

Chapter 9 – Types of Borrowers

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Learning Objectives

What you should achieve after completing this chapter:

- Understand the legal existence of each category of borrower;
- Appreciate the risk and mitigating factors involved in dealing with each type of borrower;
- Understand the different borrowing needs of each type of borrower;
- Understand the different forms of documents that a lender needs to sight for each category of borrower; and
- Understand the overall credit implications in dealing with each type of borrower.

1. Types of Borrowers

Borrowers constitute deficit units. They come under various entities such as:

- (i) Personal;
- (ii) Sole proprietor;
- (iii) Partnership;
- (iv) Company;
- (v) Co-operatives;
- (vi) Societies; or
- (vii) Government corporations and agencies.

Incorporation of these entities and their continued existence differ. Lending financial institutions must have a sound understanding of their role and continued legal existence.

2. Personal

Personal borrowers, who are individuals or joint individuals, form the largest group of borrowers. In order to have legal capacity to borrow, the individual must attain the age of 18. The reason being, under the Age of Majority Act 1971, a person is a minor if he has not attained the age of 18 and is not competent to contract as stated under section 11 of the Contracts Act 1950.

Contracts entered into by minors are *prima facie* void except for contracts of necessities.

Borrowing needs by personal customers can vary from financing asset acquisition to personal consumption. Examples of asset acquisition are investment in landed properties, vehicles, shares, etc. Personal consumption is to meet peak expenditure periods during festive seasons, medical expenses, and educational expenses. Essentially, it is to tie over cash flow irregularities during these periods.

Age is an important factor to consider for lending to personal customers. The minimum legal age limit to borrow is set at 18. For credit cards, it is 21 years of age as stipulated by Bank Negara Malaysia (BNM). Is there a maximum age limit? In other words, can a 60 year-old person apply for credit facilities? The answer is there are no legal restrictions on borrowing. Therefore, it is entirely the respective financial institutions' credit decision based on credit considerations.

While individual borrowers are common, equally common are two or more joint borrowers. Where joint borrowers are two as in the case of husband and wife or parent and child or amongst siblings, can there be five joint borrowers? Again, there are no legal restrictions. It is up to financial institutions to establish the

rationale in the light of business wisdom and their information technology (IT) design. For example, five members of a family have entered into a sale and purchase agreement to purchase a house. If the IT design is to have a maximum of three borrowers, then the remaining two will nevertheless be chargors together with the three borrowers.

Mentally disordered persons are not competent to enter into contracts as per sections 11 and 12 of the Contracts Act 1950. It would be unlikely for a mentally challenged person to individually apply for a credit facility. But, it might just be possible in the case of joint applications. Due care must be exercised.

In the case of individuals adjudicated bankrupt by the High Court, no loans should be processed. The practical difficulty here is that a bankruptcy search normally takes time. So, searches done with CTOS and others will help minimise this problem.

3. Sole Proprietor

When an individual decides to venture into business, then a simple form of business to set up is a **SOLE PROPRIETORSHIP** firm. The owner becomes the **sole proprietor**. Registration is required under the Registration of Business Act 1956, at the Companies Commission of Malaysia (CCM) or Suruhanjaya Syarikat Malaysia (SSM) following a merger between the Registrar of Business and Registrar of Companies in 2003.

To illustrate the difference between a sole proprietor and sole proprietorship, let's take an example. Ms Alice registers a business called Allison Boutique. The sole proprietor is Ms Alice. The name of the sole proprietorship business is Allison Boutique. Ms Alice is personally liable for all the debts of the business.

Advantages of forming a sole proprietorship are as follows:

- Simple to form;
- All profits accrue to the owner;
- Management decisions are easy to make; and
- No elaborate regulatory requirements.

On the other hand, there are disadvantages too, as follows:

- All losses must be borne by owner solely;
- No check and balance in management decisions;
- Limitation in increasing capital; and
- No succession plan.

A certificate of registration is issued by the Registrar upon registration. It must be renewed every year whereupon a renewal certificate will be issued.

For a lender, the comfort can be that a sole proprietor is expected to show high commitment in business due to unlimited liability. Failure could cause him to lose his personal assets. But in the absence of an audited financial statement, reliable financial information cannot be obtained, thus limiting quantitative analysis.

A common error is to address a sole proprietor as a company. For example, it is an error to say, 'my company, "Allison Boutique" has an account with your bank'. Instead, it should be stated as 'my business has an account with your bank'.

Another error is to propose the proprietor's personal guarantee for credit facilities taken by the business. This is redundant as the proprietor is personally liable for all the firm's debts.

