Advisory

Companies Act 2013

Raising the bar on Governance

The recently enacted Companies Act, 2013 (the New Act) is a landmark piece of legislation and likely to have far reaching consequences on all companies incorporated in India. The erstwhile Companies Act, 1956 was in existence for well over fifty years and was lately seeming quite ineffective at handling present day challenges of a growing industry and the complexities related with the growing stakeholders' interests.

The New Act promises to substantively raise the bar on governance and in a comprehensive form purports to deal with some very relevant themes. On the flip side, it appears to be quite pervasive and thrusts greater responsibility and obligation on the Board of Directors and Management in Indian companies.

The KPMG in India team takes a closer look at the important changes and developments to help companies assess the impact and develop a clear strategy on compliance and governance.

Theme 1: Increased Reporting Framework

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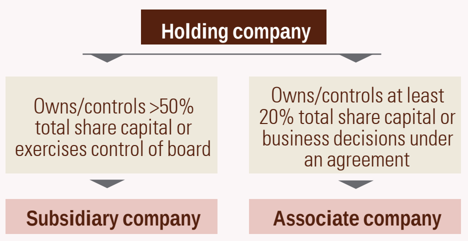
New definition of subsidiary, associate, Joint Venture company [sections 2(6) and 2(87)]



Financial Year to be uniform

a. All companies to follow uniform FYE 31 March
b. Exemptions (subject to conditions and approval process) if a company is:
   – A holding/ subsidiary of a company incorporated outside India; and
   – Required to follow a different FYE for consolidation of its accounts outside India
c. Transitional compliance phase: Two years

Mandatory requirement for Consolidated Financial Statement (CFS) [section 129]

a. In addition to standalone financial statements, every company to prepare CFS if it has a:
   – Subsidiary; or
   – Associate; or
   – Joint Venture company
b. No exemption for intermediate holding companies for preparing CFS

> **Penalty for violation:**
> **Officer in default:**
> Imprisonment one year; Fine between INR 50,000 – 500,000

Revision in Financial Statement [sections 130 and 131]

a. Pursuant to an order made by a court or Tribunal on an application for revision of financial statements made as under:
   – by the Central Government, Income-Tax, SEBI etc. in the following cases
     • Fraudulent financial reporting; or
     • Mismanaged affairs casting doubt on financial statements; or
   – by the Directors of a company only in the following cases:
     • Financial statements and Board Report are non-compliant; and
     • Voluntary restatement by Directors possible only for the past three years

Changes in Depreciation regulation [section 123(2) and Schedule II]

a. Concept of Useful Life takes prominence over standard mandated rates
b. Justification required where Useful Life ≠ Schedule II for prescribed companies. Other cases Useful Life ≤ Schedule II
c. Applicability of Component Accounting
d. Transitional provision: Depreciate carrying value less residual value over balance life. Adjust net worth if useful life has been exhausted

Mandatory Internal Audit and reporting on Internal Financial Controls [section 138]

a. Assurance on adequacy and effectiveness of Internal Financial Controls (which includes orderly and efficient conduct of business, and prevention and detection of frauds and errors) to be given:
   – in Directors and Auditor's report for all listed entities; and
   – only in Auditor's report for all other entities
b. Internal Audit made mandatory for:
   – all listed companies; and
   – public limited companies with:
     • loans/deposits ≥ INR 250 mn ; or
     • paid up capital ≥ INR 100 mn
c. Internal audit to be done only by CAs; or CWAs; or other professionals decided by the Board

> **Penalty for violation:**
> 1. Company: Fine between INR 50,000 – 2,500,000
> 2. Officer in default: Imprisonment up to three years; fine between INR 50,000 – 500,000

Theme 6: Inclusive CSR Agenda

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Obligation Trigger and Calculation

a. Covers all companies in India meeting any one or more of the following conditions:
   – Turnover ≥ INR10 bn
   – Networth≥ NR 5 bn
   – Net Profit ≥ INR 50 mn
b. CSR contribution to be 2 percent of average net profit before tax for last three financial years
c. Contributions to be made towards causes listed under Schedule VII

