7

FORMATION OF JOINT STOCK COMPANY

You have learnt that formation of a sole proprietorship organisation or a partnership firm does not involve much formalities so much so that even the registration is not compulsory. That is not the case with formation of a joint stock company as it involves a lengthy legal procedure. Its registration with the Registrar of Companies is obligatory, before it can commence its business. In this lesson you shall learn about the various stages involved in the formation of a Joint Stock Company and have an idea about the important documents that regulate its functioning.

OBJECTIVES

After studying this lesson, you will be able to:

- explain the meaning of promotion and promoters;
- state the role and importance of promoters;
- identify the various stages of promotion of Joint Stock Company; and
- describe the content and significance of important documents such as MOA, AOA and Prospectus.

7.1 STAGES IN THE FORMATION OF A JOINT STOCK COMPANY

It is very easy to establish a sole proprietorship business or a partnership firm as there are a few regulations to meet. But for the establishment of a company, a lot of formalities are to be complied with. The registration of the company is mandatory before starting its operation. The formation of a company, right from the origin of idea to establish a company goes through four different stages, like:

Stage –I Promotion

Stage- II Incorporation

Stage- III Raising of Capital

Stage- IV Commencement of Business

Let us now learn about these stages in details.

7.2 PROMOTION

Promotion of a business simply refers to all those activities that are required to be undertaken to establish a new business unit for manufacturing or distribution of any product or provide any service to the people. It starts with conceiving an idea of business or discover an opportunity for doing a business, assess its feasibility and then take the necessary steps to launch the business unit. This involves ascertaining as to whether all the basic requirements such as land, building, raw material, machine, equipments etc. are available or not. If they are available one can assemble them, arrange the necessary funds and set up the business unit to give shape to the initial idea of establishing the business. The whole process is called business 'promotion' and the person who does it is called the 'promoter'.

Before knowing the various stages of promotion of a joint stock company let us discuss about the role and importance of promoters.

7.2.1 ROLE AND IMPORTANCE OF PROMOTER

A promoter can be defined as a person or group of persons who conceive the idea of setting up a new business, assess its feasibility and take necessary steps to arrange the basic requirements and establish a business unit say, a Company and put into operation. Promoter plays a pivotal role in the promotion of a company. He conceives the idea of business enterprise, analyses its prospects, works out a tentative scheme of organisation, brings together the requisite men, material, machines and money and starts the enterprise.

7.2.2 TYPES OF PROMOTERS

The task of business promotion may be carried out by an individual, a firm, a body corporate or a banker. Based on the nature of their operation the promoters can be classified into the following categories.

(a) **Professional Promoters:** These promoters are specialists in promoting new business ventures. They do it on a whole time basis as their occupation or profession. They initiate all the steps in establishing new enterprises and find out the persons who can finance it. After completing all the formalities they pass on the management to their owners or shareholders and then move to another new venture.

(b) **Financial Promoters:** These promoters float companies only during favorable conditions in the securities market. They have the financial capacity and look forward to opportunities for new investment.

(c) Technical Promoters: These promoters are technical experts in different fields. They make use of their specialised knowledge, experience and training in promoting new business. They generally charge fees for their services.

(d) Entrepreneurial Promoters: They are the people who conceive new ideas of business, take necessary steps to set up the business unit to give it a shape and ultimately control and manage it. Most promoters in India (like Tata, Birla, Ambanies) fall in this category.

(e) Specialised Institutions: There are certain financial institutions which provide financial assistance and guidance in launching new ventures and often collaborate with new entrepreneurs to promote new business. They also provide management and technical expertise to the existing enterprises.

(f) Government: Both the central and state governments also act as promoters in most cases where the new business is floated either in public sector or joint sector which involve huge amount of capital and risk. HMT, ONGC, SAIL, BHEL are glaring examples of units set up by the government.

INTEXT QUESTIONS 7A

1. Define the term 'Promotion' in your own words.

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____

2. The stages of formation of a Company are given below.

    (a) Commencement of business

    (b) Raising of capital

    (c) Promotion

    (d) Incorporation

    Write them in correct order.