With regards to signing, it is common practice to sign and affix a rubber stamp of the name of the business. Though it is not a legal requirement to affix the rubber stamp, it is a practice that makes it clear the proprietor is signing on behalf of the business and not under his personal name.

4. Partnership

A partnership is an association of two or more persons to do business with a view to profit. Like a sole proprietor, it is a firm with no separate legal entity. Registration is required under the Business Registration Act 1956.

However, partnership businesses are governed by the Partnership Act 1961. While the Act is in place, it is common for firms to draw up their own Partnership Deed. In the absence of a deed, the Partnership Act 1961 will prevail. Where there is a deed but not shown to the lender, the lender need not concern himself with the provisions of the deed. However, if it is shown, then the lender is put on notice and must be guided by it.

Advantages of a partnership:

- Able to raise higher capital;
- Risk and losses can be shared;
- Wider management expertise; and
- Minimum regulatory requirement.

Disadvantages:

- No separate entity;

- Profits are shared;
- Possibility of disputes arising between partners; and
- Unlimited liability.

Personal guarantee of partners is redundant as all partners are liable for the entire debts of the partnership firm.

Generally, the maximum number of partners in a partnership is limited to 20 under section 14(3) of the Companies Act 1965 unless the partnership is a professional firm, as in the case of a law or an accounting firm where the number is limited to 50.

In dealing with partners in a partnership firm, although ideally, consent from all partners should be obtained at times, it may not be possible. However, as each partner is an implied agent of the partnership, the act of one will bind all partners. Therefore, it is sufficient to deal with any partner who has mandate to act on behalf of the partnership.

4.1 Incoming partner

It is common for a new partner to be admitted, to increase capital and or to add expertise of some form. An incoming partner will only be liable for debts created after his admission as a partner. Therefore, a lender should obtain a letter of undertaking or personal guarantee from the new partner to admit liabilities of the partnership firm's existing debts subject to the presence of consideration.

This will be especially useful for non-revolving facilities like term loans. However for revolving facilities like overdrafts, applying the rule in "Clayton's case" (*Devaynes v Noble*), new credits will go towards settlement of earliest debts. Thus, new debts will amount to fresh loans and make the new partner liable for debts.

4.2 Outgoing partner

In partnership, it is also common for a partner to become deceased, retire or resign. Such a partner's liabilities will be determined as of the date, he becomes deceased, retire or resign, provided the lender is given notice. The outgoing partner is not liable for new debts incurred after the said date. It is easy to determine the amount for a non-revolving facility. But for revolving facilities such as overdrafts, incoming credits will repay the earliest debts. Thus, new debts after the outgoing partner's notice date will absolve the outgoing partner from any liabilities as per rule in "Clayton's case" (*Devaynes v Noble*).

For this reason, personal guarantees are taken from partners to prevent the rule in Clayton's case from operating to the lender's disadvantage, though the partners' personal guarantee may seem redundant as all partners are jointly and severally liable for the entire debts of the partnership firm nevertheless.

4.3 Facilities

Credit facilities partnerships apply for would be for fixed assets and/or working capital financing.

It is common for partnership firms to reconstitute into a limited company after some years.

5. Companies

Companies can be divided into private limited and public limited companies. The latter can be either a listed or unlisted public companies. Private limited companies cannot raise funds by issuing shares to the public, unlike public listed companies.

5.1 Incorporation

There must be a minimum of two persons to incorporate a company. They are initially called the **promoters** of the company. The minimum of two shareholders must subscribe to one share each. Once they comply with the registration requirements as required by the Companies Commission of Malaysia, the promoters will have successfully incorporated a company with a distinct company name and number. The promoters are then called **shareholders**.

Since only two shares of RM1 each have been issued and paid up at this moment, it can be called a "Two Ringgit" company.

Later, the shareholders will subscribe for more shares, as the company increases the issued, and called up share capital. The maximum share capital that can be raised is bound by the amount of authorised share capital. A lender would be concerned to know how the capital was increased. Whether it was by way of a cash call, which would increase the company's cash position or by way of a share swap, which will not improve the cash position. This will be stated in Form 24, which is a return filed at the Companies Commission of Malaysia (CCM).

However, the shareholders liabilities are limited to the extent of the issued and called up share capital only regardless whether it is paid up or not. Once paid up, it is called paid up share capital. There can be instances where they wish to raise capital exceeding the authorised share

capital. In such a case, the company must file a return with the Registrar of the Companies Commission of Malaysia (CCM) to give notification of an increase.

Companies represent a separate legal entity. In law, they are a separate legal person. Therefore, it is even possible for a company to be a sole proprietor of a sole proprietorship. They can sue and be sued. They can contract in and contract out. This means companies are different from the owners called the **shareholders**.