Administration and Reporting

a. Board to appoint a three-member CSR committee including one Independent Director
   – Committee responsibility:
   – Formulate CSR policy;
   – Recommend CSR activities;
   – Monitor CSR expenditure
b. Mandatory reporting on CSR under section 135
c. Even where companies are not required to appoint Independent Directors under section 149, in case a company does meet the criteria under section 135, it will have to mandatorily appoint one Independent Director on the Board
d. In case of failure to spend, reasons to be disclosed. Penalties for non disclosure

> **Penalty for violation:**
> i. **Company:** Fine between INR 50,000 – 2,500,000
> ii. **Officer in default:** Imprisonment upto 3 years and / or Fine between INR 50,000 to INR 2,500,000

Theme 5: Wider Director and Management Responsibility

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Mandatory Director Appointment

Company parameters	≥1 Director Resident in India ≥182 days	≥1 Woman Director	≥1/3rd Independent Director	Audit Committee	Nomination and remuneration committee
Listed	✓	✓	✓	✓	✓
Unlisted (All)	✓				
Share Capital ≥ INR 1 bn		✓	✓	✓	✓
Turnover ≥ INR 3 bn		✓	✓		
Loan/Debentures/ Deposits ≥ INR 2 bn			✓	✓	✓

> **Penalty for violation:**
> i. **Company:** Fine between INR 100,000 – 500,000
> ii. **Officer in default:** Imprisonment upto one year; fine between INR 25,000 – 100,000

Additional Responsibility on Independent Directors [section 149]

a. Code of Professional Conduct imposing stringent responsibility and accountability
b. Maximum term of five years extendable by another five years subject to a special resolution
c. Retirement by rotation not applicable
d. Liable only for acts with knowledge of and attributable through Board Process and with his consent or connivance or not having acted diligently
e. Direct/indirect pecuniary/other relationships through relatives not permitted
f. Declaration of Independence mandatory each year.
g. Stock options not permitted. Only sitting fees and profit related commission.
h. Independent directors to hold one annual meeting where no non-independent director, KMP or Senior Management can attend.

Audit Committee [section 177]

a. Composition:
   – Mandatory for prescribed companies to constitute an Audit Committee
   – ≥ three directors (majority should be Independent Directors)
b. The Chairperson and majority of the Audit Committee members should have the ability to read and understand financial statements
c. Responsibilities:
   – Recommend appointment, remuneration of auditors and monitor their independence and effectiveness
   – Examine financial statements and auditor's report thereon
   – Approve related party transactions
   – Scrutiny of inter-corporate loans and investments
   – Undertake asset valuation
   – Evaluate internal financial controls and risk management systems
   – Monitor end use of funds raised through public offers

Content of Directors Report [section 134]

a. All companies to, inter-alia, state:
   – Devised proper systems to ensure proper compliance with all applicable laws in India and that this system is operating effectively.
   – Taken proper and sufficient care for maintenance of adequate accounting records for safeguarding assets and preventing and detecting fraud and other irregularities.
   – On development and implementation of a risk management policy
b. Listed and prescribed companies to state:
   – Internal financial controls have been laid down and they are operating effectively.
   – Manner in which performance evaluation of the Board members have been conducted.