    (a) ______________________

    (b) ______________________

    (c) ______________________

    (d) ______________________

7.2.3 STEPS INVOLVED IN PROMOTION OF A COMPANY

The task of promotion usually involves the following four steps or phases.

1. Discovery of a business idea
2. Investigation and Verification

3. Assembling
4. Financing the Proposition

Let us know in detail about these steps.

(1) Discovery of a Business Idea

The process of business promotion begins with conception of an idea of business opportunity. The idea may come from non-availability of any product to satisfy the existing need of people or inability of an existing product to satisfy the changing need of the people or a new invention that can create a new product. For example, during early 1940's there was no "Walkman". The marketing executive of an electronic company found people busy in hearing music holding a big radio on their shoulders while travelling. This particular scene perturbed the marketing executive and he thought how nice would it be if the radio could be reduced to a very small size which can be kept in pocket and a wire be connected to the ear. This idea gave birth to the new product "Walkman".

(2) Investigation and Verification

Once the idea has been conceived, a thorough investigation is made to establish the soundness of the proposition, taking into consideration its technical feasibility and commercial viability. As in the case of 'Walkman' if there was no technology by which the size of the radio could be reduced to small size or no technology to transmit the sound from the radio to the ear through earphone, the proposition of producing the "Walkman" would have been impossible. Similarly, if technology is available but the cost involved in making a "Walkman" would be so high that no customer could be able to purchase it; or the demand is too limited and the return on investment is low, the idea is not considered as commercially viable.

All these investigations on technical feasibility, commercial viability and profitability are presented in a report called "project report" or "feasibility report". This feasibility report is the primary or basic document that helps in procuring licenses and arrange the necessary finance from financial institutions and other investors.

(3) Assembling

Once the promoter is convinced of the feasibility and profitability of the proposition, he takes steps in assembling or making arrangements for all the necessary requirements such as land, building, machinery, tools, capital, etc. Decision is also to be made regarding size, location and layout etc. for the plant, and make contracts with suppliers for raw materials, enter into agreement with the dealers to purchase equipments, make agreement with bankers to finance and take initial steps for the setting up of a Company.

(4) Financing the Proposition

At this stage, financial plans are prepared with respect to the amount of capital required, the nature of capital structure i.e., the proportion of capital to be raised from owners fund and that from borrowing from banks and others, and how and when to raise the share capital from the general public. Agreements are made with merchant bankers, underwriters and stock brokers who are to assist the capital issue and so on.

INTEXT QUESTIONS 7B

1. How does an idea of business opportunity generate? Give any three points.

   (a) ______________________________

   (b) ______________________________

   (c) ______________________________

2. Write in about 30 words, how the following activities/documents/authorities are related with promotion of a company.

(a) Assembling

____

____

(b) Project report

____

____

7.3 INCORPORATION

A sole proprietorship or partnership firm can be formed to carry out its business even without any registration. But a company can not be formed or permitted to run its business without registration. Infact, a company comes into existence only when it is registered with the Registrar of Companies. For this purpose the promoter has to take the following steps:

(a) Approval of Name

It has to be ensured that the name selected for the company does not match with the name of any other company. For this, the promoter has to fill in a "Name Availability Form" and submit it to the Registrar of Companies along with necessary fees. The name must include the words(s) 'Limited' or 'Private limited' at the end. Once it is approved, the promoter can proceed with other formalities for the incorporation of the Company.

(b) Filing of Documents

After getting the name approved the promoter makes an application to the Registrar of Companies of the State in which the Registered Office of the company is to be situated for registration of the company. The application for registration must be accompanied by the following documents.

(i) Memorandum of Association (MOA): It defines the objectives of the company and

Notes

Incorporation

(a) Approval of name

(b) Filing of documents

(c) Payment of filing and registration fees states about the range of activities or operation. It must be duly stamped, signed and witnessed.

(ii) Articles of Association (AOA). It contains the rules and regulations regarding the internal management of the company. It must be properly stamped, duly signed by the signatories to the Memorandum of Association and witnessed.

(iii) A list of persons who have agreed to become Directors with their addresses etc.

(iv) Written consent of the proposed Directors to act in that capacity, duly signed by each Director.

