Companies Act 2013: Beginning of a new era
Dear reader,

We are delighted to share with you our new publication *Companies Act 2013: Beginning of a new era*.

The MCA has so far notified and made effective 283 sections, out of total 470 sections of the 2013 Act. The MCA has also issued final rules relating to 19 chapters, covering most of the notified section. To address practical issues, the MCA has also amended Schedule II (regarding depreciation), proposed/issued three orders for removal of practical difficulties and issued certain General Circulars to provide more clarity.

The enactment is a milestone event with far-reaching consequences. Companies should not underestimate the impact of new law. The MCA has addressed some key pain areas for companies; however, implementation of the 2013 Act isn't still a hassle free process. Implications and consequences can be severe, if a company fails to take immediate steps to implement the 2013 Act. A case in point is directors’ and auditors’ reporting responsibilities with regard to internal financial controls. Though the reporting is needed at year-end, internal financial controls should exist and be operating effectively throughout the year. Another example is the approval required for related party transactions or loans and investments. There are numerous such issues requiring immediate action from companies.

We compliment the Government of India, especially the MCA, for maintaining a highly consultative approach throughout the process of issuing the 2013 Act and in finalizing the rules. Nonetheless, a large number of interpretative issues and concerns continue to exist, and many of those are discussed in this publication. The most fundamental being the numerous matters where it appears that the final rules may not be in consonance with the 2013 Act. Many of these issues can be addressed through appropriate changes in the rules, schedules and general circulars. A few others may need some amendments to the 2013 Act. We believe that this is not the end of the road, and herein lies a significant opportunity for the MCA to continue engaging with constituents as it has been doing so in the past. Ultimately, all of us would like to see a legislation that is robust, and strikes a sweet spot between business reality and regulatory needs.

We expect that the MCA/ICAI will come out with a detailed guidance on various issues arising from the 2013 Act and rules. In the meanwhile, this publication expresses our thoughts, perspectives and point of view, on key issues. However, these should not be treated as formal guidance, as there may be different views on these matters and the final say on these issues will be with the courts/regulators. Also, any views or opinions expressed in this publication represent our judgment at the time of publication and may be subject to change, including, but not limited to, due to further actions of the courts or regulators, without notice. We recommend that readers seek appropriate legal/professional advice regarding any specific issues that they encounter.

The new legislation is very vast and therefore we decided to focus on some key topics in respect of which the 2013 Act and rules are notified. These topics are broadly categorized into — financial reporting, audit and auditors, related party transactions, loans and investments, corporate social responsibility, corporate governance and mergers, amalgamations and reconstructions. For the purposes of this publication, we have decided to focus more on changes brought by the final rules issued under the 2013 Act, and avoid repeating what was covered in our earlier publications and Webcasts.

The SEBI, vide Circular dated 17 April 2014, amended Clauses 35B and 49 of the Listing Agreement. The RC49, among other matters, deals with aspects such as related party transactions, independent directors, Audit Committee and vigil mechanism. Though the purpose of RC49 is to align the requirements of the listing agreement with the 2013 Act, there are significant differences, which either impose new requirements or materially alter those contained in the 2013 Act.

Though this publication focuses on requirements of the 2013 Act in certain specific areas; to help listed companies better understand applicable framework, a brief overview of RC49 is given at the relevant places.

It is a matter of great joy to engage with you on this historic change, as we have been doing so traditionally. We hope you will find this publication useful in having a better understanding of the new law. We look forward to your feedback on the publication.

Ernst & Young LLP
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Uniform financial year

The definition of term “financial year” is applicable from 1 April 2014. It requires a company to adopt a uniform accounting year ending 31 March. Companies which are currently following a different financial year need to align with the new requirement within two years. A proviso to the definition states that a company may apply to the NCLT for adoption of different financial year, if it satisfies the following two criteria:

- Company is a holding or subsidiary of a company incorporated outside India, and
- Company is required to follow a different financial year for consolidation of its financial statement outside India.

The Central Government has still not constituted the NCLT and many provisions relating thereto are not currently notified. Under section 434 of the 2013 Act, certain matters pending with the High Court, District Courts or the CLB, as the case may be, which will be within the jurisdiction of the NCLT, would be transferred to the NCLT from a notified date. Till such time, the courts and the CLB will continue to function. In the absence of NCLT, a company may contact the MCA to seek guidance with regard to which of these authorities they should file an application for adoption of a financial year other than one ending on 31 March.

Practical issues and perspectives

In accordance with AS 21, AS 23 and AS 27, a parent company can use financial statements of subsidiaries, associates and joint ventures drawn up to a different reporting date to prepare CFS if it is impractical to have their financial statements prepared up to the same reporting date as the parent. How is the impracticality provision of AS 21, AS 23 and AS 27 impacted by the requirement to have a uniform financial year?

Section 129(4) of the 2013 Act states that “the provisions of this Act applicable to the preparation, adoption and audit of the financial statements of a holding company will, mutatis mutandis, apply to the CFS.” Hence, the requirement concerning uniform financial year applies to both separate financial statements of the parent company as well as CFS of the group.
A parent company has unilateral control over all its subsidiaries. Hence, it should normally be able to obtain their financial statements for the same reporting date as the parent and use them in the preparation of CFS. However, this may not be practical for all the associates/joint ventures. For example, an associate/joint venture incorporated outside India may have non 31 March year-end, either due to requirement of local regulations or requirement prescribed by other significant shareholder. Since the parent company does not have unilateral control over these associates/joint ventures, it may not be in a position to require them to prepare an additional set of financial statements for 31 March year-end for use in its consolidation. Similarly, in case of Indian associates/joint ventures, it is possible that these companies have 31 March year-end for their own statutory reporting. However, their systems may not be geared-up to provide timely information for use in the parent’s CFS. For example, due to requirements of listing agreement, a listed parent needs to finalize its CFS within 60 days of the year-end. However, its non-listed associates/joint ventures need much more time to finalize their financial statements. In such cases, maximum six months gap between the reporting dates of the parent company and its associates or jointly controlled entities may be permitted, provided that companies meet criteria prescribed in accounting standards for use of different period financial statements.

National Financial Reporting Authority

Under the 2013 Act, the NFRA will replace the NACAS. NFRA will be a quasi-judicial body and will have responsibility to ensure overall quality of financial reporting. In addition to advising the Central Government on formulation of accounting standards for adoption by companies/class of companies, the NFRA will:

- Make recommendations to the Central Government on formulation and laying down of auditing policies and standards for adoption by auditors
- Monitor and enforce compliance with accounting and auditing standards in the manner as may be prescribed
- Oversee the quality of service of professionals associated with ensuring compliance with standards, and suggest measures required for improvement in quality and such other related matters as may be prescribed, and
- Perform other prescribed functions.

The Central Government has not yet constituted the NFRA. Also, the final rules relating to NFRA are not yet notified. The transitional provisions in the Accounts Rules state that accounting standards prescribed under the 1956 Act will continue to be accounting standards under the 2013 Act, until accounting standards are specified by the Central Government under the 2013 Act. The transitional provisions also state that until NFRA is constituted, the NACAS will continue advising the Central Government on formulation of accounting standards. Though not mentioned specifically, it appears that for the time being, the ICAI will continue to perform its existing functions, e.g., those relating to formulation of auditing standards and monitoring/enforcing compliance both with the accounting and auditing standards.
Disclosures required

The 2013 Act read with the Accounts Rules require several disclosures about performance, risks, etc. Key disclosures include:

- Extract of the annual return, which covers matters such as indebtedness, shareholding pattern, details of promoters, directors and KMP and changes therein, details of board meetings and attendance, remuneration of directors and KMPs and penalty or punishment imposed on the company, its directors/officers
- Financial summary or highlights
- Change in the nature of business, if any
- Details of directors or KMP who were appointed or have resigned during the year
- Names of companies which have become or ceased to be its subsidiaries, joint ventures or associate companies during the year
- Details of significant and material orders passed by the regulators or courts or tribunals impacting the going concern status and company’s operations in future
- Statement indicating development and implementation of risk management policy for the company including identification therein of elements of risk, if any, which, in the opinion of the Board, may threaten the existence of the company

On the lines of pre-revised Clause 49, RC49 requires that as part of the directors’ report or as an addition thereto, a MD&A report should form part of the Annual Report to the shareholders. This MD&A should include discussion on the following matters within the limits set by the company’s competitive position:

- Industry structure and developments
- Opportunities and threats
- Segment-wise or product-wise performance
- Outlook
- Risks and concerns
- Internal control systems and their adequacy
- Discussion on financial performance with respect to operational performance
- Material developments in Human Resources/Industrial Relations front, including number of people employed

Disclosures required under RC49 are similar to those under the pre-revised 49. However, companies need to ensure proper synchronization of these disclosures with the new disclosures under the 2013 Act.

In the case of a listed company, the board needs to disclose information under the three heads, viz., board report, Directors’ Responsibility Statement and MD&A. A listed company may present MD&A either separately in the annual report or as part of the board report itself. Though information requirements of the board report and MD&A are worded differently; from practical perspective, the presentation of such information is likely to significantly overlap with each other. A listed company may need to structure its board report and MD&A carefully so that meaningful information is presented to users without duplication, while ensuring compliance with both the requirements.

Preparation of board report

The Accounts Rules require that the board report will be prepared based on the SFS of a company. This report must contain a separate section wherein a report on the performance and financial position of each subsidiary, associate and joint venture company included in the CFS is presented.

In many cases, this disclosure for each subsidiary, associate and joint venture may become very cumbersome for companies. Also, investors and analysts typically look at performance and financial position of the consolidated group, as against each individual entity. Therefore, groups will have to provide stand-alone performance of each company for complying with the 2013 Act and consolidated performance for the benefit of investors and other stakeholders.
Disclosure regarding median remuneration

Section 197 of the 2013 Act requires every listed company to disclose in the board's report the ratio of the remuneration of each director to the median employee's remuneration and such other details as may be prescribed. The Managerial Personnel Rules clarify how median remuneration is measured. They also require several additional disclosures, examples include: (i) % increase in remuneration of each director, CEO, CFO, Company Secretary or Manager, if any, in the financial year, (ii) % increase in the median remuneration of employees in the financial year, (iii) explanation on the relationship between average increase in remuneration and company performance, (iv) comparison of the remuneration of the KMP against the company's performance, (v) key parameters for any variable component of remuneration availed by directors, and (vi) ratio of the remuneration of the highest paid director to that of the employees who are not directors but receive remuneration in excess of the highest paid director during the year.

Practical perspectives

These disclosures are in many respects consistent with the disclosures required globally. For example, the Dodd Frank Act in the US and recent changes in the Company Law in UK require similar disclosures. It is believed that these disclosures will bring about greater accountability amongst companies. Also, disclosure regarding remuneration of the employees, who are not directors but receive remuneration in excess of the highest paid director, during the year, may bring to focus the real decision makers.

The Managerial Personnel Rules clarify that median means the numerical value separating the higher half of a population from the lower half and the median of a finite list of numbers may be found by arranging all the observations from lowest value to highest value and picking the middle one. Assuming a company has three categories of employees, i.e., 1150 workers, 550 officers and 299 middle and senior management. The median remuneration would be what employee number 1,000 would be earning, if they were arranged in an ascending or descending order based on their remuneration. In this case, that happens to be a worker. The comparison of a worker's remuneration with the CEO will reflect a significant disparity and may not give any meaningful information to the users.

Similar disparity may arise in the case of a company which has many branches in countries where remuneration is high. In such cases, inclusion of foreign salaries with Indian workers to determine the median may reflect a distorted comparison.

To give more meaningful information to users, some companies may voluntarily disclose category-wise comparison in addition to the disclosures required as per the Managerial Personnel Rules. In the above example, comparison of median remuneration of middle and senior management with CEO's salary may provide more meaningful information.

Disclosure of KMP remuneration and its linkage to company performance can make the board more accountable and reassure investors that the board is negotiating with executives at "arm's length." Disclosure of remuneration packages also provides information to investors about the incentives being set for executives. This could assist them to assess the company's prospects and risk profile, such that the share price more accurately signals the market's assessment of the stream of expected profits. Thus, through improving investor confidence and providing relevant information about company prospects, disclosures may enhance efficiency in equity markets. However, unlimited disclosure would be unlikely to deliver net benefits; for instance, detailed revelation of a company's strategy may undermine its competitive advantage and long-term performance. In other words, the benefits of transparency need to be balanced against compliance costs and possible adverse consequences for a company's commercial position.

Effective date

In the 2013 Act, the board report includes many matters, which hitherto were not required in the 1956 Act. These matters to be reported may be very onerous and time consuming to prepare. Hence, the applicability date is important. Section 134 of the 2013 Act dealing with board report is applicable from 1 April 2014. The MCA has clarified that the rules will also apply from 1 April 2014. However, neither the 2013 Act nor the rules clarify as to how this requirement should be applied. The following three views were possible:

(i) The new requirement applies to all board reports for periods beginning on or after 1 April 2014.

(ii) It is applicable to all board reports for periods ending on or after 1 April 2014.

(iii) It is applicable to all board reports issued on or after 1 April 2014.

General Circular no 8/2014 issued on 4 April 2014 has addressed this issue. It clarifies that the Board's report in respect of financial years, which commenced earlier than 1 April 2014, will be governed by the relevant provisions of the 1956 Act (View (i)). A company having 31 March year-end applies the requirements of the 2013 Act for board reports issued with respect to year ended 31 March 2015. A company having any other year-end will apply the requirements from the next financial year onwards. For example, a company having 31 December year-end will apply the requirements of the 2013 Act for boards reports issued with respect to year ended 31 December 2015. Till such date, the requirements of the 1956 Act will continue to apply. 
Internal financial controls

Directors’ responsibility

Section 134(5)(e) of the 2013 Act requires that in case of listed companies, Directors’ Responsibility Statement should, among other matters, state that directors had laid down internal financial controls and such controls are adequate and were operating effectively. An explanation given to clause (e) of section 134(5) states as below:

“For the purposes of this clause, the term ‘internal financial controls’ means the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.”

Hence, the 2013 Act lays down very wide responsibility regarding internal financial control reporting on the directors. It includes policies and procedures for ensuring orderly and efficient conduct of business – thereby covering not just financial reporting aspects, but also the strategic and operational aspects of the business and the efficiency with which those operations are carried out. For the purpose of this publication, internal financial controls related to financial reporting aspects are referred as “financial reporting controls” and those related to strategic and operational aspects of the business are referred to as “business controls.”

Section 134(3)(p) of the 2013 Act states that in case of a listed company and every other public company having such paid-up share capital as may be prescribed, the board report will include a statement indicating the manner in which formal annual evaluation has been made by the board of its own performance and that of its committees and individual directors. Section 134(3)(q) of the 2013 Act enables the Central Government to prescribe additional matters for inclusion in the board report. With regard to section 134(3)(p), sub-rule 8(4) of the Accounts Rules states as below:

“Every listed company and every other public company having a paid up share capital of twenty five crore rupees or more calculated at the end of the preceding financial year shall include, in the report by its Board of directors, a statement indicating the manner in which formal annual evaluation has been made by the Board of its own performance and that of its committees and individual directors.”

With regard to section 134(3)(q), sub-rule 8(5) of the above rules states as below:

“In addition to the information and details specified in sub-rule (4), the report of the Board shall also contain: ...”

One of the disclosures contained in the sub-rule 8(5) is “the details in respect of adequacy of internal financial controls with reference to the financial statements.”

RC49 requires that discussion on “internal control systems and their adequacy” is included in the MD&A report. Also, the board has to ensure the integrity of the company’s accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.

Auditors’ responsibility

Section 143(3) of the 2013 Act states that the auditor's report, among other matters, will state “whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.” This requirement is applicable to all companies, including non-listed public and private companies. Neither the 2013 Act nor the Audit Rules define the term “internal financial controls” for this purpose.
Practical issues and perspectives

The 2013 Act has already prescribed the directors’ responsibility with respect to internal financial controls. It requires that in case of listed companies, Directors’ Responsibility Statement should state that directors had laid down internal financial controls and such controls are adequate and operating effectively. For this purpose, “internal financial controls” include both financial reporting controls and business controls. In addition, rule 8(5) under the Accounts Rules requires that the board report should contain details for adequacy of financial reporting controls. The rules do not refer to adequacy of business controls.

Given the specific requirement in the 2013 Act, what is the relevance of requirement on similar matter prescribed in the Accounts Rules? How do these two requirements interact with each other?

One view is that the 2013 Act requires directors’ reporting on internal financial control only in case of listed companies. In contrast, auditors are required to report on the existence and operating effectiveness of internal financial controls in all companies. To bridge this gap, the Accounts Rules require directors of even non-listed companies to comment on the matter. Under this argument, the requirement regarding directors’ responsibility will apply as below in table 1:

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<td>Listed</td>
<td>Directors’ Responsibility Statement</td>
<td>Adequacy/existence and operating effectiveness of internal financial controls using wider definition in the 2013 Act, i.e., both financial reporting controls and business controls</td>
</tr>
<tr>
<td>Non-listed</td>
<td>Board’s report</td>
<td>Adequacy of internal financial controls pertaining to financial statements, i.e., only financial reporting controls</td>
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In this view, there is no conflict between the requirements of the 2013 Act and the Accounts Rules. Also, the directors’ responsibility with regard to reporting on internal financial controls will be in sync with the auditors’ responsibility. In the case of listed companies, the directors’ responsibility will be based on the wider definition of internal financial controls (i.e., both financial reporting controls and business controls); whereas in the case of non-listed companies, the definition of internal financial controls is narrowed to financial reporting controls.

The second view is that the MCA has included this provision in the Accounts Rules to address significant concerns that were being raised about the definition of internal financial controls and to bring the same in line with the global practices. Hence, the intention of the MCA is to restrict internal financial control reporting in case of listed companies to financial reporting controls only; it does not intend to extend such reporting to non-listed companies. In this view, there are two fall outs. The first concern is that in trying to narrow the definition of internal financial controls, the Accounts Rules have inadvertently made the requirement applicable to non-listed companies. The second concern is that of the Accounts Rules overriding the 2013 Act.

The third view is that the directors of both listed and non-listed companies are required to report on internal financial controls pertaining to financial statements, i.e., financial reporting controls only. Under this view, the Accounts Rules have the effect of (i) extending the internal financial control reporting requirement to non-listed companies, and (ii) narrowing the definition of “internal financial control” to financial reporting controls. In this view, the Accounts Rules are overriding the 2013 Act.

Table 1
It may be appropriate for the MCA/ICAI to address this issue. Until such guidance or clarification is provided, our preferred view is that the 2013 Act and the Accounts Rules should be read harmoniously so that there is no conflict. Hence, our preferred approach is to apply the first view.

Reference is drawn to sub-rules 8(4) and 8(5) of the Accounts Rules as reproduced above. Sub-rule 8(4) deals with annual evaluation of the board, and is applicable to listed and specified class of public companies. Sub-rule 8(5) prescribes other matters, including comment on internal financial controls, to be included in the board report. Sub-rule 8(5) starts by stating that “in addition to matters prescribed under sub-rule 8(4).” Does it mean that the requirements under sub-rule 8(5) apply only to companies prescribed in the sub-rule 8(4)?

Sub-rule 8(5) of the Accounts Rules is worded in a confusing manner. One view is that by drawing reference, its applicability is restricted only to companies mentioned in the sub-rule 8(4), i.e., listed companies and public companies having paid-up share capital of ₹25 crore or more at the end of the preceding financial year. The second view is that sub-rule 8(4) and 8(5) are independent and have been issued in the context of two different sections, i.e., section 134(3)(p) and section 134(3)(q), of the 2013 Act, respectively. Whilst the first section refers to “class of companies”; there is no such reference in the latter. Also, the sub-rule 8(5) does not state that its applicability is restricted only to companies mentioned in the sub-rule 8(4). Hence, the requirements covered under the sub-rule 8(5) apply to all companies, including private companies.

We expect that the MCA/ICAI may provide guidance on various issues regarding internal financial control reporting. Until any guidance or clarification is provided, our understanding is that sub-rule 8(4) and 8(5) are independent. Hence, our preferred approach is to apply the second view on this issue, i.e., requirements covered under sub-rule 8(5) apply to all companies.

The term “internal financial controls” is not explained in the context of auditors’ reporting responsibility. What is the scope of auditors’ responsibility for reporting on internal financial controls?

In the 2013 Act, the meaning of the term “internal financial controls” is given only in the explanation to section 134(5) clause (e). The explanation begins with the use of words “for the purposes of this clause” and assigns a wider meaning to the term.

One view is that in the absence of any other definition/explanation, the explanation to clause (e) in section 134(5) is relevant for deciding the auditors’ reporting responsibility as well. This implies that an auditor needs to report on internal financial controls relating not only to the financial statements, but also other matters such as policies and procedures for ensuring orderly and efficient conduct of business and safeguarding of assets, i.e., auditors’ reporting includes both financial reporting controls and business controls.

The second view is that before using the explanation given for the purposes of a particular section for interpreting another section, one needs to look at the context. The directors of a company are responsible for overseeing all aspects relating to functioning of a company. Hence, wider meaning of the term ‘internal financial controls’ in the context of their responsibility may be somewhat justified. However, the auditors’ responsibility is only with regard to reporting on financial statements and matters connected therewith. An auditor is typically not expected to look into or comment on strategic and operational business decisions, including whether management is running business efficiently. In many cases, an auditor may not have sufficient knowledge/expertise to do so. Basis this, the proponents of this view suggest that the auditor is required to comment only about adequacy/existence and operating effectiveness of internal financial controls pertaining to financial statements, i.e., financial reporting controls only.

We understand that the ICAI is developing guidance on various issues arising from the 2013 Act, including the framework on auditors’ responsibility to report on internal financial controls. Until such guidance or clarification is provided by the ICAI, our preferred approach is to apply the second view. We expect that the ICAI may clarify the same in due course.
In accordance with section 129(4) of the 2013 Act, the requirement concerning preparation, adoption and audit of the financial statements of a holding company, mutatis mutandis, apply to the CFS. Does it mean that directors as well as auditor of a parent company are also required to comment regarding existence and operating effectiveness of internal financial controls in the entire group?

Neither section 129(4) nor any other section of the 2013 Act requires the provisions concerning preparation of the board report of a parent company to be applied, mutatis mutandis, to the consolidated board report. In fact, there is no concept of a “consolidated board report” under the 2013 Act. Rather, sub-rule 8 in the Accounts Rules is clear that board report needs to be prepared based on the standalone financial statements of a company. Considering this, directors of a parent company are not required to comment regarding adequacy/existence and operating effectiveness of internal financial controls for the group as a whole.

With regard to auditors’ reporting responsibilities, two views seem possible. The first view is that section 129(4) of the 2013 Act deals with issuance of audit opinion on the CFS, i.e., whether CFS present true and fair view in accordance with the applicable accounting standards. Reporting on internal financial control is not the same as issuing audit opinion on the CFS. Hence, auditors’ reporting on internal financial control does not apply to the CFS.

According to the supporters of the second view, section 143(3) requires reporting on “internal financial control” to be part of the auditors’ report. Hence, section 129(4) read with section 143(3) indicates that the requirements concerning auditors’ reporting on internal financial control are likely to apply to the CFS as well.

From our perspective, the second view appears to be a more logical reading of the relevant sections of the 2013 Act. However, the final decision rests with the MCA/ICAI. In providing guidance, the ICAI may consider providing exemptions relaxation for immaterial subsidiaries and newly acquired subsidiaries included in the CFS, on the lines of exemption available under the SOX Act. The ICAI may also consider providing guidance on how to deal with associates and jointly controlled entities accounted for using the equity method and proportionate consolidation, respectively, in the CFS, where the parent may not have the right/authority to evaluate the internal financial controls and/or may lack the access necessary to make such an evaluation.

