

# Companies Act 2013

Helping raise the bar on 'Governance'

**Raajnish Desai**

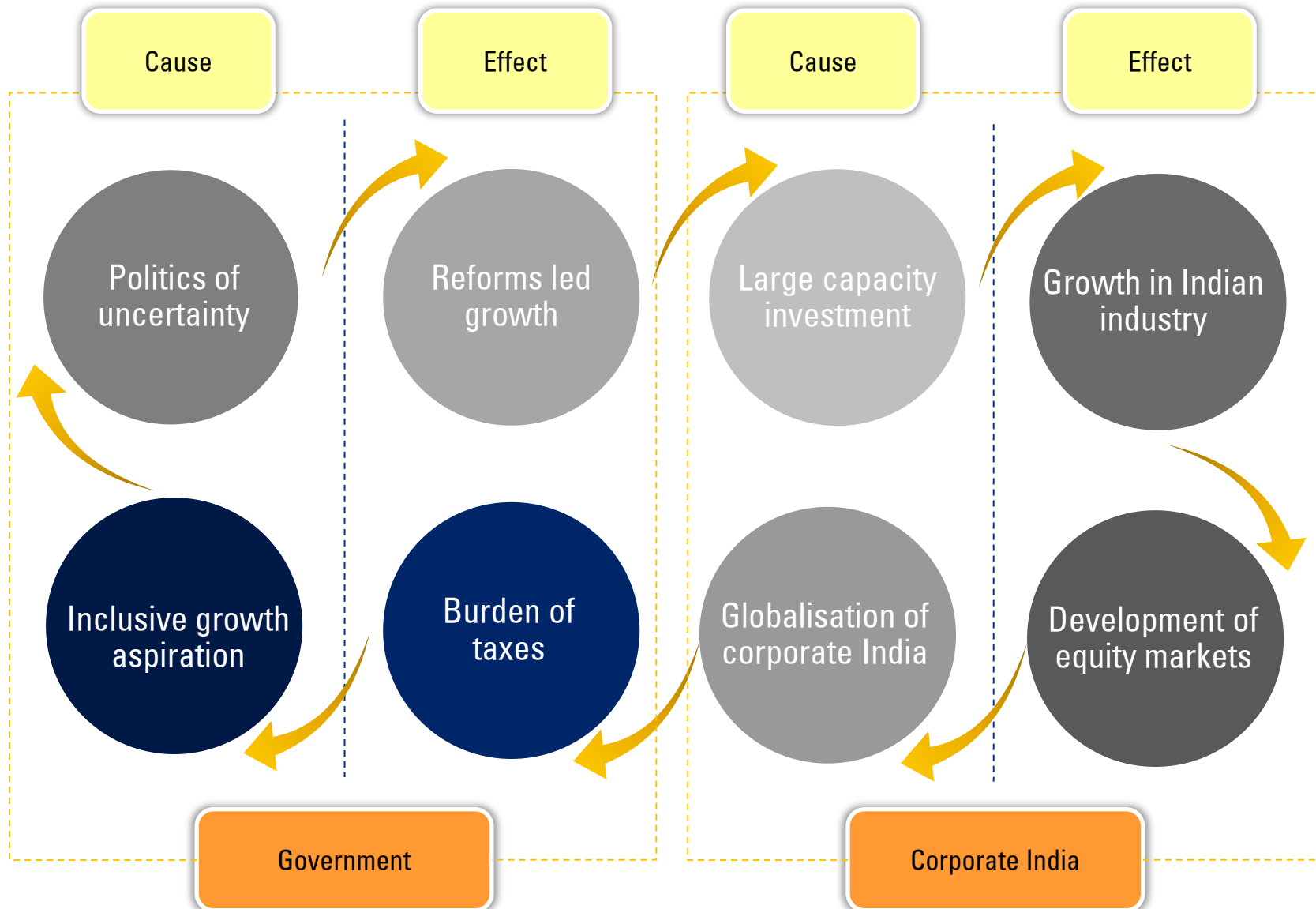
Chartered Accountant and Company  
Secretary

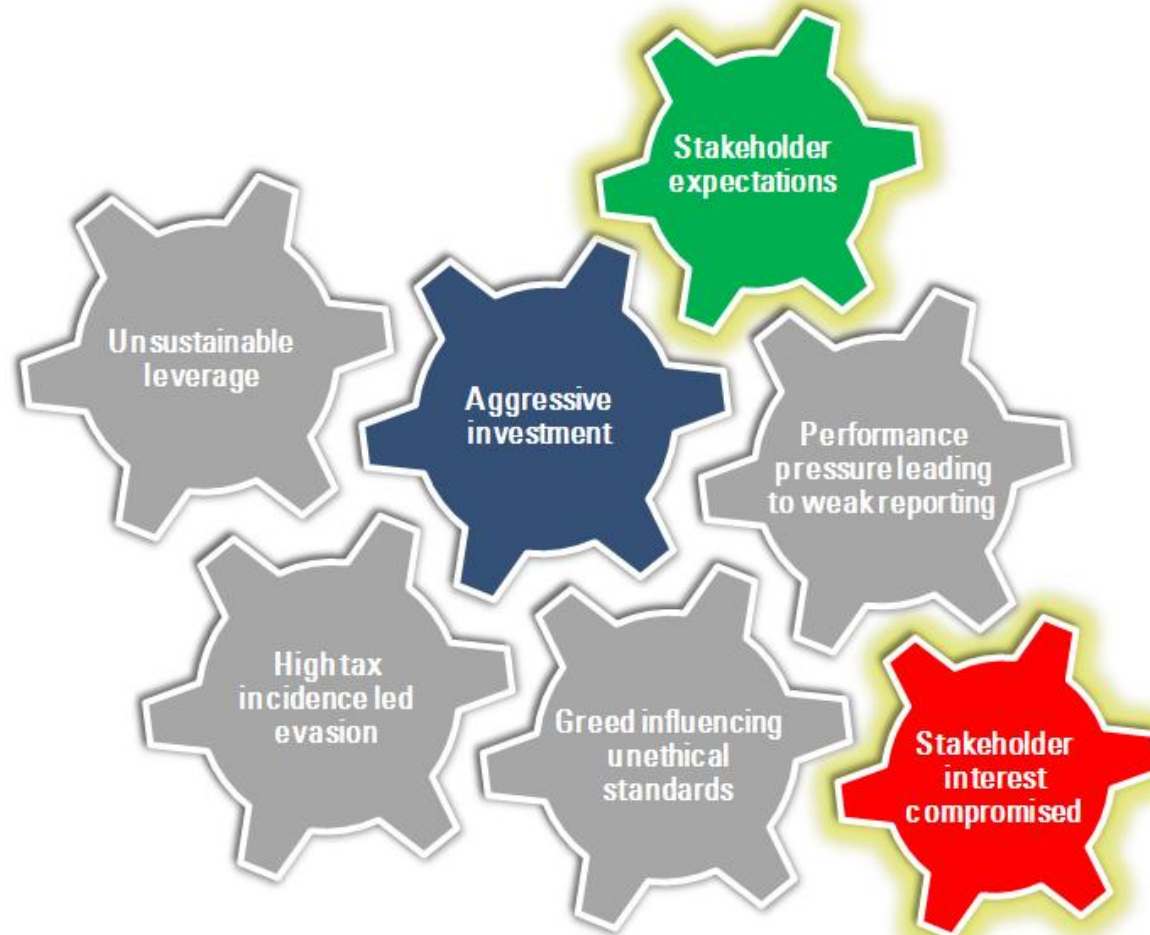
**8 March 2014**  
**Mumbai CPE Session**



