CHAPTER NO. II

REVIEW OF DIFFERENT GUIDELINES

CHAPTER NO. 2

2.1 INTRODUCTION:

The CCI guidelines for valuation of share valued the prices on a simple average of "asset backing method and capitalisation of the profit method" This simple average is followed to be modified only by reference to the market price of shares for listed companies In this process of valuation some assumptions are made which over a period have been challanged and consequently free pricing have emerged

It has been observed that CCI formula followed conservative standard while fixing the premium on shares Some of the points are as under.

a) To compute NAV, the amount of premium to be charged in forthcoming public issue was not considered at all
b) It is also unreasonable to assume that additional equity raised for non-project requirements of funds would not contribute towards profitability.
c) No attention is paid to present maintainable profits of the company and Earning Per Share (current as well as future) of the company to arrive at reasonably fair price for the company
d) It is not logical to assume that equity raised for project finance will earn only 50% of what the company is earning on the present networth
e) The formula was conservative and mainly oriented towards investors protection The formula relied heavily on past performance of the company and did not take in to account other relevant factors like intangible assets like goodwill, brand values of it's products for the calculation of N A.V.
f) The capitalisation rate (inverse of Price Earning Ratio) used to be determined on the basis of the market behaviour of the scrip under question However, the lowest capitalisation rate available under the CCI regime was only 8.00% (i.e the highest Price Earning Ratio was 12.5) Applying a universal average like this resulted in gross deficiencies in calculating the current market value (Fair Value) of a scrip Besides the basis for capitalisation of average profit after tax was totally financial and qualitative factors like industry, competition, growth of the company, projects and promoters etc had no bearing on the specified capitalisation rates.

It was also felt that the CCI formula based premium had conditioned the investors to a very high return in a short span of time Till now, the investor's profit have been largely contributed through underpricing of issues The free pricing regime would now require the investors to get used to lower and realistic market driven returns premium due weightage was not given to the ruling market price. From the same resources, another set of data reveals that in 56 percent of the public as well as right issues, actual premium did not tally with the CCI premium. The premium was higher in 9 30% public issues and 27 00% in right issues, where as it was lower in 26.80% of the public issues and 29.80% of right issues This just highlights a point that CCI formula for pricing was not near real situations. The conservative pricing policy resulted in heavy oversubscriptions where by problems of fund manager mounted up as well as exploitation of investors increased on one excuse or the other. The issue business just became a gamble

Let us now review the C C.I and S E B I guidelines for valuation of securities

2.2 AN OVERVIEW OF THE C.C.I. GUIDELINES DT. 13.7.90

The guidelines for valuation of shares and premium fixation given in Annexure No.1 were made public on 13th July, 1990 In the context of dilution of the foreign shareholding in the FERA companies, Government set up an Expert group on valuation of shares in 1977 consisting of eminent people from the Financial Institutions, Industry and Finance professionals and in the light of the Report submitted by this group formulated, the guidelines

The guidelines were adopted and applied by the office of the CCI uniformly so that there was no allegation of arbitrariness in fixation of premium The principles of valuation implied in these guidelines were made known to all the leading Chartered Accountants who were dealing with the FERA companies and cases and they generally agreed to the Government approach in this regard After the one time dilution of ownership in the FERA companies was over, the same guidelines are being followed by the CCI with some minor changes

Valuation of shares according to the guidelines is computed after taking into account the following three elements

I Net Asset Value (N.A.V),
II Profit Earning Capacity Value (P E.C V.),
III Market Value (If the shares is listed) (M V),

A NAV is the net worth of a company divided by the total number of the existing as well as the proposed issue of equity shares

B PECV of the share is arrived at by multiplying the earning per share by 6 66 representing a capitalisation rate of 15% The earning per share is calculated by dividing the average post tax profit by the total number of equity shares

C MV is taken as the average of the high and low of the market quotations of the shares for the last two years and the monthly High and Low of the latest year

D Fair Value (F V) is worked out by averaging the NAV and PECV

E If the F V arrived at as at (iv) above is less than M.V ,weightage is given for the higher MV in the following order

If M.V is higher by more than,
- 50% of the F V , the Capitalisation rate is 12%,
- 50% to 75% of the F.V., the Capitalisation rate is 10%,
- 75% & above of the F.V., the Capitalisation Rate is 8%.

F. M V is not directly taken as an element in calculating F V. but only through a weightage in the PECV

Fixation of share price was made generally for the following cases in so far as the CCI was concerned

a) Disinvestment of existing equity by the foreign shareholder or mergers / amalgamations.

b) Issue of fresh capital by an existing company for expansion / diversification

c) Conversion of the convertible portion of debentures

In cases under (a) and (c) above, the parameters for calculating the NAV and the PECV require modifications as suggested below

(I) Net Asset Value:-

In calculating the NAV the face value of the fresh issue of equity capital is added to the existing "net worth" This does not amount to realistic estimate of the future net worth of the company because the premium element is an assured addition to the net worth.The argument against the inclusion of the premium element is presumably based on the premise that the element which itself is the subject matter for determination can not be taken as part of the net worth While this is partially true one cannot altogether ignore the element of premium in the calculation of the net worth. For taking care of this element the NAV can be reworked after including in the networth the premium which is arrived at on the basis of the existing guidelines The Fair Value will then have to be calculated afresh on the basis of the adjusted NAV *(ii) Profit Earning Capacity Value:*

In calculation of PECV different rate of capitalisation and provision for fixation has to be taken care of

(a) Capitalisation rate:-

It is observed that the different rates of capitalisation at 15%, 20% and 17 5% for manufacturing, trading or intermediate companies as mentioned in the guidelines are not being applied presumbly because it is difficult to identify the activities of a company separately and the companies do not fit into these categories strictly For example, non banking financial companies, or companies dealing in computers or in service industry cannot be categorised as 'trading' or intermediate companies'. The practice of taking a uniform rate of capitalisation at 15% may therefore be continues and the different rates mentioned in the guidelines done away with

(b) Provision for taxation:-

In the calculation of PECV, provision for taxation at the current statutory rate or the actual tax liability whichever is higher, is assumed in the guidelines. This assumption does not seem realistic in the light of the observations made elsewhere in the guidelines that "the crux of estimating the PECV lies in the assessment of the future maintainable earning of the business It should not be overlooked that the valuation is for the future and that it is the future maintainable stream of earnings that is of great significance in the process of valuation "

It would be better to get an auditor's certificate from the company on the future liability for taxation, after taking into account the tax incentives and allowances for the next three years, and compare that with the actual provision for taxation for the last three years and take that amount whichever is higher

Alternatively, a 15% deduction or the average actual tax provision for the last three years, whichever is higher, can be made to arrive at the post tax profit. The actual tax liability "cannot be interpreted to mean the actual tax liability in the latest accounting year."

