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By Shankar Jaganathan



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Editorial

The Union Cabinet's decision to set up National Financial Reporting Authority (NFRA) looks to be a continuation of the trend toward more stringent enforcement regime. Initially the move triggered by demonetization and later propelled by banking frauds that are tumbling out of the closet by the dozen seem to be consolidating into a distinct cultural shift that shapes a strict enforcement regime.

As penal action against violations become more certain, we believe professionals like Chartered Accountants and Company Secretaries cannot solely rely on manual processes to track compliance. CimplyFive could be the answer to the needs of these professionals as they seek automated solutions that is not only reliable but also has inbuilt triggers for alerts to prevent non-compliance. This is all the more required for secretarial compliance, which is right under the nose of company directors who are the custodians of corporate governance and cannot plead ignorance of non-compliance on this front.

Staying in tune with the current issue that is hogging the headlines, in our series the **First of First** we have captured the failure of Glasgow Bank in 1878 CE that resulted in the bankruptcy of more than 1500 shareholders leading to the audit of financial statements being mandated in companies.

Continuing our series **CALL FOR CHANGE**, in this issue we address the need of social enterprises for a new organizational form on the lines of Community Interest Companies (CIC) in UK and Low Profit Limited Liability Company (L3C) in the USA. With increasing funds flow to Social Enterprise coming from CSR funds and Private foundations, a distinct organizational form for social enterprise could make a big difference in developing a more inclusive and social just India. Our other regular features **–Gist of Changes in the Companies Act** and **Statutory Compliance Calendar** is also included in this issue.

Please feel free to share your feedback with us at contact@cimplyfive.com. We look forward to your feedback with interest and as ever strive to improve the quality of everything we do.

Happy reading,

Shankar Jaganathan
Editor of iComply
March 5, 2018

A CALL FOR CHANGE:
Social Enterprises: A Crying Need for a new Organizational form

Introduction:

Globally social enterprises have emerged in the decades flanking either side of the third millennium to address the unmet needs of the underserved sections of our society. In an economy made up of commercial enterprises and philanthropic organizations, social enterprises emerged to satisfy the unmet social needs of society by fusing a commercial business model with philanthropic objectives. Micro finance business for financing economically disadvantaged groups is a popular illustration of social enterprise.

The Idea

Social Enterprises seek to combine the profit generating ability of businesses with the social objectives targeted by not-for-profit entities. While multiple definitions for social enterprise exist, the core concept is of a business targeting social objectives by attracting investors with financial returns and active participation in decision making.

In contrast to the donor funded not-for-profit organizations, social enterprises raise money from socially sensitive financial investors who seek fair returns even as they voluntarily restrict the funds raised to be used solely for fulfilling specified social objectives.

Further where not-for-profit organizations provide their goods and services free of cost or at subsidized rates, social enterprises look to recover their costs and target a moderate profit. In short social enterprises seek to operate with a business brain and the not-for-profit heart.

Social enterprises are different from socially responsible businesses. While a business seeks to maximize its financial returns by complying with all legal requirements, socially responsible business

temper their profit pursuit by following the spirit of law which often go beyond the letter of law. In many cases socially responsible businesses also adopt socially or environmentally desirable practices much ahead of legal requirement mandating it. However, this voluntary adoption does not change their primary objective, which is to run a business incorporated for generating maximum economic and financial returns.

In contrast social enterprises use business as a vehicle for achieving primarily social objectives such as fulfilling the needs of the poor and the underserved, providing employment for the specially abled like the blind and physically handicapped or creating market avenues for socially desirable products and services like organic food products, day-care centres for children and the aged.

Precedent in the Western World

Recognizing the distinct value of organizations that prioritize social returns over economic returns, the governments of the UK and the USA have created special provisions for incorporating social enterprises.

In UK, the government in the year 2005 enacted a provision for incorporating Community Interest Companies or CICs in short. CIC has all the features of a limited liability company with only two restrictions. CICs are prohibited from distributing their capital to investors and in addition a cap is fixed on the dividend they can declare. While enacting this legislation in UK, no upper limit on the cap was specified. Instead they permitted the regulators to fix the cap acknowledging that in initial periods a higher dividend may needed to be provided to attract the desired quantum of capital into this sector.