The auditor of a parent company and the CFS may not be the auditor of all the subsidiaries, associates and joint ventures that are included in the CFS. In such cases, the parent company and its auditor will have to put a system in place whereby the auditor of each of the component includes in their audit report, the reporting on internal financial controls. The parent company’s auditor can use these audit reports to finalize the reporting on internal financial controls on a consolidated basis. This is an approach similar to what is currently being followed for issuing audit report on the CFS.

The Guidance Note on Audit of Consolidated Financial Statements allows the parent company auditor to rely upon the work performed by the auditors of subsidiaries, associates and joint ventures, while issuing audit opinion on the CFS. In such cases, the auditors’ report on CFS may draw attention to the fact that part of the audit of the group was carried out by other auditor(s). To avoid any potential issue, it is suggested that the ICAI issues similar guidance for reporting by auditors on matters relating to internal financial controls also.

Other key perspectives

The director’s and auditor’s reporting concerning internal financial controls will be with respect to periods commencing from 1 April 2014 or after. For a company, whose financial year begins on 1 April 2014, this implies that the system of internal financial controls should be in place and be operating effectively from 1 April 2014. It may be noted that sections containing requirements concerning internal financial controls were notified on 26 March 2014 and the final rules were issued on 27 March/31 March 2014. This leaves companies with an impossible task. This issue is further complicated because an appropriate framework/guidance regarding implementation of internal financial control system and reporting thereon is not yet issued.

In contrast to the above, when SOX requirements were made applicable in the US, the SEC had given an adequate time for providing (i) companies an opportunity to complete the preparatory work, and (ii) auditors an opportunity to gear up for the new requirements.

It may be appropriate for the MCA to deal with this issue and provide a transition period of at least one year for companies and auditors to implement this requirement. From companies’ perspective, it may be noted that there can be severe implications and consequences, including, modified/qualified reporting, if it is observed after the year-end that either controls were not existing or they were not operating effectively. To avoid such issues, it is imperative that companies engage with their auditors/professional advisors for control testing much before the year-end. This is likely to help them in taking corrective measures on a timely basis.
Definition of the term ‘subsidiary’

In accordance with the 2013 Act, “‘Subsidiary company’ or ‘subsidiary,’ in relation to any other company (that is to say the holding company), means a company in which the holding company:

(i) Controls the composition of the board of directors, or
(ii) Exercises or controls more than one-half of the total share capital either on its own or together with one or more of its subsidiary companies.”

The draft rules stated that for the above purpose, total share capital includes both paid-up equity share capital and preference share capital. This resulted in a very unique situation whereby a lender providing finance to a company in the form of redeemable preference shares would treat the borrower as its subsidiary, if the preference shares worked out to be more than 50% of the total share capital.

In the Definition Rules, the definition of total share capital is changed. The Definition Rules state that for the purposes of definition of subsidiary and associate company, “total share capital” comprises paid-up equity share capital and convertible preference share capital. In our view, a convertible preference share includes both optionally as well as compulsorily convertible preference shares. However, preference shares with no option of conversion into equity capital will not be considered for determining if a company is a subsidiary/associate company. Also, instruments, such as, convertible warrants or options and convertible debentures, are not considered for determining if a company is a subsidiary/associate company.

Practical issues and perspectives

Undoubtedly, the Definition Rules represent an improvement vis-à-vis the draft rules. However, it leaves scope for significant structuring. Consider the following two examples:

(i) For regulatory and other purposes, company A does not want to present a loss making entity (company B) as its subsidiary. Company B may issue convertible debentures to company A. The convertible debentures give it tremendous powers, but unlike preference shares are not considered for determination of subsidiary.

Though company A is completely funding and possibly in control of company B, it would not be treating company B, as its subsidiary.

(ii) Consider another scenario, company C desires to present a hugely profit making company D as its subsidiary, though it may not have any board control. Company D plans to get significant equity investment from an investor J whereby J will own the entire equity capital of D, and also control the board of D. Company D issues new equity shares to J and J also acquires the existing equity capital of D from the market. Also, D issues to C, optionally convertible redeemable preference shares (exceeding the 50% threshold), where conversion right is non-substantive, deeply out of the money and in practical terms may never get exercised. In this case, J in substance controls D. However, based on the definition, it may be possible to argue that both J and C control D. Whilst AS 21 recognizes that a subsidiary may have two parent companies; however, it is may not reflect true economic substance of the arrangement.

Is the definition of the term “subsidiary company” under the 2013 Act in sync with the definition under AS 21? If this is not the case, which definition should be used for preparing CFS?

AS 21 read with AS 23 is clear that potential equity shares of the investee are not considered for determining voting power. Also, control under AS 21 is based on voting power, as against total share capital ownership under the 2013 Act. Hence, the definition of the term “subsidiary company” under the 2013 Act is different from that under AS 21.

(iii) One view is that the Accounts Rules, among other matters, state that consolidation of financial statements will be made in accordance with the applicable accounting standards. Thus, for preparing CFS, definition given under AS 21 is relevant. For legal and regulatory purposes, definition of subsidiary as per the 2013 Act should be used.
However, there are others who do not appear to be convinced with the view expressed in the previous paragraph. They point out that it is a well settled position in India that in case of conflicting requirements between the statute and accounting standards, the law will prevail. They further argue that the final rule requires the use of accounting standards (AS 21) for preparing CFS but is not relevant for identifying the subsidiaries that will be included in the CFS. For identifying the subsidiaries, definition under the 2013 Act should be used.

This is an area where MCA/ICAI needs to provide guidance. Until such guidance or clarification is provided or AS 21 is revised, our preferred view is that identification of subsidiaries for consolidation should be based on the economic substance; rather than, mere legal form. If definition given in the 2013 Act is used to identify subsidiaries for CFS, one may end-up consolidating companies where the reporting company has provided loan in the form of convertible preference shares that do not have any voting power. Hence, our preference is to apply the first view. Under this view, a company applies AS 21 definition to identify subsidiaries to be consolidated. For legal and regulatory purposes, definition of subsidiary as per the 2013 Act should be used.

Consolidated financial statements

Section 129(3) of the 2013 Act requires that a company having one or more subsidiaries will, in addition to separate financial statements, prepare CFS. Hence, the 2013 Act requires all companies, including non-listed and private companies, having subsidiaries to prepare CFS.

The 2013 Act also provides the below:

- CFS will be prepared in the same form and manner as SFS of the parent company.
- The Central Government may provide for the consolidation of accounts of companies in such manner as may be prescribed.
- The requirements concerning preparation, adoption and audit of financial statements will, mutatis mutandis, apply to CFS.
- An explanation to section dealing with preparation of CFS states that “for the purposes of this sub-section, the word subsidiary includes associate company and joint venture.”

While there is no change in section 129(3), rule 6 under the Accounts Rules deals with the “Manner of consolidation of accounts.” It states that the consolidation of financial statements of a company will be done in accordance with the provisions of Schedule III to the 2013 Act and the applicable accounting standards. The proviso to this rule states as below:

“Provided that in case of a company covered under sub-section (3) of section 129 which is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act.”
Given below is an overview of key requirements under the Schedule III concerning CFS:

- Where a company is required to prepare CFS, it will *mutatis mutandis* follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet and statement of profit and loss.

- In CFS, the following will be disclosed by way of additional information:
  1. In respect of each subsidiary, associate and joint venture, % of net assets as % of consolidated net assets.
  2. In respect of each subsidiary, associate and joint venture, % share in profit or loss as % of consolidated profit or loss. Disclosures at (i) and (ii) are further sub-categorized into Indian and foreign subsidiaries, associates and joint ventures.
  3. For minority interest in all subsidiaries, % of net assets and % share in profit or loss as % of consolidated net assets and consolidated profit or loss, separately.

- All subsidiaries, associates and joint ventures (both Indian or foreign) will be covered under CFS.

- A company will disclose list of subsidiaries, associates or joint ventures which have not been consolidated along with the reasons of non-consolidation.

**Practical issues and perspectives**

AS 21 does not mandate a company to present CFS. Rather, it merely states that if a company presents CFS for complying with the requirements of any statute or otherwise, it should prepare and present CFS in accordance with AS 21. Keeping this in view and proviso to the rule 6, can a company having subsidiary take a view that it need not prepare CFS?

This question is not relevant to listed companies, since the listing agreement requires listed companies with subsidiaries to prepare CFS. This question is therefore relevant from the perspective of a non-listed company.

Some argue that because neither AS 21 nor Schedule III mandates preparation of CFS, the Accounts Rules have the effect of not requiring a CFS. Instead, a company should present statement containing information, such as share in profit/loss and net assets of each subsidiary, associate and joint ventures, as additional information in the Annual Report. In this view, the Accounts Rules would override the 2013 Act. If it was indeed the intention not to require CFS, then it appears inconsistent with the requirement to present a statement containing information such as share in profit/loss and net assets of each of the component in the group.

Others argue that the requirement to prepare CFS is arising from the 2013 Act and the Accounts Rules/ accounting standards cannot override/ change that requirement. To support this view, it is also being argued that the Accounts Rules refer to AS 21 for the requirement concerning preparation of CFS and AS 21, in turn, refers to the governing law which happens to be the 2013 Act. Hence, the Accounts Rules/ AS 21 also mandate preparation of CFS. According to the supporters of this view, the proviso given in the Accounts Rules deals with specific exemptions in AS 21 from consolidating certain subsidiaries which operate under severe long-term restrictions or are acquired and held exclusively with a view to its subsequent disposal in the near future. If this was indeed the intention, then the proviso appears to be poorly drafted, because the exemption should not have been for preparing CFS, but for excluding certain subsidiaries in the CFS.

In our view, this is an area where the MCA/ ICAI need to provide guidance/ clarification. Until such guidance/ clarifications are provided, our preferred approach is to read the “proviso” mentioned above in a manner that the Accounts Rules do not override the 2013 Act. Hence, our preference is to apply the second view, i.e., all companies (listed and non-listed) having one or more subsidiary need to prepare CFS.

The subsequent issues are discussed on the assumption that our preferred view, i.e., all companies having one or more subsidiary need to prepare CFS, is finally accepted. If this is not the case, views on subsequent issues may need to be reconsidered.
IFRS exempts non-listed intermediate holding companies from preparing CFS if certain conditions are fulfilled. Is there any such exemption under the 2013 Act read with the Accounts Rules?

Attention is invited to discussion on the previous issue regarding need to prepare CFS. As mentioned earlier, our preferred view is that all companies having one or more subsidiary need to prepare CFS. Under this view, there is no exemption for non-listed intermediate holding companies from preparing CFS. Hence, all companies having one or more subsidiaries need to prepare CFS.

Currently, the listing agreement permits companies to prepare and submit consolidated financial results/financial statements in compliance with IFRS as issued by the IASB. For a company taking this option, there is no requirement to prepare CFS under Indian GAAP. Will this position continue under the 2013 Act?

Attention is invited to discussion on the earlier issue regarding the requirement to prepare CFS. As mentioned earlier, our preferred view is that CFS is required for all companies having one or more subsidiary. The Accounts Rules are clear that consolidation of financial statements will be done in accordance with the provisions of Schedule III to the 2013 Act and the applicable accounting standards. Hence, companies will have to mandatorily prepare Indian GAAP CFS, and may choose either to continue preparing IFRS CFS as additional information or discontinue preparing them.

The ICAI has recently proposed a new roadmap for implementation of Ind-AS in India and submitted it to the MCA for its consideration. In accordance with the roadmap, companies meeting the criteria below will prepare their CFS in accordance with Ind-AS from accounting period beginning on or after 1 April 2016. Comparatives for the year ending 31 March 2016 will also be in accordance with Ind-AS.

- Companies whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India
- Companies other than those covered in (a) above, having net worth of ₹500 crore or more
- Holding, subsidiary, joint venture or associate companies of companies covered under (a) or (b) above

We recommend that the MCA should re-examine this issue and allow companies to voluntarily prepare CFS under IASB IFRS instead of Indian GAAP. More than 100 countries around the world use IFRS, which is now effectively a gold standard. Therefore, it may be inappropriate to not accept IFRS CFS. We also recommend that when Ind-AS are notified for preparing CFS, they should be notified with no or very few changes from the IASB IFRS.

An explanation to section 129(3) of the 2013 Act states that “for the purpose of this sub-section, the word subsidiary includes associate company and joint venture.” The meaning of this explanation is not clear. Does it mean that a company will need to prepare CFS even if it does not have any subsidiary but has an associate or joint venture?

The following two views seem possible on this matter:

- One view is that under the notified AS, the application of equity method/proportionate consolidation to associate/joint ventures is required only when a company has subsidiaries and prepares CFS. Moreover, the Accounts Rules clarify that CFS need to be prepared as per applicable accounting standards. Hence, the proponents of this view argue that if a company does not have a subsidiary but has an associate or a joint venture.

- The second view is that the above explanation requires associates/joint ventures to be treated at par with subsidiary for deciding whether CFS needs to be prepared. Moreover, the 2013 Act decides the need to prepare CFS and the Accounts Rules are relevant only for the manner of consolidating entities identified as subsidiaries, associates and joint ventures. Hence, CFS is prepared when the company has an associate or joint venture, even though it does not have any subsidiary. The associate and joint venture are accounted for using the equity/proportionate consolidation method in the CFS.

We understand that the MCA/ICAI may provide an appropriate guidance on this issue in the due course. Until such guidance is provided, from our perspective, the second view appears to be more logical reading of the explanation. Hence, our preference is to apply the second view.
Section 129(4) read with Schedule III to the 2013 Act suggests that disclosure requirements of Schedule III mutatis mutandis apply in the preparation of CFS. In contrast, explanation to paragraph 6 of AS 21 exempts disclosure of statutory information in the CFS. Will this exemption continue under the 2013 Act?

A company will need to give all disclosures required by Schedule III to the 2013 Act, including statutory information, in the CFS. To support this view, it may be argued that AS 21 (explanation to paragraph 6) had given exemption from disclosure of statutory information because the 1956 Act did not require CFS. With the enactment of the 2013 Act, this position has changed. Also, the exemption in AS 21 is optional and therefore this should not be seen as a conflict between AS 21 and Schedule III. In other words, the statutory information required by Schedule III for SFS will also apply to CFS.

The disclosures given in the CFS will include information for parent, all subsidiaries (including foreign subsidiaries) and proportionate share for joint ventures. For associates accounted for using equity method, disclosures will not apply. This ensures consistency with the manner in which investments in subsidiaries, joint ventures and associates are treated in CFS.

Some practical challenges are likely to arise in implementing the above requirement. For example,

- It is not clear as to how a company will give disclosures such as import, export, earnings and expenditure in foreign currency, for foreign subsidiaries and joint ventures. Let us assume that an Indian company has US subsidiary that buys and sells goods in USD. From CFS perspective, should the purchase/sale in US be treated as import/export of goods? Should such purchase/sale be presented as foreign currency earning/expenditure?

- How should a company deal with intra-group foreign currency denominated transactions which may get eliminated on consolidation? Let us assume that there are sale/purchase transactions between the Indian parent and its overseas subsidiaries, which get eliminated on consolidation. Will these transactions require disclosure as export/import in the CFS?

ICAI should provide appropriate guidance on such practical issues. Until such guidance is provided, differing views are possible. One view is that the MCA has mandated these disclosures to present information regarding imports/exports made and foreign currency earned/spent by Indian companies. To meet disclosure objective, CFS should contain disclosures such as import, export, earnings and expenditure in foreign currency for the parent plus Indian subsidiaries (100% share) and Indian joint ventures (proportionate share). These disclosures may be omitted for foreign subsidiaries and joint ventures. Since disclosures for foreign operations are not being given, there may not be any intra-group elimination.

The second view is that Schedule III has mandated specific disclosures and one should look at disclosures required and ensure compliance. Hence, for each subsidiary and joint venture, import, export, earnings and expenditure in foreign currency is identified based on its domicile country and reporting currency. To illustrate, for a US subsidiary having USD reporting currency, any sale and purchase outside US is treated as export and import, respectively. Similarly, any income/expenditure in non-USD currency is foreign currency income/expenditure. Under this view, intra-group transactions may either be eliminated or included in both import and export.
In the absence of specific guidance/clarification, we believe that first view is the preferred approach. To explain the approach adopted, we recommend that an appropriate note is given in the financial statements.

Assume that the 2013 Act requires even non-listed and private groups to prepare CFS. Under this assumption, the following two issues need to be considered:

- The date from which the requirement concerning preparation of CFS will apply. Particularly, is it mandatory for non-listed/private groups to prepare CFS for the year-ended 31 March 2014?
- Whether the comparative numbers need to be given in the first set of CFS presented by an existing group?
- Basis the General Circular no. 8/2014 dated 4 April 2014, non-listed/private groups need to prepare CFS from financial years beginning on or after 1 April 2014.
- Regarding the second issue, Schedule III states that except for the first financial statements prepared by a company after incorporation, presentation of comparative amounts is mandatory. In contrast, transitional provisions to AS 21 exempt presentation of comparative numbers in the first set of CFS prepared even by an existing group.

One may argue that there is no conflict between transitional provisions of AS 21 and Schedule III. Rather, AS 21 gives an exemption which is not allowed under the Schedule III. Hence, presentation of comparative numbers is mandatory in the first set of CFS prepared by an existing company.

Subsidiary financial statements

A proviso to section 136(1) of the 2013 Act requires every company having one or more subsidiaries to:

- Place separate audited accounts in respect of each of its subsidiary on its website, if any
- Provide a copy of separate audited financial statements in respect of each of its subsidiary, to a shareholder who asks for it.

The listing agreement requires all listed companies to maintain a functional website containing basic information about the company, including financial information. The 2013 Act does not mandate non-listed companies to have their website.

The 2013 Act requires a listed company to place its financial statements, including CFS, if any, and all other documents required to be attached thereto, on its website. Listed companies are also required to place financial statements of their subsidiaries on the website. For non-listed companies, the 2013 Act only requires financial statements of subsidiaries to be hosted on the website, if they have one. Interestingly, it does not mandate non-listed companies to place their own SFS or CFS on the website, even if they have one. However, many companies may choose to do so voluntarily.

Practical issues and perspectives

The discussion below explains key issues relating to foreign subsidiary’s financial statements. Though these discussions refer to these financial statements for hosting on the website, they equally apply when they are not hosted on website. For example, in the case of a non-listed company, it may not have a website and hence would not be required to host the financial statements of foreign subsidiaries on the website. Nonetheless, the discussions below would still be relevant as these financial statements are required to be made available to shareholders on request.

Are financial statements of foreign subsidiaries, for placing on the website, needed to be prepared in accordance with Indian GAAP, i.e., notified accounting standards and Schedule III? Or will it be sufficient compliance if a company uses the financial statements prepared as per local GAAP for this purpose.

Neither the 2013 Act nor the final Accounts Rules provide any guidance on this matter. In the absence of guidance, one possible view is that it is acceptable to host foreign subsidiaries’ local GAAP financial statements on the website. The proponents of this view make the following arguments:
• Requirement to host subsidiaries’ financial statements on the website is given in a proviso to section 136(1). Section 129, which deals with preparation of financial statements as per notified accounting standards and Schedule III, is not applicable to foreign companies.

• Section 2(40) of the 2013 Act defines the term “financial statements.” It prescribes minimum components of financial statements; however, it does not require whether these financial statements should be prepared as per Indian GAAP or any other GAAP.

The counter view is that financial statements of foreign subsidiaries to be hosted on the parent company’s website need to be prepared as per Indian GAAP. The proponents of this view make the following arguments:

• Attention is drawn to the fourth proviso to section 137(1). It requires financial statements of foreign subsidiaries to be filed with the RoC. This seems to suggest that these financial statements are subject to certain requirements of Indian regulation and, therefore, should be prepared in accordance with the requirements of the 2013 Act.

• Section 2(40) only defines the minimum components of financial statements. It does not prescribe as to how these financial statements should be prepared. Section 129, which requires financial statements to be prepared in accordance with Indian GAAP, is relevant for preparing all financial statements required to be prepared under the 2013 Act.

ICAI should provide guidance on this issue. Until such guidance is provided, our preferred view is that it is acceptable to host foreign subsidiaries’ local GAAP financial statements on the website.

Subsequent issues are discussed based on the view that financial statements of foreign subsidiaries for hosting on the website need not be prepared under Indian GAAP. If this is not the case, views on the subsequent issues may need to be reconsidered.

It may also be noted that even if foreign subsidiaries’ financial statements are not prepared under Indian GAAP for hosting on the website, they may still have to be converted to Indian GAAP for the purposes of preparing CFS.

Whether the financial statements of foreign subsidiaries need to be translated into English for hosting on its website/giving them to shareholders? Let us assume that an Indian parent company has a Chinese subsidiary which has prepared its financial statements in the Chinese language. Would a Chinese version of the financial statements suffice for hosting on the website or the Indian parent will need to host an English version?

No specific guidance under the 2013 Act is available on this matter. There is nothing specific in the 2013 Act which prohibits a non-English version. However, a non-English version may not serve any useful purpose. Also, the financial statements of foreign subsidiaries need to be filed with the RoC. There are other provisions in the 2013 Act, e.g., section 380 and 381, which require certified English translation before filing the documents with the RoC. One may argue that the same analogy would apply. Considering this and to meet the requirement in spirit, a company may have to translate financial statements in English before hosting them on its website. Currently also, companies are following similar practices.

Some foreign jurisdictions do not require an audit of financial statements. Is it compulsory to have financial statements of a foreign subsidiary audited under the 2013 Act?

The 2013 Act is clear. Companies with one or more subsidiaries need to place audited financial statements of each subsidiary on their website, if they have one. It also requires companies to provide a copy of audited financial statements of each subsidiary to shareholders on their request. The language used suggests that it is mandatory for a company to have financial statements of all its subsidiaries audited for this purpose, even if there is no other requirement to have a foreign subsidiary financial statements audited.

Are financial statements of foreign subsidiaries to be audited by an Indian auditor or foreign auditor?

Neither the 2013 Act nor the Accounts Rules nor Audit Rules contain an explicit requirement for audit of foreign subsidiaries by an Indian auditor. In the absence of any specific requirement, one may argue that it is acceptable if financial statements of foreign subsidiaries prepared in accordance with their local GAAP are audited by a foreign auditor. To support this view, it may also be argued that foreign auditor has comparatively better knowledge about local GAAP of foreign subsidiary and laws/regulations impacting financial statements in the respective jurisdiction. Hence, the foreign auditor will be better equipped to audit local GAAP financial statements of foreign subsidiaries.
However, the counter argument is that financial statements will be treated as "audited" only if the audit is carried out in accordance with the requirements of the 2013 Act. Hence, there is a requirement to get financial statements of each foreign subsidiary audited in accordance with the requirements of the 2013 Act.

ICAI should provide guidance on this issue. Until such guidance is provided, our preferred view is that it is acceptable if financial statements of foreign subsidiaries prepared in accordance with their local GAAP are audited by a foreign auditor.

In accordance with the first proviso to section 129(3), a company needs to attach along with its financial statements, a separate statement containing the salient features of the financial statements of its subsidiaries in such form as may be prescribed. In this context, Form AOC-1 requires companies to present the statement containing information, such as, share capital, reserves & surplus, total assets, total liabilities, investments, turnover, profit before taxation, provision for taxation and profit after taxation, for each subsidiary. For foreign subsidiaries, should this information be prepared in accordance with Indian GAAP or the local GAAP of the subsidiary?

Attention is invited to our earlier discussions on whether the financial statements of foreign subsidiaries need to be prepared in accordance with Indian GAAP. Similar arguments may apply here as well, except that this requirement is contained in section 129 and not section 136.

One view is that statement containing salient features should be prepared based on the local GAAP financial statements of all subsidiaries. Under this view, salient features of Indian subsidiaries are prepared using Indian GAAP financial statements and those of foreign subsidiaries are prepared using their local GAAP financial statements.