(c) Computation of average profit:-

The method of computation of average profits given in the guidelines implies that (i) no new company can issue shares at a premium and (ii) even if a company has started production and performed well in the latest year and the shares of the company are quoted high depending upon the performance, it will not be allowed a further issue at a premium because it has made profit only in one year

Keeping in view the observation already quoted in the above paragraph from the guidelines there should be no objection to assume in the case of such a company the profit of the latest year as the "maintainable" profit for the future and allow the normal capitalisation rate of 15% without giving any weightage for Market Value As six monthly results are published by all the listed companies according to the Stock Exchange requirements,there should generally be no objection in taking the audited six monthly results also for computing the "maintainable profits"

(iii) Market Value:-

The prices prevailing in the stock exchanges are mainly influenced by the market forces of demand and supply and speculation being rampant due to too much money chasing too few scrips in the market, the quotations are not indicative of the performance of the company, hence, market value cannot be taken as a direct "input" in valuation but only given certain weightage as mentioned in the guidelines. The only suggestion in this regard is that in the case of right issue at premium, the ex-right price may be kept in view while considering the rate of capitalisation to be adopted instead of a straight average of the High and Low for the last three years

Conversion Price for Debentures .

Though the existing guidelines do not deal with the determination of the price for equity in the case of convertible debentures, this has assumed importance in the expanding capital market when many companies went for mega issues of convertible debentures Normally in the determination of conversion price for equity, the increase in equity as a result of conversion is not taken in to account if the conversion takes place six months after the date of allotment of debentures This has resulted in many companies getting the benefit of a high premium at the time of conversion without looking in to the expansion of the equity base which was higher by many times over the existing equity base In the interest of the investing public Government should frame guidelines indicating the extent to which conversion will be permitted, the expansion in the equity base as a result of such conversion and the period of conversion etc

Taking into account the dismal performance in the secondary market of the non-convertible portion of debentures, it is suggested that,

1 Not less than 50% of the amount of the PCDs should be converted by the companies in one or two stages

2 In determining the price for conversion increase in the equity as a result of conversion with in 12 months from the date of allotment shall be taken into account

3 The redemption period for the Khokha portion of debentures should be reduced from the resent 7 years to 5 years to make these debentures more attrractive

4 The equity should not be allowed to increase more than, say three times the existing equity with in two years from the date of conversion This will take care of the serviceability of the enhanced equity base.

5 Conversion price for conversion after 18 months from the date of allotment should be determined by the CCI at the time of conversion and not in advance. This enabled the CCI to have a look at the latest financial performance of the company at a date nearer the stage of conversion

Fixation of premium for rights issue is a point of controversy raised by many companies through the press and the authority of the CCI was being questioned for it's interference between the shareholders and the company and directing the companies to issue shares at a premium lower / higher than what was settled between the management and the shareholders The policy of Government in this regard was clearly stated as far back as 1965 in the booklet on Capital Issues Control Published by the Ministry of Finance which is reproduced below and which holds good even today

"It is not the intention that existing shareholders who part with their rights should get no renunciation price The view taken is that rights price should be reasonably smaller than the premium element in the issue price in order that the company gets the larger portion of the extra money for productive use in its legitimate business and the shares do not attract unhealthy speculation This view, which is widely held abroad involves no financial loss or injustice to the shareholders It merely aims at reducing the lure of very large windfalls and encouraging the shareholders to take a long term and steady view of investment When a company makes further issue before reaching optimum production, the question of premium is examined on merits and whenever necessary discussed with representatives of the company"

2.3 REVIEW OF THE C.C.I. GUIDELINES Dt.13th April 1992.

The Government of India, Ministry of finance announced liberalised procedures regarding pricing of equity issues on 13th April 1992 This guidelines is in supression of earlier guidelines for valuation of equity shares announced in 1990 The new guideline is issued with a view to make it more conducive to the healthy growth of the capital market

Listed companies which have been paying dividend continuously for the past three years will be allowed to fix the price for further issues This guidelines is in a way stricter than the earlier one in that companies were allowed earlier to issue shares at a premium even if they have not paid dividend, but had good earnings (eg Apollo Tyres Ltd) The present guidelines insist on payment of dividend because it appears, a view is held that only in dividend paying companies, the share prices are consistently high and that a company can alwalys pay dividend out of accumulated earnings of past years The 'listed company which are less than three years old but have paid dividend right from inception can fix their own premium in consultation with their shareholders at a general body meeting

A new company has necessarily to issue shares at par only because there is no track record of past profitability to rely upon The tangible backing for the issue is the assets to be acquired by such issues which will not at that point of time be anything more than the par value New companies are not in a position to pay dividend to the shareholders during the gestation period, hence the long term investors generally do not favour any premium on the shares On the question of establishing a track record of the promoters of a new company, this is very subjective and may be difficult to distinguish one promoters from another for allowing premium issue in a new company The very fact that only companies with a track record of consistent profitability of three to five years are allowed to be listed in the stock exchanges in countries having free pricing mechanism points to a situation where issues by new companies can not but only at par

Although, it is stated that the present valuation guidelines will not be applicable to closely held companies, it is amply made clear that the C C.I will not accept a price for the new shares in a closely held companies below the price arrived at by the existing valuation guidelines This means the existing valuation guidelines published on 13th July 1990 still form the benchmark for determining the price after taking in to consideration the projected earning of the company The projected earnings mentioned here refer to the appraisal of the projected earnings by a financial institution or a bank

According to the Press Note No 17 issued by the department of Industrial Development on 19th November 1991, the price of the new equity in the expansion of foreign equity up to 51 percent in Indian companies will be fixed by the C C I on the basis of market prices, computed on the basis of the six months period preceding the date on which the application is received in the office of the C C I with a discount of up to 10% This policy had come in for criticism on the ground that it would be unfair to ask foreign companies to acquire equity at market prices which are determined by an imperfect market abounding in malpractices such as price rigging and insider trading The

Government seems to have reviewed the guidelines in the light of this criticism and this policy has now been revised