# 1947-2013: Transformational forces in India have kept recalibrating the paradigm of 'Governance'

Companies Act 2013





Companies Act 1956 proving redundant for 'Investor Protection'

**Focus on**

**6**

**critical themes**

1. **Rigour on 'Increased reporting framework'**
2. **Higher 'Auditor accountability'**
3. **'Easing restructuring' of companies**
4. **'Onerous responsibility' on Board , Independent Director, Audit Committee, KMP**
5. **Push on 'Inclusive agenda' (CSR)**
6. **Emphasis on 'Investor protection'**

**Sweeping changes to help Companies raise the bar on 'Governance'**

### Companies Act 1956

**XIII Parts**  
(XXVI Chapters)

**~700+**  
Sections

**XV**  
Schedules



### Companies Act 2013 ('the New Act')

**XXIX**  
Chapters

**470**  
Sections

**VII**  
Schedules

#### **Consent of both Houses of Parliament:**

December 2012 (Lok Sabha) and  
August 2013 (Rajya Sabha)

#### **President assent:**

August 2013

#### **Draft Rules:**

Release in three phases. Two tranches issued in September 2013; Third tranche issued in Oct 2013. Fifth and Sixth tranche of Rules closed for public comment in Dec 2013.

#### **Effective date:**

99 sections made effective from 12 September 2013; others to follow



**Rigour on 'increased reporting framework'**

**Accounts, audit and types of committees (including Chapter IX and X of Rules)**

### Applicability

All companies:

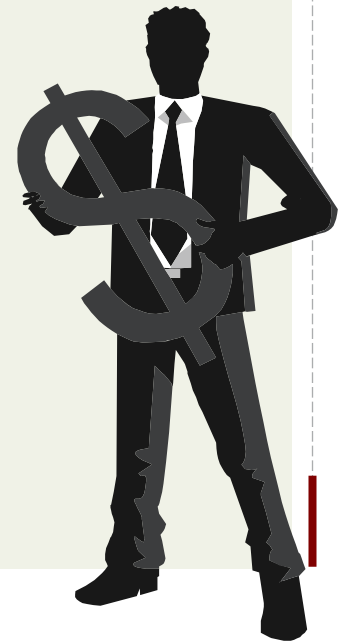
- Financial statements defined for the first time in the Companies Act and to include:
  - Balance Sheet
  - Profit and Loss Account/ Income and Expenditure Account
  - Cash flow statement
  - Statement of changes in equity, if applicable
  - Any explanatory note annexed to or forming part of the above

### Exceptions

- a. One Person Company (OPC), small company and Dormant company need not include the Cash flow statement
- b. Small company (Section 2(85) means a company other than a public company with a **paid up capital of Rs 50 lakhs; or turnover as per last P&L account does not exceed Rs 2 crores**; Exceptions: Holding companies/ Subsidiary companies/ Special Act companies

### Implication

- All companies other than OPCs/ small companies and dormant companies will have to present Cash flow statement and Statement of changes in Equity (if applicable)



### Applicability

All companies:

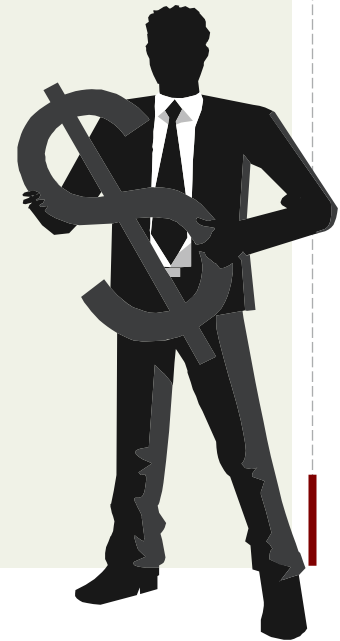
- to follow a uniform FYE 31 March
- to align with new requirement within two years from commencement of New Act
- incorporated on/after 1 January to close books on 31 March in the following year (i.e. more than 12 months period)
- If incorporated before 1 January, then the year-end will be 31 March (period would be less than one year)

### Exceptions

- a. Company/body corporate that is holding/subsidiary of a foreign company incorporated outside India. However, application to Tribunal (NCLT) necessary
- b. If required, to follow different FY for consolidation of accounts outside India
- c. Not clear whether it is a one-time application to the Tribunal

