

Loan represented by book debts – ordinary course of business

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Book debt is the money that a customer owes a company for a good or service purchased on credit. Any debit in the books of accounts for any sale or service provided to a recipient is a trade debt which arises in the ordinary course of business of such entity.



In accounting parlance, all bills raised other than cash bills/ memos, initially the account of the party is debited for whom sale or service is provided and as and when the payment is received from such party, his account is credited in the books of accounts of the company. It is customary for the business organisations to extend credit facilities to the customers depending upon the demand of the product, creditworthiness of the customer and so on. Therefore, till such time the payment is received and credited in the books of account of such party, the due to the company is of the nature of book debts. In fact, banks do extend credit facilities to companies on books debts maintained by the companies.

Loan presented by book debts

Section 296 of the Companies Act, 1956 (the previous Act) dealt with book debts in certain cases for the loan to directors. If the transaction represented by a book debt which was from its inception in the nature of loan or an advance to directors, then such book debt would be considered as loan to directors.

Section 185 of the Companies Act, 2013 (the Act) broadly merged both the sections 295 and 296 of the previous Act. It is important to understand whether all book debts of a company can be termed as in the nature of loan; the answer is negative.

In the matter of Pennwalt India Ltd vs ROC, the Hon'ble Bombay High Court held that to ascertain whether a transaction is loan or not, surrounding circumstances, relationship and character of the transaction and the manner in which parties treated the transactions will have to be considered. Hence, with reference to each transaction with directors and other person in whom the directors are interested, the nature of transactions has to be studied, in case they relates to book debts.

Interestingly, the Bombay High Court in a petition in *Fredie Ardeshir Mehta (Dr) v Union of India* (1991) 70 Com Cases 210, 213 (Bom) came to the conclusion that a company selling one of its flats to one of its directors on receiving half price in cash and agreeing to accept the balance in instalments does not give a loan to the director. It is a credit sale. It cannot be described even as an indirect loan. The court found support about the distinction between a loan and a credit from some income tax cases.

Ordinary course of business

One can find the phrase “ordinary course of business” in the Act in multiple places but it finds no place in the definition section of the Act. Proviso to section 188 (1) of the Act, on related party transactions exempts any transactions entered into by the company in its ordinary course of business other than transactions which are not on an arm’s length basis.

The Institute of Company Secretaries of India has issued a guidance note on related party transactions. It has listed many factors for consideration to decide whether a transaction is in the ordinary course of business or not. If the business is carried out by a company and revenue is generated in compliance of its objects clause of memorandum of association, broadly, one can say that the transactions entered into with the company with another party is in the “ordinary course of business”. Similarly, any transaction of purchase or availing services to carry on its own business also falls under ordinary course of business.

Quasi loan

There may be another situation when a company make a quasi-loan, when it pays sum of money for the director to a third person or reimburses expenditure incurred by a third party for the director in such circumstances that the director agrees or becomes liable to reimburse the company.

Such a transaction does not constitute a loan for the purposes of terming it as loans to directors. A company may issue a credit card to a director for use on company business. At times, some of the expenses incurred by a director through that credit card for his personal purposes and the company pays the dues on credit card to the credit card issued bank. Such expenses incurred by the director are to be reimbursed to the company by him and such amounts are not loans to directors.

Relaxation extended

Sub-section 2 to section 185 of the Act extends relaxation from the provisions of sub-section 1 of section 188 of the Act namely (a) special resolution is passed and (b) the loans are utilised by the borrowing company for its principal business activities. The same is reproduced below.

Section 185(2) - A company may advance any loan including any loan represented by a book debt, or give any guarantee or provide any security in connection with any loan taken by any person in whom any of the director of the company is interested, subject to the condition that—

(a) a special resolution is passed by the company in general meeting:

Provided that the explanatory statement to the notice for the relevant general meeting shall disclose the full particulars of the loans given, or guarantee given or security provided and the purpose for which the loan or guarantee or security is proposed to be utilised by the recipient of the loan or guarantee or security and any other relevant fact; and

(b) the loans are utilised by the borrowing company for its principal business activities.

From the above relaxation, it is clear that the explanatory statement needs to disclose full particulars of the loans given, or guarantee given or security provided. Therefore, one can very well understand book debts being in the ordinary course of business do not fall within the provisions of sub section 1 of section 185 of the Act.

Conclusion

In order to attract the provisions that a loan is represented by a book debt, the transaction has to be, from its inception, in the nature of loan or an advance to directors. If, for some compelling reasons, the business transactions fall outside the exemption provisions for related party transaction and need the necessary approvals, yet again after obtaining such approvals, amount shown as book debt would not be considered as loan.

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