The positive impact of Community Interest Companies in UK with over 10,000 entities incorporated in the first ten year period looks to have triggered some state governments in the US to enact their own version of CICs. In the US they are called the Low-Profit Limited Liability Companies or L3Cs that in short, have most of the features of CICs. But in the US, an additional trigger was a stipulation of Internal Revenue Services that permitted Foundations to invest in for-profit entities provided they qualified as Program Related Investments (PRIs) that furthered the Foundation's objectives and had a higher risk-return profile compared to a commercial investment. As qualification under this stipulation was subjective, that required satisfying the scrutiny of IRS officials, in 2008 Vermont became the first state in the US to permit L3Cs thereby providing assured approval from IRS.

In both UK and in the US, these companies have their name suffixed with the term CIC and L3C respectively to help their stakeholders and the general public distinguish them from other for-profit ventures.

Given this distinct global trend, is there a need for such legislations in India? Can the new form of organization help channelize the large flow of CSR funds and the increasing number of High Net-worth Individuals who are setting up foundations to meet the social goals?

Indian Need for Social Enterprises

A Legal need

The need for Companies Act, 2013 to provide for a separate organization to run social enterprise is required as under the current legislation, a not for profit company incorporated under Section 8 of the Act cannot do the following:

i. Use its income or profits for any purpose other than its stated objective of promoting commerce, arts, science, sports, education, research, social welfare, religion, charity, environment protection or such other objects.
ii. Declare dividend to its shareholders and on dissolution, distribute its assets among its members.
iii. Further, companies incorporated under Section 8 of the Act as not-for-profit companies are also prevented from compensating or remunerating its Directors thereby restricting its ability to attract talent for managing and governing these organization.

Social Need

Prominent among the factors that highlight the need for a thriving social enterprise sector in India, is the need to eradicate wide spread poverty, child malnutrition and inadequate healthcare facilities for the poor and rural residents.

Further, the mandate for corporate CSR spends, which brings in annual resources to the tune of Rs.10,000/- crores needs social enterprises to absorb and use it productively.

Finally, social enterprises can supplement the government initiatives of public food distribution system, creating new businesses that provide employment opportunities for the specially-abled and serve the needs of rural population and population at the base of the pyramid, who are currently underserved or unserved.

Given these imperatives, can the Companies Act, 2013 be amended to incorporate a new form of social enterprises by inserting a new section, 8 A. This section could provide for incorporating Social Enterprises (SEs) which are incorporated for pursuing any legal permitted commercial activity and provide for compensating its Directors and limit the return they provide to their shareholders to less than 10% of the capital contributed, in any form, be it dividend distribution or return of surplus on dissolution or liquidation on the lines of CIC companies in UK and L3C companies in the US. This would accelerate Social Enterprises in India to thrive and accelerate the pace at which an inclusive, poverty free India is realized.

Birth of Statutory Audit: Triggered to Protect the Shareholders in 1900 CE

Statutory audit, an integral part of the corporate governance structure today is of relatively recent origin, mandated only in 1900 CE. Prior to this, audit of a company's accounts was discretionary, triggered by the need of promoters to enhance their credibility required while raise money or reassuring investors about financial mismanagement concerns or when shareholders expressed dissatisfaction with the quality of accounts presented.

In one of the earliest instances, East India Company in 1624 CE proposed a detailed system of accounting and audit, when their shareholders refused to pay calls on shares amounting to £80,000. Subsequently some proactive managements that needed to raise money more frequently like railroad companies, provided for regular audit in their by-laws.

Both the UK Joint Stock Companies Act, 1844, the first act that permitted companies by registration and the UK Companies Act, 1856, the first act that provided for limited liability had an optional clause, by virtue of it being placed in the model Articles of Association, for appointment of auditor and for the auditors to submit their report to the shareholders.

It took a scam of enormous magnitude that bankrupted more than 1500 shareholders of a bank in Scotland for statutory audit to be mandated for a company's accounts to protect shareholders.

The Concept

Global Investors Dictionary defines audit as 'an evaluation of a company's financial records to verify that stated assets and liabilities match the actual assets and liabilities.' Initially when the practice of audit was started only non-executive shareholders were appointed as auditors. Audit as it evident required examination of books of accounts. This naturally limited the eligible shareholders who could act as auditors to bankers, bank clerks and merchants, people conversant with books of accounts.

As the complexity of audits increased, the Shareholder-auditor was permitted to utilize the services of professional accountants at company's expense. Once professional accountants were engaged to audit at the expense of the company, the role of Shareholder-auditor became indistinguishable from that of a director, thereby leading to the concept of shareholder-auditors, who acted as a conduit for the auditor to interact with the company being eliminated.

