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Unit IB07: Formation of a Company

Name: \_\_\_\_\_

Date: \_\_/\_\_/\_\_

### **Stages of Formation**

To fully understand the process, one can divide the formalities into four distinct stages, which are:

- (i) Promotion;
- (ii) Incorporation;
- (iii) Subscription of capital; and
- (iv) Commencement of business.

## Promotion Stage

### Meaning

Promotion is the first stage in the formation of a company. It involves conceiving a business opportunity and taking an initiative to form a company so that practical shape can be given to exploiting the available business opportunity. Thus, it begins with somebody having discovered a potential business opportunity.

### Functions of a Promoter

- (i) Identification of business opportunity: The primary activity of a promoter is to identify a business opportunity. The opportunity may be in respect of producing a new product or service or making some product available through a different channel or any other opportunity having an investment potential.
- (ii) Feasibility studies: It may not be feasible or profitable to convert all identified business opportunities into real projects. The promoters, therefore, undertake detailed feasibility studies to investigate all aspects of the business they intend to start.
  - a. Technical feasibility: Sometimes an idea may be good but technically not possible to execute. It may be so because the required raw material or technology is not easily available.
  - b. Financial feasibility: Every business activity requires funds. The promoters must estimate the fund requirements for the identified business opportunity. If the required outlay for the project is so large that it cannot easily be arranged within the available means, the project has to be given up.
  - c. Economic feasibility: Sometimes it so happens that a project is technically viable and financially feasible but the chance of it being profitable is very little. In such cases as well, the idea may have to be abandoned.
- (iii) Name approval: Having decided to launch a company, the promoters must select a name for it and submit, an application to the registrar of companies of the state in which the registered office of the company is to be situated, for its approval.
- (iv) Fixing up Signatories to the Memorandum of Association: Promoters must decide about the members who will be signing the Memorandum of Association of the proposed company. Usually the people signing memorandum are also the first Directors of the Company. Their written consent to act as Directors and to take up the qualification shares in the company is necessary.
- (v) Appointment of professionals: Certain professionals such as mercantile bankers, auditors etc., are appointed by the promoters to assist them in the preparation of necessary documents which are required to be with the Registrar of Companies.
- (vi) Preparation of necessary documents: The promoter takes up steps to prepare certain legal documents, which must be submitted under the law, to the Registrar of the Companies for getting the company registered. These documents are Memorandum of Association, Articles of Association, and Consent of Directors.

### Memorandum of Association

Memorandum of Association is the most important document as it defines the objectives of the company. No company can legally undertake activities that are not contained in its Memorandum of Association.

### **Clauses in the Memorandum**

1. 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.
2. 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.
3. 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.
4. Liability Clause: It contains financial limit up to which the shareholders are liable to pay off to the outsiders on the event of the company being dissolved or closed down.
5. Capital Clause: It contains the proposed authorized capital of the company. It gives the classification of the authorized 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 authorized capital. However, the company is permitted to alter this clause as per the guidelines prescribed by the companies Act.
6. 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 with the terms and conditions of the agreement

### **Legal Position of Promoters**

Promoters undertake various activities to get a company registered and get it to the position of commencement of business. But they are neither the agents nor the trustees of the company. They are personally liable for all the contracts which are entered by them, for the company before its incorporation, in case the same are not ratified by the company later. Also, promoters are not the trustees of the company.

Promoters of a company enjoy a fiduciary position with the company, which they must not misuse. They can make a profit only if it is disclosed but must not make any secret profits. Promoters are not legally entitled to claim the expenses incurred in the promotion of the company. However, the company may choose to reimburse them for the pre-incorporation expenses.

### **Statutory Declaration**

A declaration stating that all the legal requirements pertaining to registration have been complied with is to be submitted to the Registrar with the above-mentioned documents for getting the company registered under the law. An advocate of High Court or Supreme Court can sign this statement.

**Agreement**

The agreement, if any, which the company proposes to enter with any individual for appointment as its Managing Director or a whole time Director or Manager is another document which is required to be submitted to the Registrar for getting the company registered under the Act.

**Consent of Proposed Directors**

Apart from the Memorandum and Articles of Association, a written consent of each person named as a director is required confirming that they agree to act in that capacity and undertake to buy and pay for qualification shares, as mentioned in the Articles of Association.

**Articles of Association**

Articles of Association are the rules regarding internal management of a company. These rules are subsidiary to the Memorandum of Association and hence, should not contradict or exceed anything stated in the Memorandum of Association

**Payment of fee**

Along with the above-mentioned documents, necessary fees have to be paid for the registration of the company. The amount of such fees shall depend on the authorised share capital of the company.

## **Incorporation**

### **Meaning of Incorporation**

The application is to be filed with the Registrar of Companies of the state within which they plan to establish the registered office of the company. The application for registration must be accompanied with certain documents about which we have already discussed in the previous sections.