The second view is that most of the information required in Form AOC-1 is basic financial information. For foreign subsidiaries also, such information under Indian GAAP is readily available from their reporting packages used for consolidation purposes. Hence, the statement containing salient features for all subsidiaries (including foreign subsidiaries) should be prepared based on Indian GAAP numbers.

Our preferred approach is to apply the second view on this matter.

Abridged financial statements

Like the 1956 Act, the 2013 Act also allows listed companies to circulate AFS. The Accounts Rules contain a format (Form AOC-3) for presentation of AFS, which is similar to the format prescribed under the 1956 Act. Additionally, the Accounts Rules contain the following clarification:

“Where a company is required to prepare consolidated financial statements i.e. consolidated balance sheet and consolidated statement of profit and loss, the company shall mutatis mutandis follow the requirements of Schedule III of the Act, as applicable to a company in the preparation of balance sheet and statement of profit and loss. In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Accounting Standards including the items specified at Serial numbers (1) and (2) under the heading ‘general instructions for the preparation of consolidated financial statements’ contained in the said Schedule.”

From the above, it appears that the preparation and circulation of abridged CFS is not allowed. Thus, AFS will be allowed only in the case of separate financial statements. This also ensures consistency with clause 32 of the listing agreement.
Depreciation

Amendments in Schedule II to the 2013 Act

Minimum vs. indicative rates

In Schedule II originally notified, all companies were divided into three classes.

(i) Class I basically included companies which may eventually apply Ind-AS. These companies were permitted to adopt a useful life or residual value, other than those prescribed under the schedule, for their assets, provided they disclose justification for the same.

(ii) Class II covered companies or assets where useful lives or residual value are prescribed by a regulatory authority constituted under an act of the Parliament or by the Central Government. These companies will use depreciation rates/useful lives and residual values prescribed by the relevant authority.

(iii) Class III covered all other companies. For these companies, the useful life of an asset will not be longer than the useful life and the residual value will not be higher than that prescribed in Schedule II.

Pursuant to a recent amendment to Schedule II, distinction between class (i) and class (iii) has been removed. Rather, the provision now reads as under:

“(i) The useful life of an asset shall not be longer than the useful life specified in Part ‘C’ and the residual value of an asset shall not be more than five per cent of the original cost of the asset:

Provided that where a company uses a useful life or residual value of the asset which is different from the above limits, justification for the difference shall be disclosed in its financial statement.”

From the use of word “different”, it seems clear that both higher and lower useful life and residual value are allowed. However, a company needs to disclose justification for using higher/lower life and/or residual value. Such disclosure will form part of the financial statements.

Continuous process plant

Under Schedule II as originally notified, useful life of the CPP, for which there is no special depreciation rate otherwise prescribed, was 8 years. This was a major concern for certain companies using CPP as they would have been required to write-off their entire plant over 8 years. The amendment to Schedule II has resolved the issue as useful life of the CPP has now been increased to 25 years. Moreover, the impact of amendment as explained in the preceding paragraph is that a company can depreciate its CPP over a period shorter or longer than 25 years, with proper justification.

BOT assets

In accordance with amendment made to Schedule XIV to the 1956 Act in April 2012, a company was allowed to use revenue based amortization for intangible assets (toll roads) created under BOT, BOOT or any other form of PPP route (collectively, referred to as “BOT assets”). Since Schedule II as originally notified did not contain a similar provision, an issue had arisen whether revenue based amortization will be allowed going forward.

The recent amendment to Schedule II has addressed this concern. In accordance with the amendment, a company may use revenue based amortization for BOT assets. For amortization of other intangible assets, AS 26 needs to be applied.

Double/ triple shift working

Under Schedule II, no separate rates/ lives are prescribed for extra shift working. Rather, it states that for the period of time, an asset is used in double shift depreciation will increase by 50% and by 100% in case of triple shift working.

Let us assume that a company has purchased one plant and machinery three years prior to the commencement of the 2013 Act. Under Schedule XIV, single, double and triple shift depreciation rates applicable to the asset are 4.75%, 7.42% and 10.34%, respectively. Under Schedule II, its life is 15 years. For all three years, the company has used the asset on a triple shift basis and therefore, depreciated 31.02% of its cost over three years. For simplicity, residual value is ignored.

On transition to Schedule II, the asset has remaining Schedule II life of 12 years, i.e., 15 years – 3 years. The management has estimated that on single shift basis, remaining AS 6 life is also 12 years. The company will depreciate carrying amount of the asset over 12 years on a straight-line basis. If the company uses the asset on triple shift basis during any subsequent year, depreciation so computed will be increased by 100%. In case of double shift, depreciation will be increased by 50%.

Transitional provisions

With regard to the adjustment of impact arising on the first-time application, the transitional provisions to Schedule II state as below:

“From the date Schedule II comes into effect, the carrying amount of the asset as on that date:

a) Will be depreciated over the remaining useful life of the asset as per this Schedule,

b) After retaining the residual value, will be recognised in the opening balance of retained earnings where the remaining useful life of an asset is nil.”
**Practical issues and perspectives**

Proviso in the latest amendment to Schedule II states that if a company uses a useful life or residual value of the asset which is different from limit given in the Schedule II, justification for the difference is disclosed in its financial statements. How is this proviso applied if notified accounting standards, particularly, AS 6 is also to be complied with?

AS 6 states that depreciation rates prescribed under the statute are minimum. If management's estimate of the useful life of an asset is shorter than that envisaged under the statute, depreciation is computed by applying the higher rate. The interaction of the above proviso and AS 6 is explained with simple examples:

(i) The management has estimated the useful life of an asset to be 10 years. The life envisaged under the Schedule II is 12 years. In this case, AS 6 requires the company to depreciate the asset using 10 year life only. In addition, Schedule II requires disclosure of justification for using the lower life. The company cannot use 12 year life for depreciation.

(ii) The management has estimated the useful life of an asset to be 12 years. The life envisaged under the Schedule II is 10 years. In this case, the company has an option to depreciate the asset using either 10 year life prescribed in the Schedule II or the estimated useful life, i.e., 12 years. If the company depreciates the asset over the 12 years, it needs to disclose justification for using the higher life. The company should apply the option selected consistently.

(iii) Similar position will apply for the residual value. The management has estimated that AS 6 life of an asset and life envisaged in the Schedule II is 10 years. The estimated AS 6 residual value of the asset is nil. The residual value envisaged under the Schedule II is 5%. In this case, AS 6 depreciation is the minimum threshold. The company cannot use 5% residual value. In addition, Schedule II requires disclosure of justification for using a lower residual value.

(iv) Alternatively, let us assume that the management has estimated AS 6 residual value of the asset to be 10% of the original cost, as against 5% value envisaged in the Schedule II. In this case, the company has an option to depreciate the asset using either 5% residual value prescribed in the Schedule II or the estimated AS 6 residual value, i.e., 10% of the original cost. If the company depreciates the asset using 10% estimated residual value, it needs to disclose justification for using the higher residual value. The company should apply the option selected consistently.

Whether the amendment regarding BOT assets allows revenue based amortization only for toll roads? Or can a company apply revenue based amortization to other type of intangible assets created under the BOT model?

The amendment in Schedule II reads as follows “For intangible assets, the provisions of the accounting standards applicable for the time being in force shall apply except in case of intangible assets (Toll roads) created under BOT, BOOT or any other form of public private partnership route in case of road projects.” The amendment clearly suggests that revenue based amortization applies to toll roads. The same method cannot be used for other intangible assets even if they are created under PPP schemes, such as airport infrastructure.

Schedule II clarifies that the useful life is given for whole of the asset. If the cost of a part of the asset is significant to total cost of the asset and useful life of that part is different from the useful life of the remaining asset, useful life of that significant part will be determined separately. This implies that component accounting is mandatory under Schedule II. How does component accounting interact with AS 6 requirements and the amendment in the Schedule II, which allows higher or lower useful life, subject to appropriate justification being provided?

Component accounting requires a company to identify and depreciate significant components with different useful lives separately. The application of component accounting is likely to cause significant change in the measurement of depreciation and accounting for replacement costs. Currently, companies need to expense replacement costs in the year of incurrence. Under component accounting, companies will capitalize these costs as a separate component of the asset, with consequent expensing of net carrying value of the replaced part.

The application of component accounting, including its interaction with Schedule II rates and AS 6 requirements, is likely to vary depending on whether a company treats useful life given in the Schedule II as maximum life of the asset (including its components) or it is treated as indicative life only.

Particular, attention is invited to earlier discussions regarding interaction between AS 6 and the proviso added through the recent amendment to Schedule II. Let us assume that the useful life of an asset as envisaged under the Schedule II is 10 years. The management has also estimated that the useful life of the principal asset is 10 years. If a component of the asset has useful life of 8 years, AS 6 requires the company to depreciate the component using 8 year life only. However, if the component has 12 year life, the company has an option to either depreciate the component using either 10 year life as prescribed in the Schedule II or over its estimated useful life of 12 years, with appropriate justification. The company should apply the option selected consistently.
Is component accounting required to be done retrospectively or prospectively?

Component accounting is required to be done for the entire block of assets as at 1 April 2014. It cannot be restricted to only new assets acquired after 1 April 2014.

How do transitional provisions in Schedule II apply to component accounting?

AS 10 gives companies an option to follow the component accounting; it does not mandate the same. In contrast, component accounting is mandatory under the Schedule II. Considering this, we believe that the transitional provisions of Schedule II can be used to adjust the impact of component accounting. If a component has zero remaining useful life on the date of Schedule II becoming effective, i.e., 1 April 2014, its carrying amount, after retaining any residual value, will be charged to the opening balance of retained earnings. The carrying amount of other components, i.e., components whose remaining useful life is not nil on 1 April 2014, is depreciated over their remaining useful life. The transitional provisions relating to the principal asset minus the components are discussed elsewhere in this publication.

In case of revaluation of fixed assets, companies are currently allowed to transfer an amount equivalent to the additional depreciation on account of the upward revaluation of fixed assets from the revaluation reserve to P&L. Hence, any upward revaluation of fixed assets does not impact P&L. Will the same position continue under the 2013 Act also? If not, how can a company utilize revaluation reserve going forward?

Under the 1956 Act, depreciation was to be provided on the original cost of an asset. Considering this, the ICAI Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets allowed an amount equivalent to the additional depreciation on account of the upward revaluation of fixed assets to be transferred from the revaluation reserve to the P&L.

In contrast, schedule II to the 2013 Act requires depreciation to be provided on historical cost or the amount substituted for the historical cost. In Schedule II as originally notified, this requirement was contained at two places, viz., Part A and notes in Part C. Pursuant to recent amendment in Schedule II, the concerned note from part C has been deleted. However, there is no change in Part A and it still requires depreciation to be provided on historical cost or the amount substituted for the historical cost. Therefore, in case of revaluation, a company needs to charge depreciation based on the revalued amount. Consequently, the ICAI Guidance Note, which allows an amount equivalent to the additional depreciation on account of upward revaluation to be recouped from the revaluation reserve, may not apply. Charging full depreciation based on the revalued amount is expected to have significant negative impact on the P&L.

AS 10 allows amount standing to the credit of revaluation reserve to be transferred directly to the general reserve on retirement or disposal of revalued asset. A company may transfer the whole of the reserve when the asset is sold or disposed of. Alternatively, it may transfer proportionate amount as the asset is depreciated.

Schedule II to the 2013 Act is applicable from 1 April 2014. Related rules, if any, also apply from the same date. It may be noted that the requirements of Schedule II are relevant not only for preparing financial statements, but also for purposes such as declaration of dividend. Given this background, is Schedule II applicable to financial years beginning on or after 1 April 2014 or it also needs to be applied to financial statements for earlier periods if they are authorized for issuance post 1 April 2014?

Schedule II is applicable from 1 April 2014. As already mentioned, Schedule II contains depreciation rates in the context of Section 123 dealing with “Declaration and payment of dividend” and companies use the same rate for the preparation of financial statements as well. Section 123, which is effective from 1 April 2014, among other matters, states that a company cannot declare dividend for any financial year except out of (i) profit for the year arrived at after providing for depreciation in accordance with Schedule II, or (ii) ...

Considering the above, one view is that for declaring any dividend after 1 April 2014, a company needs to determine profit in accordance with Section 123. This is irrespective of the financial year-end of a company. Hence, a company uses Schedule II principles and rates for charging depreciation in all financial statements finalized on or after 1 April 2014, even if these financial statements relate to earlier periods.

The second view is that based on the General Circular 8/2014, depreciation rates and principles prescribed in Schedule II are relevant only for the financial years commencing on or after 1 April 2014. The language used in the General Circular 8/2014, including reference to depreciation rates in its first paragraph, seems to suggest that second view should be applied. For financial years beginning prior to 1 April 2014, depreciation rates prescribed under the Schedule XIV to the 1956 Act will continue to be used.
In our view, second view is the preferred approach for charging depreciation in the financial statements. For dividend declaration related issues, reference is drawn to discussion under the section “Declaration and payment of dividend.”

How do the transitional provisions apply in different situations? In situation 1, earlier Schedule XIV and now Schedule II provide a useful life, which is much higher than AS 6 useful life. In situation 2, earlier Schedule XIV and now Schedule II provide a useful life, which is much shorter than AS 6 useful life.

In situation 1, the company follows AS 6 useful life under the 1956 as well as the 2013 Act. In other words, status quo is maintained and there is no change in depreciation. Hence, the transitional provisions become irrelevant. In situation 2, when the company changes from Schedule XIV to Schedule II useful life, the transitional provisions would apply. For example, let’s assume the useful life of an asset under Schedule XIV, Schedule II and AS 6 is 12, 8 and 16 years respectively. The company changes the useful life from 12 to 8 years and the asset has already completed 8 years of useful life, i.e., its remaining useful life on the transition date is nil. In this case, the transitional provisions would apply and the company will adjust the carrying amount of the asset as on that date, after retaining residual value, in the opening balance of retained earnings. If, on the other hand, the company changes the useful life from 12 years to 16 years, the company will depreciate the carrying amount of the asset as on 1 April 2014 prospectively over the remaining useful life of the asset. This treatment is required both under the transitional provisions to Schedule II and AS 6.

Let us assume that a company has adjusted WDV of an asset to retained earnings in accordance with the transitional provisions given in Schedule II? Should such adjustment be net of related tax benefit?

Attention is invited to the ICAI announcement titled, “Tax effect of expenses/income adjusted directly against the reserves and/or Securities Premium Account.” The Announcement, among other matters, states as below:

“... Any expense charged directly to reserves and/or Securities Premium Account should be net of tax benefits expected to arise from the admissibility of such expenses for tax purposes. Similarly, any income credited directly to a reserve account or a similar account should be net of its tax effect.”

Considering the above, it seems clear that amount adjusted to reserves should be net of tax benefit, if any.

### Declaration and payment of dividend

The 2013 Act states that a company will not declare/pay dividend for any financial year except:

- Out of profits of the company for that year after depreciation
- Out of accumulated profits for any previous financial year(s) arrived at after providing for depreciation
- Out of both
- Out of money provided by Central Government/state government for payment of dividend in pursuance of any guarantee given by them.

The 2013 Act contains the following provisions for interim dividend:

- Interim dividend may be declared during any financial year out of the surplus in the P&L and out of profits of the financial year in which interim dividend is sought to be declared.
- If a company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend will not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

Whilst the 2013 Act does not mandatorily require a specified percentage of profits to be transferred to reserves, it contains specific conditions for declaration of dividend out of reserves. The Dividend Rules state that “in the event of adequacy or absence of profits in any year, a company may declare dividend out of surplus subject to the fulfillment of the prescribed conditions” (emphasis added). The Dividend Rules prescribe the following conditions in this regard:

(i) Rate of dividend declared will not exceed the average of the rates at which dividend was declared by it in 3 years immediately preceding that year. However, this restriction does not apply to a company, which has not declared any dividend in each of the three preceding financial years.

(ii) Total amount to be drawn from accumulated profits will not exceed an amount equal to 1/10th of the sum of its paid-up share capital and free reserves.

(iii) The amount so drawn will first be utilized to set off losses incurred in the financial year before any dividend in respect of preference or equity shares is declared.
(iv) The balance of reserves after such withdrawal will not fall below 15% of its paid up share capital.

(v) No company will declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year. The loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

From the first condition, it appears that a company having history of dividend can declare maximum dividend upto past three years’ average. However, there is no limitation for companies not having dividend payout history.

Practical issues and perspectives

Under the 1956 Act, the rules relating to dividend declaration out of reserves applied to declaring of dividends out of reserves but did not apply for declaring dividend out of accumulated past years’ profit lying in the P&L surplus. The Dividend Rules issued under the 2013 Act indicate that restrictions under the rules may apply even for declaring dividend out of opening P&L surplus. Does it mean that a company can no longer freely declare dividend from accumulated past year profits lying in the P&L surplus?

There seems to be some confusion on this matter. Whilst the 2013 Act allows declaring both interim and final dividend out of previous years’ accumulated profit, the language used in the Dividend Rules indicate that such declaration will be subject to conditions laid down in the Dividend Rules.

One view is that the 2013 Act allows free distribution of dividend out of past year accumulated profits and the Dividend Rules cannot override this position. Hence, the restrictions prescribed in the Dividend Rules do not impact declaration of dividend out of accumulated P&L surplus balance.

The second view is that the 2013 Act and Dividend Rules should be read harmoniously. The Dividend Rules do not override/ change the provision of the 2013 Act; rather, they only prescribe top-up condition. Moreover, in the 2013 Act, the definition of the term “free reserves,” includes previous years’ accumulated profit. Hence, going forward, companies will need to comply with the Dividend Rules for declaring dividend from previous years’ accumulated profits.

We believe that the MCA did not intend to make requirements concerning declaration of dividend out of surplus stricter under the 2013 Act vis-à-vis those under the 1956 Act. The language used in section 123 suggests this. Hence, view 1 appears to be preferred approach. However, one may not rule out possibility of different view. To avoid any potential challenges, the MCA should provide clarification on this matter. Until such clarification is provided, we suggest that a company proposing to declare dividend out of P&L surplus balance consults the legal professionals.

Unlike the 1956 Act, the 2013 Act does not contain provision for adjustment of past losses before declaring dividend from the current year profit. Does it mean that a company may declare dividend from current year profit without adjusting past losses?

Whilst the 2013 Act does not contain provision requiring adjustment of past losses/depreciation before declaring dividend from the current year profit, similar provision is contained in the final Dividend Rules. The rule reads as below:

“No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year. The loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.”

The above paragraph should be typically appearing as an independent rule. However, currently, it is mixed with the declaration of dividend out of reserve requirements.

How does the option given in the Schedule II to use higher useful life interact with the dividend related provisions of the 2013 Act? Assuming that an asset has AS 6 useful life which is much longer than the life prescribed in Schedule II. In accordance with the proviso recently added in the Schedule II, a company elects to depreciate the asset over its AS 6 useful life. For the purposes of calculating profit for declaration of dividend, is the company required to charge additional depreciation to comply with Schedule II life?

Section 123(1) and (2) of the 2013 Act require that for the purpose of declaring dividend, profit should be calculated in accordance with the provisions of Schedule II. Since the Schedule II itself allows the company to charge depreciation based on AS 6 useful life, we believe that there is no need to charge additional depreciation to comply with Schedule II life for the purpose of calculating profit for declaration of dividend.
Section 123 of the 2013 Act dealing with declaration of dividend is applicable from 1 April 2014. The Dividend Rules also apply from the same date. Does it mean that dividend declared on or after 1 April 2014 is governed by the requirements of the 2013 Act? Alternatively, can a company take a view that General Circular No 8/2014 applies and therefore the 2013 Act will apply for declaring dividend in respect of financial years beginning on or after 1 April 2014?

General Circular 8/2014 is relevant only for preparation of financial statements, board report and auditors’ report. Declaration of dividend does not fall under any of the three items. Hence, the General Circular is not relevant in this case.

Section 123 of the 2013 Act applies to dividends declared on or after 1 April 2014. Hence, it may be argued that any dividend declared by a company on or after 1 April 2014 is governed by the requirements of the 2013 Act. The acceptance of this view, among other matters, implies that a company declaring dividend on or after 1 April 2014 will not be required to transfer any profits to reserves.

Whilst the above view seems appropriate from dividend distribution perspective; there is confusion regarding its interaction with provision related to financial statements. Section 123 also requires that even profit for the concerned year should be determined as per the 2013 Act. However, this may not be permitted under General Circular 8/2014 which states that financial statements for financial year beginning earlier than 1 April 2014 are prepared as per the requirements of the 1956 Act. Please refer “Depreciation” section of the publication for discussion on the issue related to charging of depreciation in the financial statements for financial year beginning prior to 1 April 2014 and its interaction with dividend declaration requirements.

The MCA/ICAI should provide appropriate guidance on this matter. Until such guidance is provided, a company may need to consult its legal professionals on how to deal with this issue.

**Utilization of securities premium**

Under the 2013 Act, companies covered under the prescribed class will not be allowed to use the securities premium for the following key purposes:

(i) Issue of fully paid preference shares as bonus shares
(ii) Writing off preliminary expenses of the company
(iii) Writing off debentures and preference share issue expenses
(iv) Providing for premium payable on redemption of preference shares/debentures

It is understood that the Central Government introduced these restriction over the use of securities premium to align the accounting requirement with Ind-AS. Since Ind-AS are currently not notified, the rules do not define companies which will be covered under the prescribed class. This implies that currently, there will be no company covered under the prescribed class and the above restrictions will not apply.

It may be noted that the ICAI has recently proposed a new roadmap for implementation of Ind-AS in India and submitted it to the MCA for its consideration. The roadmap recommends preparation of Ind-AS accounts only at the CFS level. It seems that even companies, which are covered under the eligibility criteria for preparation of Ind-AS CFS, will continue preparing SFS in accordance with Indian GAAP. A perusal of the section indicates that for these companies, restrictions on utilization of securities may apply in both the Indian GAAP SFS and Ind-AS CFS. We believe that the MCA may further clarify while prescribing companies to whom Ind-AS and the restrictions on utilization of securities premium will apply.
Free reserves

In accordance with the 2013 Act, the term “free reserves” means “such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:

Provided that

▸ Any amount representing unrealized gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or

▸ Any change in carrying amount of an asset or of a liability recognized in equity, including surplus in P&L on measurement of the asset or the liability at fair value,

Shall not be treated as free reserves.”

Practical perspectives

▸ The definition of the term “free reserves” appears to be based on the principle that a company should not include unrealized gains; but unrealized losses are included for computing free reserves.

One common example of reserve which may typically get excluded is revaluation reserve created on upward revaluation of fixed assets. Similarly, a company, which is applying hedge accounting principles of AS 30, will exclude hedging reserve from the “free reserves” if the hedging reserve has a positive (credit) balance. If the hedging reserve has a negative (debit) balance, it will be deducted from free reserves. An issue is likely to arise when the aggregate hedging reserve is positive, but it includes items with negative and positive balances. In this case, should the company exclude only net positive amount from the hedging reserve? Or should it include losses and exclude profits at each individual instrument level? No clear guidance is available on this issue. In the absence of clear guidance, it appears that a company may elect to follow either approach on this matter.

▸ The manner in which the term “free reserves” is defined, particularly its proviso (a), suggests that unrealized gains, whether shown as reserves or credited to P&L, are not free reserves. Thus, if a company has recognized foreign exchange gains on translation of receivable, payables or loans in accordance with AS-11 or recognized mark-to-market gains on derivative contracts in accordance with AS-30, such gains are not treated as free reserves. A company includes these amounts in free reserves upon realization, e.g., when receivable is realized or derivative is settled. Interestingly, any unrealized losses on the same will be treated as a reduction of the free reserves.

The application of this principle is likely to create some practical challenges. Tracking the unrealized gains and its subsequent realization on an individual item basis will be a very cumbersome exercise.

