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Expert Expressions
Corporate Governance Demystified

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IS SMALL BEAUTIFUL?

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Every large economy has space for big entities and for much smaller entities. 50 years ago, Schumacher believed that small companies that are run well, can be beautiful. Non-compliance can however detract from the beauty.

For as long as one can remember, big listed entities, found to be non-compliant with regulations, have been at the receiving end of significant penalties levied by SEBI and Stock Exchanges. Smaller unlisted companies have managed to stay out of the limelight, even though their track records are nothing much to write home about. Rightly did Shakespeare observe:
"When beggars die, there are no comets seen;
The heavens themselves blaze forth the death of princes."

A recent study of penalties levied by the Ministry of Corporate Affairs (MCA) on smaller unlisted entities clearly points to the fact that many minor procedural non-compliances, that could have been avoided with some care, have led to penalties, which in many cases, are no more than a slap on the wrist. This gives rise to the question whether the imposition of such penalties is sufficiently persuasive when it comes to ensuring that smaller entities pay attention to statutory compliances.

We had initially intended to look at the non-compliances brought out in MCA orders over a period of 6 months. However, even the 3 weeks from May 1, 2024 to May 22, 2024 have thrown up 108 such cases, creating a sample size that is adequate for arriving at appropriate conclusions.

One of the principles on which regulatory philosophy ought to be founded is whether penalty imposed compensates the administrative effort involved in going through the papers, levying a penalty, notifying it to the persons concerned, and enforcing it. Whether a cost-effective approach ought to be adopted in such cases, or whether there should be a zero-tolerance approach, not considering the cost, is a matter that needs a wider debate. The related question which should arise is whether a first offence ought to be disposed of with a warning or a letter of admonition, rather than a penalty being imposed. Many of these would be small companies, without an adequate administrative apparatus to take care of compliances, primarily because of the costs involved. Whether such cases, especially of first offences, ought to attract monetary penalty, is a matter which the relevant authorities ought to consider in the context of facilitating the doing of business by those who are getting started out. No matter how small a monetary penalty is, it

will get captured in the regulatory track record of the company concerned, and serve as a disincentive for persons wishing to be associated with that company. Even criminal law offences that are less heinous, have provisions for probation, so that the persons concerned are put on notice regarding the need for good conduct, without slapping a penalty on them for the first offence. Needless to say, if such an approach is seriously countenanced, it would be necessary to set out, with clarity, the kind of offences covered, after considering the systemic implications of those offences, before deciding whether such an approach would serve public interest. It is also worthwhile to remember that the responsibility for ensuring compliance is to be equally shared by all Directors, both executive and non-executive, as also by the KMPs, in both listed and unlisted entities.

Among the 108 cases, the most repetitive and the most common revelation has been that the company concerned failed to maintain a registered office for a certain number of days. This has varied from 5 days to a little over 300 days of non-compliance. The penalty levied has varied from a few thousand rupees to Rs 1 lakh, with the company and its Directors being held accountable.

There have been quite a few cases of companies having fallen foul of the law for something as mindless as not having relevant details printed on the letterhead of the company. This is an inexcusable irregularity, and should not be countenanced. It might be possible to eliminate, or at least reduce, such cases of non-compliance if an exhaustive checklist is made available to those wanting to set up companies, indicating what the basic requirements are.

There have also been cases in which books of accounts and the financial statements have not been properly maintained, or have not been authenticated, and have not been produced before the relevant authorities. There is also a case of non-filing of annual return and financial statements, for which the penalty is in the region of Rs 20,000 each for the company and the Director. Non-filing is certainly a very serious matter that ought to be strictly dealt with. Clearly, this is a category of offence which merits a higher penalty than some of those that have been discussed in the preceding paragraphs.

In one case, no Company Secretary was appointed for a period of 354 days. This attracted a penalty of Rs 5 lakhs each for the company and the 2 Directors. One wonders whether not having a KMP in place for close to a year should have merited a higher penalty. The non-appointment of a Company Secretary for 1393 days seems to have attracted the same penalty as a non-appointment for a much shorter period. The question to be considered is whether these should be treated as continuing offences, with the penalty increasing for every month of non-compliance.

One company did not file e-form BEN-2 for 1401 days. The penalty was Rs 5 lakh, with Rs 1 lakh each for the Directors. This again is a case of extraordinary delay, which ought to have attracted a seriously disincentivising punishment.

In one case, a company that was required to spend Rs 3.19 lakhs towards CSR expenditure, transferred the unspent CSR amount to the “CSR unspent fund” specified in Schedule VII, with a delay. The penalty imposed on the company was Rs 6.38 lakhs, and each of the 3 Directors were fined Rs 31,900. It is possible to raise the question whether this being, strictly speaking, not a case of ill-intentioned diversion or unauthorised activity, should have merited a lesser penalty.

The cases described in the preceding paragraphs are indicative of a situation where non-compliance on account of delay or lack of awareness seems to have merited penalties that were significant in the context of the offence. The overarching question that requires to be asked is whether such companies that do not seem to have the bandwidth or the ability to comply with legal provisions, ought to be allowed to exist as companies. Cleaning up the environment, as has been attempted by the Stock Exchanges in the case of listed entities, albeit with limited success, is a matter that the MCA needs to seriously address. It is not necessary to have an ecosystem in which more than 100,000 companies exist, perhaps in search of taxation benefits, without the ability or the willingness to comply with rules or regulations. Having a higher threshold for companies to come into existence, and being strict with compliances, would considerably enrich the system.

Given the comprehensive databases that exist, it is entirely possible that a Director, who was on the Board of a small non-compliant company, carries the cross of non-compliance, even though he /she might have been on the Board for a short period, and might not have been in the know of the non-compliance in question. A cleaner ecosystem would have lesser players, each of whom is in a position to comply, no matter how onerous the requirements seem. At the same time, it is necessary to revisit the relevance of the various compliances in question, so that some which do not appear to be presently serving the purpose originally intended to be served, are taken out of the rule book. There

has been a very laudatory attempt to take out of the statute books, the enactments that are clearly past their sell by date. A similar comprehensive exercise ought to be attempted for rules, guidelines and forms that had been introduced to address a limited purpose.

The Companies Act, 2013 has brought into existence LLPs, with much lower compliance requirements. Perhaps it is necessary to have a one-time exercise to persuade the non-compliant companies to convert themselves into LLPs, so that the administrative burden on them, and the supervisory bodies, is considerably reduced. If small is to be beautiful, the conversion suggested should be attempted without any further delay.