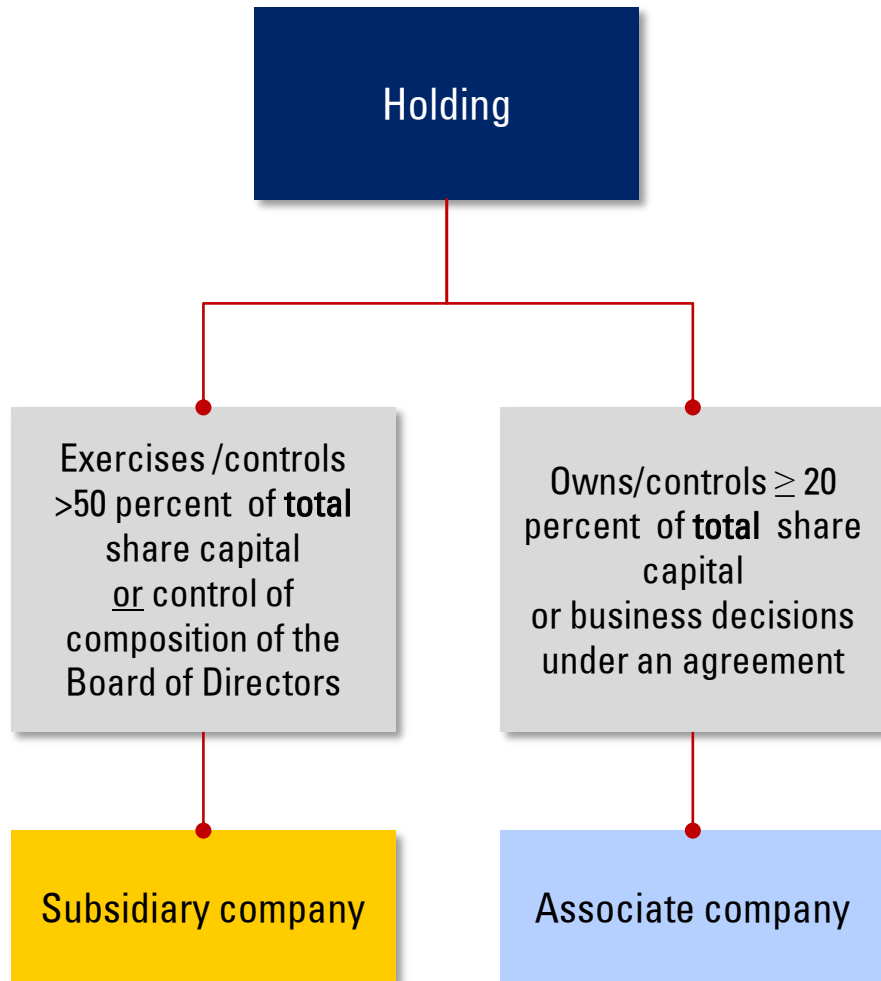
### Implication

- Companies in India following different FYE will have to change the FY





### Subsidiary / Associate: Section 2(6) and 2(87)



#### Requirement

- AS 21/23 conditions now in contradiction with the Act. Holding > 50/20 percent of 'nominal equity share capital' now replaced with 'total share capital'
- Associate: No rebuttable presumptions; includes joint venture

#### Implication

- Different sets of companies might be identified as subsidiaries/associates between AS 21/23 and the Act
- Will need clarity on whether Companies Act 2013 or Companies (AS) Rules, 2006 will prevail
- Private equity investees might be impacted



# Consolidated Financial Statements (CFS) required for all companies: Section 129

Companies Act 2013

## Applicability

Mandate for all companies to prepare CFS in respect of the following entities:

- Subsidiary; or
- Associate; or
- Joint venture company

## Requirement

- a. CFS will have to be done in addition to standalone financial statements
- b. Mandatory even if immediate parent overseas
- c. 1<sup>st</sup> proviso to Section 129: requires a statement containing salient features of the FS of the subsidiaries in prescribed form (could be similar to existing section 212 reporting) / Schedule III prescribes a format for reporting net assets and share in profit. **[Form 9.1 prescribed under Rules]**

## Implication

- Earlier, Clause 41 mandated only listed companies to prepare CFS
- Significant responsibility on unlisted companies and private limited companies
- Groups with complex tiered structures and private equity firms will have to prepare CFS at each intermediate holding company level



### Applicability

- Fraudulent financial reporting
- Mismanaged affairs casting doubt on financial statements
- Non-compliance with sections 129 or 134

Window open only for three financial years for voluntary restatement

### Requirement

Court/Tribunal may approve following applications:

- **Regulatory intervention:**
  - Central government; or
  - Tax authorities; or
  - SEBI; or
  - any other Regulatory authority
- **Voluntary application:**
  - Directors

### Implication

- Detailed process for revision, including involvement of current and previous auditors (may lead to frivolous litigations)
- May require current auditor to re-audit entire financial statements for one or more previous periods
- MAT implications to be evaluated if reported profits change on account of restatement



### Applicability

- 'Useful life' instead of 'standard mandated / minimum rates of depreciation'
- Prescribed companies to justify in case, 'useful life' is different from 'Schedule II'
- For other companies 'useful life' cannot be less than the useful life prescribed in Schedule II
- Double shift rate to be raised by 50 percent and triple shift: raised by 100 percent
- No specific provision for items up to INR 5,000

### Requirement

#### Transitional provision

- Depreciate carrying value less residual value over balance life. Adjust net worth if useful life exhausted

Illustration (Useful life reduced from 20 to 15 yr)	Case A	Case B
Useful Balance Life (Yrs)	5	0
WDV (INR)	100	100
Depreciation/Yr (INR)	20	100
Charged to	P&L	R&S

#### Component Accounting

- If cost of part of asset is significant and has useful life different from the remaining asset, useful life for that part could be determined separately for depreciation

### Implication

- Reduction in balance life in several cases
- Implementing component accounting would be burdensome especially for capital intensive companies
- Depreciation / useful life of intangibles not clearly specified



# Comparative snapshot of depreciation rates

Companies Act 2013

Nature	Companies Act 2013		Companies Act 1956 Single Shift (SLM)	
	Life (Years)	%	Life (Years)	%
<b>Building:</b> Factory building	30	3.34	30	3.34
<b>Building:</b> Others including temporary structure	3	33.33	1	100
<b>Plant and machinery</b>				
General	15	6.67	21	4.75
Continuous process plant	8	12.5	19	5.28
<b>Furniture and fitting:</b> General rate	10	10	16	6.33
<b>Motor vehicle</b>	8	12.5	9	11.31
<b>Office equipment</b>	5	20	14	7.07
<b>Computers and data processing units:</b>				
Servers and networks	6	16.21	6	16.21
End user devices such as desktop/laptop etc	3	33.33	6	16.21
<b>Laboratory Equipment:</b> General	10	10	14	7.07