▸ It may be noted that the term ‘free reserves’ do not include securities premium. However the term ‘net worth’ will include securities premium. It is important to understand these fine nuances because these terms are frequently used in the 2013 Act; for example, with respect to limits on loans and investments.
Debenture redemption reserve

Section 71(4) of the 2013 Act requires that where debentures are issued by a company under this section, the company will create a DRR account out of the profits of the company available for payment of dividend and the amount credited to such account will not be utilised by the company except for the redemption of debentures.

The SCD Rules contain the following provision regarding creation of DRR:

- DRR is created out of the profits of the company available for payment of dividend.
- The company needs to create DRR equivalent to atleast 50% of the amount raised through the debenture issue before debenture redemption commences.
- Every company required to create DRR needs to invest/deposit a sum, which will not be less than 15% of the amount of debentures maturing during the following year, in specified deposits/securities.
- In case of partly convertible debentures, DRR will be created in respect of non-convertible portion of debenture issue.
- The amount credited to DRR will not be utilised by the company other than for the purpose of redemption of debentures.

Section 2(30) of the 2013 Act defines debenture as “debenture” includes “debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not” (emphasis added). Section 2(12) of the 1956 Act defined debenture as “debenture” includes “debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not” (emphasis added).

There seems to be an argument that the word “instrument” used in the 2013 Act has a wider meaning than the word “security” used in the 1956 Act. Thus, the definition under the 2013 Act may include several instruments, e.g., commercial paper and promissory note evidencing debt, as debenture, beyond our normal understanding of a debenture. This is particularly onerous, if one considers it together with the requirement to create a DRR on all such instruments.

Under the 1956 Act, threshold for minimum DRR varied depending on the class of companies. These thresholds were lower than those prescribed under the 2013 Act. Table 2 describes minimum DRR required for debentures.

<table>
<thead>
<tr>
<th>Class of company</th>
<th>1956 Act</th>
<th>2013 Act</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Public issue</td>
<td>Private placement</td>
</tr>
<tr>
<td>All India Financial Institutions regulated by Reserve Bank of India and Banking Companies</td>
<td>Nil</td>
<td>Nil</td>
</tr>
</tbody>
</table>
Practical issues and perspectives

The applicability of the 2013 Act requires higher DRR to be created vis-à-vis that required under the 1956 Act. How does it impact the creation of DRR for debentures issued prior to the commencement of the 2013 Act?

The language used in section 71(4) suggests that it deals only with creation of DRR for debentures issued under section 71, i.e., any new debenture issued on or after 1 April 2014. For debentures issued before 1 April 2014, the requirements of the 1956 Act continues to apply. Let us assume that a manufacturing company has issued two tranches of non-convertible debentures. The first tranche was issued on 28 March 2014 and the next tranche on 4 April 2014. The creation of DRR on the first tranche is governed by the 1956 Act and the company needs to create a minimum DRR of 25%. The creation of DRR on the second tranche is governed by the 2013 Act and the company needs to create minimum DRR of 50% on the second tranche.

The SCD Rules state that in case of partly convertible debentures, DRR will be created in respect of non-convertible portion of debenture issue. However, there is no such clarity for FCDs. Does it mean that minimum 50% DRR needs to be created on the amounts raised through issuance of FCDs?

The logical answer is that no DRR is required to be created. However, in the absence of any exemption under the 2013 Act/SCD from creation of DRR for FCDs, some argue that a minimum 50% DRR needs to be created on the entire amount of FCD. However, the acceptance of this argument may give outrageous results. Let us assume that a company has issued partly convertible debentures, where 99% of the debentures have conversion option. In this case, DRR needs to be created only for 1% non-convertible portion. However, if all the debentures were having conversion option, the company will need to create a minimum 50% DRR. This obviously cannot be the intention of the law. The MCA should provide clarification on this matter.

Re-opening/revision of accounts

The 2013 Act contains separate provisions relating to:

- Re-opening of accounts on the court/tribunal’s order
- Voluntary revision of financial statements or board’s report

Re-opening of accounts on the court/tribunal’s order

On an application made by the Central Government, the Income-tax authorities, the SEBI, any other statutory/regulatory body or any person concerned, the tribunal/court may pass an order to the effect that:

(i) The relevant earlier accounts were prepared in a fraudulent manner, or

(ii) The affairs of the company were mismanaged during the relevant period, casting a doubt on the reliability of financial statements

If the tribunal/court issues the above order, a company will need to re-open its books of account and recast its financial statements.

Voluntary revision of financial statements or board’s report

If it appears to directors that financial statements/board’s report do not comply with the relevant requirements of the 2013 Act, the company may revise financial statements/board report in respect of any of the three preceding financial years. For revision, a company will need to obtain prior approval of the tribunal.

The Tribunal, before passing the order for revision, will give notice to the Central Government and the Income-tax authorities and consider their representations, if any.

Detailed reasons for revision of such financial statement/board’s report will be disclosed in the board’s report for the relevant financial year in which such revision is being made.

The provisions of the 2013 Act concerning re-opening/revision of accounts are yet to be notified. The MCA has issued the draft rules concerning these provisions. However, the final rules on this subject are still awaited. The date from which the provisions of the 2013 Act concerning re-opening/revision of accounts apply is unknown.
Practical perspectives

Reopening of accounts whether voluntarily or mandatorily is not an easy process. The draft rules had prescribed several onerous steps which need to be completed for revision. Also, there are certain issues which are not clear. Given below is an overview of key aspects which may need to be considered:

► If the present auditor is different from the auditor who audited original financial statements, the current auditor is required to audit and report on the revised financial statements. However, before such revision, the views of the original auditor also need to be obtained and considered.

► Before the board approves any revision of financial statements or board report, the proposed revision is to be presented to the directors who authenticated the original financial statements/board report. Dissent and dissent vote, if any, at the board meeting, on such revision should be recorded with reasons in the minutes of the board meeting.

► If a company revises its financial statements for a period earlier than the immediately preceding financial year, it is mandatory to revise financial statements for all subsequent periods. However, it is not clear whether the revision of SFS will also trigger the revision of CFS.

► Many merger, amalgamation and reconstruction schemes approved by the court contain an appointed date which is earlier than the beginning of the current financial year. It is not clear whether a company will be required/allowed to revise its financial statements for earlier periods to give effect to the court scheme from the appointed date.

► In case of a voluntary change in accounting policy, error and reclassification, Ind-AS requires that comparative amount appearing in the current period financial statements should be restated. One may argue that this tantamounts to voluntary revision of financial statements for earlier periods. While the 2013 Act allows revision of previous period financial statements to correct an error, it is not clear whether a company is also allowed to revise financial statements in other cases, say, to apply change in accounting policy with retrospective effect.

We expect that the MCA may clarify these issues in the final rules.
Appointment of auditors

Given below is an overview of key changes introduced by the Audit Rules, concerning auditor appointment vis-à-vis the draft rules:

- Like the draft rules, the Audit rules also require the Audit Committee to recommend auditors for appointment. The draft rules required that if the board does not agree with the Audit Committee recommendation and decides to eventually propose its own nominee at the AGM, the board will explain the reasons for not accepting the Audit Committee recommendation in the board report. It was expected that to avoid such disclosures, there will be pressure on the board to accept the Audit Committee recommendation.

In the Audit Rules, the language has changed and it is stated that the board will record reasons for its disagreement with the Audit Committee and send its own recommendation to the AGM. Though the Audit Rules do not specifically require disclosure in the board report, section 177(8) of the 2013 Act requires that if the board has not accepted any recommendation of the Audit Committee, the same will be disclosed in the board report with reasons. Hence, the position as mentioned in the draft rules will continue.

- The draft rules required that before recommending appointment, the Audit Committee or the Board, as the case may be, will consider the completed and pending proceedings against the proposed auditor before the ICAI or the NFRA or Tribunal or any Court of law. Hence, one interpretation was that the board/Audit Committee need to consider any completed/pending proceedings, including matters not related to professional conduct, against the auditor.

In the Audit Rules, it has been clarified that the Audit Committee or the Board, as the case may be, needs to consider only order or pending proceeding relating to professional matters of conduct against the proposed auditor. In our view, this change represents a significant improvement vis-à-vis the draft rules.

- To help the audit committee/board evaluate pending proceedings against the proposed auditor, the Audit Rules require the proposed auditor to submit a list of proceedings against the auditor or audit firm or any partner of the firm with respect to professional matters of conduct.

- Under the 2013 Act, an auditor is appointed for a term of 5 years. However, the appointment needs to be ratified each year at the AGM. The Audit Rules clarify that “if the appointment is not ratified by the members of the company, the board of directors shall appoint another individual or firm as its auditor or auditors after following the procedure laid down in this behalf under the Act.”
Practical issues and perspectives

In accordance with the Audit Rules, the board/audit committee need to consider order/pending proceeding relating to matters of professional conduct against the proposed auditor. Does it mean that the board/audit committee cannot recommend such person for appointment as auditor?

Attention is drawn to section 141 of the 2013 Act dealing with eligibility, qualifications and disqualifications of the auditor. Its clause (3)(h) states that a person, who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction, is not eligible for appointment as auditor. The section does not refer to “order/pending proceeding relating to matters of professional conduct” as a criterion for disqualification. In other words, disqualification is triggered only on conclusion of the proceedings and if the person is convicted for an offence involving fraud, and not before such conviction.

Hence, mere order/pending proceedings against the proposed auditor do not necessarily disqualify the person from being appointed as auditor. The board/audit committee, upon consideration of the matters, may still decide to recommend the person/firm for appointment as auditor.

The Audit Rules state that if the appointment of auditor is not ratified by the members, the board will appoint another individual/firm as its auditor(s) after following the procedure laid down in the 2013 Act. In the case of non-ratification, will the board be required to follow the procedures only for appointment of auditor or will it follow the procedures relating to removal as well as appointment of auditor?

From a perusal of the explanation given in the Audit Rules, two views seem possible. The first view is that if the appointment of auditor is not ratified at the AGM, the board needs to follow only the procedure regarding appointment of auditor for appointing a new auditor. The contrary view is that the board should follow both the procedures, viz., procedures relating to removal of auditor as well as appointment of new auditor. Particularly, the procedure for removal of auditor will require the Central Government approval and special resolution at the general meeting, since the auditor has been removed before completion of a five year term.

The MCA should provide clarity on this matter. Until such guidance or clarification is provided, our preferred view is that the board should follow both the procedures, viz., procedures relating to removal of auditor as well as appointment of new auditor.

Assume that a person/firm, previously appointed as auditor, incurs any of the disqualifying conditions mentioned in the 2013 Act. In such a case, what is the procedure to be followed for appointment of new auditor? Is the company also required to follow the procedures relating to removal of auditor as prescribed in the 2013 Act?

Section 141(4) of the 2013 Act states as below:

“Where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor.”

Section 139(8) of the Act states as below:

“Any casual vacancy in the office of an auditor shall:

(i) In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the Comptroller and Auditor-General of India, be filled by the Board of Directors within thirty days, but if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company at a general meeting convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next annual general meeting…”

We believe that a company is not required to follow the procedures relating to removal of auditor in cases where an auditor has to vacate its office due to incurrence of any disqualifying condition under the 2013 Act. Such vacation is treated as casual vacancy which can be filled by the board of directors within 30 days. It may be noted that the auditor so appointed holds office only till the conclusion of the next AGM. Subject to compliance with other requirements of the 2013 Act, the AGM can re-appoint the same auditor for a block of five years.
Rotation of auditors

In accordance with the 2013 Act, listed companies and companies belonging to the prescribed class cannot appoint or re-appoint the auditor for: (a) More than two terms of five consecutive years, if the auditor is an audit firm; (b) More than one term of five consecutive years if the auditor is an individual. Under the draft rules, the prescribed class included all companies excluding one-person companies and small companies. This is changed in the Audit Rules. Under the Audit Rules, auditor rotation applies to the following classes of companies excluding one person companies and small companies:

- All listed companies
- All non-listed public companies having either (i) paid-up share capital of ₹10 crore or more, or (ii) public borrowings from financial institutions, banks or public deposits of ₹50 crores or more
- All private limited companies having either (i) paid-up share capital of ₹20 crore or more, or (ii) public borrowings from financial institutions, banks or public deposits of ₹50 crores or more

The auditor, who has completed his term, will not be eligible for re-appointment as auditor in the same company for five years from completion of the term. The same restriction applies to the audit firm which has common partner(s) with the outgoing audit firm at the time of appointment.

Incoming auditor/audit firm is also not eligible for appointment if they are part of the same network as the outgoing auditor. In simple words, the auditor has to be rotated outside the network firm and not within the network firm. The term “same network” has been explained to include the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control.

If a partner in the outgoing audit firm, who is in charge of the firm and also certifies financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm will also not be eligible to be appointed as auditor for a period of five years.

Transitional requirements

Like the draft rules, the Audit Rules are clear that holding of the office by the auditor prior to the commencement of the 2013 Act will be included to determine the time of rotation. In other words, rotation applies retrospectively. In determining the time of rotation, service period also includes period served by network firms. For example, firm A audited Client X for the first four years. Thereafter, it moved to firm B which is the firm under the same network. Hence, service period completed by firm A and firm B will be included to determine the time of rotation.

Effective date

Section 139 (2) of the 2013 Act dealing with auditor rotation is applicable from 1 April 2014. The Audit Rules also apply from the same date. One of the provisos to section 139(2) of the 2013 Act states that existing companies, which are covered under auditor rotation requirement, should comply with those requirements within three years from the date of commencement of the 2013 Act. Section 1(3) of the 2013 Act states that different dates may be appointed for bringing into force different provisions of the 2013 Act and any reference in any provision to the commencement of the 2013 Act will be construed as a reference to the coming into force of that provision. Hence the three year period in this regard starts from 1 April 2014. Illustration 2 given in paragraph 6(3) of the Audit Rules also confirm this point. One heading in the illustration indicates that three years countdown starts from the AGM held after the commencement of section 139(2), i.e., from the first AGM held on or after 1 April 2014.
Practical issues and perspectives

Whilst auditor rotation improves independence, it also increases audit cost, imposes excessive burden on companies, increases the risk that new auditors may not be able to detect errors and frauds, and does little to enhance the audit quality. Globally, in countries where auditor rotation is mandated, e.g., Italy, Netherlands and Brazil, it is applicable either only to listed entities, or to listed entities and public interest entities, such as, banks and insurance companies. In none of these geographies, auditor rotation is applicable to private companies or to non-listed public companies. The MCA has generally been very considerate in addressing practical challenges. We believe that it will follow a similar approach in relaxing the rotation requirements in the Audit Rules by using the removal of difficulties section and address the genuine issues faced by the industry and audit profession.

For deciding auditor rotation, will paid up share capital include non-convertible preference shares also?

For auditor rotation, paid-up share capital includes paid-up equity share capital and paid-up preference share capital, whether convertible or not. Also, it appears that paid-up share capital includes only amount received toward face value of shares. Amount received toward securities premium is not included in the paid-up share capital. Also, the share application money pending allotment is not included in the paid-up share capital. Please also refer discussion on similar issue under the head “Woman director.”

Under section 2(71) of the 2013 Act, a private company is deemed to be a public company if it is subsidiary of another company, which is not a private company. In simple terms, a private company, which is a subsidiary of public company, is deemed a public company. For auditor rotation, whether a deemed public company is governed by the criteria applicable to a private company or public company?

The proviso to section 2(71) states that “a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act.” The language used indicates that a company deemed to be a public company is treated at par with the public company for applying all the requirements of the 2013 Act. Hence, in the given case, the criteria applicable to a public company are relevant.

Whether an Indian private company, which is subsidiary of a foreign public company, also needs to apply the criteria for auditor rotation as applicable to a public company?

Section 2(20) of the 2013 Act defines the term “company” to mean “a company incorporated under the Companies Act 2013 or any previous company law.” Accordingly, a company, which is incorporated under the relevant legislation of a foreign country, will not qualify as a “company” under the 2013 Act.

The proviso to section 2(71) states that “a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act.”

Under the 1956 Act, the issue regarding companies incorporated outside India is dealt with under the section 4(7). The section read as below:

“A private company, being a subsidiary of a body corporate incorporated outside India, which, if incorporated in India, would be a public company within the meaning of this Act, shall be deemed for the purposes of this Act to be a subsidiary of a public company if the entire share capital in that private company is not held by that body corporate whether alone or together with one or more other bodies corporate incorporated outside India.”

A similar provision does not exist under the 2013 Act. This has resulted in an ambiguous position with regard to private companies which are subsidiaries of foreign public companies. One may argue that a “foreign company” is not a “company” under the 2013 Act. Hence, the proviso to section 2(71) is not triggered. Under this view, a private company, which is subsidiary of foreign company, will always be a private company.

Apparently, the concept enshrined in section 4(7) of the 1956 is not contained in the 2013 Act. Hence, it seems more logical that under the 2013 Act, a private company is deemed a public company only when it is a subsidiary of an Indian public company. This issue impacts not only the auditor rotation criteria, but also applicability of many other key provisions of the 2013 Act, e.g., requirements concerning Woman Director, Independent Directors, Audit Committee and Nomination & Remuneration Committee. Considering wider implications, it may be appropriate for the MCA to clarify the position.
What is the relevant date for assessing whether a company meets the criteria for auditor rotation? What happens if there is any change in the threshold from year-to-year?

Scenario 1: Assume that a private company (ABC) had paid up share capital of ₹20 crore or more on 1 April 2014. It needs to rotate its existing auditor who has completed more than 10 years of service within the next 3 years. During the financial year 2015-16, ABC reduces its paid-up share capital to below ₹20 crore. ABC does not have borrowings exceeding ₹50 crore. Is ABC still required to rotate its existing auditors?

Scenario 2: A private company (XYZ) did not meet any criteria for auditor rotation on 1 April 2014. It, therefore, appointed its existing auditor who has completed more than 10 years of service for another five year-term. During the financial year 2015-16, XYZ increased its paid-up share capital to above ₹20 crore. Hence, it now meets the auditor rotation thresholds. Will such requirement apply prospectively or retrospectively to XYZ?

Neither the 2013 Act nor the Audit Rules provide any guidance on approach to be followed if there is a change in the threshold over the period. Therefore, multiple views may be possible/acceptable. It is expected that the ICAI/MCA may provide guidance on these issues. Until such guidance is provided, possible views and our preferred approach on these issues are explained below.

Rotation requirements of the 2013 Act, read with the Audit Rules, apply from 1 April 2014. Hence, on the said date, a company needs to assess whether it meets the prescribed criteria. If so, it needs to prepare itself for the rotation as per the principles explained in the Audit Rules. For example, if an audit firm has already completed 7 or more years of service, the company will need to rotate its existing auditors within the next 3 years.

In scenario 1, ABC meets the rotation criteria at 1 April, 2014, but during the transition period of 3 years flips out of the rotation criteria. One view is that the rotation criterion is tested at 1 April 2014, and on that basis, ABC’s existing auditor can serve as auditor for no longer than 3 years. The second view is that since ABC is no longer a covered company, it has an option of either continuing with its existing auditors beyond three years or appointing new auditors voluntarily. Since neither the 2013 Act nor the Audit Rules provide any specific guidance on this aspect, our preference is toward the second view, viz., ABC seems to have a choice in this matter.

In scenario 2, though the 2013 Act or Audit Rules do not provide any specific guidance, the wording used suggests that the requirement applies retrospectively and the earlier service period, i.e., the period when XYZ did not meet the prescribed criteria, will also be included in the 10 year limit.

It appears that the 3 year transition period is applicable only on first time applicability of rotation requirements at 1 April 2014. It does not apply in cases where the prescribed threshold is met at a subsequent date. In such cases, XYZ will need to rotate the audit firm at the time of next appointment/re-appointment if the 10 year service has already been completed by the audit firm.

How do the rotation requirements apply in cases where a company goes through amalgamation/merger/demerger, etc.? Let us say that ABC Limited is merging into DEF Limited and DEF is the surviving company. Assume ABC and DEF have different audit firms and that there was no break in service.

Though no specific guidance is available on this particular matter, it appears that rotation requirements will be decided based on the transferee/surviving company. This is irrespective of the size of the two companies and the name of the surviving company which may or may not have changed. Hence, if DEF is the surviving company and ABC’s auditors are appointed as auditor of the merged company, they can be appointed for two five year terms. On the other hand, if DEF is the surviving company and its auditors continue to be the auditor of the merged company, the period since their original appointment as auditor of DEF will be included for determining the auditor rotation period.

Will any change in the management/business of a company have impact on the auditor rotation period? Let us assume that at 1 April 2014, an audit firm is the auditor of MNO Limited (listed company) for past 15 years. Four years back, the controlling shareholder of MNO sold its stake to an independent third party. Pursuant to this, the management of MNO changed completely. In this case, can a view be taken that the 10 year period should start from the date of change in the management and not from the date on which the firm was originally appointed as auditor of MNO?

Auditor rotation requirements apply vis-à-vis the company and not its management/controlling shareholder/business. Hence, any change in the management of MNO does not impact the auditor rotation period. In this example, since the audit firm has already completed 10 years of service to MNO, it needs to be rotated out within three years transitional period.
How do the rotation requirements apply to a company having, say, calendar year-end or June Year-end? Assume two scenarios (i) company will follow 31 March year-end in two years, and (ii) it will get exemption to continue with its existing calendar or June year-end.

Appointment/re-appointment of auditor take place at the AGM and are valid until the conclusion of the next AGM irrespective of the year end. Three/five years, as relevant, will be counted from AGM to AGM.

An explanation in the Audit Rules states that “if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years.” What is meant by the terms ‘person in charge of audit firm’ and ‘retires’?

The meaning of the phrase ‘in charge of the audit firm’ is not clear. In a multi-disciplinary, multi-locational firm, it is not clear whether the Chief Executive Officer (CEO), Head of the Audit Practice, partner in-charge of the local office or the audit partner who is in charge of the engagement, will be considered as ‘in charge of the audit firm.’ The ICAI/MCA need to provide guidance on this aspect.

The term ‘retires from the said firm’, should in our view not be read literally as someone leaving the firm on reaching his or her retirement age. Rather, it should be read more broadly as someone leaving the firm, irrespective of the reason for leaving.

In case of banking and insurance companies, the rotation requirements prescribed by RBI/IRDA are different from those prescribed under the 2013 Act. Particularly, the RBI and IRDA require two years cooling off period, instead of 5 years cooling off period required under the 2013 Act. This may raise a potential issue as to how RBI/IRDA requirements will work vis-à-vis auditor rotation requirements under 2013 Act?

It may be noted that the requirements of the 2013 Act apply to insurance companies and banking companies, except to the extent these provisions are inconsistent with the requirements of the Insurance Act 1938/the IRDA Act 1999 and the Banking Regulation Act, 1949, respectively. These Acts do not contain specific requirements regarding auditor rotation. Rather, the Banking Regulation Act specifically refers to audit by a person duly qualified under the Companies Act. Since, under the 2013 Act, cooling off period of less than 5 years does not meet eligibility requirement, a potential issue may arise for banking and insurance companies.

Under the 2013 Act, an audit firm is appointed for two 5 year terms, which is then followed by a 5 year cooling off period. In the case of RBI, an auditor is appointed for 4 years, followed by a two year cooling off period. Thus, one may also raise an issue of whether a 5 year cooling off period is relevant in the case of a bank. Similar concern is also relevant in the case of an insurance company. We suggest that the MCA, the RBI and the IRDA should provide an appropriate clarification on the same.

In accordance with the Audit Rules, a break in the term for a continuous period of five years is considered as fulfilling the requirement of rotation. In other words, an audit firm becomes eligible for fresh appointment only if there has been a break in the audit service for a continuous period of five years. Is this requirement applicable prospectively or retrospectively?

Let us assume that a company has changed its auditor two years-back. Before the change, the audit firm had audited the company for a continuous period of more than 10 years. From the current financial year onward, the company desires to appoint the same audit firm as its auditor. In this case, will the previous period of service be also included to decide the auditor rotation period?