5.2 Substantial shareholders

In public listed companies, there are many shareholders. Those holding 5% or more shareholdings are regarded as **substantial** shareholders. Among them some are appointed directors. Substantial shareholders are also deemed persons connected under section 133A of the Companies Act 1965.

5.3 Directors

Directors are people engaged by the shareholders to manage the company. With regards to appointment of directors, there is a trend to form a nominating committee to screen all potential directors in line with good corporate governance practices for public companies. This practice is good for the overall business of lending as appointment of unscrupulous directors can be avoided or at least minimised.

Collectively, the directors will form a board of directors. The **Chairman** will head the board meetings where strategies and policies to run the company will be formulated. The company secretary, among other things, will minute all **meetings**. One person among the directors would assume the **Chief Executive Officer (CEO)** or **President's** post and will be involved in the day-to-day running of the company together with, if any, other executive director/s. These directors will then implement the strategies and policies by preparing action plans with the help of the management team, comprising the General Manager, line managers, supervisors and all other employees of the company.

Non-Executive Directors involve themselves only in board meetings and provide their expertise in formulating strategies and policies. The implementation is left to the CEO or President. In some companies, the chairman himself could be the **Executive Chairman**, thus involving himself in the day-to-day running of the company.

For corporate shareholdings, a nominee director may be appointed. Although some directors are not shareholders, they are appointed for their professional expertise. In private limited companies, lenders obtain

personal guarantees of all directors (excluding nominee directors, if any) to ensure their personal commitment to the company. For public listed companies, the directors would not want to commit their personal guarantee, as their stake could be small or they may be merely providing professional service in return for directors' remuneration. It is important to note that a directorship does not come with the need to extend guarantee for the company's liabilities. *Personal* guarantees are always extended by individuals in their personal capacity. It is therefore wrong for credit officers to stipulate 'Directors' Guarantee' as a condition in their credit proposal. They should spell out the names of the individuals whose guarantee is assessed to provide meaningful support.

In private limited companies, the shareholders and directors can be the same persons. Some shareholders may not be directors. As said earlier, it is usual to ask directors to execute personal guarantees. At the same time, the personal guarantee of major shareholders could also be negotiated, although they may not be directors, since their net-worth may be significant to provide the lender with a way out. More importantly, they may be running the business by default even though they may not be directors.

Directors' remuneration or loans to directors in the case of exempt private companies, is an avenue for funds to be siphoned out of the company when the cash flow does not permit following continuous losses or small profits. Lenders can impose a covenant to cap directors' remuneration and or to not permit extension of loans to directors without the lender's prior written permission. If there are loans from directors to the company, such loans do enhance the company's financial position. If the lender assess such loans to be critical to the financial well being of the company, then a covenant can be imposed where directors' loans are to be subordinated to repayment of the lender's borrowings.

5.4 Audit committee

The **Securities Commission** has issued broad guidelines to public listed companies to form an Audit Committee, towards better corporate governance. Each company will draw up their own specific guidelines for the audit committee's terms of reference and duties and responsibilities.

In public listed companies, an Audit Committee is appointed by the Board from amongst its members – say five members of which three are non-executive directors.

An extract of the terms of reference adopted by a public listed company is enumerated below.

Terms of reference

- (i) The Audit Committee shall be granted the authority to investigate any activity of the company and its subsidiaries and all employees shall be directed to cooperate as requested by members of the Committee.
- (ii) The Audit Committee shall be empowered to retain persons having special competence as and when necessary to assist the committee in fulfilling its responsibilities.
- (iii) The Audit Committee shall provide assistance to the Board in fulfilling its fiduciary responsibilities particularly relating to business ethics, policies, financial management and control.
- (iv) The Audit Committee through regularly scheduled meetings, shall maintain a direct line of communication between Board, External Auditors, Internal Auditors and Financial Management.
- (v) The Audit Committee shall provide greater emphasis on the audit functions by increasing the objectivity and independence of External and Internal Auditors and providing a forum for discussion that is independent of the management.

Besides their terms of reference, the Audit Committee's duties and responsibilities among other things is to act as an independent and objective party in reviewing the company's financial information presented by its management. This is good for the lending business as the corporate customer can attach further reliability to the financial information provided.