Presuming no Residual Value

### Applicability

Internal financial controls:

- All listed companies – Directors and auditors report
- Others – only auditors report

Internal Audit: (i) All listed companies; and (ii) other public limited companies with:

- Loans from banks Fls/deposits  $\geq$  INR 25crore; or
- paid up capital  $\geq$  INR10crore

### Requirement

- a. Board's assurance on internal financial controls to cover
  - financial statements
  - ensuring orderly and efficient conduct of business
- b. Internal audit done only by
  - CAs; or
  - CWAs; or
  - other professionals decided by the Board

### Implication

- Amendments will be required to the CARO statement that was erstwhile only an ICAI guidance
- Coverage beyond SOX404 to include assurance on operations and business controls ?
- Extremely onerous requirement to document controls and procedures and testing the operative effectiveness of controls





**Higher 'auditor  
accountability'**

### Appointment

- Instead of reappointment at each AGM, auditor to be appointed for a block of five years, though to be ratified at each AGM

### Number of Audits

- Maximum of 20 companies can be audited by an individual auditor

### Extended authority to members

- At each AGM, members will have option to:
  - rotate audit partner/team
  - appoint joint auditor

### Extended disqualification /independence criteria

- If business relations with company/subsidiary/holding/associate
- If auditor's associates are involved in any prohibited services with the company
- Relatives of auditor included for independence

### Rotation Principles

- All auditors would be subject to rotation, except in case of One Person and Small Companies
- While a partnership firm would be eligible for two consecutive five year terms, an individual auditor would be eligible for only one such term
- Term prior to commencement of New Act will be retrospectively reckoned for computing 5-10 year validity
- After completion of audit engagement term, the auditor will be subject to a continuous five-year cool off period
- Incoming auditor cannot be an associate or from same network as the outgoing auditor
- Transition period of three years set to implement the change





### Non audit and Prohibited services

- Any service, other than statutory audit, rendered by the auditor required to be pre-approved by the Board or the audit committee.
- Notwithstanding above, the following services cannot be provided:
  - a. Accounting and book keeping
  - b. Internal audit
  - c. Design and implementation of financial information system
  - d. Actuarial services
  - e. Investment advisory services
  - f. Investment banking services
  - g. Rendering of outsourced financial services
  - h. Management services
  - i. Any other kind of services as prescribed

### Applicability

- Prohibited services cannot be provided either directly or indirectly to either the company or its holding or subsidiary companies
- Audit firms + related entities – can it potentially cover the whole network?

### Transition

- Ongoing prohibited non-audit services cannot be continued beyond the end of the first financial year after the date of the section becoming effective

### Implication

- Several services in the list of prohibited services may need to be precisely defined
- Tax services are not in the list of prohibited services

1

Observation, comments on financial transactions or **matters which have an adverse effect on the functioning of the company**

6

**Delays in depositing money into IEPF**

2

Qualification, reservation or **adverse remark** on maintenance of accounts

5

Provisions for **foreseeable losses** on long term/ derivative contracts

3

**Adequacy** of internal financial control system and **operating effectiveness** of such controls

4

Disclosure of effect of **pending litigation** on financial position

- Report to Audit Committee or Board on fraud committed against company by officers or employees
- **Escalate to Central Government if happening frequently or amount is material at 5 percent of net profits or 2 percent of turnover or if dissatisfied with action by audit committee or Board on immaterial frauds**

### NFRA role

- **Accounting and Auditing Regulator**
- Recommend accounting and auditing standards
- Monitor and enforce compliance of above standards
- Oversee **quality of services** of Chartered Accountants and suggest measures for improvement in quality of services – Quasi Judicial powers
- NFRA shall constitute a Chairman to be appointed by the Central Government and such other members not exceeding 15 consisting of part time and full time members
- NFRA Chairman and full time members to be independent during their appointment and for 2 years post ceasing to hold such appointment

### Power to investigate

- NFRA has powers of a Civil court of law and can require production of books of account and other documents, summoning and enforcing attendance of persons and examining them on oath, inspections of books of accounts and registers, issuing commissions for examination of witnesses or documents
- Power to investigate *suo moto* or on a reference made to it by the Central Government for such class of bodies corporate or persons
- If misconduct proved, severe penalties and power to debar a member/firm for upto ten years
- If NFRA initiates investigation, no institute/body to initiate/ continue any proceedings
- Appellate Authority to be constituted by the CG



**Push on 'Inclusive  
Agenda' (CSR)**

### Applicability

- Covers all companies in India meeting any one or more of the following conditions:
  - Sales  $\geq$  INR1,000CR
  - Net worth  $\geq$  NR 500CR
  - Net Profit  $\geq$  INR 5CR
- CSR contribution
  - 2% of average net profit **before tax** for last three financial years
- Contributions to be made towards causes listed under Schedule VII\*

### Administration and reporting

- Board to appoint a three-member CSR committee including one Independent Director
- Committee responsibility:
  - Formulate CSR policy;
  - Recommend CSR activities;
  - Monitor CSR expenditure
- Mandatory reporting on CSR under section 135
- In case of failure to spend, reasons to be disclosed. Penalties for non disclosure

### Implication

- Schedule VII and the Rules seem to hint at possibility of aligning business goals with social objectives
- No clarity on income-tax stand on allowability of CSR contributions
- Onerous responsibility on the Board to report and comply with a wide set of requirements and reports

\* **Hunger, Poverty, Education, Gender Equality, Child mortality, HIV/AIDS program, Environment, PM's National Relief and 'such other matters that may be prescribed'**

### Wide set of compliances to be taken care of:

- CSR Committee to make a responsibility statement: **'Complied with in letter and spirit'**
- Tax treatment to be decided by CBDT only
- Activities cannot be exclusively for benefits of employees/their families
- Only CSR in India is eligible
- Trusts, societies, foundations may carry out CSR activities on behalf of the company
- Activities on a collaboration/pool basis may also be acceptable