Once the concept of non-shareholders as auditors was accepted, it was necessary to ensure that auditors were technically qualified and objective. This is the reason for prescribing a professional qualification as a prerequisite for being an auditor and for eliminating officers, suppliers, customers, lenders and borrowers from becoming an auditor, who could have other interests that colour their objectivity.

The First of First

City of Glasgow Bank was the fifth bank in Scotland formed in 1839 with 779 partners and a paid up capital of £656,250, the largest capital for a Scottish bank at

that time. As was the practice then, the shareholders of the bank had unlimited liability.

Glasgow Bank with 88 branches faced its first crisis in 1857, due to the collapse of a Scottish bank, which led to a run on its deposits, as depositors rushed to takeout their savings. The bank closed its operations from November 11, 1857 till the end of that year. During the closure of business there was a change in the bank's management and the new management started presenting annual accounts from 1857 to build confidence.

By 1878, the bank had grown to 133 branches, deposits of £8 million, and had 1,819 shareholders, all with unlimited liability.

In September 1878, the Scottish newspaper Glasgow News wrote about troubles at a Scottish bank without mentioning any name. Concerned by the news, Bank of Scotland on September 11, 1878, asked the Glasgow bank to retire the bills of exchange discounted by it. Glasgow bank in turn asked for a loan of £500,000. Prior to granting the loan, Bank of Scotland wanted an examination of the books of accounts of Glasgow bank. On September 28, 1878, the accounting firm that conducted this examination reported a high percentage of non-performing assets. Based on the accountant's report, Bank of Scotland refused the loan, triggering the Glasgow bank's failure.

Analysis of the failure revealed it to be a multiyear affair with assets overvalued and liabilities understated to conceal insolvency. The last balance sheet published by the bank's management was on June 5, 1878. A comparison between the two balance sheets of June 5, prepared by the management and October 1, 1878, the date Glasgow bank closed its door reflected the magnitude of accounting cover-up. Assets were lower by £4,679,300 and liabilities higher by £2,103,800, resulting in the positive net-worth of the bank of £1,592,100 reported on June 5 turning into a deficit of £5,191,000.

Asset inflation took many forms, depreciated investments, loans to related parties, unrecorded sale of gold, and loans to insolvent firm. Gold reserves of £293,182 were shown, where none existed. Loans to four firms given in excess of security held was £4,270,000, investments were reflected at cost, when their realizable value was lower by £600,000.

In addition, loans were granted to insolvent firms. Cross examination of witnesses revealed that between 1873 and 1878, Smith, Fleming & Co, a borrower, had never been refused a loan. They had obtained fresh loans from the bank after offering to pay over fourteen years £500,000 out of a total loan outstanding of £1,300,000.

Intention to hide the precarious state of bank's liquidity position led the management to mismanage business and misrepresent the accounts. As a consequence, for a number of years annual dividend at the rate of 9% to 12% was paid in the absence of profits leading to the bank's net-worth turning negative.

The bank failure triggered unlimited liability of its shareholders who had to finally pay £2,750 on every share with a face value of £100. This led to 1,565 shareholders filing for bankruptcy, leaving only 254 shareholders solvent.

The City of Glasgow Bank's failure and the staggering bankruptcy of the large number of its shareholders led to the Companies Amendment Act, 1879. Two major features of the amendment were permission for unlimited companies to re-register as limited companies and stipulation for compulsory annual audit for all banking companies registered thereafter with limited liability.

The Act specifically required the auditors to report whether the balance sheet reflected a 'full and fair' view. As the benefits of Audit became evident to shareholders in the decades that followed, the practice of mandatory audit was extended to non-banking companies in 1900.

Companies Act, 2013

Section 139 of the Act provides for appointment of Statutory Auditor, who are required to report on the state of affairs of the Company to its shareholders. The Act further stipulates the qualification required to be an auditor and spells out the rights and duties of an auditor.

Current Usage

Being a mandatory provision, all the companies incorporated in India have a statutory auditor who is appointed by the shareholders and reports to the shareholders on the state of affairs of the company. However, efficacy of audits continue to remain a matter of concern, as visible in the PNB-Nirav Modi saga today.