> **Penalty for violation:**
> i. **Company:** Fine between INR 50,000 – 2,500,000
> ii. **Officer in default:** Imprisonment upto three years and /or fine between INR 50,000 to INR 500,000

Theme 2: Higher Auditor Accountability

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Auditor Appointment and Rotation

a. Maximum 20 audits permitted per individual Auditor/Partner of a firm
b. Instead of reappointment in each AGM, Auditor to be appointed for a block of five years:
   – Individual Auditor eligible for appointment of single block of five years; and partnership audit firms to be eligible for appointment of additional consecutive block of five years
   – Auditor to be subject to a five-year cooling period post completion of his previous term
   – Incoming Auditor cannot be an associate or a network firm in relation to the outgoing Auditor
   – Transitional compliance phase: Three years
   – As per draft rules, pre-commencement term to retrospectively apply for computing balance validity of current Auditor's tenure prior to reappointment
c. Significant restrictions on non-audit services that can be provided by Auditors. All non-audit services to be pre-approved by the Board or Audit Committee
d. National Financial Reporting Authority (NFRA) to be the new regulator for Auditors and will have powers to recommend, enforce and monitor compliance of accounting and auditing standards

Auditor's Reporting Responsibility

a. Audit report to cover:

1. Observations, comments on financial transactions and adverse matters
2. Qualification or adverse remark on maintenance of accounts
3. Adequacy of internal financial control system and effectiveness
4. Disclosure of effect of pending litigation on financial position
5. Provisions for foreseeable losses on long term/derivative contracts
6. Delays in depositing money into IEPF

b. Report to Audit Committee or Board on fraud committed against company by officers or employees and 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

Theme 3: Easier Restructuring

3

Rationalizing Multilayered Structures

a. Maximum of only two Investment SPV company levels permitted between investor company and investee company

> **Penalty for violation:**
> 1. Company: Fine of INR 25,000 – 5,00,000
> 2. Office in default: Imprisonment upto two years; fine INR 25,000 – 1,00,000

b. Exemption:
   – Acquisition of overseas subsidiary with existing multiple layers allowed under foreign law; or
   – Multi-layering required under any law in force

Simplifying Procedures for Merger [section 232]

a. National Company Law Tribunal (NCLT) to approve schemes of restructuring companies in place of High Court
b. Auditor to certify that accounting treatment specified in the Scheme conforms with Accounting Standard for listed, unlisted and private companies
c. Consent of majority Members/ Creditors >75 percent (in value)
d. Merger of listed company into unlisted company allowed subject to:
   – Exit opportunity being provided to public shareholders; and
   – Valuation is done as per SEBI guidelines

Minority buy-out [section 236]

a. Acquirer holding ≥90 percent share capital (in value) may notify intent to buy-out balance equity shares
b. Exit valuation to be done by **Registered Valuer [section 247]**
c. No opportunity provided for minority to dissent

Cross-border Merger [section 234]

a. Merger of Indian company with foreign company and vice-versa now permitted
b. Central Government to make necessary Rules in consultation with RBI and notify permitted jurisdictions
c. Merger to be approved by NCLT
d. Consideration only in cash or Depositary Receipts

Fast-track Merger [section 233]

a. Merger between the following entities possible without NCLT approval:
   – Two or more small companies; or
   – Holding and wholly owned subsidiary; or
   – Prescribed types of companies (list awaited)
b. Declaration of Solvency required to be submitted
c. Consent required from:
   – Members owning > 90 percent of total number of shares
   – Majority creditors owning 90 percent in value

Share capital reduction [section 66]

a. No share capital reduction permitted in companies that have overdue deposit / interest
b. No buy-back permitted until after three years from remediation of defaults on deposits; preference shares; or term loans
c. Multiple buy-back within a year not permitted
d. Schemes of arrangement involving buy-back/capital reduction to require Auditor's certificate and comply with conditions of section 66/68

Theme 4: Emphasis on Investor Protection

4

Related Party Transactions [section 188]

a. Transactions in ordinary course of business on arm's-length basis permissible. Central Government approval not required anymore
b. Board approval required where transactions are either not in the ordinary course of business /not at arm's length.
c. Special resolution, where no related party can vote, required for non-arm's length transactions or transactions not in the ordinary course of business where
   – Share capital > INR 10 mn; or where
   – Sale, purchase of goods, services, leasing of property transaction value exceeds 5% of annual turnover or 20 percent of networth