(v) The notice about the exact address of the Registered Office of the company. It may, however, be filed within 30 days of incorporation or registration.

(vi) A copy of the name approval letter received from the Registrar of Companies.

(vii) A statutory declaration that all the legal requirements of the Companies Act in regard to incorporation have been complied with.

(c) Payment of Filing and Registration Fees

Along with the above documents, necessary filing fees and registration fees at the prescribed rates are also to be paid.

The Registrar will scrutinise all the documents and if he finds them in order, he will issue a Certificate of Incorporation. The moment the certificate is issued, the company comes into existence. So this certificate may be called as the Birth Certificate of a Joint Stock Company.

INTEXT QUESTIONS 7C

1. State the utility of 'Name Availability Form'.

2. Mention the name of the certificates/documents relating to following activities/ formalities–

(a) The certificate issued by the Registrar of companies certifying that the company has come into existence.

(b) The document, which contains the various rules and regulations that govern the management of the company.

(c) The document that defines the objectives of the company.

7.4 Raising Capital or Subscription of Capital

After the company is incorporated, the next stage is to raise the necessary capital. In case of a private limited company, funds are raised from the members or through arrangement from banks and other sources. In case of a public limited company the share capital has to be raised from the public. This involves the following:

(a) Preparation of a draft prospectus and get it inspected (vetted) by SEBI to ensure that all information given in the prospectus fully complies with the guidelines laid down by SEBI in this regard.

(b) Filing a copy of the prospectus with the Registrar of Companies.

(c) Issue of prospectus to the public by notifying in a newspaper and inviting the public to apply for shares as prescribed in the prospectus.

(d) If the minimum subscription has been received, shares should be allotted to the applicants as per SEBI guidelines and file a return of allotment with the Registrar of Companies.

(e) Listing of shares in a recognised stock exchange so that the shares can be traded there. Preferably, consent of a stock exchange for listing should be obtained before issue of the prospectus to the public.

SEBI- Securities and Exchange Board of India

*Before commencing the business, every public limited company must have to show that adequate funds have been raised from the public. So when the company gives the offer to the public to subscribe its shares, it must ensure that a minimum number of shares must be subscribed by the investors. This is called **minimum subscription**, which is 90% of the total number of shares offered to the public. If the application money received is less than the minimum subscription, then the company must return all the application money of the investors and it cannot start its operation. To avoid this risk, the share issuing company may appoint underwriters, who undertake to buy the shares if these are not subscribed by the public. The underwriters perform their job on commission basis. This process of appointing underwriters to ensure the minimum subscription of capital is known as Underwriting.*

7.5 Commencement of Business

In case of a private limited company, it can immediately start its business as soon as it is registered. However, in case of public limited company a certificate, known as 'certificate of commencement of business', must be obtained from the Registrar of Companies before starting its operation. For this purpose it has to file a statement with the following declarations to the Registrar of Companies.

(a) That a prospectus has been filed with the Registrar of Companies.

(b) That the shares have been allotted upto the amount of the minimum subscription.

(c) That the Directors have taken up or purchased the minimum number of shares required to qualify themselves to be Director.

(d) That no money is liable to become refundable to the applicants by reason of failure to obtain permission for shares to be traded in a recognised stock exchange.

(e) A statutory declaration by a Director or the Secretary of the company stating that the requirements relating to the commencement of business have been duly complied with.

The Registrar of Companies will scrutinise all these documents and if he is satisfied that the process of securing the minimum prescribed capital has been done honestly and efficiently and the minimum prescribed capital has been obtained from the public, then he shall issue a Certificate of Commencement of Business.

INTEXT QUESTIONS 7D

1. State the difference between certificate of incorporation and certificate of commencement of business.

2. Mention the subsequent action to be taken up by the company in the following situations:

(a) A company received application from the public to subscribe 75% of its total share capital.

(b) A new company is uncertain about the minimum subscription of its share capital.

(c) The certificate of incorporation has been issued to a new Private Limited Company.

(d) The certificate of incorporation has been issued to a new Public Limited Company.