5.5 Resolutions

The company secretary's role is to maintain *inter-alia* records pertaining to the company. One such record is the board resolution. The voice of the company can be heard through the resolutions passed at board meetings. In other words, a company "speaks" through resolutions. A resolution must be passed at the board meeting and signed by the directors and company secretary for anything a company wants to do. For example, if a company wishes to apply for credit facilities or accept approved credit facilities or open/close a bank current account or change company signatories, it must obtain a mandate by way of a board resolution. There could be many people appearing before bankers to negotiate on behalf of companies. Bankers must establish if they have the authority to do so. Therefore, it is important for a lender to sight the board's resolution for any request directors make on behalf of the company, by sighting the mandate as reflected in a board resolution.

There are two types of resolution a company passes, namely:

- (a) Ordinary resolution – 14 days' notice period must be given.
- (b) Special resolution – 21 days' notice period must be given.

These two resolutions can be passed either by calling for a formal Board of Directors meeting or by way of circularisation to all directors. When the former is done a Board of Directors' resolution is passed and when the latter is done a circular resolution is passed. At times, we may see an extract resolution. This happens when several issues are discussed in a Board of Directors meeting, but only one issue is relevant to the bank. Then, an extract of the resolution is passed to the bank.

While it is important to sight these resolutions, bankers need not be concerned whether internal formalities have been complied with in passing these resolutions as stated in the Turquand case.

5.6 Classes of share capital

While the maximum amount of monies that can be raised by way of capital is determined by the authorised capital, there are different types or classes of capital, namely:

5.6.1 Ordinary share capital

Shareholders subscribing to ordinary shares become the owners of the company. If the company makes profits, then the board of directors can decide to declare dividends. The final dividend is proposed by the directors and approved by the shareholders at the Annual General Meeting. In instances where the company's financial performance is good, directors can approve interim dividends for which there is no need for shareholders' approval at an Extraordinary General Meeting. (**Note:** ordinary shareholders are not entitled to a fixed rate of dividend.) It depends entirely on the company's financial performance and dividend policy. Sometimes although profits are made, yet no dividends are paid due to a retention policy to self-finance expansion plans rather than seeking financial assistance from lenders.

On the other hand, if losses are made, no dividends are declared unless the company has accumulated retained earnings from past years. Dividends cannot be declared out of capital funds.

High dividend payouts in relation to profits are an avenue for directors to siphon funds out of a company. Therefore, banks will impose covenants such as, either:

- (i) No dividend payment without prior written permission from lender; or
- (ii) Dividend payments are capped at not more than, say 5% of profits.

This measure is largely taken to prevent companies from suffering a cash flow drain or deliberate attempts by directors to declare high dividends when the company's cash flow does not permit. Therefore, this covenant must be closely monitored. Consequences of breaches can lead to an event of default, leading even to a recall of credit facilities.

For non-public listed companies, if payment of dividend is accrued then it may not involve any cash payout. It would be only a book entry where the dividend payable is reduced and amount due to shareholders increased. Here again, a covenant can be imposed by a lender to state that amount due to shareholders is to be subordinated to the repayment of the lender's borrowings. However in the event the company goes into liquidation, the amount due to shareholders will have less priority as compared to secured lending.

All ordinary shares carry voting rights. Therefore, shareholders can influence resolutions being passed at Annual General Meetings or Extraordinary General Meetings.

However class A ordinary shares are not entitled to voting rights.

While ordinary shareholders enjoy many privileges, they will be the last to be paid in the event of company liquidation. In most instances, there won't be much left if the company is wound up following continuous losses.

5.6.2 Bonus share

However, there are other ways to reward ordinary shareholders without draining cash flow, that is by declaring bonus shares. Bonus shares are issued by capitalising either capital or revenue reserves. Capital reserves appear in the form of share premiums, asset revaluation and/or a capital redemption reserve fund (CRRF). Revenue reserves appear in the form of general reserves and/or retained earnings. For example, bonus shares of one for four may be declared. This means for every four existing ordinary shares, one-bonus share is issued. Bonus shares are also commonly called free shares. They are not entirely free because they are issued as an alternative method of profit distribution to

prevent cash drain in the company. This method also has its merits as compared to dividend payouts as these shares have the prospect of capital appreciation and more dividends in the future. Of course, this is provided the company continues to return good a financial performance.

5.6.3 Rights issue

Ordinary shareholders are also entitled to rights issues. This is a right extended to existing shareholders to subscribe for more ordinary shares. They are usually issued below market price. For example, one for four at an issue price of, say – RM2.50. Nominal value is say – RM1. Current market price is, say – RM4.00 (cum rights price). The market price is expected to fall to RM3.70, once the ex date is announced. This means non-existing shareholders who want to buy the shares need to pay RM3.70 on the open market. The existing shareholders can subscribe for the rights at RM2.50. Hence, they will end up with 5 shares totalling RM18.70, averaging to RM3.70 each. If the existing shareholder does not subscribe, he will then have 4 shares worth RM14.80, versus their previous worth of RM16.00. This is a **pre-emptive right** provided for in the Companies Act 1965 to the existing shareholders. This right is effectively a First Right of Refusal given to the existing shareholders relating to new shares issued by the company. This will enable the existing shareholders to protect their proportionate percentage of ownership in the company.