Determination of the price for increasing foreign equity to 51% as mentioned in the press note no 17 of ministry of industry will no more be applicable and the price can be decided by the shareholders under section 81(1)of the Companies Act 1956, but shall not be less than that arrived at by the existing valuation guidelines This means the existing valuation guidelines published on 13-7-1990 is the benchmark here also But this change in policy has to be viewed against the background, that the indian promoters who are allowed to subscribe only up to 40% of the equity of a company under Rule 19(2)(b) of the Securities (contract) Regulations Rules. 1957, can increase their holding only by purchasing shares in the stock exchanges at whatever price prevailing there in. A relexation of this rule may have to be agreed to by the Government, whenever the indian promoters may like to increase their holding up to 51% as the foreign companies

If the price is fixed on the basis of the market price instead of an artificially determined fairvalue, the company will get more resources from the shareholders depending on the forces of demand and supply of scrips in the stock exchanges and to that extent less drawing from the financial institutions will be required for financing their expansion. But this has to be seen in the light of past experience when management of some companies did not want to issue the shares even at the price calculated by the C C.I on conservative basis Instances are not lacking where promoters tried to make a fast buck by selling their rights at higher prices by artificially depressing the price of the new issues below the fairvalues The present valuations guidelines are silent on this aspect The Government should have fixed minimum price on the basis of valuation guidelines even for listed companies, leaving the ceiling open to be decided by the companies in consultation with their merchant bankers

As per the present guidelines the merchant bankers have to fix such price of equity shares which are attractive to the prospective investors, acceptable to the promoters and advantageous to the company

The Estimate Committee of the Lock Sabha in it's report presented to the LockSabha on 27-4-1992, is reported to have suggested that the office of the C.C.I should be abolished and that S E B.I should ensure that the merchant bankers may evolve commonly acceptable evaluation norms and methodology, assimilating objectivity in the pricing of shares The SEBI has also issued certain guidelines for disclosures and investors protection

The commonly acceptable evaluation norms or parameters followed by the Government so far, while evaluating the shares of the companies are the market trends of the shares, the net asset value of the shares, the value of the shares on the basis of the company's profit earning capacity, the future growth prospects of the company,the ratio of the Right issues in the total paid up capital, the dividend paying capacity of the company etc

The guidelines issued by the then Government and now by the SEBI does not imply that Government is averse to companies following the fundamentals and other parameters followed by the CCI in the fixation of premium so far or that the company and merchant bankers can have "free for all" field in determining the issue prices solely on the basis of the P/E ratio, which change with every speculative bout in the capital market

The very fact that a company goes for an issue at a premium implies that the position of the company is financially sound and the company is capable of raising money without an underwriting support It was based on this assumption that the CCI was not allowing underwriting of those issues, where the premium charged was more than 25 00% of the face value of the shares This practice was discontinued later, on the plea of certain merchant bankers that the underwriting fee collected on the premium issues would be some small compensation for the devolvement of due issues of greenfield companies

2.4 ABOLITION OF CAPITAL ISSUES CONTROL:

In the context of the changing economic and industrial scenario, the CIC Act had lost its relevance While the primary intention of the legislation was to excercise control over capital issue pricing and promoting rational expansion of companies, it had become a bureaucretic machinery which hardly played any effective role in proper utilisation of the country's resources It had clearly outlived its utility in view of the following reasons -

1 Institutional financing has become a regular feature for financing of projects. Almosts all the projects are appraised by financial institutions and CCI hardly had any role in appraising the viability of the projects It used to rely on the appraisal report of the financial institutions and also used to put a disclaimer clause in its consent letter disowing all responsibility for the soundness of the project

2 Fixation of premium by a regulatory agency had become an antiquated phenomenon and it was felt that in the context of the gradual globalisation of the Indian economy, it should be left to market forces This is in line with the trend in all developed countries The practice of fixation of premium by CCI based on certain guidelines resulted in fixation of very low premium even for companies with good track record, thereby increasing the cost of raising capital for companies

3 With the merchant banking profession coming of age in India and with high level of awareness in investor population, fixation of premium by CCI had lost all significance The risk of undersubscription to public issues had also been eleminated with most issues being underwritten by financial institutions / banks /mutual funds and brokers The fixation of low premium by CCI only served the interests of speculators as opposed to the genuine investors and resulted in heavy oversubscription to public issues with the small investors having virtually a negligible chance of getting allotment in good issues

4 There was plethroa of legislation and guidelines on capital issues namely the Companies Act 1956, CIC Act, The Securities Contracts (Regulations)Act 1956, SEBI Act and Guidelines issued by Ministry of Finance, Stock Exchange Division and CCI Division It was necessary to have one regulatory body to regulate capital issues, capital market intermediaries and the stock exchanges SEBI was well geared to perform this role and hence the office of the CCI had become redundant

The report of the Narsimhan Committee on financial sector reforms observed that, " the controls were excercised by the CCI One aspect of this control was that the prior approval of the CCI was necessary for any new issue in the market In the senario that we envisage it would be for the merchant bankers and the underwriters who should offer professional advice on a particular issue, on the nature of instruments, it's terms and pricing and/or the issuer to decide on these matters The Committee does not belive that either the CCI or for that matter, the SEBI should be involved in prior sanction of new capital issues in respect of companies, whose scrips are listed on the stock exchanges In respect of unlisted shares, however, where investor awareness of the prospectus and background of the promoters may not be high and with a view to prevent any misuse by promoters, it may be stipulated that the stock exchange should approve the prospectus in terms of the guidelines issued by SEBI as an aspect of self regulation rather than SEBI should be directly involved even at the pre-issue stage "

The committee further observed that "the regulations of the capital market should aim at protecting the investor interest against possible risks and fraud. For this purpose, the committee proposed that SEBI should formulate a set of guidelines to protect the interest of investors and abolished office of CCI transferring it's market regulatory functions to SEBI The role of the SEBI is that of market regulator to see that the market is operated on the basis of well laid down principles and guidelines

The CIC Act had virtullay lost all significance in the context of the liberlised policies of the Government and the gradual globalisation of the economy Hence, CIC Act was finally abolished on 29 5 92

2.5 *CONSEQUENCES OF REPEAL OF C.I.C. ACT:*

2.5.1 *ON PRIMARY MARKET:*

To take advantage of the repeal of CIC Act, a plethora of rights and public issues at premium flooded the market During April-October 1992 period the volume of new issue activity went up by 67% for the non Government companies Between October 1992 and December 1992, over 86 companies had entered the market to mobilise about Rs 4000 crore by way of rights and right-cum-public issues About 40 companies entered the market in October 1992 to raise an aggregate amount of Rs 2252.80 crore