7.6 Important Documents Prepared While Forming a Company

There are three basic documents, which are prepared and filed with the Registrar during the formation of a company. These are:

(1) Memorandum of Association (MOA)

(2) Articles of Association (AOA)

(3) Prospectus

Out of these three documents, MOA and AOA are filed with the Registrar of Companies before the registration along with other supporting documents while asking for certificate of incorporation. The prospectus is issued to the public at the time of subscription to capital. Of course, a copy of the prospectus is submitted to the Registrar also. Let us now have a brief idea about these documents.

1. Memorandum of Association (MOA)

The Memorandum of Association is the principal document in the formation of a company. It is called the charter of the company. It contains the fundamental conditions upon which the company is allowed to be incorporated or registered. It defines the limitations of the powers of the company. The purpose of memorandum is to enable the shareholders, creditors and those who deal with the company to know what is its permitted range of activities or operations. It defines the relationship of the company with the outside world.

The Memorandum of Association usually contains the following six clauses:

(a) **Name Clause:** It contains the name by which the company will be established. As you know, the approval of the proposed name is taken in advance from the Registrar of the companies.

(b) **Situation Clause:** It contains the name of the state in which the registered office of the company is or will be situated. The exact address of the company's registered office may be communicated within 30 days of its incorporation to the Registrar of Companies.

(c) **Objects Clause:** It contains detailed description of the objects and rights of the company, for which it is being established. A company can undertake only those activities which are mentioned in the objects clause of its memorandum.

(d) **Liability Clause:** It contains financial limit upto which the shareholders are liable to pay off to the outsiders on the event of the company being dissolved or closed down.

(e) **Capital Clause:** It contains the proposed authorised capital of the company. It gives the classification of the authorised capital into various types of shares, (like equity and preference shares) with their numbers and nominal value. A company is not allowed to raise more capital than the amount mentioned as its authorised capital. However, the company is permitted to alter this clause as per the guidelines prescribed by the companies Act.

(f) **Subscription Clause:** It contains the name and address of at least seven members in case of public limited company and two members in case of a private limited company, who agree to associate or join hands to get the undertaking registered as a company. It contains a declaration by persons who are desirous of being formed into and agree to subscribe to the number of shares mentioned against their names.

2. Articles of Association (AOA)

The Articles of Association of a company contains the various rules and regulations for the day to day management of the company. These rules are also called the bye-laws. It covers various rights and powers of its members, duties of the management and the manner in which they can be changed. It defines the relationship between the company and its members and also among the members themselves. The rules given in the AOA must be in conformity with the Memorandum of Association.

Articles of Association of a company generally contain rules and regulations with regard to the following matters:

(a) Preliminary contracts

(b) Use and custody of common seal

(c) Allotment, calls and lien on shares

(d) Transfer and transmission of shares

(e) Forfeiture and re-issue of shares

(f) Alteration of share capital

(g) Issue of share certificates and share warrants

(h) Conversion of shares into stock

(i) Procedure of holding and conducting company meetings

(j) Voting rights and proxies of members

(k) Qualification, appointment, remuneration and power of Directors

(l) Borrowing powers and methods of raising loans

(m) Payment of dividends and creation of reserves

(n) Accounts and audit

(o) Winding up.

A company can register its own Articles of Association or adopt Table A, which contains a model set of rules as given in the Schedule I of the Companies Act.

After knowing about the meaning and the contents of Memorandum of Association and Articles of Association you must be thinking, how these two documents are different from each other. Let us have a comparison between these two.

DIFFERENCE BETWEEN MOA AND AOA

Differences based on	*Memorandum of Association*	*Articles of Association*
(a) Subject Matter	It contains aims and objectives of the company.	Articles of Associations contain rules for implementation of the aims and objectives contained in the Memorandum of Association.
(b) Relationship	It defines the relationship between the company and outsiders.	Articles defines the relationship between the company and its members.
(c) Amendment	It is very difficult to amend the aims and other provisions of the Memorandum of Association.	The rules given in the articles can be easily amended by a special resolution.
(d) Limitations	The provision given in the Memorandum of Association can not be outside the scope of Companies Act.	The rules given in the Articles of Association can neither be outside the scope of companies Act nor of the Memorandum of Association.
(e) Obligation	It is obligatory for a company to prepare and submit this document to the Registrar of Companies.	It is not obligatory to submit this document to Registrar of Companies. The company may adopt Table A of the companies Act.