Consider second example. An audit firm had previously audited a company for five continuous years. After this, there was a break in the service of the audit firm for 3 years. The same audit firm was appointed auditor again and is auditing the company for past 3 years. In this case, to decide auditor rotation period is there a requirement to consider earlier service period also? Or will it be sufficient compliance if the auditor rotation period is decided only based on the current history, ignoring five year audit services performed in the earlier past?

Explanation II to paragraph 6(3) of the Audit Rules states as below:

“For the purpose of rotation of auditors:

a) A break in the term for a continuous period of five years shall be considered as fulfilling the requirement of rotation...”
Attention is invited to illustration 2 given in paragraph 6(3) of the Audit Rules. The illustration explains the application of transitional provision pertaining to rotation in the case of an audit firm. The illustration, among other matters, gives (i) number of consecutive years for which an audit firm has been functioning as auditor in the company, and (ii) maximum number of consecutive years for which the firm may be appointed in the same company (including transitional period). The note 2 to the illustration states that “consecutive years shall mean all the preceding financial years for which the firm has been the auditor until there has been a break by five years or more.”

Hence, it is clear that the requirement concerning break in the term for minimum five years applies retrospectively. Hence, in the example 1, if the company appoints old audit firm as its auditor at this stage, the firm can continue to be its auditor for only transitional period of 3 years. In the example 2, the audit firm has historically audited the company for 8 years (5 years + 3 years). Though there was 3-year break in the service, it does not satisfy qualifying condition for the fresh appointment. Hence, the audit firm may continue rendering audit services only for transitional period of 3 years.

Eligibility, qualifications and disqualifications of auditors

Financial interest and indebtedness, guarantee or security

A person is not eligible for appointment as auditor if he himself, his relative or partner:

- Holds any security or interest in a company, or its subsidiary, holding or associate company or subsidiary of such holding company.

  However, the relative is allowed to hold security or interest in the company having face value not exceeding ₹1 lac. The Audit Rules state that if any security or interest is acquired by a relative above the prescribed threshold, corrective action needs to be taken within 60 days of such acquisition or interest.

- Is indebted to the company, its subsidiary, holding or associate company or subsidiary of such holding company, in excess of ₹5 lac.

- Has given any guarantee or provided any security in connection with indebtedness of any third person to the company, or its subsidiary, holding or associate company or subsidiary of such holding company, in excess of ₹1 lac.
Practical perspectives

From the wording used, it is not clear whether the ₹1 lac/₹5 lac limit applies separately to each relative or collectively to all covered persons, including auditor (if allowed), all his relatives and partner. Also, it is not clear whether the limit will apply separately for the company, its each subsidiary, holding company, etc., or collectively to all these companies.

We suggest that the MCA/ICAI may clarify this issue. In the absence of any guidance/clarification, the wording used indicates that limits apply person/relative-wise; however, limits includes that person’s indebtedness, etc., to the company, its subsidiary, holding or associate company or subsidiary of such holding company. Example below explains this principle in the context indebtedness of an auditor’s relative.

Assume that an auditor has 10 relatives. In this case, ₹5 lac indebtedness limit will apply separately to each relative. However, while evaluating whether a relative breaches the limit, its indebtedness to the company, its subsidiary, its holding or associate company or subsidiary of such holding company is combined.

Under the 2013 Act, a person may become ineligible for being appointed as auditor of the company, not only based on his/her own transaction but also transactions entered by a “relative.” Since the definition of “relative” is not restricted to financially dependent relative, the auditor may not be able to control their actions. Even if any of these relatives inadvertently enter into a disqualifying transaction, the auditor may have to vacate his office immediately. In rare cases, an estranged relative may invest in shares of a company in a manner that will render the auditor jobless. This is likely to create significant inconvenience both for the company and auditor. To avoid such issues, we suggest that the term “relative” should be redefined by the MCA as “financially dependent individual” by using the removal of difficulties section.

Business relationship

Under the 2013 Act, a person or an audit firm are not eligible for appointment as auditor, if it, directly or indirectly, has business relationship with the company, its subsidiary, its holding, or associate company or subsidiary of such holding company or associate company. The draft rules explained the term “Business relationship” to mean any transaction entered into for a commercial purpose except professional services permitted to be rendered by an auditor.

Hence, there was a concern that an auditor cannot purchase/avail goods/services from the auditee company, its subsidiary, its holding, or associate company or subsidiary of such holding company or associate company. This was likely to pose serious practical problems not only to the auditors but also to the companies they audit. For example, an auditor of a hospital would not have been able to avail services of that hospital even if the hospital charged the same price as it would have to any other patient, and it would not have mattered if that was the only hospital available to the auditor.

In the Audit Rules, exemption regarding professional services permitted to be rendered by an auditor has been retained. To address the above concern, the Audit Rules additionally allow parties to enter into commercial transactions that are in the ordinary course of business of the company at arm’s length price, e.g., sale of products/services to auditor as customers in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.

Practical perspectives

Undoubtedly, the change made in the Audit Rules is a relief for companies and their auditors. However, it may not address all issues which are likely to arise. For example, some may refer to examples given in the relevant clause and state that they focus primarily on services being rendered to the public at large. Hence, it is not clear whether similar exemption also applies to transactions involving sale of products, say, an auditor purchasing a consumer product or real estate from the company.
The other perspective on this issue is that one need not focus too much on the examples. Rather, it is more important to understand the underlying principle, which refers to aspects such as ordinary course of business and at arm's length price. Considering this, the determination of whether a transaction impacts auditor appointment or not will be a matter of judgment and needs to be decided on case-to-case basis. Given below are some indicative examples which an auditor/companies may consider in this regard:

(i) If a transaction satisfies a basic need of the auditors' business, say, office supplies or recruitment services, one may argue that the auditor is acting akin to a “customer.” If the auditor/audit firm has a general pattern of making similar purchases, this may be another indicator that the product or service is used routinely and thus is in the “ordinary course of business” from the auditors' perspective. However, a product or service used infrequently may require further evaluation.

(ii) If the audit client (or its subsidiary, or its holding or associate company or subsidiary of such holding company or subsidiary of associate company) is in the business of selling such product or providing such service, and sells such product or service customarily and often, then it may be concluded that the transaction is in “ordinary course of business” from their perspective. If this is not the case, the matter is likely to require further evaluation.

(iii) An additional consideration is whether the terms and conditions of the transaction are standard or the same as those of other similarly situated customers of the audit client (or its subsidiary, or its holding or associate company or subsidiary of such holding company or subsidiary of associate company), or if there is anything unusual about the price, payment arrangements, other than normal, traditional commercial terms.

It may be noted that if the audit client provides usual credit period and the same period is given to auditor also, it may not breach the “ordinary course of business” condition. However, there is another criterion related to indebtedness beyond prescribed limit which may potentially trigger disqualification.

It may be emphasized that these examples are only indicative and one needs to consider specific facts and circumstances to decide whether disqualification may get triggered.

Whilst the 2013 Act uses the word “directly or indirectly,” its meaning in the context of business relationship is not explained. One view is that an analogy may be drawn from explanation given in section 144 of the 2013 Act. In section 144, this term has been explained to include “rendering of services by the firm itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity in which the firm or any partner of the firm has significance influence or control, or whose name or trade mark or brand is used by the firm or any of its partners”. Under this view, auditor independence for business relationship is not only restricted to the audit firm, but may also extend to all its affiliated entities.

The counter view is that explanation given in section 144 is relevant only for that section. In the context of business relationship, “directly or indirectly” means the covered person acting either directly or through their agents. Hence, the transactions of affiliated entities, which are otherwise not covered and are acting in their own capacity, does not impact the auditor independence.

The MCA/ICAI may clarify this issue. Until such guidance or clarification is provided, there seems to be an argument for using analogy of section 144. Hence, view 1 is our preferred approach.

**Limit on maximum number of audits**

In accordance with the 2013 Act, a person or a partner of a firm will not be eligible for appointment, if such persons or partner at the date of appointment/reappointment holds appointment as auditor of more than 20 companies. Private companies are also included in the maximum limit of 20 companies.
Practical perspectives

Under the 1956 Act read with the ICAI rules, a person/partner cannot audit more than 30 companies, including private companies, per year. Out of this, maximum 20 companies can be public companies. The 2013 Act has reduced the maximum limit to 20 companies (including private companies) with immediate effect from 1 April 2014. The auditors/audit firms with more than 20 audits (individually/per partner) stand disqualified from being appointed/reappointed as auditor of excess companies. This is likely to result in casual vacancy in the office of the auditor, requiring companies to search for a replacement auditor immediately. In certain cases, it may be difficult to find a suitable auditor in a very short period of time. We recommend that the MCA may address this issue through the order for removal of difficulties.

We believe that from an audit firm perspective, the above limit will apply on a global basis and not per partner. To illustrate, let us assume that an audit firm has 5 partners. It can accept appointment as auditor of maximum 100 companies. However, it is not the case that each partner should audit a maximum of 20 companies. That limit can be exceeded, subject to an overall limit of 100 companies for the firm. Whilst this view is clear from reading of the section; to avoid differing practices, ICAI may confirm this.

Conviction by the Court

In accordance with the 2013 Act, a person is not eligible for appointment as auditor, if that person has been convicted by a court of an offence involving fraud and period of ten years has not elapsed since such conviction.

A proviso to section 141(1) states that a firm whose majority of partners practising in India are qualified for appointment as auditor may be appointed by its firm name to be auditor of a company.

A collective reading of the two clauses suggest that if a partner in a partnership firm (including limited liability partnership), proposed to be appointed as auditor, is convicted of fraud, it may not render the entire firm ineligible for appointment as auditor. However, this is subject to a condition, viz., majority of partners practising in India are qualified for appointment as auditor.

Independence/prohibited services

Under the 2013 Act, an auditor is allowed to provide only such non-audit services to the company as are approved by its board or audit committee. However, the auditor is not allowed to render the following services either directly or indirectly to the company, its holding or subsidiary company:

- Accounting and book keeping services
- Internal audit
- Design and implementation of any financial information system
- Actuarial services
- Investment advisory services
- Investment banking services
- Rendering of outsourced financial services
- Management services
- Any other kind of services as may be prescribed

From an audit firm's perspective, the term 'directly or indirectly' includes rendering of services by the firm itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity in which the firm or any partner of the firm has significance influence or control, or whose name or trade mark or brand is used by the firm or any of its partners.

Transitional requirements

If an auditor has been rendering non-audit services to a company on or before the commencement of the 2013 Act, the auditor will need to comply with the above restrictions before the end of the first financial year. This implies that:

- For existing services, an auditor is required to comply with the above requirements on or before 31 March 2015. All engagements with an audit client or its parent or subsidiary company for any prohibited service need to be completed/terminated by 31 March 2015.
- An auditor is not allowed to enter into any new engagement with an audit client or its parent or subsidiary company for any prohibited services on or after 1 April 2014.
Practical perspectives

In certain cases, the independence requirements of the 2013 Act are stricter than those currently applicable. To illustrate, under the IESBA code, an auditor is prohibited/restricted from rendering non-audit services to the parent of its non-SEC listed audit client, only if the audit client is material to the parent. In case of non-listed non-SEC audit client, there is no restriction on rendering non-audit services to the parent if the parent is also a non-listed entity. Under the 2013 Act, restriction/prohibition will apply in all these cases. This requires companies as well auditors to consider various non-audit services being rendered to a company, its holding or subsidiary company. If it is determined that certain services are not permitted, the same needs to be completed/terminated by 31 March 2015.

Management services

Under the 2013 Act, an auditor is not allowed to render, among other services, “management service” to the company, its holding or subsidiary company. However, this term is not defined either in the 2013 Act or in the Audit Rules. In the absence of clear definition, one may argue that guidance can be taken from the IESBA Code. The IESBA code provides the following guidance on “management responsibilities”:

“290.162 Management of an entity performs many activities in managing the entity in the best interests of stakeholders of the entity. It is not possible to specify every activity that is a management responsibility. However, management responsibilities involve leading and directing an entity, including making significant decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources.

290.163 Whether an activity is a management responsibility depends on the circumstances and requires the exercise of judgment. Examples of activities that would generally be considered a management responsibility include:

a) Setting policies and strategic direction
b) Directing and taking responsibility for the actions of the entity's employees
c) Authorizing transactions
d) Deciding which recommendations of the firm or other third parties to implement
e) Taking responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, and
f) Taking responsibility for designing, implementing and maintaining internal control.”

Since the definition of “management service” is not clear and may be subject to varying interpretations, ICAI should provide guidance. In the meanwhile, auditors should take precaution not to provide any services which entail management responsibilities as discussed in the IESBA code.
Reporting responsibilities

Internal financial controls

Reporting responsibilities of the auditor concerning “internal financial control” both with respect to SFS and CFS are discussed elsewhere in this publication.

Fraud reporting

The 2013 Act requires that if an auditor, in the course the performance of his duties as auditor, has reasons to believe that an offence involving fraud is being or has been committed against the company by its officers or employees, he will immediately report the matter to the Central Government within the prescribed time and manner. Under the draft rules, reporting to the Central Government was required only for material frauds. Material frauds were defined as (a) fraud(s) happening frequently, or (b) fraud(s) where the amount involved or likely to be involved is not less than 5% of net profit or 2% of turnover of the company for the preceding financial year. For immaterial frauds, the auditor was required to report only to the Audit Committee/Board.

In the Audit Rules, distinction between material and immaterial frauds has been removed. The auditor is required to report all frauds to the Central Government irrespective of materiality. The Audit Rules state that if an auditor has sufficient reason to believe that an offence involving fraud, is being or has been committed against the company by officers or employees of the company, the auditor will report the matter to the Central Government immediately but not later than sixty days of his knowledge. The Audit Rules prescribe the following procedure for fraud reporting:

(i) The auditor will forward his report to the board or the Audit Committee, as the case may be, immediately after a fraud comes to his knowledge, seeking their reply or observations within 45 days.

(ii) On receipt of reply/observations, the auditor will forward his report, reply received and his comments on the reply to the Central Government within 15 days.

(iii) If the auditor fails to get any reply/observations within 45 days, he will forward his report to the Central Government along with a note explaining the fact.

The provision will also apply, mutatis mutandis, to a cost auditor and a secretarial auditor.

Non-compliance with this requirement knowingly and wilfully is punishable with a fine of minimum ₹1 lac which may extend to ₹25 lac.

To report the fraud related matters to the Central Government, the Audit Rules have prescribed Form ADT-4. The form requires that the report on fraud, with form ADT-4, is to be given in a sealed cover to the Secretary, Ministry of Corporate Affairs.

Practical issues and perspectives

The procedure prescribed for fraud reporting is a step in the right direction. Since the auditor will obtain the views of the Board/Audit Committee before reporting a matter to the Central Government, it may help in avoiding/minimizing situations where the auditor reports matters to the Central Government purely based on allegations and without proper evaluation.

We believe that the materiality threshold for fraud reporting is needed. In the absence of such threshold, an auditor may need to report even trivial matters of fraud/potential fraud to the Government. This may impose significant additional cost and burden on all parties, viz., the company (including its board/ Audit Committee), auditor and the Central Government and yet achieve nothing.
Both the 2013 Act and the Audit Rules require an auditor to report “frauds being committed” to the Central Government. The following key issues need to be considered regarding this:

a) Is an auditor also required to report suspected frauds to the Central Government?

b) If response to (a) is yes, at what stage an auditor should report matter to the Central Government? Consider that under the vigil mechanism, an employee has raised complaint about a potential fraud being committed by an officer of the company. The company is in the process of collecting necessary data and verifying the complaint. It is expected that the management/Audit Committee need approximately three months to verify the accuracy or otherwise of the complaint. Is the auditor required to report the matter to the Central government, without waiting for the outcome of the inquiry?

c) Is the auditor also required to report those matters of suspected frauds to the Central Government where the management/Audit Committee have ultimately concluded that no fraud is involved?

a) For fraud reporting, the use of the phrase “is being committed” is not clear. However, a reading of the 2013 Act and related the Audit Rules indicate that it is not necessary for a fraud to be finally concluded to trigger an auditor’s reporting to the Central Government. Rather, an auditor may also need to report matters of suspected frauds to the Central Government. Please refer response to issue (b) regarding the stage at which an auditor may need to report suspected frauds.

b) One view is that the Audit Rules require an auditor to report on all cases of suspected fraud to the Central Government within 60 days. Hence, as soon as, an auditor becomes aware of any complaint about a potential fraud, the auditor will report the matter to the Central Government within 60 days by adopting the procedure prescribed. Hence, auditor should not wait for completion of inquiry being conducted by the management/Audit Committee.

The second view is that based on wording used in rules, reporting to the Central Government is triggered only once “an auditor has sufficient reason to believe that an offence involving fraud is being or has been committed.” Hence, mere complaint by an employee/others may not be sufficient reason to trigger reporting to the Central Government. Also, reporting to the Central Government at a preliminary stage without proper evaluation is not consistent either with the public’s expectations or with companies’ understanding of an auditors’ role. Moreover, if an auditor reports certain matters as “potential fraud” to the Central Government without establishing proper facts, then it may create significant hardship both for the company and the auditor. Under this view, 60 days’ time-limit to report “suspected frauds” will not start immediately on the date the company receives complaint about a potential fraud and auditor become aware of the same; rather, it should start from the date when the management/Audit Committee have made reasonable progress on the matter and the auditor has “sufficient reasons” to believe that a fraud is being committed. Determination of such a stage is a matter of judgment and needs to be decided based on the facts and circumstances of each case.

Based on the wordings used in the Audit Rules and management/public expectations and understanding of auditors’ role, we prefer the second view on this matter. However, if there is a prolonged delay from the management/Audit Committee in the evaluation of a potential fraud, the auditor may decide to report the matter to the Central Government, without waiting for completion of such evaluation. We understand that the ICAI is developing guidance on auditors’ reporting responsibilities and recommend that it conforms to the second view.

c) Please refer discussion on issue at (b) above. The 2013 Act and the Audit Rules require the auditor to make its own assessment and exercise professional judgment whether there is a sufficient reason to believe that an offence involving fraud is being or has been committed. If the auditor agrees with the management/Audit Committee conclusion that no fraud is involved, reporting to the Central Government is not required. However, if an auditor does not agree with the management/Audit Committee conclusion, then the auditor needs to further probe the matter and come to conclusion whether the fraud/potential fraud is involved. If, after further probe, the auditor has sufficient reason to believe that an offence involving fraud is being or has been committed, then the auditor will need to file its report to the Central Government along with the Audit Committee/management observations. We believe that ICAI will clarify this position as part of its proposed guidance on auditors’ responsibility for fraud reporting.
Is the auditor required to report all frauds/suspected frauds, including, cases where a company may be defrauding 3rd parties, says, customers, vendors, investors, or is falsifying its books of accounts, to the Central Government?

Both the 2013 Act and the Audit Rules require the Central Government reporting only in cases where an offence involving fraud is being or has been committed against the company by its officers or employees. We believe that in other cases, including, cases where a company may be defrauding 3rd parties, the auditor is not required to report directly to the Central Government. Nonetheless, an auditor needs to consider impact of these frauds/potential frauds on the audit and while finalizing auditors' report on the financial statements. Specific attention is drawn to SA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements. An auditor needs to ensure compliance with SA 240 for conducting the audit as well as communication of fraud to the management, to those charged with governance and others.

General Circular 8/2014 clarifies that auditor's report in respect of financial years, which commenced earlier than 1 April 2014, will be governed by the relevant provisions of the 1956 Act. How does this Circular apply in the context of fraud reporting to the Central Government? The 1956 Act did not contain any requirement for fraud reporting directly to the Central Government. One view is that General Circular 8/2014 deals only with financial statements, board report and matters covered in the auditors' report. Requirement concerning fraud reporting to the Central Government is a not an auditors' report related matter; rather, it is an independent requirement, i.e., auditor's other reporting responsibility. Hence, the General Circular is not relevant in this context. Rather, an auditor is required to report any fraud, which comes to its attention on or after 1 April 2104, to the Central Government after adopting the procedure prescribed.

The second view is that requirement for fraud reporting is covered section 143 of the 2013 Act, which deals with all matters relating to powers and duties of an auditor, including its reporting responsibilities. Hence, one should read the General Circular in context of overall section 143; and not merely for matters to be covered in the auditors’ report. To support this view, it may also be argued that section 143(12) of uses the phrase “if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe ...” Hence, it is important that fraud comes to the auditors' knowledge while performing duties as an auditor under the 2013 Act and not otherwise. For the year ended 31 March 2014, an auditor is performing duties under the 1956 Act and not the 2013 Act. Hence, any fraud noticed as part of 31 March 2014 year-end audit will not trigger reporting to the Central Government. However, any fraud/potential fraud noticed as part of audit for the following year, i.e., financial year beginning on or after 1 April 2014, will trigger reporting to the Central Government.

We believe that the second view seems to be more appropriate. We recommend that ICAI may clarify this position as part of its proposed guidance on fraud reporting.

During the course of limited review as required by Clause 41 to the Listing Agreement, the audit firm notices that a fraud has been committed against the company by its officers or employees. From the perspective of fraud reporting under section 143(12), will frauds identified by the auditor in the course of a limited review under clause 41 be covered?

In accordance with section 143(12) of the 2013 Act, reporting to the Central Government is triggered if the auditor notices fraud/potential fraud in the course of performing duties as auditor. Clause 41 requires that unaudited financial results of a company should be subjected to limited review by its statutory auditors. This implies that an auditor conducts limited review of quarterly financial information in the capacity as auditor of the company and any fraud noticed during the review is during the course of performing duties as auditor. Hence, the auditor needs to report the fraud/potential fraud identified in the course of limited review in accordance with the requirements of the 2013 Act and the Audit Rules.
CARO reporting

Under the 1956 Act, the Central Government issued the CARO 2003. CARO 2003 contains various matters on which the auditors of companies (except exempted companies) have to make a statement in their audit report. The Audit Rules issued under the 2013 Act do not contain a similar order. Rather, the Audit Rules require an auditor to comment on the following three additional matters:

- Whether the company has disclosed the impact, if any, of pending litigations on its financial position in the financial statements
- Whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long-term contracts including derivative contracts
- Whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund (IEPF) by the company.

Considering the above, it appears that CARO type reporting may no longer be required under the 2013 Act. However, one should not rule out the possibility that the Central Government may prescribe such reporting requirements in due course.

Interestingly, whilst the MCA has so far not prescribed the CARO or its equivalent under the 2013 Act, Form AOC-4 (for filing financial statements and other documents with the Registrar) requires details regarding Auditors' Reporting under the CARO 2003.

Practical perspectives

The requirements contained in clauses (a) and (b) in any case require an auditor to qualify/modify the audit report if provision for foreseeable losses and litigations is not made, and the amounts involved are material. However, because of specific requirements contained in the 2013 Act, the auditor may provide a greater focus on these issues in the audit.

Transitional requirements

In addition to specific issues/aspects, one pervasive and key issue for auditor reporting was related to the applicability date. In accordance with the notification, new requirements apply from 1 April 2014. However, it was not clear as to how exactly this requirement will apply. It appeared that the following three views were possible:

(i) The new requirement is applicable to all audit reports for accounting periods commencing on or after 1 April 2014.
(ii) It is applicable to all audit reports for accounting periods ending on or after 1 April 2014.
(iii) It is applicable to all audit reports issued on or after 1 April 2014, irrespective of the period to which it pertains.

As mentioned earlier, to address the issue, the MCA has issued the General Circular no. 8/2014 dated 4 April 2014. The Circular clarifies that the Auditor's Report in respect of financial years, which commenced earlier than 1 April 2014, will be governed by the relevant provisions of the 1956 Act. Hence, view (i) will apply for the matters covered under the auditor report. In our view, this approach is logical as it ensures that the new requirement is applied prospectively.
Penalty on auditors

Section 147(5) of the 2013 Act states that “where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.”

The Audit Rules clarify that in case of criminal liability, the liability will devolve only on the concerned partner or partners, who acted in a fraudulent manner or abetted or, as the case may be, colluded in any fraud.