According to CMIE'S report, the growth in the amount of premium charged for both rights and maiden equity issues, was much, much higher thanks to abolotion of the office of CCI It is important to point out that in November 1992, a total of Rs 1034 crore was raised through rights issue by 43 companies and out of these, 26 companies charged premium of Rs 630 crore - a whopping 60 percent of the total amount raised This trend was more pronounced in December 1992 and January 1993 But in many cases, the premium charged have not even been remotly warranted by company's fundamentals like E P S , Book Values, Profit and dividend records and net asset value etc

It is evident from the findings of The Economics Times Research Bureau that "the investments in 84 out of 125 rights offers of shares and convertible debentures at premium after the introduction of free pricing turned out to be a raw deal for the shareholders So far, tuned to a psyche of getting highly priced shares at par or at nominal premium, it has been rude shock to investors as they watch helplessly the market values of the newly acquired stocks falling below or threatningly approaching their cost prices

2.5.2 *ON APPLICABILITY OF THE ACT:*

The consequence of repeal of the CIC Act is that the Act is deemed to have existed only for those actions which were commenced, procecuted and concluded Pending actions cannot continue as per the ruling in Sylhat Co-operative Central Bank Ltd V Dhirendra Nath De (AIR 1956 Assam 1966)

The question arose whether the companies which had issued capital pursuant to the CCI consent will continue to be bound by the terms and conditions of the CCI consent. No clarifications has been issued in this regard by the Government. However, the department of Campany Affairs had in the context of the repeal of the MRTP Act clarified that the conditions stipulated in the MRTP order passed u/s 21 and 22 of MRTP Act were binding only till the sections were deleted and became infructuous Thereafter, The concerned company has to examine whether the conditions are still operative in terms of other statutes currently in force

Applying the rationale of the above clarification issued by the Department of Company Affairs to the CIC Act, it appears that the conditions stipulated by CCI in this consent order have ceased to become operative consequent upon the repeal of the CIC Act, but shall remain valid up to the extent of similar provisions contained in the SEBI guidelines issued in pursuance of SEBI Act, the guidelines issued by the Central Government, the Company Act or any other legislation

Further the SEBI guidelines dated 17 6 92 provides that companies holding CCI consents issued prior to the promulgation of the ordinance repealing the CIC Act may proceed with the issues on the terms and conditions laid down there in, provided the SEBI guidelines are also followed to the extent they are not inconsistent with the terms and conditions of CCI consent The SEBI guidelines clarifies that the conditions of the CCI consents shall apply in respect of those consents pending for implementation but are silent as regards the applicability of the terms and conditions in respect of consents already implemented

2.6 APPRAISAL OF THE GUIDELINES FOR THE VALUATION OF SECURITIES:

The Pherwani committee set up by the Central Government have summarised the principal objectives of valuation guidelines as under

a) Principal objective of stipulating guidelines in relation to valuation of shares is necessarily for investors's protection
b) In terms of issue price it should be fair for the issuer
c) Prevention of malpractices, especially in terms of unfair advantage taken by either management or the pricipal shareholder(s)

Conceptual Limitation of the Guidelines :

The guidelines do not wholly take into account the intrinsic characteristic of each company / insdustry and/or market conditions prevailing at the time of issue Thus, the fair value determined has little relation to the market price of share

As the premia historically permitted have been substantially below market price,the new shareholders have benefited at the expense of existing shareholders.

The formula adopted differ in relation to equity issues and convertible debenture issues, resulting in higher premium being permitted in the case of convertible debentures issue

Practical Limitations of Existing Valuation Norms :

The major components of the existing valuation procedures are,

a) Book value,

b) Profit Earning Capacity Value.

Statistically, there appears to be a weak relationship between the book value and the market price of a share For instance, while the market places a premium on companies with an active bonus policy, the net asset value method works against the interests of such companies.

Presently, the PECV is determined by normally applying a capitalisation rate of 15% Where the issue price varies significantly from average market price, a graded capitalisation up to 8% is used However, the valuation norms ignore the considerable variations that exist in the P/E (Price Earning) ratio across corporates and industries

The average P/E ratio of the market has shown a considerable uptrend in the last few years At present,the P/E ratio ranges between 15 and 25 across a wide spectrum of industries. The capitalisation rate adopted by the existing guidelines is therefore at variance with market valuation.

PRICING - Based on the recommendations of Pherwani Commiittee,the valuation should follow the below mentioned norms,

a) For calculation of average market price period of preceding six months should be taken in to account

b) The profit earning capacity value based on the actual profit after tax calculated as per existing CCI guidelines (but including actual tax rate), capitalised at the range of rates given below. The P/E range relates to the actual average P/E as prevailing in the market for the preceding six months based on the last audited annual accounts

P/E Range	Capitalisation Rate
1	2
Below 4	15 00%
For one point increase in P/E	Reduction in capitalisation rate on a pro-rata basis by a factor of 0 7
Above 20	4 00%

For the purpose of calculation, the actual P/E should be rounded off to nearest whole number.

c) In the case of companies which have issued bonus or rights in the preceding two years the average market price would need to be suitably adjusted retrospectively in the same ratio.

d) In the case of companies making issues whether public or rights of equities or convertible debentures in a ratio greater than 1 1, the substantial increase in the floating stock would necessarily have an impact on market price Consequently, the study group recommends that the following discount rates be applied on the price as arrived at by the above formula in order to arrive at an appropriate issue price.

Issue Size	Discount Rate
Greater than 1:1 but less than 2:1	20.00%
Greater than 2:1 but less than 3:1	30.00%
Greater than 3:1 but less than 4:1	40.00%
Greater than 4:1 and above	50.00%

Available Policy Alternatives :

The Pherwani committee was of the view that for valuation of shares market oriented approach should be adopted The study group recommended that the market forces be allowed to determine premia on primary market issues The committee also recommended that besides having SEBI acting as apex monitoring agency, the principle of self-regulation would need to be developed among merchant bankers, underwriters, brokers and other participants in the primary market The committee also felt it necessary to evolve a system of disclosure of financial information including associated risks whereby prospective investors can analyse the investment opportunity and based on this information takes decision False statements, half truth, wrong projections should met with rigorous punishment with fine In view of the above discussion two policy alternatives were suggested

a) Government may immediately opt for total de-regulation and leave the pricing mechanism to the market

b) The liberalisation process may be carried out in stages

Total deregulation may be immediately considered in respect of all issues of securities where the interest of the public is not involved In other cases pricing process may be made market oriented in first stage Once the appropriate statutory and self-regulatory mechanisms, liquidity of market, rating agencies etc are put in place, total deregulation may be effected by allowing the market forces to determine premium

2.7 AN OVERVIEW OF S.E.B.I. GUIDELINES FOR EQUITY SHARES AND DEBENTURES

ISSUE OF EQUITY SHARES AND S.E.B.I. GUIDLINES :

In the light of the observations of Narasinham Committee the SEBI had formulated a set of prudential guidelines designed to protect the interest of investors and to replace the restrictive guidelines issued by the CCI, about pricing of issues.