Compliance Calendar

March 7th	TDS Payment for February 2018.
March 10th	GSTR-1 (Jan 2018): Monthly return for registered persons with aggregate turnover of more than Rs. 1.50 crores
March 15th	Pay PF contribution for February 2018
March 20th	Professional Tax payment
	GST Payment for February 2018- GSTR 3B
March 21th	ESIC monthly deposit
March 25th	PF Return for February 2018

Gist of regulatory changes in Companies Act, 2013 and Insolvency & Bankruptcy Code, 2016 in the month of February, 2018

- **05.02.2018**
  - **Exemption notification for Government Companies**

The Central Government notified that the provisions of Accounting Standard relating to deferred tax asset and deferred tax liability shall not apply for 7 years w.e.f. 01.04.2017 to a Government Company which is a public financial institution, Non-Banking Financial Company registered with RBI and generates at least 75% of its total revenue from business of infrastructure finance leasing with Government Companies and entities owned or controlled by Government.

  - **Designation of Special Courts**

The Central Government with the concurrence of the Chief Justices of the High Courts of Kerala, Orissa and Gauhati, has designated certain Courts and Judges as special court for the state of Kerala, Odisha, Assam and Union territory of Lakshadweep to ensure speedy disposal of trials in cases where the offence is punishable with imprisonment of two years or more.

- **07.02.2018**
  - **The Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations, 2018**

Insertion in Regulation 2(1): Definition for term "Evaluation matrix" and "Fair value" is inserted.

Regulation 27 substituted: It provides that to determine both the liquidation and the fair value of the corporate debtor the resolution professional should appoint two registered valuers in accordance with this regulation within 7 days of their appointment.

Regulation 35 substituted: The provisions of this regulation which was limited to Liquidation value alone is now extended even to the fair value of the corporate debtor.

Regulation 36(1) substituted: A Resolution professional is required to submit the information memorandum in electronic form to every member of the Creditors Committee within 2 weeks of their appointment as resolution professional and to each prospective resolution applicant.

Regulation 36(2)(a) substituted: It provides for the information memorandum to have description of assets and liabilities such as date of acquisition, cost of acquisition, remaining useful life, identification number, depreciation charged, book value and any other relevant details.

Regulation 36(4) substituted: Only a resolution professional can share the information memorandum subject to an undertaking from a member of the committee or a prospective resolution applicant with respect to confidentiality and usage of the information.

Regulation 36A inserted: Regulation regarding invitation to prospective resolution professionals for submission of resolution plan in Form G is inserted.

Regulation 37 substituted: It provides that the resolution plan should now include measures that are necessary for the insolvency resolution and to maximize the value of corporate debtor's assets which shall include change in portfolio of goods or services produced or rendered and change in technology used by the corporate debtor.

Regulation 39(3A) inserted: It provides that the committee of creditors should specify the amounts payable from resources towards insolvency resolution process costs, liquidation value due to operational creditors or payments to financial creditor and liquidation value due to dissenting financial creditors at the time of approving the resolution plan.

Regulation 39(4) substituted: It provides that the resolution professional should submit the resolution plan approved by the committee of creditors to Adjudicating Authority at least 15 days prior to the maximum period permitted. This shall not apply to the ongoing corporate insolvency resolution process which has completed 130th day from its commencement date.

- **The Insolvency and Bankruptcy Board of India (Fast Track Insolvency Resolution Process for Corporate Persons) (Amendment) Regulations, 2018**

Insertion of Regulation 2(1): Definition for term "Evaluation matrix" and "Fair value" is inserted.

Regulation 26 substituted: It provides that to determine both the liquidation and the fair value of the corporate debtor the resolution professional should appoint a registered valuer in accordance with this regulation within 7 days of his appointment.

Regulation 34 substituted: The provisions of this regulation which was limited to Liquidation value alone is now extended even to the fair value of the corporate debtor.

Regulation 35(1) substituted: Only a Resolution professional is required to submit the information memorandum in electronic form to every member of the Creditors Committee within 2 weeks of his appointment and to each prospective resolution applicant.

Regulation 35(2)(a) is substituted: It is provided that the information memorandum to have description of assets and liabilities such as date of acquisition, cost of acquisition, remaining useful life, identification number, depreciation charged, book value and any other relevant details.

Regulation 35(4) is substituted: Only a resolution professional can share the information memorandum subject to an undertaking from a member of the committee or a prospective resolution applicant with respect to confidentiality and usage of the information.

Regulation 35A inserted: Regulation regarding invitation to prospective resolution professionals for submission of resolution plan in Form G is inserted.