3. PROSPECTUS

After getting the Certificate of Incorporation or Registration a public limited company invites the public to subscribe to its shares. This is done by issuing a document called Prospectus. Under the Companies Act, a prospectus has been defined as "any document described or issued as a prospectus and includes any notice, circular, advertisement or other document, inviting deposits from the public or inviting offers from the public for the subscription or purchase of shares or debentures of a company or body corporate".

The main objectives of issue of a prospectus are:

(a) to inform the public about the company;

(b) to induce people to invest in the shares or debentures of the company; and

(c) to provide an authentic information about the company and the terms and conditions of issue of shares and debentures.

The prospectus usually contains the following information which is considered important for the prospective investors of shares and debentures of the company.

(a) General information regarding the name, office of the company, stock exchange where shares are to be listed, date of opening and closing of the issue, credit rating information, name of underwriters, brokers and bankers.

(b) Capital structure of the company.

(c) Terms of payment and application procedure.

(d) Company management and details of the project and project report.

(e) Other listed companies under the same management.

(f) Outstanding litigations and defaults.

(g) Management perception of risk factors.

The prospectus must be prepared with great care because on the basis of its details the public subscribes to the capital of the company. No facts should be withheld in this. It must not contain even an idea of falsehood. It should contain only truth, complete truth and nothing but truth. The future schemes and bright futures of the company are presented through this.

Companies which do not want to issue a prospectus may submit a statement in lieu of prospectus to the Registrar of Companies. It is a copy of the prospectus but is not issued to the public.

INTEXT QUESTIONS 7E

1. Define the term 'Prospectus' in your own words.

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2. Name the following documents.

   (a) The document issued by the company to the public to invite them to subscribe its share capital.

   (b) The document that binds a member with the company, company with members and members with members.

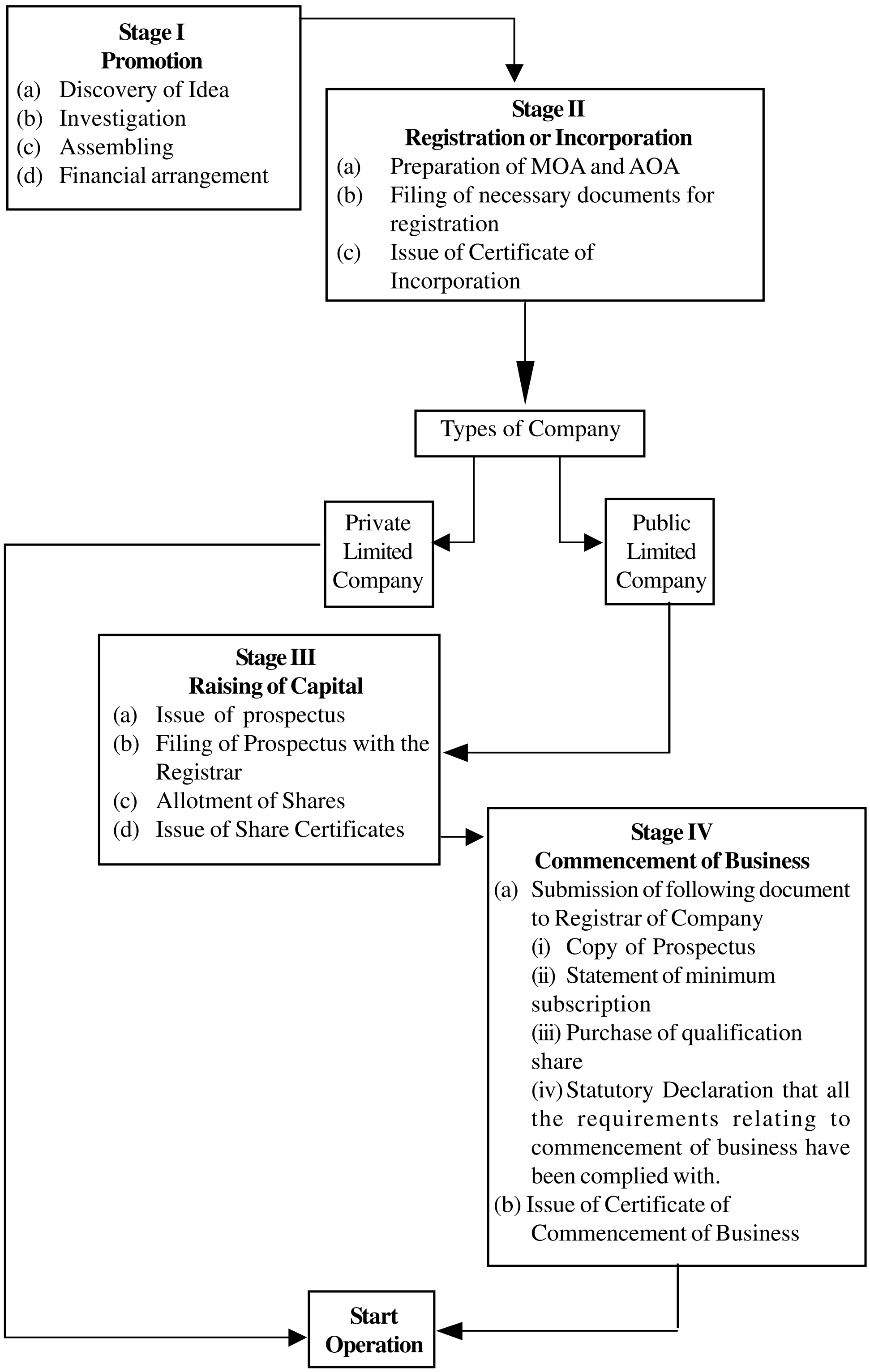
   (c) The document that contains rules for internal management of the company.