Practical perspectives

The Audit Rules have clarified the position only with respect to the criminal liability but not the civil liability. Hence, one may argue that for civil liability, joint and several liabilities of the partners and the firm can be enforced even if all the partners have not colluded in committing the fraud.
Both under the 2013 Act and RC49, requirements concerning related party transactions may be divided into four key parts, viz., identification of related parties, related party transactions, approval process and disclosure requirements. It is clear from discussion below that in most cases, RC49 contains stricter requirements vis-à-vis those under the 2013 Act. The definition of ‘related party’ under RC49 is likely to result in identification of significantly higher number of related parties vis-à-vis those under the 2013 Act. RC49 contains a broader definition of ‘related party transactions’ which is expected to cover all types of related party transactions. Unlike the 2013 Act, RC49 does not exempt related party transactions from special resolution of disinterested shareholders based on criteria, viz., (i) transaction is in the ordinary course of business and at arm’s length, or (ii) prescribed threshold regarding transaction value and share capital are not breached. The only exemption from special resolution of disinterested shareholders under RC49 is that the transaction does not breach materiality threshold. A listed company needs to consider the two requirements carefully and apply stricter of the two.

### Identification of related parties

#### Definition under the 2013 Act

The 2013 Act defines the term “related party” to mean:

1. A director or his relative
2. KMP or his relative
3. A firm, in which a director, manager or his relative is a partner
4. A private company in which a director or manager is a member or director
5. A public company in which a director or manager is a director and holds along with his relatives, more than 2% of its paid-up share capital
6. A body corporate whose board, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager, except if advice/ directions/ instructions are given in the professional capacity
7. Any person on whose advice, directions or instructions a director or manager is accustomed to act, except if advice/ directions/ instructions are given in the professional capacity

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1 Refer discussion below regarding ‘common directorship.’
(viii) Any company which is:

- a holding, subsidiary or an associate company of such company, or
- a subsidiary of a holding company to which it is also a subsidiary

(ix) Such other persons as may be prescribed.

**Related parties under “enabling clause” (clause (ix))**

In accordance with the draft rules, the following persons were to be covered under the enabling clause:

“(1) A director or KMP of the holding, subsidiary or associate company of such company or his relative, or

(2) Any person appointed in senior management in the company or its holding, subsidiary or associate company, i.e., personnel of the company or its holding, subsidiary or associate company who are members of core management team excluding board of directors comprising all members of management one level below the executive directors, including the functional heads.”

There was a concern that the definition, particularly, relations prescribed under the draft rules, will result in a long list of related parties for large conglomerates having multiple subsidiaries/operations. Many of these persons may not be in a position to influence the actions of a company, and may not even be known to the company. For example, a director or KMP of the subsidiary or associate, in most cases, may not be able to influence the parent/investor. Also, the persons at one level below executive directors and functional heads do not have authority and responsibility for planning, directing and controlling the activities of a company. Rather, they work under the supervision of the board of directors. Hence, the draft rules may have created significant administrative burden on companies to identify and track related party relations/transactions on a continuous basis, which may not serve much useful purpose. Global practice is also not to include them in related parties.

In the Definition Rules, this issue has been largely addressed. In the Definition Rules, the enabling clause includes only a director/ KMP of the holding company or his relative as the related party. We welcome the change made in the Definition Rules.

**Common directorship**

The definition of “related parties” in the 2013 Act provided that related party with reference to a company, among other matters, includes a public company in which a director or manager of the company is a director or holds along with his relatives, more than 2% of its paid up share capital (emphasis added).

To explain, assume that ABC Limited and DEF Limited are two public companies. There is no relation between the companies, except relation below.

- Mr. X is a reputed professional. He has recently been appointed as independent director on the board of ABC. Mr. X is also an independent director on the board of DEF. Based on common directorship, one will have concluded that ABC and DEF are related parties to each other. Consequently, all companies where Mr. X is a director would have become related parties to ABC and DEF.

- Consider another scenario. Mr. X is a reputed professional. He has recently been appointed as independent director on the board of ABC. One of the relatives of Mr. X holds 2% share capital in DEF. Based on the above clause, DEF would have been a related party to ABC. However, from DEF’s perspective, ABC will not have been a related party.

It appears that the Government may not have intended that a company should identify a public company as its related party merely because there is a common director. To reflect its true intention and avoid undue hardship, the Central Government has proposed to issue the Companies 1st (Removal of Difficulties) Order, 2014. In accordance with the proposed order, the word ‘or’ highlighted above should be read as the word ‘and.’ For the purpose of this publication, it is assumed that the proposed order is final and will become law soon. Hence, for a company, public company will be related party only if both the criteria are met:

- Director or manager of the company is a director in the public company, and
- Director or manager holds along with his relatives more than 2% of paid up share capital in the public company
Definition under the RC49

RC49 defines the term ‘related party’ in a broader manner. The definition under RC49 includes all related parties under the 2013 Act. In addition, it includes related parties under Ind-AS 24. RC49 states that a ‘related party’ is a person or entity that is related to the company. Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party, directly or indirectly, in making financial and/or operating decisions and includes the following:

1. A person or a close member of that person’s family is related to a company if that person:
   a) Is a related party under section 2(76) of the 2013 Act
   b) Has control or joint control or significant influence over the company, or
   c) Is KMP of the company or of a parent of the company

2. An entity is related to a company if any of the following conditions apply:
   a) The entity is a related party under section 2(76) of the 2013 Act
   b) The entity and the company are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others)
   c) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member)
   d) Both entities are joint ventures of the same third party
   e) One entity is a joint venture of a third entity and the other entity is an associate of the third entity
   f) The entity is a post-employment benefit plan for the benefit of employees of either the company or an entity related to the company. If the company is itself such a plan, the sponsoring employers are also related to the company, or
   g) The entity is controlled or jointly controlled by a person identified in (1), or
   h) A person identified in (1)(b) has significant influence over the entity (or of a parent of the entity).

An explanation to the definition states that for this purpose, the term ‘control’ will have the same meaning as defined in the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. These regulations define the term ‘control’ to include “right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner.”

Definition of relative

The 2013 Act defines the term ‘relative’ as ‘with reference to any person means anyone who is related to another, if:

(i) They are members of a Hindu Undivided Family
(ii) They are husband and wife, or
(iii) One person is related to the other in such manner as may be prescribed’

The draft rules prescribed a list of 15 relations to be covered under (iii) above. In the Definition Rules, this list has been rationalized to exclude grandparents and grandchildren. Now, it covers only 8 relations (see Table 3).

<table>
<thead>
<tr>
<th>Table 3: List of relatives</th>
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</thead>
<tbody>
<tr>
<td>Father (including step-father)</td>
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<tr>
<td>Mother (including step-mother)</td>
</tr>
<tr>
<td>Son (including step-son)</td>
</tr>
<tr>
<td>Son’s wife</td>
</tr>
</tbody>
</table>

In the context on independent directors, RC49 states that the term ‘relative’ will have the same meaning as defined under the 2013 Act and rules prescribed thereunder.
Practical perspectives

(1) Among other matters, the definition of ‘relative’ is likely to have significant impact on aspects such as coverage of related party transactions or appointment, qualification and disqualification of auditor and independent directors. We believe that rationalization of the list of relatives is an improvement from the definition contained in the draft rules and it may somewhat reduce challenges in ensuring continuing independence of the auditor/independent directors. However, the fact remains that a person may not be able to control/influence actions of other person if the other person is not financially dependent on him/her. Similarly, a person may be able to influence other persons who are financially dependent on him or her, even if they are not covered in specific list or relations. Going forward this aspect may be revisited by the MCA.

(2) Refer discussion under the head ‘common directorship’, including change made through the proposed Companies 1st (Removal of Difficulties) Order, 2014. Interestingly, the concerned clause for identifying related party is not based on the principle of reciprocity. Hence, it is possible that one company identifies other company as its related party. However, it does not necessarily mean that the second company will also identify the first one as its related party. Rather, it will perform its own independent evaluation. See example below.

ABC Limited and DEF Limited are two public companies. Mr. X, a reputed professional, is an independent director on the board of ABC. Mr. X is also a director on the board of DEF. Wife of Mr. X holds 2% share capital in DEF. Besides this, there is no relationship between two companies. In this case, ABC will treat DEF as its related party as both the criteria for identifying a public company as related party are met. For DEF, ABC is not a related party since criterion (ii) explained under the head ‘common directorship’ is not met.

Also, it may be noted that the proposed order is relevant only for the identification of public company as related party. There is no change in the criterion to determine whether a private company is related party to the company. Also, it is pertinent to note that the above differentiation between private and public companies is from the perspective of the company who is being identified as related party and not the company who is identifying its related party. Table 4 explains this aspect from ABC Limited’s perspective:

<table>
<thead>
<tr>
<th>Table 4: Related party identification</th>
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<tbody>
<tr>
<td><strong>ABC Limited</strong></td>
</tr>
<tr>
<td><strong>DEF Limited</strong></td>
</tr>
<tr>
<td><strong>Common director</strong></td>
</tr>
<tr>
<td><strong>Director’s shareholding in DEF</strong></td>
</tr>
<tr>
<td><strong>Director’s shareholding in ABC</strong></td>
</tr>
<tr>
<td><strong>Whether DEF is related party to ABC</strong></td>
</tr>
<tr>
<td><strong>Whether ABC is related party to DEF (DEF’s perspective)</strong></td>
</tr>
</tbody>
</table>
(3) Whilst the RC49 uses the terms such as ‘close member of family’, ‘joint venture’ and ‘group,’ it does not define those terms. It may be argued that since definition of related parties is based on Ind-AS 24, a listed company should refer Ind-AS for appropriate definition of these terms.

(4) The definition of ‘related party’ under the RC49 is much more exhaustive. Related parties under section 2(76) of the 2013 Act are just one element of related party relationships covered under the RC49. RC49 is likely to result in identification of much higher number of related parties and identification on a more consistent basis. Consider the example in diagram 1 below:

Diagram 1

In this example, analysis under the 2013 Act is likely to be as below:

► For company H, company A is an associate company and its related party.

► The definition of related party in the 2013 Act does not refer to joint venture as related party. However, the definition of “associate company” includes “joint venture company.” Thus, for company H, company S is also a related party.

► On the same basis as (b) above, for company Z, company S is a related party.

It is assumed that there is no other relationship between parties. Basis this, for company A, company H is not a related party. Similarly, for company S, neither H nor Z is related party. Company S and A are not related parties to each other. Company Z and H are also not related to each other.

All three related party relationships identified under the 2013 Act continue under RC49. In addition, the following new relationships get identified:

► For company A, company H is a related party under clause 2(c) of ‘related party’ definition under RC49.

► On similar lines, both H and Z are related parties to company S.

► Company S and A are related parties to each other under clause 2(e) of ‘related party’ definition under RC49.

Even under RC49, company Z and H are not related to each other.
Identification of relevant transactions

Section 188 of the 2013 Act deals with the related party transactions with respect to:

a) Sale, purchase or supply of any goods or materials
b) Selling or otherwise disposing of, or buying, property of any kind
c) Leasing of property of any kind
d) Availing or rendering of any services
e) Appointment of any agent for purchase or sale of goods, materials, services or property
f) Related party’s appointment to any office or place of profit in the company, its subsidiary company or associate company, and
g) Underwriting the subscription of any securities or derivatives thereof, of the company.

In contrast, RC49 defines the related party transactions as a transaction involving “transfer of resources, services or obligations between a company and a related party, regardless of whether a price is charged.”

Practical issues and perspectives

In the definition under RC49, specific attention is drawn to the use of the word ‘resource’ which may include even items that do not meet criteria for recognition as an asset. To illustrate, a listed company is transferring to its fellow subsidiary ‘research work’ carried out in the past which does not meet AS 26 criteria for recognition as an intangible asset. Under RC49, the proposed transaction will be covered as transfer of resource. Hence, RC 49 contains a broader definition which is expected to cover all types of related party transactions.

The two issues discussed below regarding identification of related party transactions are not relevant under RC49.

Section 188(1)(b) of the 2013 Act covers contract with related parties with respect to “selling or otherwise disposing of, or buying, property of any kind.” Does the term ‘property’ cover only ‘immovable property’? Or will it include even movable property and intangible assets?

Whilst section 188(1)(b) of the 2013 Act covers “selling or otherwise disposing of, or buying, property of any kind,” section 188(1)(a) deals with “sale, purchase or supply of any goods or materials.” This indicates that ‘goods or materials’ are not covered under section 188(1)(b) and discussions below are relevant only for other items.

Section 188 of the 2013 Act does not define the term ‘property.’ However, it may be noted that explanation (iv) to Section 232, which deals with merger and amalgamation of companies, states that “for the purpose of this section, the term property includes assets, rights and interests of every description.”

The above guidance, along with the term used, viz., ‘property of any kind’ seems to indicate that all forms of property, including intangible assets such as intellectual property rights, may be covered under Section 188(1)(b).

Further, section 44 of the 2013 Act states that shares, debentures or other interest of any member in a company will be movable property transferable in the manner provided by the articles of the company. This indicates that even shares/securities are included in definition of “property.”

Since this is a legal matter, we suggest that a company consults its legal professionals before taking any final view on the matter.

Since the term ‘property’ includes ‘securities’ also, does Section 188(1)(b) cover only sale/or transfer of securities in the secondary market or would allotment of securities, i.e., primary issue of securities, also be covered?

As discussed in the response to previous issue, the existing shares constitute property. Hence, a related party transaction involving sale/purchase, etc., of the existing shares/securities allotted in the past is likely to trigger compliance under section 188. This requires a company to assess whether it meets any of the exemption criteria and approvals required.

Fresh allotment of shares/securities may not constitute property since the company did not own those shares before the allotment. Also, the word ‘buy’ may not include fresh allotment of shares. Basis this, one may argue that fresh allotment/subscription of securities to related parties does not trigger section 188.

We believe that this is a matter of legal interpretation and a company needs to consult legal professionals before taking any final view.
Approval process

Though related party transactions both under the 2013 Act and RC49 require approval of similar bodies, there are differences in the conditions which trigger such approvals. Particularly, RC49 does not exempt material related party transactions from special resolution of disinterested shareholders based on the criteria, viz., (i) transaction is in the ordinary course of business and at arm's length, or (ii) prescribed thresholds regarding transaction value and share capital are not breached. Listed companies need to consider the requirements carefully and apply the same in a manner that compliance with both requirements can be ensured. In other words, they need to comply with stricter of the two requirements.

The 2013 Act

Section 188(1) of the 2013 Act provides below for approval of related party transactions:

“(1) Except with the consent of the Board of Directors given by a resolution at a meeting of the Board and subject to such conditions as may be prescribed, no company shall enter into any contract or arrangement with a related party with respect to:

a) Sale, purchase or supply of any goods or materials
b) Selling or otherwise disposing of, or buying, property of any kind
c) Leasing of property of any kind
d) Availing or rendering of any services
e) Appointment of any agent for purchase or sale of goods, materials, services or property
f) Such related party’s appointment to any office or place of profit in the company, its subsidiary company or associate company, and
g) Underwriting the subscription of any securities or derivatives thereof, of the company

Provided that no contract or arrangement, in the case of a company having a paid-up share capital of not less than such amount, or transactions not exceeding such sums, as may be prescribed, shall be entered into except with the prior approval of the company by a special resolution.

Provided further that no member of the company shall vote on such special resolution, to approve any contract or arrangement which may be entered into by the company, if such member is a related party.

Provided also that nothing in this sub-section shall apply to 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.”

In accordance with section 177(4)(iv) of the 2013 Act, one of the functions of the Audit Committee is “approval or any subsequent modification of transactions of the company with related parties.”

Under the 2013 Act, a company needs approval of the Audit Committee, if applicable, on all related party transactions and subsequent modifications thereto. This is irrespective of whether they are in the ordinary course of business and consummated at arm’s length or they do not breach the share capital/transaction value thresholds prescribed in the Board Rules.

For a transactions meeting both the criteria (i) transaction is entered into the ordinary course of business, and (ii) transaction is at arms’ length price, neither the board approval nor the special resolution of disinterested shareholders is required. For transactions, which are either not in the ordinary course of business or not at arm’s length, the company will need at least approval of the board, irrespective of the share capital/transaction value.

Regarding the special resolution of disinterested shareholders, there is an additional exemption which needs to be considered, viz., the company satisfies both the criteria (i) paid-up share capital of the company is below the prescribed threshold, and (ii) transaction value does not exceed the prescribed limit. Thus, a company requires approval through shareholder’s special resolution at general meeting, if criteria at (i) and (ii) below are met. Members of the company, who are related parties, are not permitted to vote on the special resolution.

(I) Related party transactions are either not in the ordinary course of business or not at arm’s length, and

(II) Company’s paid-up share capital is not less than prescribed limit, or transaction(s) amount exceeds specified threshold.
There is no change in approval process under the Board Rules. However, monetary thresholds for passing special resolution have increased vis-à-vis the draft rules. See Table 5.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Board Rules</th>
<th>Draft rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-up share capital threshold</td>
<td>₹10 crores or more</td>
<td>₹1 crores or more</td>
</tr>
<tr>
<td>Transaction value threshold</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale, purchase or supply of any goods or materials (Directly or through agent)</td>
<td>More than 25% of annual turnover</td>
<td></td>
</tr>
<tr>
<td>Selling or otherwise disposing of, or buying, property of any kind (Directly or through agent)</td>
<td>More than 10% of net worth</td>
<td>Total transaction value during the year exceeds 5% of annual turnover or 25% of net worth of the company as per its last audited financial statements</td>
</tr>
<tr>
<td>Leasing of property of any kind</td>
<td>More than 10% of net worth or 10% of turnover</td>
<td></td>
</tr>
<tr>
<td>Availing or rendering of any services (Directly or through agent)</td>
<td>More than 10% of net worth</td>
<td></td>
</tr>
<tr>
<td>Appointment to any office or place of profit in the company, its subsidiary company or associate company</td>
<td>Remuneration exceeds ₹250,000 per month</td>
<td>Remuneration exceeds ₹100,000 per month</td>
</tr>
<tr>
<td>Underwriting the subscription of any securities of the company or derivatives thereof</td>
<td>Remuneration exceeds 1% of net worth</td>
<td>Remuneration exceeds ₹1,000,000</td>
</tr>
</tbody>
</table>

To claim exemption from special resolution of disinterested shareholders either the transaction has to be in the ordinary course of business and at arm’s length or below the prescribed threshold. Based on the criteria above, it needs to be ensured that paid-up share capital of the company is below the threshold given in table 5 as well as that the transaction value does not exceed threshold given in table 5. If either of the two criteria is breached, a company will not be eligible to avail exemption unless the transaction entered into by the company is in its ordinary course of business and it has been entered into on an arm’s length basis.

**Revised Clause 49**

Under RC49, all related party transactions require prior approval of the Audit Committee, irrespective of whether they are material or not. RC49 also requires all material related party transactions to be approved by the shareholders through special resolution. Related parties should abstain from voting on such resolutions. Unlike the 2013 Act, RC49 does not exempt material related party transactions from special resolution of disinterested shareholders based on the criteria, viz., (i) transaction is in the ordinary course of business and at arm’s length, or (ii) prescribed thresholds regarding transaction value and share capital are not breached.

RC49 does not make any reference to the board approval for related party transactions. However, one may argue that under the principles of corporate governance, any matter to be referred to the shareholders is routed through the board. Also, under RC49, one of the functions of the board is to “monitor and manage potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.” This suggests that the board also need to approve all material related party transactions entered into by a listed company.

A transaction with a related party is considered to be material if the transaction/transactions to be entered into individually or taken together with previous transactions during a financial year, exceeds 5% of the annual turnover or 20% of the net worth of the company as per its last audited financial statements, whichever is higher.
**Interaction between the 2013 Act and RC49**

A listed company needs to apply stricter of the 2013 Act and RC49 requirements. Considering the impact of the 2013 Act and RC49, the approval requirements will operate as below:

(I) To comply with RC49, a listed company needs to get all related party transactions approved by the Audit Committee. It also needs to get all material related party transactions approved by the Board and Special Resolution of Disinterested Shareholders. The exemptions given under the 2013 Act will not apply.

(II) For immaterial transactions of listed companies and all related party transactions of non-listed entities, approval requirements of the 2013 Act apply. It is noted that due to differences in criteria, even an immaterial related party transaction (as per RC49) may need board/disinterested shareholder approval under the 2013 Act. For example, this may arise because transaction is not in the ordinary course of business and/or not on arms' length basis, and the share capital or transaction value thresholds are breached.

Diagram 2 below explains practical applicability of the approval process. The diagram illustrates approval requirements of both the 2013 Act and RC49.

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1Under the 2013 Act, non-listed companies, which do not meet the prescribed criteria, are not required to constitute Audit Committee. In such case, Audit Committee approval requirement does not apply.
Practical issues and perspectives

The discussion regarding practical issues focuses on the 2013 Act. Nonetheless, most of it would also be relevant for purposes of complying with the listing requirements. At appropriate places, we have made references to RC49.

Section 177(4)(iv) of the 2013 Act requires the Audit Committee approval on any transaction entered into by a company with its related parties, including subsequent modification thereto. Is the Audit Committee approval required prior to execution of the contract with a related party? Or will it be acceptable to obtain the approval after the contract has been executed?

One view is that section 177(4)(iv) does not specifically use the word ‘prior approval.’ Hence, one view is that it may be acceptable to obtain approval even after the execution of the contract. The second view is that the term used is ‘approval’ and not ‘ratification.’ This seems to indicate that the approval should be obtained prior to execution of the contract. The proponents of second view also state that it will be more prudent for a company to obtain the approval before entering into any transaction with a related party. If the Audit Committee does not approve any previously executed contract, it may have the effect of de-railing the entire transaction and causing financial loss to the company as well as the counterparty.

In case of listed companies, RC49 specifically requires all related party transactions to be pre-approved by the Audit Committee.

With regard to the board approval/special resolution of disinterested shareholders section 188(3) of the 2013 Act provides as below:

“Where any contract or arrangement is entered into by a director or any other employee, without obtaining the consent of the Board or approval by a special resolution in the general meeting under sub-section (1) and if it is not ratified by the Board or, as the case may be, by the shareholders at a meeting within three months from the date on which such contract or arrangement was entered into, such contract or arrangement shall be voidable at the option of the Board and if the contract or arrangement is with a related party to any director, or is authorised by any other director, the directors concerned shall indemnify the company against any loss incurred by it,”

Apparently, section 188(3) does not intend to allow companies to take post-facto approval for related party transactions. Rather, it prescribes the corrective measures to be taken and impact, if a company does not comply with the requirements of section 188(1) on a timely basis.

Let us assume that a company is entering into related party transaction requiring the Audit Committee and the Board approval. From the process perspective, is there any requirement to obtain the board approval first or the Audit Committee approval first?

Neither the 2013 Act and nor the Board Rules prescribe any particular process flow/order for obtaining required approvals. For example, there is no specific requirement whether a company should obtain the Audit Committee approval first or the Board approval first, if both the approvals are needed. Typically, one expects that the approval of shareholder, i.e., special resolution of disinterested shareholders, will be obtained only after other approvals have taken place. In other cases, more than one view seems possible.

- One view is that section 188 generally requires the board approval to be obtained before entering into a contract or arrangement with the related party. However, there is no clear requirement for the Audit Committee pre-approval. This seems to indicate that a company can sign the agreement with a related party by having the Audit Committee approval as condition precedent. Hence, in one scenario, the company can take the board approval first and the Audit Committee approval later.

- The second view is that the Audit Committee is required to act in accordance with the terms of reference made by the board. It would not be appropriate if the Audit Committee rejects a transaction, which has already been approved by the board. Hence, in practice, the board may first refer proposed related party transaction to the audit committee. Upon receiving the audit committee approval/rejection, the board will make its decision. To support this view, one may also draw reference to JJ Irani Committee Report2. The report, among other matters, stated that all matters relating to related party transactions and other matters involving conflicts of interest should be referred to the board only through the Audit Committee.