The guidelines classfied companies proposing to raise capital into six categories The details of classification is given in Annexure No 3 In all the categories the draft prospectus for issue of shares has to be vetted by SEBI to ensure adequacy of disclosures To introduce check on tendency of overpricing the issues, the promoter's contribution in percentage term in total issue amount is made compulsory Underwriting of the issue is also made compulsory The strength of the guidelines is that SEBI is to ensure sufficient disclosures to prospective shareholders to enable them to evaluate the issue price Onus of success or failure of the issue weighs heavily on the merchant bankers.

The SEBI guidelines mark a watershed in the history of Indian Capital Market. Earlier, issue pricing was in a straight jacket imposed by the CCI guidelines SEBI has removed this constraints and introduced an element of liberalisation This process has been initiated by SEBI after considerable internal and external debate In SEBI's own words, while it was felt that the market based approach should eventually prevail, there is another view that in the present conditions of the Indian Secondary Market where there is inefficiency, lack of transperancy and prevalence of malpractices, a totally unregulated freedom for the issuers to price their issues based on imperfect market prices would place the investors at considerable risk These are indeed prophetic words and considerable cautions has to be excercised by the investors and by the merchant banking community to ensure a degree of dependability in the pricing of the issues which will take place in the new environment

It was general feeling among capital market participants that the premium charged on various issues were not justified SEBI guidelines for issue pricing provides detailed directions for new company's issues but it has very little for existing companies. Further, it has provided virtually nothing for charging premium. The provision that companies are required to state justification for charging premium in the issue document or prospectus is typically very weak. SEBI argument is that it did not want to unnecessarily interfere in the free play of market forces and introduce a cap on premium However, SEBI can provide the broad frame work for issue pricing within which the companies should be allowed to fix their premiums without excercising control over them It may be suggested that only those companies should be allowed to charge premiums,

(1) who have declared dividends continuously for the last three years or so,

(2) where net asset value is exceeding about 25% of market price of its shares,

(3) where the book value is above the par value of the shares (after considering all previous losses and even contingent liabilities),

(4) where shares are priced higher than about 10 times the P/E ratio.

Further, without disturbing the free pricing mechanisms the investor's interest may be protected by introducing a set of norms to which pricing of issues must confirm. The issue pricing must be done by the companies on the basis of earnings per share or net worth during the last one year or only other suitable basis and the fact that the company had adhered to the norms set for issue pricing must be certified by the company secretaries or the marchant banker or chartered accountant

Inspite of these possibilities, the SEBI does not seems to be interested in interferring in the issue pricing The SEBI is often of the view that let the market forces decide the fate of the issues. However, in order to provide protection to the companies coming with issues and investors,it has made full underwriting of the issues mandatory. This will also help in restricting unusually high premiums and failure of issues.

Under the present circumstances of liberalisation, the move of SEBI not to interfere in the free pricing of the issues is justified in order to allow the market forces to play freely in the market This will not only help in educating investors and making them competent enough to have a decision about good and bad issue This will also facilitate companies and merchant bankers to play honestly and reasonably, while pricing their issues otherwise there are possibilities of failure of issues

FREE PRICING - WHAT DOES " FREE " MEAN ? :

The SEBI guidelines mention that in appropriate cases, companies will be allowed to raise fresh capital by freely pricing their capital issues The guidelines also mention that such issue price will be determined by the issuer in consultation with the lead managers to the issues. The word `free' is perhaps a misnomer simply because (a) the price must be linked to some criteria and (b) some agency must fix up the price e g the lead managers to the issues and the issuer itself

The SEBI guidelines mention that the prospectus / offer documents, should contain the net asset value of the company, the high and low prices of shares for the last two years and a justificastion for the price of the issue

In the absence of specific guidelines regarding share valuation, the companies and the mechant bankers may fix unrealistic price with reference to the market price of the scrips, which in many cases may be manipulated. In fact, some of the right issues have price tags which are very close to the market price, there by also reducing the attractiveness of the issue. Besides, the market price of scrips in the Indian Stock Market are commonly perceived to be the end result of abnormally high price-earning ratio but not an outcome of good or bad performance.

The Institute of Chartered Accountants of India have prescribed detailed guidelines on share valuation which contain time-honoured principles of valuation. These principle includes the net asset basis and the earning, with the suitable weightage to market price The net asset value should consider replacement value minus depreciation to take in to account the age of assets. The earning basis should take in to account the future earnings which should in turn, be vetted by the merchant bankers The market price should take in to account one year's average to iron out speculative fluctuations and deliberate manipulations

In the absence of such guidelines, the question of pricing may become an excercise in unbrideled licence and optimism So, the laying down of guidelines will in no way detract from the concept of the free pricing Now, let us analyse the individual componants of the SEBI guidelines.