   (d) The document that specifies the aims of the company.

   (e) The document issued by the public company which does not want to issue a prospectus.

FORMATION OF A JOINT STOCK COMPANY

FLOW CHART



7.7 What You Have Learnt

- **Promotion:** It refers to all those activities that are required to be undertaken to establish a new business (may be a company).
- **Promoter:** A promoter is a person or a group of persons who think of forming a company and take necessary steps for the same. There are different categories of promoter like Professional promoter, Financial promoter, Technical promoter and Entrepreneurial promoter. Some Specialised Institutions as well as Government may also perform the role of promoters.
- **Steps in Promotion of company**

  (a) Discovery of Idea

  (b) Investigation and Verification

  (c) Assembling

  (d) Financing the proposition
- **Incorporation:** A company comes into existence only when it is incorporated or registered with the Registrar of Companies. The promoter has to take the following steps for this purpose:

  (a) Approval of name

  (b) Filing of Documents, and

  (c) Payment of Filing and registrations fees.
- **Raising Capital:** A private company raises funds from the members or borrowing from banks and others. A public company has to raise funds from the public by issuing a prospectus.
- **Commencement of Business:** A private company can immediately start its business after receiving the Certificate of Incorporation. However, a public company can start its business only after getting the Certificate of Commencement of Business.
- Important documents prepared while forming a company:

  (a) Memorandum of Association

  (b) Articles of Association

  (c) Prospectus
- **Memorandum of Association:** It is a principal document in the formation of a company. It is called the charter of the company. It controls the relations of the company with outside parties. It fixes the aims, the name and registered office, etc. of the company. It contains the following six clauses:

  (a) Name clause,

  (b) Situation clause,

(c) Objects clause,

(d) Liability clause,

(e) Capital clause,

(f) Subscription clause.

- **Articles of Association:** It contains the various rules and regulations for the internal management of the company.
- **Prospectus:** This document is prepared by the public limited companies. The purpose of its preparation is to invite the public to subscribe its shares and debentures.

7.8 KEY TERMS

Certificate of commencement of business

Incorporation

Memorandum of Association

Minimum Subscription

Promoter

Promotion

Prospectus

Statement in lieu of prospectus

Underwriting

7.9 TERMINAL QUESTIONS

Very Short Answer Type Questions

1. Who is a promoter?
2. Enumerate the steps in the promotion of a company.
3. What is meant by Authorised Capital of a company?
4. Why is a prospectus issued by the public limited company?
5. List any two documents submitted for the registration of a company.