- Net Profit shall mean, net profit before tax as per books of accounts and shall not include profits arising from branches outside India.
- Mere donation and charity may not be allowed. CSR activity must be properly monitored and end use reported





## **Chapter XII**

# **Loans and Investments by Companies and other important provisions**

# Restrictions on giving loans to directors/interested parties



- **Section 185 prohibits loans to a director or another person in whom 'director is interested' (as defined in the section)**
  - Exception: those given in the **ordinary course of company's business** with interest not less than the bank rate declared by the RBI
  - Compliance should be ensured by both the lender and the borrower
  - **Section is effective from 12 September 2013**
- Prohibition also applies to giving guarantee or security for a loan taken by any of the aforesaid persons
- Applicability of provisions **extended** to private companies



# Restrictions on giving loans to directors/interested parties



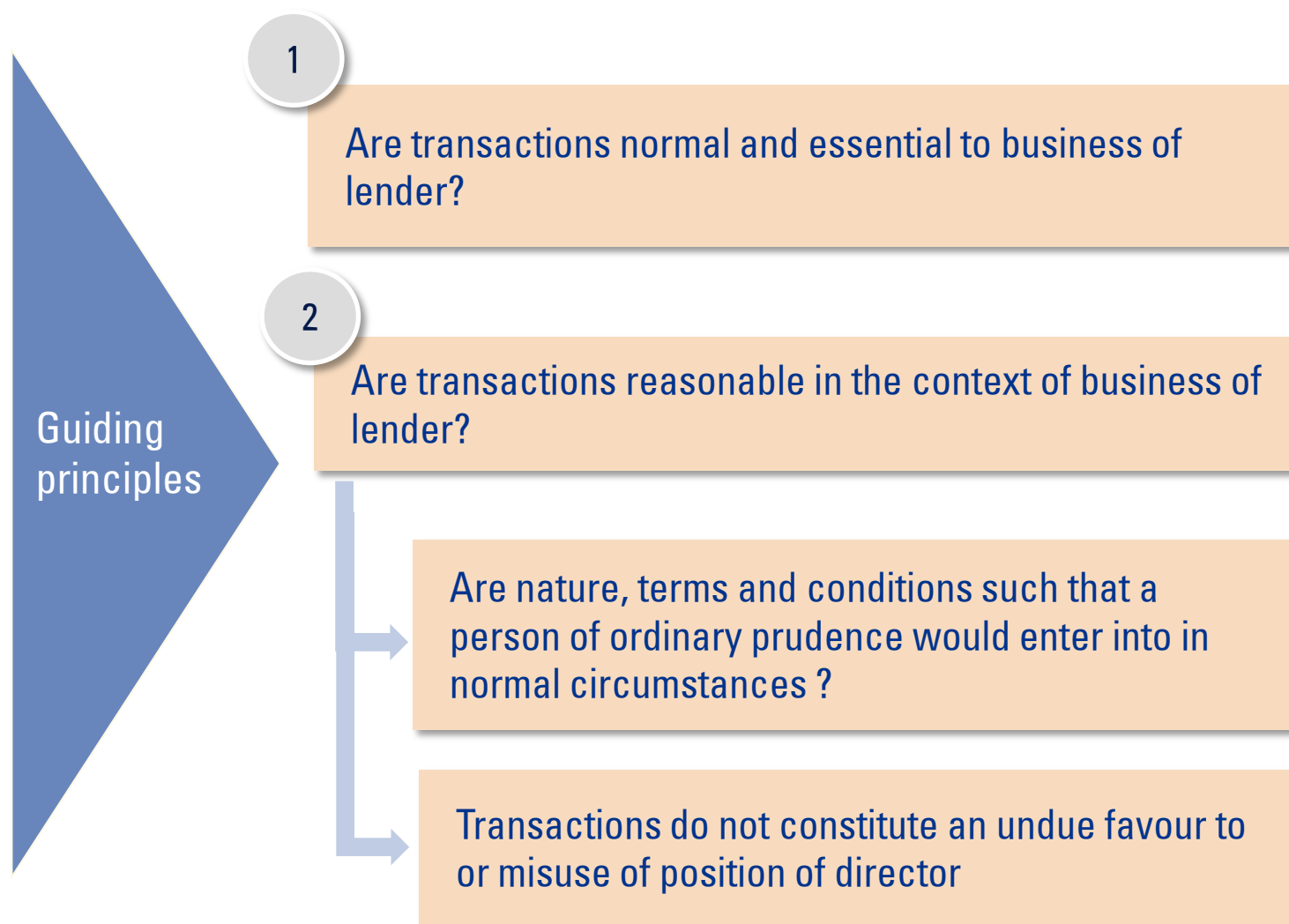
- Person in whom director is interested (defined)
  - Director of the lending company
  - Any company which is its Holding Company
  - Partner or relative (section 2[77] :**15 prescribed relations**) of such Director
  - Private company of which such director is a director or member
  - any body corporate, more than 25% of total voting power exercised or controlled by any such director/s
  - Any body corporate, BOD/ MD/ Manager **accustomed to act** in accordance with the directions of the Board/ Directors of lending company

# Loans etc. in the 'ordinary course of business' exempt

## What is ordinary course of business?

May not be considered as the same as "principal business"

To be analyzed on a case to case basis



# Loan from parent to subsidiary

- No general exemption as was available in section 295 of the 1956 Act
- Loan/security/guarantee permissible if :
  - It satisfies the criteria of being in “ordinary course of business”
  - If the criteria of being in ordinary course of business is not satisfied, the loan/security/guarantee **would not be permissible if:**
    - it is to a private subsidiary company of which any director of holding company is a director or member or
    - if 25 percent or more of the total voting power in the subsidiary company is controlled by one or more directors of the holding company (in their own right) or
    - if the subsidiary company or its Board of Directors or its MD is '**accustomed to act** as per instructions or directions of the Board of the holding company or of any of its directors'