> **Penalty for violation:**
> i. Contract may be rendered as void
> ii. Directors concerned to indemnify the loss
> iii. Director / employee involved can be fined and imprisoned (in case of a listed company)

   – Appointment to any office or place of profit in company, subsidiary or associate
   – monthly reummeration > INR 100,000
   – Remuneration for underwriting subscription of any securities or derivatives – remuneration >INR 1 mn

Insider Trading [sections 125, 194, 195]

a. Director/Key Managerial Personnel (KMP) to refrain from forward dealing/ buy options in shares or debentures of company/ holding company/ subsidiary/ associate
b. No company person (incl. any Director/KMP) with access to non-public price sensitive information to indulge in any form of insider trading/counseling.

> **Penalty for violation:**
> i. imprisonment up to five years; or
> ii. fine up to INR 250 mn or three times profits made, whichever is higher; or
> iii. both of the above

Oppression and Mismanagement [section 241-246]

a. Members or Depositors may notify Tribunal if company conduct is prejudicial to their interests
b. For fraudulent, unlawful or wrongful act; or improper or misleading statements, Class Action Suit can be filed on:
   – Company or its Directors; or
   – Auditor/audit firm; or
   – Expert/advisor/consultant
c. Who can file Class Action Suit:
   – 100 or 10 percent of total number of members
   – 100 or 10 percent of total number of depositors
   – Member(s) holding ≥10 percent of issued share capital
   – Depositor(s) holding ≥10 percent of outstanding value of deposits

Fraud Risk Mitigation

a. Fraud defined/referred to under various sections and includes:
   – Act; or
   – Omission; or
   – Concealment of fact; or
   – Abuse of position
   – Considered fraud whether or not there is any wrongful gain or loss
b. Senior Fraud Investigation Officer (SFIO) made statutory body with significant powers
c. Mandatory establishment of vigil-mechanism for directors/ employees to report concerns

> **Penalty for violation:**
> Imprisonment [3-10 years]; cognizable offence without bail

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Impact on various stakeholders

Board of Directors
- Accountability to stakeholders well beyond only shareholders
- Reporting beyond traditional SOX coverage
- Liability on Class Action Suits
- Significant penalties on Insider Trading and restatements
- Public scrutiny on CSR
- Compliance on Related Party Transactions
- Mandatory roll-out of whistle-blower vigil mechanism
- Mandate on gender diversity

Promoters
- Multi-layered structures to be collapsed
- Cross-border transactions allowed
- Mandatory CSR contribution will affect cash flows
- Wider definition of Related Party Transactions
- Heavy penalties introduced on Insider Trading
- Lower consolidation threshold may invite greater scrutiny [PE Firms to be impacted]
- New depreciation rules may affect profitability

Independent Directors
- Oversee implementation of best corporate governance practices
- Safeguard interests of all stakeholders
- Ensure adequate and functional vigil mechanism
- Determine appropriate levels of remuneration for Directors and KMP
- Compliance on Related Party Transactions
- Prime accountability on CSR compliance
- Liability on Class Action Suits

CXO and Key Management Personnel
- Ease of restructuring
- Reporting beyond traditional SOX coverage
- Wider definition of Related Party Transactions
- Lower consolidation threshold may invite greater scrutiny
- New depreciation rules may affect profitability
- Liability for Class Action Suits
- Significant penalties on Insider Trading and restatements

Audit Committee
- Additional rigour on financial reporting
- Mandatory internal audit
- Reporting beyond traditional SOX coverage
- Significant penalties on Insider Trading and restatements
- Compliance on Related Party Transactions
- Monitoring inter-corporate loans and investments
- Evaluation of internal financial controls

Multi National Corporation
- Lower thresholds for financial consolidation
- Mandatory contribution to local CSR
- Wider definition of Related Party Transactions
- Ease in cross-border restructuring
- Facility of minority buy-out
- Liability for Class Action Suits
- Board meetings through video conference
- One Resident Director mandatory
- Additional reporting responsibilities in Board's Report

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Printed in India.