(A) First Issue of New Companies :-

The provisions regarding first issue of new companies are generally fair. However, a few important difficulties arise

One major problem will arise with reference to large projects which need substantial funds. In such cases, the promoting company may have difficulty in bringing in the required 50%

contribution, in case the new company wishes to issue shares at a premium. This will effectively stymie the execution of large projects and will act as a serious deterrent to setting up plants of internationally competitive size

A new company has been defined by SEBI as a company which has not completed 12 months of commercial production and it's audited operative results are not available and where it is set up by an entrepreneur without a track record. This definition suffers from two major problems

(a) It does not take in to account a company which might like to make a second public issue with in 12 months of commencement of commercial operation, the first issue having been made before the commencement of commercial production (as is usually the case). Such companies are obviously not new companies and fall in to the category of existing companies The ideal definition of new company would have been a company which has not made public issue at all, not being a private / closely held comapany. In fact some confusion appears regarding distinction between a new company and an existing unlisted company

(b) There is an obvious error in the inclusion of the words "where it is set up by an enterpreneur without a track record" This should not form a part of the definition of a new company Actually, it should relate to the next setence in the guideline which reads "They will be permitted to issue capital to the public only at par "

(B) First Issue by Existing Private / Closely Held Companies / Other Unlisted Companies :

(a) Existing private / closely held / unlisted companies with a three years track record of consistant profitability are permitted to freely price their issues provided that not less than 20% of the total issued capital is offered to the public

(b) An existing private / closely held / unlisted company which does not have a three years track record of consistant profitability can issue shares only at par This rule however, has an exception where such a company not having three years track record, has been promoted by another company which has a five years track record of profitability In such cases,the company will have freedom to price it's issue provided that the promoting company hold not less than 50% of the total issued capital

(c) Where free pricing is permitted, the prospectus must disclose the net asset value of the company and a justifiction for the issue price The draft prospectus in all cases will have to be vetted by the SEBI to ensure adequacy of disclosures. These provisions appears to be fair

(C) Public Issue by Existing Listed Companies :-

The provisions regarding compulsory underwriting appears to be superfluous and will add considerably to the cost of the issue In case the company and the lead managers have fixed the premium after adequate homework, there should be no difficulty in obtaining subscription In any case, the provisions regarding refund if 90% subscription is not received will adequately safeuard the investor's interest

As per the Company Act, in the case of a public issue, unless the minimum subscription is received with in 120 days from the date of filing of the prospectus with the registrar of the companies, the issues becomes void The guidelines, on the other hand, provide for the computation of this period of 120 days from the date of filing of the prospectus In this respect the guidelines seems to be contradicting the Companies Act This aspect need to be clarified.

ISSUE OF DEBENTURES AND S.E.B.I. GUIDELINES :

The object of SEBI as enshrined in section 11 of the SEBI Act is to protect the interest of investors and to promote development of and to regulate the securities market by such measures as it thinks fit By the very nature of the object, it is doubtful whether SEBI has any power over the issue of securities by private companies or unlisted companies unless it is proposed by the company that such securities be listed Further, if the issue of debentures is by way of private placement not proposed to be listed, SEBI guidelines cannot be made applicable to such issue of debentures.

Section 30 of the SEBI Act provides that the Board, by notification can make regulations consistent with the Act and the rules made there under generally to carry out the purposes of the Act with the previous approval of the Central Government Section 31 of the said Act makes it obligatory that all rules and regulations shall be laid before the house of the parliament. The guidelines issued by SEBI are neither rules nor regulations issued under notification with the prior approval of the Central Government and therefore any violation of the guidelines can not attract prosecution as mentioned in the guidelines

However, since the SEBI has control over Stock Exchanges, Securities which are issued in violation of SEBI guidelines will not be listed Therefore, these guidelines will have to be observed in cases of issues of such securities by listed companies or issues of securities which are proposed to be listed

Conditions Governing Convertability :

The guidelines prescribed the following conditions governing convertibility of debentures.

(a) Under Section F(a), issue of FCDs having a conversion period of more than 36 months are not permissible unless conversion is made optional with "put" and "call" option

(b) Here the terms "put" and "call" are not defined but it is presumed that the terms mean that there should be an option available to the debenture holder whether to agree to the conversion or to continue as debenture holder.

(c) Further, this sub-clause does not refer to PCDs and therefore, it can be interpreted that PCDs can be issued having a conversion period of more than 36 months without "put" and "call" option. This does not seem to be the intention and therefore the word "FCD" should be replaced by "FCDs / PCDs"

Credit rating is compulsory in case of NCDs/PCDs/FCDs where maturity exceeds 18 months

Issue of debenture with maturity of 18 months or less are exempt from the requirements of appointment of debenture trustees or creating debenture redemption reserve To comply with this condition, it will be necessary that debentures have to be unsecured, in which case they will

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attract a very heavy stamp duty which is 0 75 percent in the state of Gujarat If the debentures are secured then there has to be a debenture trustee in whose favour the security can be created

This seems to run contrary to the provisions of the Companies Act and allows for the creation of unsecured debentures which attract the provisions of section 58A of the Companies Act A clarification is required in this regard

Under Section F(e)(1), it is provided that any conversion whether part or whole of the debenture will be optional at the hands of the debenture holder, if the conversion takes place at or after 18 months from the date of allotment but before 36 months Under clause (a) issue of FCDs having a period of 36 months is not permissible unless conversion is made optional with "put" and "call" option but under Subsection (e) conversion is optional at the hands of debenture holder if the conversion takes place at or after 18 months but before 36 months This two provisions can not be reconciled Under the first provision option comes into play if the conversion period is more than 36 months, while in the second provision it comes in to play, if the conversion is after 18 months but before 36 months

Under clause F(a) only the term FCD is used Therefore, it can mean that PCDs can be issued with a conversion period of more than 36 months and in case of such an issue the option to the debenture holder is not available under F(a) because that clause is not applicable to PCDs Option is also not available under clause F(e) because conversion is not before 36 months but after 36 months

This can not be intention and therefore, both the clauses need to be reconciled. For the purpose, following changes are suggested

(a) In clause F(a) the term "FCD" be substituted by the terms "FCDs / PCDs",

(b) The words "unless conversion is made optional with "put" and "call" option" in clause F(a) should be deleted

(c) The words "but before 36 months " in clause F(e) should be deleted.

2.8 PROMOTER'S CONTRIBUTION AND LOCK-IN-PERIOD - EQUITY SHARE

In the original text of the guidelines, it was mentioned that the equity capital to be subscribed in any issue to the public by the promoters should not be less than 25% of the total issue of equity capital upto Rs 100 crores and 20% for issues above Rs 100 Crores In the case of FCDs and PCDs, the promoter's contribution was specified to be 1/3rd of the issue amount and the convertible portion respectively

A doubt arose regarding the interpretation of these clauses as to whether the promoters were supposed to bring in the required percentage of the public issue or whether the required holdings are relatable to the share capital after the issue and conversion (whenever required) This doubt has been set at rest by a subsequent clarification which mentions that where PCDs/FCDs are issued, the promoters may bring in their contribution either by way of equity or by way of subscription to FCDs/PCDs, so that the total contribution of the promoters reaches a specified percentage of the equity after the conversion of PCDs/FCDs