Requires assessment of attendant facts  
Support assessment by a legal opinion

### 'Accustomed to act'

#### 'Main propositions'

- ✓ Some sort of general conduct indicating habit of following instructions/directions of third person; no exercise of own discretion/ judgment
- ✓ Meant to hold responsible those persons who truly control the company, i.e. are able to pull the strings by appointing as directors their own subservient
- ✓ Body corporate/ individual holding > 50% voting power or controlling composition of majority of directors has the power – **one will need to determine whether this power is habitually exercised**
- ✓ Body corporate or individual which though holding less than majority voting power, controls whole/ majority of Board would be covered if it/he habitually exercises the control

# Restrictions on giving loans



- Book debt considered as a loan if from its inception it was in the nature of a loan
- Letter of support from the parent company taken by a subsidiary company in financial difficulty (where the holding – subsidiary relationship is covered by Section 185) not prohibited
- Section does not hit investment in preference or equity shares of any of the companies in which directors are interested
  - Limits of section 372A of the 1956 Act apply (60% of paid up capital and free reserves or 100% of free reserves whichever is higher) till section 186 notified

# Existing loans

- Loans (or guarantees or security) given pursuant to section 295 of the 1956 Act but not allowed under section 185 of the 2013 Act (e.g. loan given to a director by a private company)

Whether they require immediate repayment?

- Diversity of views – no authoritative clarification yet available
- If independent legal advice supports that immediate repayment (or withdrawal) is not required
  - Position may be accepted
  - Relevant loans etc. to be considered in applying limits of section 372A/section 186 (once notified)
  - Renewal of such loans only in accordance with section 185 read with limits under section 372A/section 186 (once notified)

# Loans and investments (Section 186) – yet to be notified

## Section 186 makes significant changes to existing provisions

- Companies generally prohibited from making investments through more than two layers of investment companies
  - Exceptions
    - Overseas investee having more than two layers as per local laws
    - Where larger number of layers is required to meet any law/rule/regulation
- Limits remain the same: except that securities premium included in the 2013 Act. Further all loans including those made to other than bodies corporate to be included.
- Unlike 1956 Act:
  - **Holding company's loans/security/guarantee (only those permitted under section 185) and investment in wholly-owned subsidiary not to be excluded in applying limits**
  - **Limits also cover loans made/guarantees or security given by a private company**
- Disclosures in financial statements regarding loans/guarantees/security, including proposed utilisation
- **Rate of interest on loans to be not less than prevailing yield on 1/3/5/10 year government security (closest to loan's tenure) – presently, bank rate**

Section 372A of 1956 Act continues to apply till section 186 is notified

# Related party transactions (Section 188)



- **Related parties [Section 2(76)]**

- Specifically defined

- Coverage significantly wider than AS 18 e.g.

- much larger list of relatives compared to AS 18 (members of HUF, spouse and, as per draft rule 1.4 other relationships)
- management at one level below executive directors
- functional heads even of holding/subsidiary/associate

- Coverage of related party transactions increased as compared to the position as per the 1956 Act

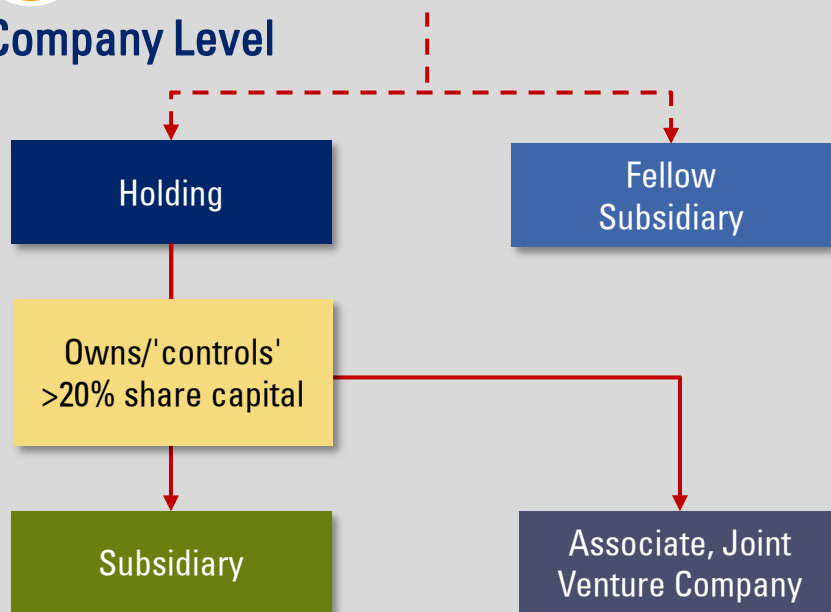
e.g. leasing of property of any kind; related party's appointment in the company, its subsidiary or associate company



Distinct from the 'Related Party' definition per AS 18

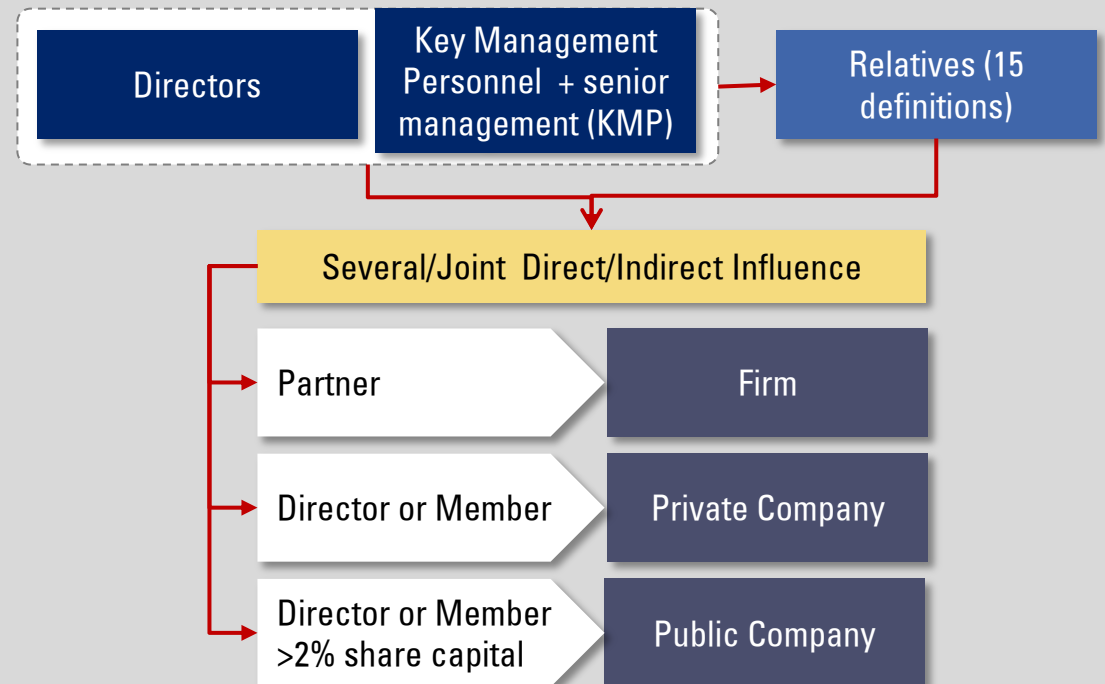
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### Company Level