5.6.4 Preference shares

This is a separate class of share as opposed to ordinary shares. Preference shareholders are preferred over ordinary shareholders in respect of dividends and capital redemption. Only after dividends are paid to preference shareholders are dividends considered for ordinary shareholders. The dividend rate payable is also fixed as opposed to ordinary shares. In the event of company liquidation preference shareholders will be paid before ordinary shareholders. Unlike ordinary shares, preference shares can be issued either in perpetuity or is redeemable, by the issuer. Ordinary shares are not subjected to redemption though there are share buy back or capital reduction schemes.

However, preference shareholders are not entitled to vote. Therefore, they will not have any influence over policies the company make. It is for this reason that the company would prefer to issue preference shares so as not to dilute the existing ordinary

shareholders' control over the company when it requires additional funds.

Different types of preference shares are issued as follows:

(i) Perpetual preference shares

These shares are issued in perpetuity. They are redeemable only at the option of the issuer. The issuer is not obligated to exercise this option.

(ii) Redeemable preference shares

These shares will be redeemed either out of profits or issuance of new shares. Two dates will be given, that is, the earliest and latest date for redemption will be stated. After redemption, the Registrar must be given notice using Form 27 Companies Act 1965. Dividend rate is fixed. They are paid only if profits are made or if the Board of Directors decides to pay from distributable profits retained from previous years.

(iii) Non-cumulative redeemable preference shares

Dividends will not be declared retrospectively in the future when dividend is declared though shareholders are entitled to fixed rate of dividend for the years when no dividends were declared for any reason whatsoever.

(iv) Participating redeemable preference shares

Over and above the fixed rate of dividend as stated above, holders are entitled to further dividends in the event the company turns in good profits. The dividends will be based on a reference formula, transparent to the stakeholders. Yet, it still possible that the Board of Directors may decide not to declare one. However, ordinary shareholders will not get any dividend unless the full dividend as per the agreed formula is declared to preference shareholders.

(v) Cumulative redeemable preference shares

Dividend, for the years in which no profits are made, are accumulated and are paid retrospectively in the year when the company is in a position to declare a dividend. All cumulative dividends must be declared to preference shareholders before any dividend can be declared to ordinary shareholders.

In today's capital market, investment alternatives for investors abound. Thus, the traditional preference share is not relatively attractive. This is because there is no upside potential to the return due to a fixed rate of return, even when the company is doing well. Further, there is no legal right for dividends when the company is not doing well. Therefore, preference shares will only be attractive if it is attached with some sweeteners such as convertibility.

5.7 Documents

In dealing with a company as a customer, the following documents must be examined by the lender:

5.7.1 Memorandum of Association

This document represents the company's constitution. It deals with the company's external matters. There are five clauses that need to be checked.

(a) Name

This will reveal the company's name. It can be possible for a company to go through a name change. If such is the case, it must be evidenced by Form 13, Companies Act 1965. Names of companies can also be close to that of other companies and/or at times can be wrongly spelt due to oversight names in correspondence or documents. The distinguishing factor should be the company number. Always keep track of the company number to ensure no mistakes are made here. For example, there are individuals who have common names like Muhammad. The difference between one from the other is the NRIC number. Besides, the company registry is more than a century old and it is inevitable not to have names close to one another. However, before incorporating, a request for availability of name must be filed using Form 13A, Companies Act 1965 with the Companies Commission of Malaysia (CCM) and approval must be obtained before proceeding with registration.

(b) Address

This will reveal the registered address of the company. As companies can be operating from various places of business, the registered address must be known. This is to enable outside parties to correspond with the company and

show proof that notices by way of mail correspondence have been served if it is addressed to the registered address. Proof of posting will be sufficient. Further, should any one need to obtain legal redress against the company, then the registered address will determine in the country and court which the case must be filed.

(c) Objects clause

Objects clauses will be the lengthiest in the Memorandum of Association. It will indicate the purpose for which the company was formed or in other words, the nature of businesses the company can engage in. It could be more than one type of business. So, the lender must verify whether the company's present activity appears in the objects clause. To share an experience, a company involved in tourism related business, approached a bank for credit facilities. However, nowhere in the objects clause was tourism stated as their business. Instead, manufacturing of rubber products was the main activity as stated in the objects clause. To set the matter right, subsequently, an amendment was filed at the Companies Commission of Malaysia.