In the case of straight equity issue for existing listed companies, the promoters have been left with both the options i e the required percentage can be that of the issue or it can relate to the total issued capital after the issue SEBI should clarify if this interpretation is correct. Further, the need for keeping both the options is not clear, as this could lead to undesirable consequences in some cases Moreover, there is conceptual error in the guidelines regarding the method of pricing the issues at par or at premium

In any case, some major difficulties arise with the concept of " minimum promoter's contribution"

(a) There is a distinct problem where there are no identifiable promoters in respect of professionally managed companies A case in point is that of Larsan Toubro Ltd, (L.& T) when there was a time when there was no promoters group as such. SEBI has calrified that in such cases, the person in charge of the management of the affairs of the company should bring in the contribution themselves or through friends, associates etc. This may not be a practicable proposition in most cases

(b) In a large number of cases, the promoters are managing the companies with equity holdings of much less than 25% / 20% if such companies, which are very often successfully run, make large issues, it may be difficult for the promoters to contribute adequate funds to reach an equity holding level of 25% / 20% This may be a serious hurdle in the context of the requirement of a growing organisation

(c) The requirement of minimum contribution of 50% in certain cases will need prior permission for investment under section 372 of the Companies Act. Also another point is that this provision runs contrary to the stock exchange listing guidelines which provide for offering a minimum of 60% of the capital to the public. This may cause practical problem

(d) In many cases, the projects have share capital contributions from international financial institutions e g ADB, IFCI and CDC At present, these are not considered as promoter's contribution It is suggested that both in spirit as well as considering the funding difficulties mentioned above, such contributions should be treated as promoter's contribution Similarly, contributions made by State Financial Development Corporation should also be treated as promoter's contribution.

(e) The guidelines do not deal with contribution by venture capital funds at all.It is felt that this issue needs an entirely separate treatment

Various lock-in-period for the promoter's contribution have been specified ranging from three years to five years In view of the large gestation periods which are common in the Indian Context, this guidelines appears to be unfair The promoters will have to hold on to the equity for a very long period after the date of allotment Therefore, it is suggested that the lock-inperiod should commence from the date of allotment in all cases Moreover, the uncertanity of date of commencement of commercial production will nullify the SEBI's instructions to put in "non transferable" inscriptions on the share certificates from a specified date Even if an estimated date is put, subsequently the actual date will have to be substituted This may mean recall of the share certificate, which is an entirely avoidable excercise. Finally uniform lock-in-period of 3 years should be prescribed for all cases

f) Other Important Provisions The definition of 'group companies' should be clearly specified to avoid any misinterpretation. Further, it is suggested that if the shareholders of group promoter companies are eligible for firm allotment, the group promoter companies themselves should also qualify for this purpose

The guidelines provide that no bonus issue shall be made within 12 months of any public/right issue The logic for providing this time gap is not clear, since in any case, the time gap between two public/right issues has been completely removed In fact, removal of the suggested time gap for bonus issue would be beneficial as far as investors are concerned

2.9 PROMOTER'S CONTRIBUTION AND LOCK IN-PERIOD - DEBENTURE

In the guidelines issued by SEBI on 11 06 1992, there was a separate section F governing issue of debentures The presumption was therefore, that for issue of debentures only compliance of section F was necessary Further, under Section A, governing first issue of new companies and Section B governing first issue by existing private / closely held companies, it was provided that they can issue capital to public only at par, unless certain conditions are complied with Since debentures are always issued at par presumption was that even new companies or non listed companies can make an issue of debentures to public at par though convertible at a latter date at premium

To avoid this misgiving, SEBI issued Clarification II From the guidelines it follows that

I. The newly inserted clause applies only to public issue and not to issue by way of private placement

II It applies to only the first public issue of new companies and therefore, if the new company has earlier made any issue and has become a listed company then this clause will not apply to the second issue by such a company by way of debentures

III The new companies are not allowed to issue convertible debentures whether FCDs or PCDs even if conversion is at par unless

1 Such a new company is set up by existing company/companies having five years track record of consistent profitability.

2 The promoter companies bring their contribution by way of additional equity or by subscription to FCDs/PCDs so that their total contribution is not less than 50 percent of the total equity after conversion

IV In other words, new companies which are set up by existing companies having five year track record of consistent profitability can not issue convertible debentures at all whether convertible at par or at premium

V If a new company set up by existing company/companies having five years track record of consistent profitability and if issues FCDs/PCDs, promoters are to bring in additional contribution by way of equity or by subsccription to FCDs/PCDs such that they hold not less than 50 percent of the total equity after conversion

VI. If they are already holding such equity as will become 50% of the total equity after conversion, they are not required to take any further equity or subscribe to any FCDs/PCDs

VII. If they are holding equity capital which falls short of 50% of the total equity after conversion, then they will have to take only such equity or contribute such amount to FCDs/PCDs as will make their holding 50 percent of the total capital after conversion

VIII If the conversion is to take place after 18 months then the promoters can take further equity at par, but if conversion is to take place at or before 18 months then they are required to take equity at the same price at which conversion is to take place.

IX. Promoters can so arrange that they may first issue equity at par to themselves so that their holdings becomes 50% of the total capital after conversion of the proposed debentures and then come out with debenture issue with conversion at premium within 18 months in which case they can avoid taking equity at premium.

For existing private / closely held / unlisted companies there is no mention whether they can issue FCDs/PCDs but it can be presumed from the provisions made for the new companies that guidelines applicable to new companies will hold good for the first issue by existing private/closely held or other unlisted companies provided they have three years track record of consistent profitability If such companies do not have such track record then they cannot issue debentures convertible whether at par or premium In the case of existing listed companies, the promoters are required to take either by way of fresh quota or by way of contribution to FCDs/PCDs Such amount as will make their total contribution to 25 percent of the total equity after conversion if the issue is up to Rs.100 crore and 20 percent if the issue is above Rs 100 crores All other conditions will be the same

Another condition for promoter's quota is that minimum subscription by each of the friends/relatives and associates under promoter's quota should not be less than Rs 1 lacs

It is not clear how this condition can be implemented for capital already held by promoters which is also to be calculated for arriving at the 50 percent, 25 percent or 20 percent as the case may be It is therefore, submitted that this condition will apply only to the new equity or subscription to new FCDs/PCDs that promoters may be subscribing to make up the required percentage of total capital

The guidelines povide that in case of PCDs/FCDs where the conversion was to be made at a price to be determined by the CCI at a later date then,