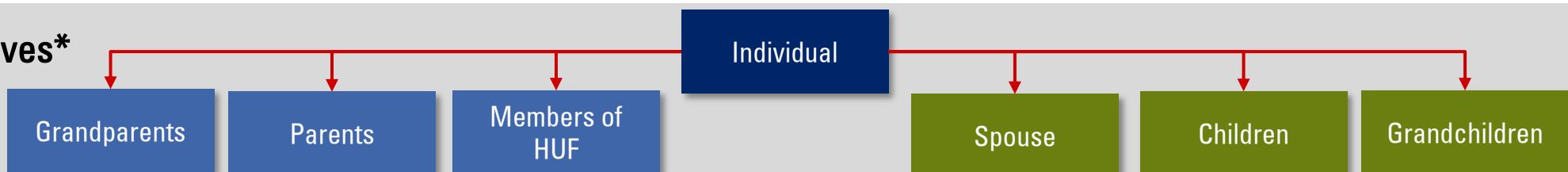
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### Management Level



3

### Relatives\*



\* Including step relations

### Applicability

- Transactions in ordinary course of business on 'arm's length' basis permissible
- Other cases such as following will need board approval :
  - **Sale, purchase** of goods, services, **leasing** of property
  - Appointment to any office or **place of profit** in company, subsidiary or associate
  - **Remuneration**  $\geq$  INR 1lac pm
  - **Underwriting subscription** of any securities or derivatives  $\geq$  10lac
- Central Government approval not required (anymore)

### Requirement

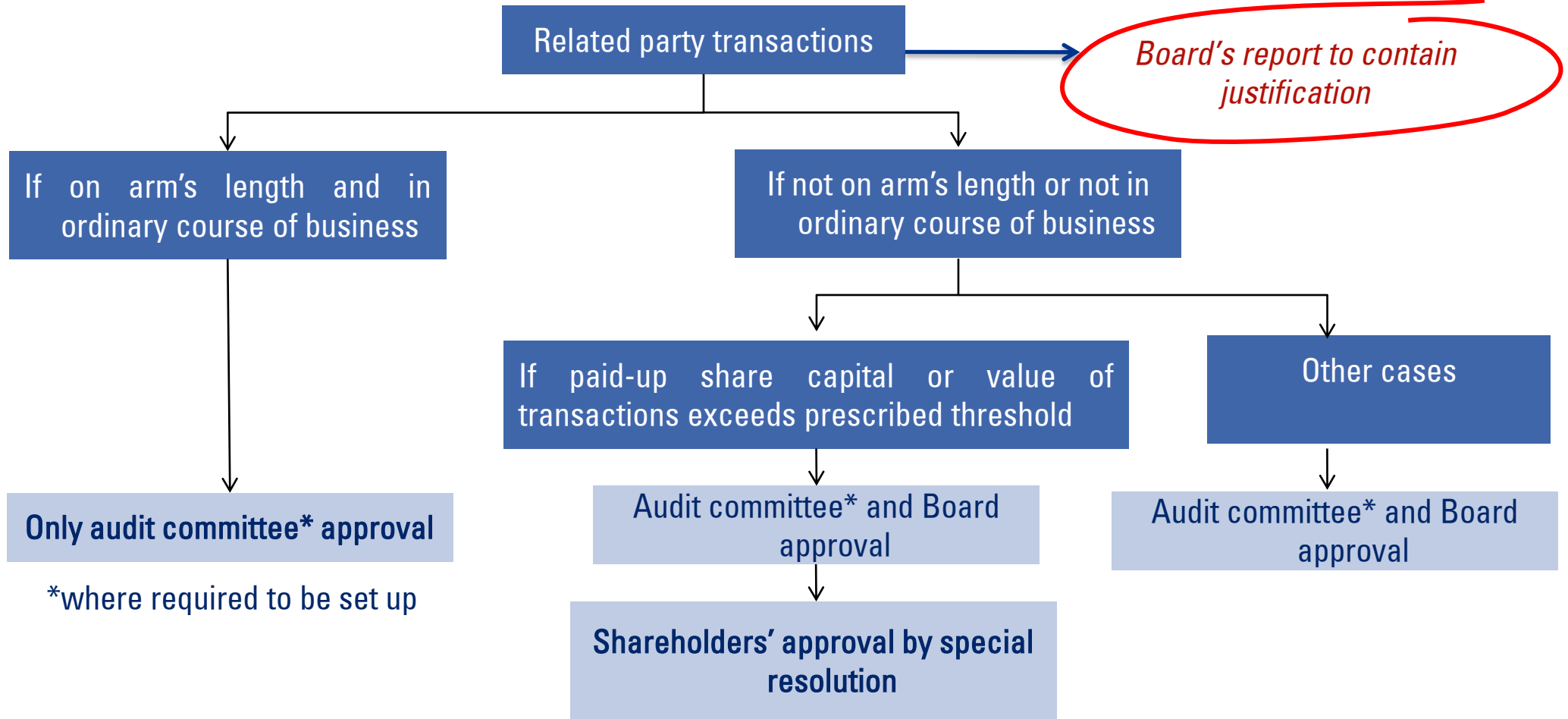
- **Special resolution** for 'non arms-length' transactions required in following cases:
  - **Share capital**  $>$  INR 1CR
  - **Sale, purchase** of goods, services, **leasing** of property with transaction value  $>$  :
    - 5% of annual turnover; or
    - 20% of net worth
  - Appointment to any office or **place of profit** in company, subsidiary or associate for **Remuneration**  $>$  INR 1lac pm
  - **Underwriting subscription** of securities or derivatives for remuneration  $>$  INR10lac