But one wonders how this can be possible. Well, it could be a case of changing the nature of business and not amending the objects clause in the memorandum due to oversight. Or, it could be due to purchasing new companies off the shelf to quickly get on with the business but not amending the objects clause in the memorandum to be in line with the business the company has in mind. This is important so that the nature of business is not ultra virus the objects clause of the memorandum.

The other clauses to check in the objects clause are the company's power to borrow and to charge company assets as security. In some memoranda, borrowing and charging powers will be specified under the objects clause but in some it will be silent. Well, all trading companies have implied powers to do so under the third schedule of the Companies Act 1965. But what should be looked out for in the objects clause is to see if there is any mention of specific restrictions against borrowing or charging of company assets.

(d) Limited liability clause

This clause makes it clear that this company is limited by shares. That is its shareholders liability is limited to the extent of the company's issued share capital. Some companies are limited by guarantee. Usually, they are non-profit making organisations such as Institut Bank-Bank Malaysia among others.

(e) Authorised share capital

The authorised share capital reflects the amount of maximum shares a company can issue to raise funds. Here the number of shares and their nominal value will be stated. Not all companies' nominal value, or also called par value, is RM1. They can be RM0.10, RM0.25 or RM0.50.

However, currently there is a trend towards issuing non-par shares, especially by borrowers who are subsidiaries of foreign companies.

The authorised capital can be increased if there is a need by filling Form 28, Companies Act 1965 at the Companies Commission of Malaysia.

5.8 Articles of Association

This document provides details of the company's internal management such as directors' powers, how meetings are to be called for, passing of resolutions, affixing the company seal, etc. However, by virtue of Turquand's case, bankers need not concern themselves as to whether procedures with regards to the company's internal management have been adhered to.

Usually, companies will adopt the contents as stated in Table A contained in the Fourth Schedule of the Companies Act 1965 as its Articles of Association. Where they deviate from Table A, it will be specified accordingly.

In the Memorandum of Association, the companies' powers to borrow and charge were mentioned. Directors who are appointed by shareholders to represent them are empowered by the Articles of Association.

5.9 Other documents

They are:

- (i) Form 24 – this will provide details of shareholdings of the company. The latest should be obtained so as to reflect the current position.
- (ii) Form 49 – this will provide details of directors. As directors can change the latest should be obtained from the company.
- (iii) Resolutions – Appropriate ones must be obtained to see if the company has given the mandate to the directors to act accordingly.

(Note: All documents obtained from the company must be certified and dated by the company secretary to reflect that the documents are authentic and the latest.)

5.10 Holding company

A holding company also called a parent company, holds shares of other companies. If it owns more than 50% to 100% shares, then this company is called a subsidiary. Where it owns 100% shares, then the subsidiary is called, a wholly owned subsidiary. Otherwise for as long as the holding company holds more than 50% but less than 100%, then it is called a partially owned subsidiary. The remaining shareholders in the subsidiary are called minority shareholders having minority interest.

A group includes a parent company and all its subsidiaries.

5.10.1 Consolidated account

A holding company is required to present final accounts for itself while the subsidiaries present their own. In addition, to show the group's financial performance, a consolidated account needs to be presented. A parent that is a wholly owned subsidiary of another parent incorporated in Malaysia need not present consolidated financial statements.

The consolidated account will show the group balance sheet, profit and loss account and cash flow statement.

The group balance sheet, will clearly show; inter alia, the parent shareholders' equity. Minority interest should be presented in the consolidated balance sheet separately from liabilities. Investments in subsidiaries should be carried at cost or revalued amounts under the parent's accounting policy for long-term investments.

Investments in associates can be reflected using either the cost or equity method.

In the profit and loss account, it should clearly show, inter alia, profits attributable to minority shareholders and that of the group separately.

5.10.2 Lenders dealing with a group of companies

A holding company may be involved in its own business or it could merely be a holding company, undertaking investments and earning dividends, as its main source of income, received from its subsidiaries.

Usually, lenders will identify the operating company to provide the loans directly for easy monitoring, rather than extending it to the holding company. The risk in doing the latter will be a case where the holding company could divert funds to any company in the group or elsewhere and lenders will then not know where their risk is. Another feature, when it comes to a group of companies is to see a lot of inter-company borrowing and lending. Again, this will not enable a lender to track the risk. So, lenders can impose covenants to restrict inter-company lending without prior written approval.