### **Documents for Incorporation**

1. The Memorandum of Association duly stamped, signed, and witnessed. In case of a public company, at least seven members must sign it. For a private company, however the signatures of two members are sufficient. The signatories must also give information about their address, occupation and the number of shares subscribed by them.
2. The Articles of Association duly stamped and witnessed as in case of the Memorandum
3. Written consent of the proposed directors to act as directors and an undertaking to purchase qualification shares.
4. The agreement, if any, with the proposed Managing Director, Manager, or whole-time director.
5. A copy of the Registrar's letter approving the name of the company.
6. A statutory declaration affirming that all legal requirements for registration have been complied with. An advocate of a High court or Supreme Court must sign this
7. A notice about the exact address of the registered office may also be submitted along with these documents.
8. Documentary evidence of payment of registration fees.

The Registrar upon submission of the application along with the required documents has to be satisfied that the documents are in order and that all the statutory requirements regarding the registration have been complied with

### **Certificate of Incorporation**

The Certificate of Incorporation is a conclusive evidence of the regularity of the incorporation of a company. Imagine, what would happen to an unsuspecting party with which the company enter contract, if it is later found that the incorporation of the company was improper and hence invalid.

Certificate of Incorporation once issued, is a conclusive evidence of the existence of the company. Even when a company gets registered with illegal objects, the birth of the company cannot be questioned. On the issue of Certificate of Incorporation, a private company can immediately commence its business. A public company, however, must undergo two more stages in its formation.

### Difference Between Memorandum of Association and Articles of Association

<b>Basis</b>	<b>Memorandum of Association</b>	<b>Articles of Association</b>
Objectives	Defines objects for which the company is formed	Rules of internal management of the company. They indicate how the objectives of the company are to be achieved
Position	Main document of the company and is subordinate to Companies Act	Subsidiary document and is subordinate to both memorandum and Companies Act
Relationship	Defines relationship between company and outsiders	Defines the relationship between members and the company
Validity	Acts beyond memorandum are invalid and cannot be ratified by the members	Acts beyond the Articles can be ratified by the members, provided it does not violate memorandum
Necessity	Every company must file memorandum of association	Not compulsory for public limited company to file memorandum and may adopt Table A in Companies Act
Alteration	Alteration is very difficult and requires approval of certain statutory authority	Can be altered by passing a special resolution by the members.

## Capital Subscription Phase

### Meaning

A public company can raise the required funds from the public by means of issue of shares and debentures. For doing the same, it must issue a prospectus which is an invitation to the public to subscribe to the capital of the company and undergo various other formalities.

### Steps in Capital Subscription

1. SEBI Approval: SEBI (Securities and Exchange Board of India) which is the regulatory authority in our country has issued guidelines for the disclosure of information and investor protection. A company inviting funds from the general public must make adequate disclosure of all relevant information and must not conceal any material information from the potential investors.
2. Filing of Prospectus: A copy of the prospectus or statement in lieu of prospectus is filed with the Registrar of Companies. A prospectus is 'any document described or issued as a prospectus including any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares or debentures of, a body corporate'.
3. Appointment of Bankers, Brokers, Underwriters: Raising funds from the public is a stupendous task. The application money is to be received by the bankers of the company. The brokers try to sell the shares by distributing the forms and encouraging the public to apply for the shares. Underwriters undertake to buy the shares if the public does not subscribe these. They receive a commission for underwriting the issue. Appointment of underwriters is not necessary.
4. Minimum Subscription: To prevent companies from commencing business with inadequate resources, it has been provided that the company must receive applications for a certain minimum number of shares before going ahead with the allotment of shares. According to the Companies Act, this is called the 'minimum subscription'. The limit of minimum subscription is 90 per cent of the size of the issue.
5. Application to Stock Exchange: An application is made to at least one stock exchange for permission to deal in its shares or debentures. If such permission is not granted before the expiry of ten weeks from the date of closure of subscription list, the allotment shall become void and all money received from the applicants will have to be returned to them within eight days.
6. Allotment of Shares: In case the number of shares allotted is less than the number applied for, or where no shares are allotted to the applicant, the excess application money, if any, is to be returned to applicants or adjusted towards allotment money due from them. Allotment letters are issued to the successful allotted. Return of allotment, signed by a director or secretary is filed with the Registrar of Companies within 30 days of allotment

## **Commencement of Business**

### **Meaning**

If the amount of minimum subscription is raised through new issue of shares, a public company applies to the Registrar of Companies for the issue of Certificate of Commencement of Business.

### **Documents for Commencement of Business**

1. A declaration that shares payable in cash have been subscribed for and allotted up to the minimum subscription mentioned in the prospectus;
2. A declaration that every director has paid in cash, the application and allotment money on his shares in the same proportion as others;
3. A declaration that no money is payable or liable to become payable to the applicants because of the failure of the company to either apply for or obtain permission to deal in its securities on a stock exchange; and
4. A statutory declaration that the above requirements have been complied with.

This declaration can be signed by a director or secretary of the company. A public company raising funds privately, which has earlier filed a Statement in lieu of prospectus, must submit only documents 2 and 4 listed above. The Registrar shall examine these documents. If these are found satisfactory, a 'Certificate of Commencement of Business' will be issued