act, 1956 or is formed in issuance of any other Indian Law. The Committee has further remarked that the respective institutes governing the professions of Chartered Accountants, Company Secretaries and Cost Accountants, Advocates do not allow Bodies Corporates to practice. The limit of 20 partners has thus been a hindrance to the growth of firms constituted by such professionals. The Committee has therefore recommended that the maximum number of partners be increased from 20 to 50 in case of firms of such professionals.

Critical Comments : Since such firms are registered under the Partnership Act it is also desirable to amend the said Act so as to ensure parity.

(13) *Inspection of Companies by Professionals* : The Committee has remarked that the number of inspections of companies under section 209A of the Act need to be stepped up drastically for ensuring better compliance of the statutory provisions of the Act. The Committee has recommended that the Central Govt. be empowered *inter alia* to notify the professionals like Company Secretaries, Chartered Accountants Cost Accountants etc. for conducting inspection of books of accounts of companies under section 209A of the Act.

Critical Analysis : The said step is a welcome move since it will ensure peer level review into the area of compliances. This will also ensure that companies act more diligently in ensuring compliances. However, it also calls for a more stringent code of conduct for the professionals to act as a deterrent against hand-in glove approach.

(14) *Bringing the Secretarial Auditor at par with the Statutory Auditor* : The Committee has recommended that in case of companies having a paid up share capital of not less than Rs. 10 lacs and not required to appoint a company secretary the provisions relating to appointment, remuneration and removal of an auditor as contained in sections 224 to 226 shall, *mutatis mutandis,* apply to the appointment, remuneration and removal of the company secretary in whole-time practice under section 383A. A company secretary in whole time practice shall not be re-appointed for more than five consecutive accounting years and he shall be eligible for appointment as such after the expiry of five years from the end of his last term.

Critical Analysis : The said step is no doubt a forward step which will recognize the potential of company secretaries in whole - time practice who shall now be appointed by the shareholders at the Annual General Meeting to hold office from the conclusion of one meeting to the conclusion of the other meeting and their remuneration shall also be fixed by the shareholders. Also special resolution under section 224A would be required in certain cases for the appointment of the secretarial auditor. However, there are some riders here for e.g.: - Will the restriction on number of audits under section 224(1B) apply to the secretarial auditor? The Institute will then need to specify the maximum number of audits that can be undertaken by a secretary in whole-time practice. Can a member in part-time employment also practice?

Issues which need to be considered before amending the Act

The following pending issues need to be considered before finalising the amendments to the Act :

(1) Provisions facilitating conduct of Board meetings through electronic means. This

should include conduct of meetings through teleconferencing as well as video conferencing.

(2) As in the case of Accounting Standards the compliance with the Secretarial Standards should be made mandatory for the public limited companies to comply (whether listed or not listed). The Institute of Company Secretaries of India has issued the SS-1 (Secretarial Standards for conduct of Board Meetings) and SS-2 (Secretarial Standards for conduct of General Meetings). Compliance with the said standards is most likely to give a boost to the implementation of corporate governance in companies.

(3) It is important to refer to a recommendation of the Justice Dhanuka Committee report [notified by SEBI vide PR/175/98 dated the 6th July, 1998] to the effect that the Companies Act should be amended to make a provision for securities audit in case of all listed companies to be conducted by a practicing company secretary. The report of the securities auditor should cover compliance with the listing agreement. The appointment of the securities auditor should be made by the shareholders at the AGM and the provisions relating to the statutory auditors should be made applicable to the appointment of such auditor.

(4) The Companies Bill of 1997 had referred to the concept of Licensed Registrar or an institutional body performing the functions of the Registrar of Companies (ROC). This proposal was shot down by the expert committee on the ground that the functions of the ROC are sovereign in nature and hence cannot be discharged by any other body. This contention with due respect is not correct since even the Depositories could be said to be performing such functions. A licensed Registrar will ensure that professionalism is instilled and corruption, red tape etc. is eliminated. Also such a Licensed Registrar will recruit professionals like company secretaries, chartered accountants and this will facilitate peer level overview of the companies registered.

(5) As regards the role of the statutory auditors is concerned there should be prohibition on their accepting any other mandates for any other jobs from the companies to which they are acting as the statutory auditors. This will ensure that there is no conflict of interest in discharge of their functions.