Without providing direct funding to subsidiaries, transfer-pricing risk is another way to divert funds. This is another area of concern to lenders. Here, a borrowing subsidiary could sell goods to another subsidiary at a low price and deliberately show lower profits or losses. This is often motivated by tax advantages enjoyed by the receiving subsidiary of such transfer pricing such as pioneer status, concessionary tax rate, unutilised tax allowances and unutilised tax losses. This will enable the group as a whole to pay less tax.

Alternatively, the same borrowing subsidiary could deliberately purchase goods at a high price from another subsidiary to show lower profits or losses for the same reasons. The financial position of the borrowing subsidiary can be weakened by such practices to the extent that it may concern the lenders.

Tracking trade debtors (receivables) and trade creditors (payables) to and from subsidiaries is a way to deal with this situation. Another option is to obtain cross guarantees. Here, the holding company will guarantee the subsidiaries' borrowings and vice versa and obtaining guarantees from among subsidiaries.

Another mode is to transfer prized assets at undervalue to subsidiaries or others, with a view to do an asset stripping of the borrowing company. Therefore, lenders must track ownership of these prized assets in the group and establish recourse to these assets in the event of default.

In practice, lenders will resort to all of the above mitigating means to monitor and control the lending relationship with the group.

5.11 Subsidiary company

A subsidiary is an enterprise that is controlled by another enterprise known as parent or holding company.

It is usual for holding companies to form subsidiaries to segregate the companies' activities into manufacturing, trading and management services arms. Loss making arms can be easily recognised. Timely strategies can be put in place to make amends. This will enable better management control of the group. Lenders can identify the operating subsidiary in need of financial support and are able to exercise greater control.

There are tax benefits too. Each and every subsidiary company can charge their expenses against their own revenue to minimise corporate tax. Capital allowances up to 100% can be claimed for the year in which the respective subsidiaries incur such CAPEX.

5.12 Associate companies

An associate company is an enterprise in which the investor has significant influence but which is neither the investor's subsidiary nor joint venture.

In such companies, the holding company holds between 20% to 50% shareholdings. The key to recognising associate companies is the concept of significant influence. This is assumed to be present when besides holding the stipulated shares, there is board representation, participation in policy-making processes, and material transactions between the investor and investee. However, it is possible that a company holds more than 20% shares without significant influence. Then, it should treat the investment as a passive investment and avoid accounting for it as an investment in an associated company.

Accounting for investments in group accounts can either follow the **cost method** or **equity method**.

Under the cost method, investment is recorded at cost. The income statement reflects income from the investment only to the extent that the investor **receives distributions from the investee's accumulated net profits**, arising subsequent to the date of acquisition. Distributions received in excess of such profits are considered a recovery of investment and are recorded as a reduction of the cost of investment.

Under the equity method of accounting, investment is initially recorded at cost and the carrying amount increased or decreased to recognise the investor's share of the investee's profits or losses after date of acquisition. The income statement reflects the **investor's share of the results of the investee's operations**.

An investment in an associate company should be accounted for in the consolidated financial statements under the **equity method** except when the investment is acquired and held exclusively with a view to its disposal in the near future in which case it should be accounted for under the cost method.

5.13 Exempt private company

These are companies with the following characteristics:

- (a) Number of shareholders not more than 20; and
- (b) No corporate shareholders.

As the name suggests – exempt private company, what could be exempted in this type of companies? Well, the regulatory requirement of filing annual returns at the CCM is simplified. The company inter alia has to declare that it would be able meet its commitments as and when they fall due. There is no need to file the full set of accounts.

The reason is to encourage unincorporated businesses to form a company and to benefit from the advantages of being a separate legal entity with limited liability as opposed to unlimited liability in the case of sole proprietorships and partnerships.

Further, some sections of the Companies Act 1965 are not applicable to exempt private companies. For example, under Sections 133 and 133A of the Companies Act 1965 a company cannot extend loans to its directors or to persons connected with it. However, this does not apply to exempt private companies. Therefore, an exempt private company can extend loans to its directors or to persons connected with it. Further under the same sections, exempt private companies are eligible to guarantee for loans extended to other companies although they are not related. These are important benefits for an exempt private company.

All associated and subsidiary companies are certainly not exempt private companies as they have a corporate shareholder. However it is possible for a holding company to be an exempt private company provided not more than twenty shareholders own it.

6. Co-operative Societies

All co-operative societies are registered under the Co-operative Societies Act 1948. A registered society may make loans to its members, employees and subsidiaries, or to another registered society which had obtained approval of the Registrar-General as prescribed by the rules.

The co-operative societies in Malaysia operate under the supervision of three authorities namely:

- (a) The Farmers Organisation Authority (FOA) established in 1973 – to consolidate and merge agro-based co-operatives.
- (b) Department of Co-operative Development – to supervise urban and non-agro-based co-operatives.
- (c) Fisheries Development Authority (MAJUIKAN) – to supervise fishing co-operatives.