In case of listed companies, RC49 requires all related party transactions to be pre-approved by the Audit Committee. This indicates that in case of listed companies, only the second view should be applied. For non-listed companies also, the second view is preferred approach. In other words, it is preferable approach to get the Audit Committee approval first before referring a related party transaction to the board.

**Related parties not entitled to vote**

For transactions requiring approval through special resolution at the general meeting, second proviso to the section 188(1) states that no member of the company will vote on such special resolution, if such members are related parties. RC49 also contains similar requirement for approval of material related party transactions. Is the prohibition from voting applicable to all shareholders who are related parties? Or does it apply to only those related parties who are conflicted with respect to the specified transaction?

Consider the example in diagram 3. Subsidiary S intends to make royalty payment to Parent P, which is concluded to be not at arm's length or not in the ordinary course of business. Also, the prescribed threshold criteria are breached, requiring special resolution at the general meeting. Members of the company, who are related parties, are not permitted to vote on the special resolution. It is clear that P is not entitled to vote on the special resolution. However, it is not clear if other related parties also are not entitled to vote. In simple words, what is not clear is from whose perspective the related parties should be considered. In this case whether it is related parties of S, or related parties of P who are shareholders in S or both or all related parties that may have a conflict of interest in that transaction. Particularly, in this fact pattern, the question is whether Investor A can vote on the special resolution.

Neither the 2013 Act nor the Board Rules nor RC49 are clear which related parties are not entitled to vote. This is likely to result in multiple views on the matter.

The first view is that a perusal of the second proviso to Section 188(1) indicates that all members of a company, who are related parties, are barred from voting on special resolution to approve a related party contract/arrangement. However, such a strict interpretation of the proviso creates an ambiguity. Also, it is likely to result in undue hardship to the parties who may not be conflicted in the transaction. These parties may argue that without any reason, they are being deprived of legal rights available under the 2013 Act.

The supporters of first view argue that if certain provisions of law are not clear, one needs to look at overall context for interpreting/understanding those requirements. In this case, the requirements have been introduced to avoid conflict of interest. Hence, one should apply requirements keeping this context in the mind.

Considering the above, supporters of the first view argue that only such members who are related to a company and have an interest in the subject matter of special resolution should not be allowed to vote. Hence, in the above example, investor A should not be barred from voting unless A is also interested party in the transaction and/or related to parent P.

The second view is that subsidiary S is interested in making payment to its parent P. Hence, it may attempt to influence decision of its related parties. Consequently, no related party of subsidiary S should be entitled to vote. Under this view, investor A, who is related party to S, will also not be entitled to vote. One major drawback with this view is that investor A may be an unrelated party to P and may want to stop such royalty payment because it is unreasonable. However, Investor A will not be entitled to vote.

The third view is that all related parties of Parent P, who are also shareholders in subsidiary S, are not entitled to vote. The acceptance of this view may pose additional practical challenges since subsidiary S may not be aware about related parties of P.

The fourth view is that related parties of both S and P (who are shareholders in S) are not entitled to vote.

We believe that the first view is logically correct and probably reflects the intention of the legislator. It may be appropriate for the MCA and the SEBI to clarify. Until such guidance or clarification is provided, it may be appropriate for a company to consult legal professionals before taking any final view.
Special resolution in case of wholly owned subsidiaries

In certain cases, it may so happen that all shareholders in a company are related parties and therefore not entitled to vote. For example, consider a scenario where a wholly owned subsidiary proposes to enter into a transaction with its holding company. It is concluded that the transaction requires special resolution at the general meeting. Members of the company, who are related parties, are not permitted to vote on the special resolution. In this case, how does the subsidiary comply with the special resolution requirement?

The Board Rules state that in case of wholly owned subsidiary, the special resolution passed by the holding company will be sufficient for the purpose of entering into the transactions between wholly owned subsidiary and holding company.

In many cases, Indian companies are wholly owned subsidiaries of overseas companies. A reading suggests that in such cases, the overseas company need to pass special resolution. However, since the 2013 Act/RC49 do not have any jurisdiction over the overseas entities, one may argue that this may not apply in such cases.

Consider another example. Assume that XYZ Private Limited is a joint venture between three companies, viz., X Limited, Y Limited and Z Limited. XYZ is entering into a common related party transaction with all three shareholders. In this case, it is unclear as to how XYZ will comply with the requirement concerning special resolution of disinterested shareholders, if such resolution is needed. Using an analogy of wholly owned subsidiaries, one may argue that special resolution passed by X Limited, Y Limited and Z Limited may be sufficient compliance. Alternatively, it may also be argued that since there are no disinterested shareholders, the requirement concerning special resolution is infructuous for XYZ Limited.

We suggest that MCA and SEBI provide an appropriate guidance on such issues.

Master agreements

With regard to the Audit Committee/Board/disinterested shareholders’ approval required on related party transactions, can a company take a view that it will be sufficient compliance if it obtains the required approval on the master agreements (“MA”) with broad terms agreed therein? Or is it mandatory to obtain separate approval on each transaction?

Neither the 2013 Act nor the Board Rules nor RC49 provide any guidance on whether a company needs to obtain separate approval of the Audit Committee/Board/disinterested shareholders, as applicable, on each contract/transaction or it is sufficient compliance if the company obtains the required approval on the MA with the broad terms agreed therein. Under the second view, the company does not require separate approval for any sub-agreement/purchase order executed between parties.

One view is that section 188 refers to ‘any contract or arrangement.’ Therefore, separate approval for each contract, including sub-agreement, is required. However, the second view is that the term arrangement has wider meaning than the term ‘contract/agreement.’ Hence, one may argue that for standard contracts involving sale/rendering of goods/services, it is possible to obtain the requisite approval only on the MA, which lays down all critical terms and conditions such as type of good/service, pricing arrangement, credit period and payment terms. Based on the terms agreed in the MA, subsequent transactions are consummated and these transactions are closely aligned with the terms agreed in the MA. In this case, one may argue that subsequent purchase orders/sub-agreements are merely an execution of what has already been agreed and approved. They do not result into any new contract/arrangement. Hence, there is no need for obtaining any separate approval on the same. However, if the sub-agreement contains terms, which are different from the MA, or there is any modification in terms or the underlying circumstances have changed, separate approval is needed. Also, for the contracts, which are highly complex and specialized in nature, it may not be possible to define all critical terms under the MA. Rather, a company needs to obtain separate approval for each such contract.

Since the 2013 Act or Board Rules or RC49 do not deal with this aspect, a company may need to evaluate its specific facts and circumstances and consult professionals, including legal professionals, before taking any final view.
**Non-reciprocal relationship**

As mentioned earlier, identification of related parties under the 2013 Act is not based on the principle of reciprocity. It is possible that one company identifies another company as its related party. However, it does not necessarily mean that the second company will also identify the first one as its related party. Let us assume that ABC Limited and DEF Limited are two public companies. Based on its evaluation and criteria prescribed, ABC determines that DEF is its related party. However, for DEF, ABC is not a related party. ABC is proposing to sell a big piece of land to DEF. It is determined that the transaction is not in the ordinary course of business. Also, the prescribed threshold criteria are breached.

In the above case, how the approval process will work? Do both ABC and DEF need to obtain approvals required for related party transaction?

It appears that the identification of related parties and related party transactions is an independent exercise for each company. Such identification is likely to determine, among other matters, approvals required. In the example above, ABC has identified DEF as its related party and, therefore, proposed land deal is related party transaction from ABC's perspective. This requires ABC to obtain the requisite approvals, viz., the Audit Committee and Board approval and special resolution of disinterested shareholders, as appropriate.

From DEF's perspective, ABC is not a related party. Hence, one may argue that proposed land deal is not a related party transaction for DEF. Basis this, it may be argued that DEF need not obtain approvals required for related party transactions.

**Ordinary course of business**

Since RC49 does not contain any exemption from approval process based on the ‘ordinary course of business’ criterion, this discussion is not directly relevant under RC49. However, demonstrating that a transaction has been entered into by a company in its ordinary course of business is likely to help in the approval process and demonstrating good corporate governance. Hence, the following discussion may be useful even under RC49 from this perspective.

What is meant by the phrase ‘ordinary course of business’?

What are the key factors to be considered in determining whether a transaction is in the ordinary course of business?

The phrase ‘ordinary course of business’ is not defined under the 2013 Act or the Board Rules. It seems that the ordinary course of business will cover the usual transactions, customs and practices of a business and of a company.

In many cases, it may be apparent that a transaction has been entered into by a company in its ‘ordinary course of business.’ For example, a car manufacturing company sells cars to its sister concern. The price charged for the sale is the same as what it charges to other corporate customers who are unrelated parties. In this case, it seems clear that the company has entered into the transaction in its ordinary course of business.

Similarly, in certain extreme cases, it may be clear that the transaction is highly unusual and/or extraordinary from the company as well as its business line perspective. Hence, it is not in the ordinary course of business. SA 550 Related Parties contains the following examples of transactions outside an entity’s normal course of business:

- Complex equity transactions, such as corporate restructurings or acquisitions
- Transactions with offshore entities in jurisdictions with weak corporate laws
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged
- Sales transactions with unusually large discounts or returns
- Transactions with circular arrangements, for example, sales with a commitment to repurchase, or
- Transactions under contracts whose terms are changed before expiry.
The above examples are just illustrative and not conclusive. In cases where related party transaction is not falling under either of the two extremes, the assessment of whether a transaction is in the ordinary course of business is likely to be highly subjective, judgemental and will vary on case-to-case basis. No authoritative guidance is available on making this assessment. The experience indicates that companies may like to consider the following aspects:

- Whether the transaction is covered in the main objects or objects incidental to the main objects as envisaged in the Memorandum of Association
- Whether a transaction is usual or unusual, both from the company and its line of business perspective. To illustrate, a particular telecom company may not have outsourced its IT process in the past. However, most of other telecom companies have already outsourced their IT process to save cost. In this case, one may argue that the transaction may be unusual for the company; however, it is not unusual for the telecom industry.
- Frequency: If a transaction is happening quite frequently over a period of time, it is more likely to be treated as an ordinary course of business. However, the inverse does not necessarily hold true.
- Whether transaction is taking place at arm's length: SA 550 contains “sale with unusually large discounts or returns” as an example of transaction which is not in the normal course of business. Hence, arms’ length price is also one factor for this evaluation. However, it may not be sole determining factor. In certain cases, a company may be able to demonstrate that even transactions at below cost price are in the ordinary course of business. For example, if a company is selling cars at below cost to increase its market share. The same price is applicable to all customers, including related parties.
- Business purpose of the transaction: For example, a company has 20 floor building for its office. Out of this, two floors are vacant and the company leases the same to its sister concern at market rent. In this case, one may argue that lease has been entered into by the company in its ordinary course of business. Consider another example. A software company purchased land and constructed building thereon just to lease the entire building to its group company. In this case, it may be difficult to justify that transaction represents ordinary course of business.
- Whether transaction is done on similar basis with other third parties
- Size and volume of transaction

Finally, the assessment of whether a transaction is in the ordinary course of business is likely to be very subjective, judgemental and will vary on case-to-case basis. The factors mentioned above may help companies in making this assessment. However, they cannot take into account the unique circumstances of each business and transaction or replace the exercise of judgment by the management.

Arms’ length

Since RC49 does not contain any exemption from the approval process based on the “arms' length” criterion, this discussion is not directly relevant under RC49. However, demonstrating that a transaction has been entered into by a company on an arms’ length basis is likely to help in the approval process and demonstrating good corporate governance. Hence, the following discussion may be useful even under RC49 from this perspective.

Are there any specific methodologies/approaches to be used for identifying whether a related party transaction has been entered into on an arms' length basis? If no such methodologies/approaches are prescribed under the 2013 Act, can a company use the methodologies/approaches prescribed under other statutes, e.g., the Income-tax Act? What are other key factors to be considered?

The 2013 Act or the Board Rules do not prescribe methodologies and approaches, which may be used to determine whether a transaction has been entered into on an arm’s length basis. One may consider the following aspects in this regard:

- TP guidelines under the Income-tax Act, 1961, prescribe methodologies/approaches to be used for determining arms’ length price. In absence of specific guidance under the 2013 Act, one may find methodologies/approaches under the TP guidelines to be useful. However, it may be noted that the objective of the TP guidelines is different from that of the 2013 Act. The purpose of the TP guidelines is to ensure that there is no tax leakage. The 2013 Act requirements aim to protect minority shareholders’ interest. Hence, one may need to factor these differences in objective and make suitable adjustments to the methodologies/approaches under the TP guidelines.
Section 188 does not require the ‘registered valuer’ certification to determine ‘arm’s length’ price. However, one may evaluate the same on case by case basis. In many cases, whether the transaction is at arms’ length price may be clear from the face of the transaction itself, without any further analysis. For example, refer earlier example where a car manufacturing company sells cars to its sister concern at the same price which is charged to unrelated corporate customers. In this case, one may argue that price is at arms’ length without involving registered valuer. In other cases, complex analysis/valuation may be needed. In such cases, the involvement of registered valuer may help companies in demonstrating that transaction has been entered into on arms’ length basis.

Under the 2013 Act, an explanation states that the expression ‘arm’s length transaction’ means a transaction between two related parties that is conducted as if they are unrelated, so that there is no conflict of interest. Neither the 2013 Act nor the Board Rules clarify how a company can demonstrate the absence of ‘conflict of interest.’ From common parlance perspective, it appears that to demonstrate this, a company will need to show that the existence of special relationship between the contracting parties has not affected the transaction and its critical terms, including the price, quantity and other terms and conditions governing the transaction. Hence, terms of the transaction are comparable to those which unrelated parties would have agreed for a similar transaction.

Disclosure in the board report

Section 188 (2) of the 2013 Act requires that every contract/arrangement entered into under section 188 (1) will be referred to in the board report along with justification.

RC49 prescribes the following additional disclosures for listed companies:

- Policy on dealing with related parties on its website and in the annual report
- Details of material related party transactions on a quarterly basis along with the compliance report on corporate governance
- Disclosure by senior management to the Board of all material financial and commercial transactions where they have a personal interest that may have a potential conflict with the interest of the company

Practical issues and perspectives

The 2013 Act requires that every contract/arrangements entered into under section 188(1) is referred in the board’s report, along with justification for entering into such transaction. Does it require a company to disclose even the transactions, which are entered into by the company in its ordinary course of business and at arms’ length price and therefore, require neither board approval nor special resolution of disinterested shareholders, in the board report?

From a reading of 188(2), it seems clear that only transactions covered under the section 188(1) require disclosure in the board report. Transactions meeting the exemption criteria in third proviso, viz., transactions entered into by a company in its ordinary course of business and at arms’ length price, are completely outside the scope of section 188(1). Hence, the 2013 Act does not require disclosure of such transactions in the board report.

Whilst the above view seems clear from the 2013 Act, the MCA has prescribed Form AOC-2 in the Accounts Rules for disclosure of related party transactions in the board report. The form includes disclosure for (i) all (both material and immaterial) related party transactions which are not on arms' length basis, and (ii) material related party transactions which are on an arms’ length basis. It seems that in prescribing disclosures at (ii) above, the Form AOC-2 has gone beyond disclosures required under the 2013 Act.
Beginning of a new era

Since the Form notified by the MCA has prescribed specific disclosures, we believe that a company may, out of abundant caution, disclose material related party transactions even if they are entered into on an arms’ length basis. We believe that the MCA should resolve this inconsistency and amend Form AOC-2 to omit disclosures not required by the 2013 Act.

This disclosure regarding related party transactions in the board report is applicable to both listed and non-listed companies. In addition, listed companies need to make disclosures required under RC49. To avoid/ minimize duplication of similar disclosures and give meaningful information to users, a listed company may need to structure its board report, annual corporate governance report and annual report carefully.

Transitional requirements

The 2013 Act or the Board Rules do not contain any specific transitional provisions. The SEBI Circular regarding amendment to the RC49 states as below:

“The provisions of Clause 49(VII) as given in Part-B shall be applicable to all prospective transactions. All existing material related party contracts or arrangements as on the date of this circular which are likely to continue beyond 31 March 2015 shall be placed for approval of the shareholders in the first General Meeting subsequent to 1 October 2014. However, a company may choose to get such contracts approved by the shareholders even before 1 October 2014.”

Practical issues and perspectives

How does the applicability of the 2013 Act impact related party contracts that have been previously entered into by a company and are alive on the commencement of Section 188? Can a company take a view that these contracts are grandfathered and hence no fresh approval is required? What will be the implication of any subsequent amendment to these contracts?

The 2013 Act or the Board Rules do not provide any specific guidance on this issue. One view is that the 2013 Act is applicable to all contracts, including contracts previously entered into by a company. Hence, if a company enters into any new transaction/sub-agreement/purchase order under the previously signed contract, it will need to obtain approvals, if any, required under the 2013 Act. However, the second view is that section 188 does not prescribe any retrospective application. Rather, it is applicable only to new contracts/arrangement entered into by a company. Hence, one may argue that ‘grandfathering’ may be permitted. However, any modification in the nature and type of transaction with related parties will trigger approval requirements under the 2013 Act.

For listed companies, RC49 requires that all existing material related party contracts or arrangements, which are likely to continue beyond 31 March 2015, should be placed for approval of the shareholders in the first General Meeting subsequent to 1 October 2014. However, a company may choose to get such contracts approved by the shareholders even before 1 October 2014.

Hence, a listed company, for material contracts/arrangements likely to continue beyond 31 March 2015, needs to comply with the approval requirements of RC49. In other cases, it seems likely that grandfathering may be permitted. However, any modification in the nature and type of transaction with related parties will trigger approval requirements under the 2013 Act.

We recommend that before taking any final view on the matter, a non-listed company should consult with the legal professionals.
Loans to directors and subsidiaries

In accordance with section 185 of the 2013 Act, a company cannot, directly or indirectly, give any loan, including loan represented by a book debt, to any of its directors or to any other person in whom the director is interested or give any guarantee or provide any security in connection with any loan taken by him or such other person.

The 2013 Act explains the expression ‘any other person in whom director is interested’ to include “a body corporate, the board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the board, or of any director or directors, of the lending company.” Apparently, this explanation may cover subsidiary companies. Hence, one interpretation was that a holding company cannot give any loan to/guarantee/security on behalf of its subsidiary. This view, along with the fact that section 185 is applicable from 12 September 2013, has created significant hardship for many companies. This was particularly for the reason that in many cases, a subsidiary may not be able to raise finance without support of its holding company.

Since the notification of section 185, the MCA has tried addressing this hardship through various circulars; however, these circulars were not very clear.

To address this issue, the Board Rules provide the following exemptions. These exemptions are subject to a condition that loans should be utilized by the subsidiary company for its principle business activities.

- Any loan made by a holding company to its wholly owned subsidiary company or any guarantee given or security provided by a holding company in respect of any loan made to its wholly owned subsidiary company is exempted from the requirements under 185.
- Any guarantee given or security provided by a holding company in respect of loan made by any bank or financial institution to its subsidiary company (includes subsidiaries that are not wholly owned) is exempted from the requirements under this section.

In other words, there seems to be prohibition only with respect to giving of loans to a subsidiary that is not a wholly owned subsidiary. It is understandable that most companies will take the position stated in the Board Rules, though the concern whether the rules can override the 2013 Act remains.
Loans and investments by companies

Section 186 of the 2013 Act requires that a company will not (i) give loan to any person/other body corporate, (ii) give guarantee or provide security in connection with a loan to any person/other body corporate, and (iii) acquire securities of any other body corporate, exceeding the higher of:

- 60% of its paid-up share capital, free reserves and securities premium, or
- 100% of its free reserves and securities premium.

The 2013 Act states that for providing loan/giving guarantee/security or acquiring security exceeding the above limit, a company will need to take prior approval by means of a special resolution passed at the general meeting.

Unlike the 1956 Act, the 2013 Act did not contain any exemption for loan made/guarantee given/security provided by a holding company to its wholly owned subsidiary companies. Consequently, it was required that a company will include the amount of loan/guarantee/security to its wholly owned subsidiary as well in the 60%/100% limit. This was likely to create hardship for many subsidiary companies, which are significantly dependent on their parent for financing. Also, in many cases, loans given, guarantee and security provided by the parent may have immediately breached the 60% or 100% limit.

To address the above challenge, the Board Rules provide that where a loan or guarantee is given or where a security has been provided by a company to its wholly owned subsidiary company or a joint venture company, or acquisition is made by a holding company of the securities of its wholly owned subsidiary company, the requirement concerning special resolution at the general meeting will not apply. However, the company will disclose the details of such loans or guarantee or security or acquisition in the financial statements.

Practical perspectives

From a reading of the Board Rules concerning section 185 and 186, the following position emerges:

- A parent company can give loan to/ provide security or guarantee on behalf of its wholly owned subsidiary company or acquire securities of wholly owned subsidiaries. These loans/guarantees/security will not be included to determine whether the company has breached the 60%/100% limit. This effectively brings the position at par with what was prevalent under the 1956 Act.

- A parent company can provide security or guarantee on behalf of its subsidiary company which is not wholly owned subsidiary company. However, it cannot give any loan to such subsidiary company. These guarantees/security will be included in determining whether the company has breached the 60% or 100% limit.

- Loan given to, security/guarantee provided on behalf of the joint venture company will not be included in determining whether the company has breached the 60% or 100% limit.

- In the Board Rules, there is no relaxation/exemption on the requirement concerning charging of interest on loans. Hence, it appears that a company may need to charge interest at the specified rate on all its loans, including loans given to wholly owned subsidiaries and joint ventures. In accordance with the 2013 Act, rate of interest cannot be less than prevailing yield on one year, three year, five year or ten year Government Security closest to the tenor of the loan.

These changes in the rules help resolving many practical challenges that were likely to arise. However, an unresolved issue is that a company can no longer give interest free loan to its wholly owned subsidiary. This is likely to create significant hardship for many groups. Also, the concern regarding rules overriding the law remains.

Omnibus resolution

One of the paragraphs in the Board Rules states that special resolution passed at a general meeting to give any loan or guarantee or investment or provide any security will specify the total amount up to which the board of directors is authorized to give such loan or guarantee, to provide security or acquire investments. This suggests that omnibus resolution will be permitted. The draft rules had permitted omnibus resolution only for guarantees.
**Investment in mutual funds**

Section 186 of the 2013 Act deals with all loans and investments made by a company, including loans etc. to a person. Hence, there is a concern whether investments in mutual funds will also be included in the 60%/100% limit. Under the 1956 Act, section 372A dealt only with inter-corporate loans and investments. Hence, such investments were not included in the 60%/100% limit.

It may be noted that in section 186, sub-paragraph dealing with loans, guarantee and security refer to person as well as body corporate. However, the sub-paragraph dealing with investment covers only acquisition of securities of a body corporate. In an earlier decision, the Supreme Court has held that mutual funds constituted as trust are not body corporate. This seems to suggest that section 186 does not apply to investments in mutual funds and they will not be included in the 60%/100% limit.

**Foreign currency loans**

Under the 2013 Act, the rate of interest cannot be less than prevailing yield on one year, three year, five year or ten year Government Security closest to the tenor of the loan. This is likely to result in an apparent issue in case of foreign currency loans. For example, an Indian company is making loan to a body corporate in Japan where interest rates are negligible. In such a case, it may not be appropriate to require companies to charge interest based on the rates applicable to government securities in India. To address this issue, the MCA should clarify that currency of the government securities should be consistent with the currency of loan.

**Loan between fellow subsidiaries**

As mentioned earlier, there appears to be a prohibition on the parent company giving loans to its subsidiary that is not a wholly owned subsidiary. This raises an interesting issue whether a company can give loan to its fellow subsidiary. Assume that parent P has two subsidiaries, viz., S1 and S2. The parent owns 75% equity capital of S1 and 100% equity capital of S2. It seems clear that P cannot give loan to S1. The issue is whether S2 can give loan to S1.