- the price of conversion and time of conversion shall be determined by the company at a general meeting of shareholders of company
- the consent of holders of PCDs/FCDs for the conversion terms should be obtained individually,
- conversion is to be given effect to only for those debentures holders who sent their positive consent,
- such debenture holders who do not send their positive consent will not be presumed to have given such consent on the basis of non-receipt of their negative reply but they will have to be given an option to get the convertible portion of debentures redeemed or repurchased by the company at a price which shall not be less than the face value of the debenture,
- where the consent from the Controller of Capital Issue stipulates cap price for conversion, the board of the company may determine the price at which the debenture may be converted

The debenture trust deed has to be executed within six months of the closure of the issue. From this condition, it is apparent that it referes to right/public issue as it refers to closure of the issue Therefore, the same is not applicable in case of private placement of debentures

The following disclosures will be necessary amongst others for the purpose of raising of debentures, A The existing and future equity and long term debt ratio,

B Servicing behaviour on existing debentures,

C Payment of due interest on due dates on term loans and debentures,

D Certificate from financial institutions/bankers giving their no objection for a second or pari passu charge being created in favour of Trustees to the proposed debenture issue,

E Premium amount on conversion, time of conversion in stages, if any, shall be pre-determined and stated in the propectus,

F Redemption amount, period of maturity, yield on redemption for PCDs/FCDs should also be stated in the propectus,

G Rate of interest

It is provided that rate of interest on debentures will be freely determinable by the issuer and therfore the issuer can issue debentures with zero interest The companies shall file with SEBI alongwith their applications, certificates from their bankers that assets on which security is to be created are free from any encumbrances and the necessary permission to mortgage the assets have been obtained

The debenture issuers are not permitted for acquisition of shares/providing loans to any company belonging to the same group The same group here shall have the meaning as defined under the MRTP Act which has now been incorporated in the Comapnies Act The security should be created within six months from the date of debentures. If for any reasons companies are not in a position to create securities within 12 months from the date of issue of debenture, the companies shall be liable to pay 2 percent penal interest to the debenture holders If securities are not created even after 18 months, meeting of the debenture holders will have to be called with in 21 days to explain the reasons there of and the date by which the securities would be created

If the non convertible portion of the PCD is treated then the discount there on and procedure for purchase on the spot trading basis must be disclosed in the prospectus

2.10 APPROACH OF FINANCIAL INSTITUTION AND RESERVE BANK OF INDIA

1. FINANCIAL INSTITUTIONS : -

The public financial institutions were working together to work out some informal formula for fixing premiums on shares Such a move of the financial institutions can make the recently awarded freedom to premium fixation a myth Because,the financial institutions hold large chank of shares of private sector companies from the blue chips to the ordinary laggards and the financial institutions can dectet the terms in case they do not like the pricing at the general body meeting

Even the large companies can not possibly alienate the financial institutions and still go ahead with premium fixed by themselves, in case the institutions oppose it, given the abject dependent of corporate sector on the financial institutions for funding their activities

The financial institutions have suggested that the premium should be the average of the prices in the last twelve months or it should reflect the book value of the share, the higher of the two can be the offer price of the shares with the stock prices soaring high in the last one year any of the companies coming with a public offer can have a problem while fixing premiums of shares on such norms The move can create difficulty for companies which have controlling stake with oversea parent bodies

A large number of the overseas holding companies had decided to increase their stake in their Indian outfits, following the liberalisation of investment rules and amendments to the FERA For these companies fresh investment in the equity stock can prove costly and at times even prohibitive

THE R.B.I. APPROACH :-

The Reserve Bank of India has directed that in case of public issues, the issue price of shares of private commercial banks should not be less than that based on the net asset value and the profit earning capacity value The formula of the erstwhile Controller of Capital Issues be followed

The apex bank has stipulated that in the case of rights issue and special allotment to employees, the premium payable should not be less than half of the premium fixed for the public issue A bonus issue can only be made simultaneously with the right or public issues and subject to the guidelines issued by SEBI

The R B I may selectively allow preferential issues at a price not less than the average market value of the immediately preceding six months in the case of listed shares In the case of unlisted shares the price is based on the net asset value and the EPS according to the erstwhile CCI formula The price so determined has to be certified by the chartered accountant The R B I guidelines have precedence over any guidelines of SEBI in this respect

2.11 REVIEW OF MALEGAON COMMITTEE REPORT

The SEBI constituted a committee (Malegaon Committee) to review the existing disclosure requirements in offer documents and reccommed additions there to and modifications there of, so that the disclosures assist in protecting the interest of investors The committee has suggested many changes in existing disclosure requirements In this section only relvant suggestions are reviewed

(1) The committee had suggested that the use of projected earnings be prohibited Because future is uncertain and hence there is no point in giving attractive projected balancesheet figures

(2) Another suggestion of the committee is emphasis on past performance of the issuing company or promoting companies On the basis of past performance, the investors can decide better about his/her investment

(3) The suggestion of the committee about disclosure of preissue EPS for the last three years, average return on Net Worth in the last three years, NAV based on last balansheet, NAV after issue and comparision there of with the issue price and minimum return on increased Net worth required to maintain pre-issue EPS are welcome steps in the direction of investor's protection

(4) Another suggestion of the committee is that , effect must be given to the possibility of the consequent increase in capital while computing the accounting ratios on the assumption that the option to subscribe will be excercised

(5) Another good suggestion is about disclosure of management's discussion and analysis of the financial condition and results of the operations presented in the financial statements This will help the investor, in understanding the company's financial result It will also clear their doubt and confusion

(6) The suggestion of the committee about inclusion of capitalisation statement in the offer document is also good one.

(7) As regards pricing of the shares, the committee suggested that authority be given to the Board of Directors to fix a price at which the issue should be made with in a specified price band (price range) The price should be fixed by a resolution to be passed by the Board of Directors at a meeting of the Board. The notice of such a meeting be issued before 48 hours to the stock exchanges.

(8)A very important suggestion made by the committee is related to charging of premium by unlisted or closely held companies The committee suggested that the right to an unlisted company to make a first public issue at a premium should be available only when the networth of the comapny before the issue repesents not less than 20% of the net worth of the company as it would be after the issue is made and the unlisted company has a net worth before the issue of not less than Rs.3 crores.

(9) Another suggestion by the committee is that where a division of a company is spun off into a separate company and track record of profitability of the division (Established on the basis of an auditor's certificate) should be considered in the same manner as for a partnership converted in to a company.