Housing co-operatives was formed in 1949 with the aim to provide members with housing finance at reasonable cost and on softer terms of repayment than those offered by the major financial institutions.

Most of the housing co-operatives raised additional funds from lenders by charging their housing schemes. Borrowing requirements of other co-operatives could either be for working capital or asset financing.

7. Societies and Clubs

Societies and clubs are unincorporated bodies. They have no legal status of their own. Formed by persons grouping themselves together and at a general meeting of members agreeing to form a society or club.

Members draw up and adopt rules and/or constitution. Except for societies, which must be registered with the Registry of Societies, all others do not require registration.

Section 9(c) of the Societies Act 1966, provides that a registered society may sue or be sued in the name of a member registered with the Registrar of Society, as a public officer of the society as such. If no such person is registered, the society may be sued or sue in the name of any office-bearer of the society.

Societies and clubs may be dissolved in the same way they were formed. Meaning members who agree to form then can also decide to dissolve them. The Registrar can also deregister them. The court, on the application by members or any other person, may order the dissolution of a society or club.

For club members, their liabilities are restricted to the amount of their subscriptions.

Committee members usually run societies and clubs. They cannot act outside the scope given by the general body of members. Borrowing to acquire land and buildings is common and is extended in the names of the committee members. It is also common to take third party securities. All borrowings must be supported by a resolution passed by the committee members.

To recover debts from societies or clubs, legal proceedings must be commenced against the committee or principal office bearers. But judgment can only be enforced against the property of the society as per section 9(e)(i) of the Societies Act 1966. Office bearers can become personally liable only if they extend their personal guarantee.

Assets acquired by the society or club will be registered in the name of trustees who could be the committee members. In taking such assets as security, lenders must ensure:

- (a) The power to borrow on behalf of the members is present;
- (b) The signatories to the charge are authorised; and
- (c) The purpose of borrowing is within the authority given to the trustees, committee or board.

Trustees may contract on behalf of the existing members of the society or club. New members joining after the contract date are not bound by it unless they give their consent.

Once a society or club ceases to exist, assets will be distributable amongst members as at that date and the personal representatives of those who have died since that date.

8. Government Corporations and Agencies

Federal Government Accounts relate to all Government Ministries, Ministry of Finance Incorporated, Kazhanah Incorporated and Petronas.

State Government Accounts relate to the Perbadanan Kemajuan Negeri, Menteri Besar Incorporated and State Economic Development Corporations.

Government Agencies Accounts relate to the Malaysian Industrial Development Authority (MIDA), Malaysian Industrial Development Finance (MIDF), Malaysia Palm Oil Board, Malaysia Cocoa Board, and Malaysia Rubber Board.

Government Departments Accounts relate to the Department of Agriculture, Fisheries, FAMA, JAKIM, JPJ, Custom, etc.

Statutory Bodies Accounts relate to RISDA, FELDA, FELCRA, MARDI, BERNAS, etc.

Some of these bodies are in the midst of being corporatised.

Municipal Council/Local Authorities Accounts relate to DBKL, MPAJ, MPJB, MPSA, Majlis Bandaran, Majlis Daerah, etc.

Lending to these bodies entail minimum credit risk as the government backs them.

9. Summary and Conclusion

All dealings by lenders with borrowers depend on whether they are individuals, unincorporated or incorporated bodies. Legal provisions for each category differ. Risks in managing the relationships also differ. This chapter addresses all these pertinent issues, keeping in mind throughout, the CREDIT implications in all aspects. Granted they are not exhaustive, readers should also relate their own experiences in dealing with each category of customers as they progress in their work place.

Practice Questions

1. What is the age of majority for personal borrowers?
2. Where does a sole proprietorship register its business?
3. Define a partnership business.
4. How does a shareholder differ from a director?
5. Explain the difference between an executive and non-executive director.
6. What is the significance of resolutions in a company?
7. What are the differences between ordinary shares and preference shares?
8. Explain the difference between a bonus issue and a rights issue.
9. Explain the pre-emptive right available to existing ordinary shareholders in the context of a rights issue.
10. Briefly explain the five major clauses found in the Memorandum of Association.
11. What are the differences between the Memorandum of Association and Articles of Association?
12. Define subsidiary company.
13. What risk does a lender encounter in lending to a group of companies?
14. Explain the difference between cost and equity method in accounting for investment in associated companies.
15. What are exempt private companies?
16. Under which Act do co-operative societies require registration?
17. Name three requisites a lender must ensure when taking assets belonging to societies and clubs as a security.