Short Answer Type Questions

6. State the steps involved in promotion of a company.
7. What is Article of Association?
8. Give any two differences between Memorandum of Association and Articles of Association.
9. Explain the meaning of Entrepreneurial promoter.
10. State any two clauses of Memorandum of Association.

Long Answer Type Questions

11. Define a prospectus and state its contents.
12. As a promoter, how will you obtain certificate of commencement of business? Explain in brief.

13. What is meant by Articles of Association. State its contents.
14. Explain in brief any two basic documents which are required to be filed in formation of a company.
15. Distinguish between Memorandum of Association and Articles of Association.

7.10 ANSWERS TO INTEXT QUESTIONS

7A

2. (a) Promotion

   (b) Incorporation

   (c) Raising of Capital

   (d) Commencement of business

7B

1. (a) Non-availability of any product to satisfy the existing need.

   (b) Inability of an existing product to satisfy the changing need.

   (c) New invention that creates new product.

2. (a) It is making arrangements for necessary resources such as land, building, machinery tools, etc. to start a new company.

   (b) It is a report consisting the details about the technical feasibility in relation to the proposed business activity.

7C

1. It helps the company to get its proposed name approved by the Registrar of Companies.
2. (a) Certificate of Incorporation
   (b) Articles of Association
   (c) Memorandum of Association

7D

1. Certificate of Incorporation gives legal status to the company. It is also known as birht certificate of the company. But certificate of commencement of business allows to start the operation. These two certificates are required by the public limited company, but in case of private limited company only certificate of Incorporation is required to start the operation.
2. (a) Since it has not received the minimum subscription, the application money received from the investors must be returned.
   (b) Can appoint underwriters.
   (c) Start operation immediately.
   (d) Go to the public for capital and then obtain the certificate of commencement of business.

7E

2. (a) Prospectus
   (b) Articles of Association
   (c) Articles of Association
   (d) Memorandum of Association
   (e) Statement in lieu of Prospectus

DO AND LEARN

(A) Collect advertisements of three different companies inviting the public to subscribe their shares. Compare their contents regarding following points

Articles	Company A	Company B	Company C
Name			
Objectives			
Types of shares to be subscribed			
Total Amount of Issue			
The issue price of each share			

(B) Go to the nearby company and collect the following information.

(i) Name of the company.

(ii) Year of establishment of the Company.

(iii) The nature of activity.

(iv) Whether the company is private or public.

(v) Share capital of the Company and kinds of shares.

(vi) Names of the Directors of the company.

(vii) Names of the Bankers of the Company.

Any other relevant information.

ROLE PLAY

Rakesh and Mohan are partners of a Toy manufacturing firm situated at NOIDA. They had started their business in a small house in the year 2004 to sell the toys in the local market of NOIDA. Day-by-day, the demand for their toys increased and today they sell the toys in the entire state of Uttar Pradesh and in the neighbouring states.

One day Gopal, a friend of Rakesh, (who works as Managing Director of a ball pen manufacturing company at Hyderabad), came to his office and discussed about the performance of his business.

Rakesh : Now-a-days there is a very high demand for our toys in the market.

Gopal : Oh, that's good.

Rakesh : But during the last one year we have not been able to supply the toys as per the demand of the market.

Gopal : But, why?

Rakesh : The problem is, we don't have sufficient infrastructural facilities to increase our production capacity to meet the increasing demand. we are also now not in a position to expand our business. Financial constraints and huge risk always trouble us.

Gopal : Okay. Why don't you convert your partnership into joint stock company.

(During the discussion, Mohan joined them)

Rakesh : But we have no idea how to form a joint stock company

Gopal tries to explain the formation of a joint stock company to them.

Assume the role of the above three friends and continue the conversation.

Chapter at a Glance

7.1 Stages in the formation of a Joint Stock Company

7.2 Promotion

- 7.2.1 Role and Importance of Promoter.
- 7.2.2 Types of promoters
- 7.2.3 Steps in Promotion of a Company

7.3 Incorporation

7.4 Raising capital or subscription of capital

7.5 Commencement of Business

7.6 Important Documents prepared while forming a company