### Implication

- **Related party definition becoming broader and onerous**
- 'Arm's length' in ordinary course of business may be too subjective to defend
- Company will have to maintain robust system of continuously monitoring records and list of 'related parties'
- Member classified as 'related party' **debarred from voting** on any 'related party transaction' even if he is not involved in instant case



# Related party transactions



*Board's report to contain justification*

If on arm's length and in ordinary course of business

Only audit committee\* approval

\*where required to be set up

If not on arm's length or not in ordinary course of business

If paid-up share capital or value of transactions exceeds prescribed threshold

Audit committee\* and Board approval

Shareholders' approval by special resolution

Other cases

Audit committee\* and Board approval

Paid up share capital equals or exceeds INR 10 million

**Prescribed thresholds (as per draft Rules**

Related party transactions exceed threshold limits of **5%** of annual turnover or **20%** of net worth

**Central Government approval no longer required**

# Related party transactions

- Transactions entered into without approval of board/members (where so required)
  - voidable at board's option if not ratified within 3 months
  - for such transactions with parties related to a director or authorised by a director, director to indemnify for loss
- **Stringent punishment for non-compliance**
  - Company may proceed against defaulting director or other employee for recovery of loss
  - Imprisonment and/or fine for defaulting director/employee (imprisonment only for listed company)

## Disclosure of interest by directors

- **Disclosure required for contract/arrangement entered/proposed to be entered into with:**
  - a body corporate in which the director(s) hold more than 2% shareholding or where a director of the company is a promoter, manager, chief executive officer of that body corporate
  - a firm or other entity in which such director is a partner, owner or member
- **Interested directed prohibited from participating**
- **Contract/arrangement entered into without disclosure (or with participation by interested director)**
  - voidable at the option of the company

## Related party transactions: “Arms length”

- **No methods/ approaches specified to determine ‘arm’s length transaction’**
  - Comparison of the terms with those of an identical or similar transaction with one or more unrelated parties
  - Comparison of the terms to known market terms for identical or similar transactions
  - Consider not only price but also other terms and conditions e.g. credit terms, contingencies, specific charges
  - **Involvement of an external expert to determine market value and confirm market terms and conditions**
  - **Guidance from TP regulations may also be taken**
- Definition in Act to be used for legal/ regulatory purposes only
  - AS 18 disclosures to still be as per definitions of AS 18

Different from AS 18

### Prohibition on Insider Trading

- No director/KMP shall be involved in forward dealing or buying options in shares or debentures of company/ holding company/ subsidiary/ associate
- No company person including any Director or KMP with **access to non-public price sensitive information** to indulge in any form of insider trading including counseling.
- *Price sensitive information: means any information which relates directly or indirectly to any company and which if published is likely to materially affect the price of securities of the company*

### Non-compliance

- Non compliance would entail:
  - imprisonment up to five years; or
  - fine up to INR 25CR or three times profits made, whichever is higher; or
  - both of the above

## Mandatory secretarial audit (Section 204)



- Every listed company and a company belonging to other class of companies as may be prescribed to annex to its Board report a secretarial audit report given by a Company Secretary in practice
  - Board is required to explain in full any qualification or observation or remark made by the CS in practice in his report
  - Non-compliance with this section: company/ officer/ CS in practice in default shall be punishable with fine between Rs 1 lakh-Rs 5 lakhs



- **Voting through electronic means (Section 108)**
  - The Central Government to prescribe the class or classes of companies and the manner in which a member may exercise his right to vote by electronic means
- **Maintenance and inspection of documents in electronic form (Section 120)**
  - Documents, records and registers permitted to be kept and inspected in electronic form in the form and manner as may be prescribed



## Private placement of securities (Section 42)



- Companies are permitted to make private placement of securities subject to compliance with this section
  - No of persons to whom offer made **cannot exceed 50** (excluding QIBs and employees of the Company under an ESOP scheme) in each financial year
  - Explanation 1 to Section 42 covers all scenarios: listed co/ unlisted co/ offer/ invitation to subscribe/ company intends to list securities on a stock exchange in India or outside deemed to be an offer to the public
  - No fresh offer can be made unless the allotments of an earlier offer have been completed or the offer/ invitation is abandoned
  - Monies payable towards subscription shall be paid through cheque to demand draft or other banking channel but not by cash
  - Company required to allot securities within 60 days or refund application money within 15 days thereafter. Interest at 12% payable on delay in refund.

## Private placement of securities (Section 42)



- Companies are permitted to make private placement of securities subject to compliance with this section
  - Monies received on application to be kept in a separate bank account in a scheduled bank and utilized for adjustment against allotment or repayments/ refunds
  - Company required to make an offer to persons by name. Company to keep record of all offer made and file with Registrar within 30 days complete information on private placement offers made
  - Prohibition on use of public advertisements/ media/ marketing or distribution channels or agents to inform the public at large
  - Company to file with Registrar a return of allotment
  - Contravention: Company/ its promoters/ directors shall be liable for penalty extending to the amount of offer/ Rs 20 million whichever is higher. Company required to refund all monies within 30 days of imposition of penalty.



**In summary**

1. Rigour on **'increased reporting framework'**
2. Higher **'auditor accountability'**
3. **'Easing restructuring'** of companies
4. **'Onerous responsibility'** on Board , Independent Director, Audit Committee, KMP
5. Push on **'Inclusive agenda'** (CSR)
6. Emphasis on **'Investor protection'**

# 6

Ways to improve  
**'Value'**

Great opportunity for companies to raise their bar on  
**'Governance'**



## Q&A



**Thank you**

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