Regulation 36 substituted: It provides that the resolution plan should now include measures that are necessary for the insolvency resolution and to maximize the value of corporate debtor's assets which shall include change in portfolio of goods or services produced or rendered and change in technology used by the corporate debtor.

Regulation 38(3A) inserted: It provides that the committee of creditors should specify the amounts payable from resources towards fast track process costs, liquidation value due to operational creditors or payments to financial creditor and liquidation value due to dissenting financial creditors at the time of approving the resolution plan.

Regulation 38(4) substituted: It provides that the resolution professional should submit the fast track corporate insolvency resolution plan approved by the committee of creditors to Adjudicating Authority at least 15 days prior to the maximum period permitted. This shall not apply to the ongoing fast track corporate insolvency resolution process which has completed 50th day from its commencement date.

- **09.02.2018**
  - **The Companies (Registered Valuers and Valuation) Amendment Rules, 2018**

MCA has extended the time limit up to which a person shall be allowed to render the valuation services without Registration Certificate from 31.03.2018 to 30.09.2018.

It is also provided that where a company appoints an unregistered Valuer before 30.09.2018 then the valuation or part of it, if pending on such date should be completed within three months thereafter.

- **Enforcement notification**

Central Government hereby has notified commencement of 43 sections out of the 93 sections amended by the Companies (Amendment) Act, 2017 with effect from 09.02.2018.

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- **21.02.2018**

Companies (Removal of Difficulties) Order, 2018

In order to ensure better corporate governance in companies, MCA vide its order has inserted a new proviso to section 169 (1) to provide for removal of independent director who is re-appointed for second term, only by way of a special resolution and after giving a reasonable opportunity of being heard. For which, earlier an ordinary resolution was prescribed under the said section.

- **23.02.2018**

➢ **Circular to Designate a website for publishing Forms under the Regulations vide General Circular No. IP(CIRP)/006/2018**

IBBI has designated www.ibbi.gov.in as the website wherein the Public Announcements and Brief Particulars of Invitations of Resolution Plans shall be published.

It is also clarified that the interim resolution professional, the resolution professional or the liquidator shall send in mail the Public Announcements and Brief Particulars of Invitations of Resolution Plans in PDF form using their e-mail address registered with the Board topublic.ann@ibbi.gov.in and invite.rp@ibbi.gov.in respectively. The Board shall upload the forms received by it on the designated website.

➢ **Confidentiality of Information relating to Processes under the Insolvency and Bankruptcy Code, 2016 vide General Circular No. IP(CIRP)/007/2018**

The Board has clarified that Insolvency Professional, whether acting as Interim Resolution Professional, Resolution Professional or Liquidator should keep the information confidential and not disclose the information otherwise than as provided in the Act i.e., after obtaining consent from the relevant parties and obtaining undertaking on the usage of the information provided.

➢ **Exemption notification to Government Companies**

MCA has amended Serial number 8 of the exemption notification No.G.S.R.463(E) dated 05.06.2015. Serial number 8 referred to exemption from Accounting Standard 17 on Segment Reporting for the Government Companies engaged in defence production. Now this exemption is broad based by removing reference to Accounting Standard 17 and replacing it with Accounting Standards on Segment reporting.

➢ **The Companies (Accounts) Amendment Rules, 2018**

A proviso is inserted in Rule 10 to provide that the companies following Companies (Indian Accounting Standards) Rules, 2015 shall prepare a Statement containing salient features of financial statements in Form AOC-3A

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About us

CimplyFive Corporate Secretarial Services Private Limited

Leverage research and technology to eliminate procedural non-compliance risk for entities regulated by the Indian Companies Act, 2013

Mission:

Provide a cost-effective, secure web-based, menu driven, subscription services that provides curated resolutions, timely alerts and informative dashboards to free the management bandwidth for pursuing business goals

BLISS

(Board Leaders Integrated Software Solution)

- A digital productivity tool for Compliance with the Companies Act,2013
- Provides comprehensive coverage of Board meetings, Shareholder meetings and Sub-committee meetings
- Rich bank of curated but editable resolutions
- Fully integrated modules- Agenda, Minutes, Registers and Returns
- Timely alerts and reminders
- Rich and real-time dashboard

www.ca2013.com: Company law at your fingertips. A free to use website, integrating Companies Act with Rules, Notification, Orders and Circulars that is real time and online

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