One view is that S2 will not have any business/commercial reason to give loan to S1, except their relationship with the Parent P. Hence, it may be argued that S2 is giving loan to S1 on behalf of its parent. Since section 185 of the 2013 Act prohibits provision of both direct and indirect loans, some believe that loan proposed to be given by S2, in substance, contravenes the 2013 Act.

According to the supporters of the second view, one should not generalize the situation to state that a subsidiary will always act on behalf of its parent and apply all the restrictions of the parent to its subsidiary. In their view, if one can establish that P has not provided any back-to-back funding to S2 and S2 has made its independent decision to provide loan to S1, S2 will not be acting on behalf of its parent P. The supporters of this view believe that in such cases, S2 can provide loan to S1, without getting impacted by the prohibition on its parent company.

Companies should consider fact pattern specific to their situation and seek legal consultation before proceeding on these matters.

**Loan from foreign parent**

It appears that the restrictions under sections 185 and 186 of the 2013 Act apply to a company which is providing the loan. These sections do not prohibit the borrower company from accepting loan from its parent. Let us assume that an overseas company intends to provide interest free loan to its partly owned Indian subsidiary. In this case, one may argue that since sections 185/186 do not apply to the foreign company, there is no restriction on the company giving loan to its Indian subsidiary. Similarly, these sections do not prohibit Indian subsidiary from accepting loan from its foreign parent. Hence, it may be argued that such loan is not in contravention of sections 185 and 186 of the 2013 Act. It may be appropriate for the MCA to clarify this.
Transitional requirements

One paragraph in the Board Rules state that where the aggregate of the loans and investment so far made, guarantee and security so far provided, along-with the investment, loan, guarantee or security proposed to be made, exceed the limits prescribed, then no investment or loan will be made or guarantee will be given or security will be provided unless previously authorized by special resolution passed at the general meeting.

An explanation to the above paragraph of Board Rules clarifies that it would be sufficient compliance if such special resolution is passed within one year from the date of notification of this section.

The main paragraph in the Board Rules and explanation thereto are drafted in a confusing manner. A collective reading of the two indicates that for loans existing at the enactment date, i.e., 1 April 2014, and new loans granted during the first year, a company can pass special resolution by 31 March 2015 if the 60%/100% limit is breached. In other words, a company is not required to take prior-approval by special resolution for making loans or investment or providing security/guarantee during the first year in excess of the limit. In such cases, resolution may be passed by 31 March 2015.

It is understandable that many companies may prefer taking this view. However, like many other instances, there is a concern that Board Rules may be overriding the 2013 Act since the 2013 Act requires prior approval by special resolution. We suggest that before taking final view, a company may like to consults its legal professionals.
The 2013 Act requires that every company with net worth of ₹500 crore or more, or turnover of ₹1,000 crore or more or a net profit of ₹5 crore or more during any financial year will constitute a CSR committee.

The CSR Rules state that every company, which ceases to be a company covered under the above criteria for three consecutive financial years, will not be required to (a) constitute the CSR Committee, and (b) comply with other CSR related requirements, till the time it again meets the prescribed criteria.

**Constitution of CSR committee**

The 2013 Act requires a company, which meets the CSR applicability criteria, to constitute a CSR committee comprising three or more directors. The 2013 Act also states that out of these three directors, at least one director should be an independent director.

The CSR Rules state that a non-listed public company or a private company, which is not required to appoint an independent director as per the 2013 Act/ Directors’ Appointment Rules, can have its CSR Committee without an independent director. Also, a private company having only two directors on its board can constitute the CSR Committee with the two directors.

Some people argue that the CSR Rules are changing the requirements of the 2013 Act. Hence, an issue arises whether a subordinate legislation can override the main legislation. However, most people are likely to welcome the clarifications provided in the CSR Rules.

**CSR expenditure**

In accordance with the 2013 Act, the board of each company covered under the CSR requirement needs to ensure that the company spends, in every financial year, at least 2% of its average net profits made during the three immediately preceding financial years in pursuance of CSR policy. Neither the 2013 Act nor the CSR Rules prescribe any specific penal provision if a company fails to spend the 2% amount. However, the board, in its report, needs to specify the reasons for not spending the specified amount.
Practical issues and perspectives

Scope/ applicability

Section 135(1) of the 2013 Act, dealing with the applicability criteria for CSR requirements, refers to net worth/turnover/net profit ‘during any financial year’. What is meant by the phrase ‘during any financial year’? Does it require a company to consider its net worth/turnover/net profit for the immediately preceding financial year or the current financial year?

One view is that ‘financial year’ refers to completed period/year in respect of which the financial statements of a company are made-up. The supporters of this view refer the following:

- The definition of ‘net profit’ in the CSR Rules refers to net profit as per the financial statements.
- A proviso to the rule 3(1), dealing with CSR applicability to foreign companies, refers to net worth/turnover/net profit as per the balance sheet and P&L.
- A company cannot determine with certainty whether a criterion is met till the completion of a financial year. To illustrate, it may be possible that cumulative turnover of a company breaches prescribed `1,000 crore limit at one point in time during the year. However, the position may change at a later date, say, due to significant sale return.

Thus, a company uses its financial statements for the immediately preceding financial year to determine CSR applicability.

The supporters of the second view emphasize on the use of the word ‘during’. They mention that dictionary meaning of the word ‘during’ is ‘throughout the course’ or ‘at one point within a period of time’³. Hence, this word is more connected with the concurrent evaluation or evaluation throughout the period. Considering these arguments, the supporters of this view believe that a company considers its net worth/turnover/net profit during the current year to determine CSR applicability. For example, none of the thresholds are currently met in the case of ABC Limited. They are likely to be met during the financial year 2015-16. ABC complies with the CSR requirements as soon as it meets those criteria in 2015-16, and cannot delay it to 1 April 2016 and onwards.

A clarification from the MCA will help in settling this issue. Until such guidance or clarification is provided, our preferred approach is to apply the second view, i.e., a company considers its net worth/turnover/net profit during the current year to determine CSR applicability. Under this view, it may so happen that a company may meet the prescribed criteria toward the year-end. Thus, it may not be able to spend 2% of its average net profit on CSR activities during the current year. This may require the company to explain its factual position and reason for not spending in the board report.

Whilst two views seem possible for deciding the CSR applicability, the provisions for exit from the CSR requirements seem more clear. The rules state that a company can move out of CSR requirements only if the prescribed criteria are not met for three consecutive years.

Paragraph 3(1) of the CSR Rules states as below:

“Every company including its holding or subsidiary, and a foreign company defined under clause (42) of section 2 of the Act having its branch office or project office in India, which fulfils the criteria specified in sub-section (1) of section 135 of the Act shall comply with the provisions of section 135 of the Act and these rules.”

Does it mean that if a company is covered under the CSR requirements, its parent/subsidiary will also be automatically covered by the CSR requirements?

The reason for referring to holding/subsidiary company in the rule is not clear. Apparently, two views seem possible. The first view is that a parent/subsidiary company cannot claim exemption from the CSR applicability merely because its subsidiary/parent company complies with the same. Although, the paragraph contains the phrase ‘including its holding or subsidiary,’ it also states that ‘which fulfils the criteria specified in sub-section (1) section 135 of the 2013 Act’. Hence, each company in the group should evaluate whether it meets the prescribed criteria. If so, it will comply with the CSR requirements.

The second view is that if a company satisfies the prescribed criteria for CSR applicability, CSR requirements automatically become applicable to its holding and subsidiary companies. It does not matter whether they satisfy the prescribed criteria or not.

The former view seems a more plausible intention, which the MCA should confirm.

http://www.macmillandictionary.com/dictionary/british/during
http://www.thefreedictionary.com/during
Do the CSR requirements also apply to the foreign companies, viz., Indian branch/project offices of foreign companies operating in India?

Neither section 135 of the 2013 Act nor sections 379 to 393 dealing with foreign companies nor the Foreign Companies Rules refer to applicability of the CSR requirements to foreign companies having Indian/branch project office.

However, paragraph 3(1) of the CSR Rules, as reproduced in the previous discussion, makes it clear that a foreign company having its branch/project office in India will comply with the CSR requirements, if the branch/project office fulfils the prescribed criteria.

Meaning of net profit

In accordance with section 135(1) of the 2013 Act, one of the criteria for the CSR applicability is that a company has a net profit of ₹5 crore or more during any financial year. The 2013 Act does not specifically explain the meaning of net profit for this purpose.

In accordance with section 135(5) of the 2013 Act, a company meeting the CSR applicability criteria needs to spend, in every financial year, at least 2% of its average net profits made during the three immediately preceding financial years, in pursuance of its CSR policy. An explanation to the section 135(5) states that for the purpose of this section, the average net profit will be calculated in accordance with section 198. Section 198 deals with calculation of profit for managerial remuneration and requires specific addition/deduction to be made in the profit for the year.

In addition, CSR Rules define “net profit” as below. The CSR Rules do not refer whether the definition is relevant for the applicability criteria or CSR expenditure.

“‘Net profit’ means the net profit of a company as per its financial statement prepared in accordance with the applicable provisions of the Act, but shall not include the following, namely:

(i) Any profit arising from any overseas branch or branches of the company, whether operated as a separate company or otherwise; and

(ii) Any dividend received from other companies in India, which are covered under and complying with the provisions of section 135 of the Act.”

How should one resolve the above contradiction?

There may be two possible ways of looking at the definition of net profit in the CSR Rules. The first view is that the CSR Rules define net profit for the purposes of applicability as well as the amount to be spent on CSR activities. The supporters of this view argue that both under section 198 and the CSR Rules, starting point to make adjustments is net profit as per the financial statements. To reconcile two requirements, they believe that a company uses net profit as per the financial statements as starting point and make adjustment required under the CSR Rules to arrive at “net profit” under the CSR Rules. The company uses “net profit” so determined to make specific adjustments required under section 198.

The second view is that the CSR Rules define net profit in the context of the applicability criterion for CSR requirements. The amount that needs to be spent on CSR is based on the average net profits determined in accordance with section 198. The supporters of this view believe that under section 198, debits and credits are allowed only for items specified in the section. If a company makes any debit/credit for any other item, including, items specified in the CSR Rules, net profit so determined is not as per section 198. Hence, if this view is taken, there will be no conflict between the 2013 Act and the CSR Rules. However, it implies that profit arising from overseas branches and dividend received from other Indian companies covered under the CSR requirement will not get excluded from the ‘average net profit’, for determining CSR spend.

It may be argued that the first view better reflects intention of including ‘net profit’ definition in the CSR Rules. Also, one may argue that it conforms to the harmonious interpretation of the 2013 Act and the CSR Rules. Hence, the first view is preferred approach. However, this view is not beyond doubt and arguments can be made to support second views also. Since this is a legal matter, we suggest that a company consults the legal professionals before taking any final view on the matter.
**CSR expenditure and its accounting**

The 2013 Act requires the board of each company covered under the CSR to ensure that the company spends, in every financial year, at least 2% of its average net profits made during the three immediately preceding financial years in pursuance of its CSR policy. If a company fails to spend the 2% amount, is there any legal/constructive obligation on companies to spend the shortfall in the subsequent years?

Neither the 2013 Act nor the CSR Rules prescribe any specific penal provision if a company fails to spend the amount. Also, there does not appear to be any legal obligation on companies to make good short spend of one year in the subsequent years. This indicates that there is no legal obligation on companies to incur CSR expenditure. However, due to disclosure of short spend in the board report, many reputed companies can ill-afford not to spend the prescribed amount. Hence, the naming and shaming policy will create an implied pressure on companies to spend the requisite amount. Also, reputed companies, who have not been able to spend the requisite amount in one year, may try to spend the shortfall in subsequent years.

What is the appropriate accounting for CSR expenditure incurred? Is a company required to charge such amount as an expense to P&L? Alternatively, can a company take a view that CSR is not a mandatory expense and/or expense relating to business and therefore, it should be charged directly to equity?

The argument that CSR expense is a voluntary cost and/or expense not related to business does not appear to be tenable. A company needs to incur this expenditure under the governing law, viz., the 2013 Act. Non-incurrence of this expenditure may severely impact the reputation of a company.

Attention is drawn to paragraph 5 of AS 5 which states as below:

“All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.”

**The Framework for the Preparation and Presentation of Financial Statements** defines the term “expense” as below:

“Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.”

Considering the above, we believe that CSR expenditure is an item of expense for the company which needs to be charged to P&L. This approach may also support the company’s claim to a tax deduction.

Let us assume that a company has incurred lower amount on CSR activities in year 1. It expects to cover-up the short-spent amount in the subsequent years. Is the company required to create a provision toward such short-spent amount?

As discussed earlier, there is no legal obligation on a company to spend on CSR or cover for the shortfalls in the spend in subsequent years. It may so happen that a company does not spend the requisite amount, but discloses that it will cover the shortfalls in subsequent years, thereby creating a constructive obligation for itself.

Whilst there is no doubt that provision for constructive obligation is required under IFRS and Ind-AS; the answer to this question under Indian GAAP seems clear from the two EAC opinions. In both these opinions, the EAC seems to have taken a view that constructive obligation are not provided for. In the recent opinion published in *The Chartered Accountant* of July 2013, the EAC opined “Since as per Department of Public Enterprises Guidelines, there is no such obligation on the enterprise, provision should not be recognised. Accordingly, the committee is of the view that the requirement in the DPE Guidelines for creation of a CSR budget can be met through creation of a reserve as an appropriation of profits rather than creating a provision as per AS 29. On the basis of the above, the committee is of the view that in the extant case, it is not appropriate to recognise a provision in respect of unspent expenditure on CSR activities. However, a CSR reserve may be created as an appropriation of profits.”
Another opinion is contained in Volume 28, Query no 26. In this query EAC opined “A published environmental policy of the company by itself does not create a legal or contractual obligation. From the Facts of the Case and copies of documents furnished by the querist, it is not clear as to whether there is any legal or contractual obligation for afforestation, compensatory afforestation, soil conservation and reforestation towards forest land. In case there is any legal or contractual obligation, compensatory afforestation, felling of existing trees or even acquisition of land could be the obligating event depending on the provisions of law or the terms of the contract.”

Let us assume that a company incurs higher CSR expenditure during any financial year, say, 3% of its average net profit. Can it carry forward the benefit of higher expenditure and use the same to spend lower amount in the subsequent years?

Neither the 2013 Act nor CSR Rules provide any guidance on whether a company can carry forward the benefit of higher expenditure and use the same to spend lower amount in subsequent years.

Since there is no legal obligation for CSR expenditure in the first place, the question of carrying forward the benefit of higher expenditure in one year to spend lower amounts in subsequent years may not be so relevant. Also, from an accounting perspective, the excess expenditure may not meet the definition of an asset, exactly like the lower expenditure not meeting the definition of a liability. This requires a company to charge off the entire expenditure incurred during the year to its P&L.

Can a company incur capital expenditure on CSR related activities? If so, how such expenditure will be included in the 2% limit? Will the company include the entire amount in the year in which capital expenditure is incurred or only depreciation of the capital expenditure will be included in 2% limit for each year?

Paragraph 7 of the CSR Rules explains CSR expenditure in an inclusive manner. It states as below:

“CSR expenditure shall include all expenditure including contribution to corpus, or on projects or programs relating to CSR activities approved by the Board on the recommendation of its CSR Committee, but does not include any expenditure on an item not in conformity or not in line with activities which fall within the purview of Schedule VII of the Act.”

Considering the above, one may argue that a company can incur both capital and revenue expenditure on CSR activities. However, no guidance is available on how capital expenditure will be included in the CSR limit. Many believe that if the contribution is made to a trust, then it does not matter whether the trust has spent it on capital assets or operating expenditure, and both would be counted in the 2% limit of the current year. However, if a company itself is incurring CSR expenditure, the capital assets will be owned by the company. Consequently, in such cases, one may argue that only depreciation on the capital asset will be counted as the CSR expenditure. Some income may be generated from use of the capital asset earmarked for CSR activity, say, fee collected from school run for poor children. The CSR Rules are clear that such income will not form part of the business profit for the company; rather, it needs to be incurred on CSR activities.

The MCA may consider clarifying this issue. Until such guidance is provided, it may be appropriate for a company to consult legal professionals before taking final view.

The rule 4(5) states that the CSR projects/programs/ activities, which benefit only the employees of a company and their families, will not be considered as CSR activity. Let us assume that a company is incurring expenditure on CSR activities which benefit both (i) general public, and (ii) employees of the company and their families. Will the expenditure on such activities be included in the 2% CSR expenditure limit?

A reading of the rule 4(5) indicates that employees of a company and their family should not be sole beneficiaries of the CSR activities being carried out by a company. However, it may be acceptable, if together with the general public, some employees also get benefit from the CSR activities of a company. In our view, to meet this requirement in substance, it needs to be ensured that employees and their families are not the most significant users.
To illustrate, assume that a company is operating a school for poor children. In the same school, children of some low paid workers of the company have also been granted admission. These children constitute 5-10% of the total school population. In this case, expenditure on running the school will qualify as the CSR activity. Consider another scenario. The company has a factory at a place which is very far from the city. In the school, the company has also granted admission to the children of some villagers staying close to the factory; however, the number of such children is relatively small, say, 5-10%. In this case, it may be difficult to argue that the expenditure qualifies as CSR expenditure.

A related issue arises in cases where a company is distributing its products at free of cost, purely as CSR activity. Let us assume that a pharmaceutical company distributes free medicine for treatment of poor people. It is also assumed that the activity qualifies as CSR under the 2013 Act read with the CSR Rules. The cost of production of medicine given free is ₹65 and their maximum selling price is ₹100. The 2013 Act or the CSR Rules do not provide any guidance on whether the cost or selling price of medicine should be included in the CSR expenditure. However, from common parlance perspective, it may be argued that actual cost is the expenditure incurred by a company and it may not include any opportunity cost. Hence, the preferred view is that actual cost of production (i.e., actual expenditure incurred) should be considered for this purpose and the amount spent by pharmaceutical company on CSR is ₹65.

Let us assume that a company has created a trust to carry out its CSR activities. Should the company consolidate that trust under AS 21?

The ICAI has considered the issue regarding the consolidation of trust in the Guidance Note on Accounting for Employee Share-based Payment. The Guidance Note states that AS 21 requires consolidation of only those controlled entities which provide economic benefits to the company. Since an ESOP trust does not provide any economic benefit to the company in the form of return on the investment, it is not required be consolidated.

Typically, trusts created for CSR activities are independent and the company is not a beneficiary. One may argue that no economic benefits, in form of return on investment, flow back to the company. Hence, the CSR trust should not be consolidated.

A company makes payment to an implementation agency for carrying out CSR activities on its behalf. Should the company treat payment made to an implementation agency or actual expenditure incurred by the agency as CSR expenditure?

The implementation agency carries out the underlying activities on the company’s behalf. The rules require the CSR committee to monitor the activities of the agency. Further, the agency needs to provide periodic reports on the projects/activities undertaken and expenditure incurred to the company. These aspects suggest that any payment made by a company to the implementation agency does not discharge the company of its obligation. Rather, the agency is holding money on the company’s behalf and it needs to be ensured that the amount is actually spent on the stated purpose. Hence, one may argue that any amount paid by a company to the implementing agency is only an advance payment. It cannot be treated as CSR expenditure, until the expenditure is actually incurred by the agency.

How should a newly incorporated company comply with the requirement concerning 2% CSR expenditure? Let us assume that MNO Limited is incorporated during the financial year 2014-15. MNO met CSR applicability criteria in the first year of incorporation itself. How can MNO comply with the requirement concerning CSR expenditure @ 2% of average net profit for the three immediately preceding financial years?

Two views seem possible. The first view is that section 135(5) requires 2% of the average net profits made during three immediately preceding financial years to be spent on CSR activities. Since MNO was not in existence for the past three years and does not have profit/loss available for three preceding financial years, CSR expenditure requirement is not applicable to it. In other words, the CSR requirement for MNO will be met only after it has a history of three financial years.

The second view is that when a company is in existence for less than three years, the average of periods in existence should be considered. Just because the company is in existence for less than three years, does not make the requirement of CSR redundant.

It may be appropriate for the MCA to clarify this issue. Until such guidance or clarification is provided, one may argue that it is not necessary for a company to be in existence for 3 years to start incurring CSR expenditure. Hence, the second view seems to be the preferred approach.
Can a company incur expenditure on activities not covered under the Schedule VII and include the same in the 2% expenditure limit?

The CSR Rules are clear that only the expenditure incurred on activities mentioned in the Schedule VII is included in the 2% expenditure limit.

**Transitional requirements**

The requirements concerning CSR are applicable from 1 April 2014. For companies covered under the requirement, how does the requirement concerning 2% expenditure apply in the first year?

A reading of the 2013 Act and the CSR rules suggests that in the first year of application, a company covered under the requirement needs to incur 2% of its average net profit for past 3 years (i.e., financial year 2011-12, 2012-13 and 2013-14) on the CSR activities. Let us assume that a company covered under the CSR requirements has earned net profit of ₹50 crores, (₹12 crores) (net loss) and ₹34 crores during the immediately preceding three years. In this case, the company's average net profit is ₹24 crores i.e., one-third of (₹50 crores - ₹12 crores + ₹34 crores). Hence, the company needs to spend 2% of its average net profit, i.e., 2% of ₹24 crores, on CSR activities.

For companies having other than 31 March year-end, an additional issue is whether they are required to apply the CSR requirements from 1 April 2014 or from the beginning of their next financial year. Will a company having 31 December year-end apply the requirement from 1 April 2014 or 1 January 2015 onward?

Interestingly, the CSR Rules state that reporting requirements of the 2013 Act will apply to financial years commencing on or after 1 April 2014. However, there is no such clear guidance on the constitution of CSR committee and/or CSR expenditure.

One view is that a company determines if it meets the thresholds specified in section 135(1) on a financial year basis. Once the applicability criteria is met, the company sets up a CSR committee and starts spending 2% of its average net profits determined in accordance with section 198 of the 2013 Act. Thus, a company with a calendar year-end will examine this requirement at 1 January 2015 and start spending for the calendar year 2015. Thus, it will not be required to spend on CSR for the year ended 31 December 2014.

The second view is that since the section is applicable from 1 April 2014, the intention is to make companies spend from that date onwards. The three years of average net profit for a calendar year company would comprise of calendar year 2011, 2012 and 2013.

The MCA may clarify this issue. Pending the issue of such guidance/clarification, it may be noted that CSR requirements of the 2013 Act are primarily driven by disclosure requirements. Since it is clear that disclosures will apply from the financial year beginning on or after 1 April 2014, it may be argued that other CSR requirements will also apply from the same date. Hence, view 1 is the preferred approach. This implies that a company, which has calendar year-end and meets the prescribed criteria, will apply CSR requirements from 1 January 2015 onward.
Beginning of a new era
Composition of the board/non-executive directors

Both under the 2013 Act and RC49, directors are categorized into two classes, viz., executive directors (ED) and non-executive directors. Non-executive directors are further sub-categorized into independent directors (ID) and others (NED). Whilst the 2013 Act recognizes the concept of ED, ID and NED, it prescribes minimum requirement only in respect of ID. For the balance composition, a company is free to choose between ED and NED. In contrast, RC49 requires that the board of directors of a listed company should have an optimum combination of executive and non-executive directors. It also requires that minimum 50% of the board should comprise of non-executive directors, which include both IDs and NEDs.

Neither the 2013 Act nor the Directors’ Appointment Rules nor RC49 contain any specific information about functions, roles and responsibilities of NED. With regard to liability of NED, the 2013 Act states that NED, not being a promoter or KMP of the company, will be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently. RC49 contains such a clause for ID, but not for NEDs.

Practical perspectives

From a practical perspective, unlike an ID, an NED is not expected to be independent of the company and its promoters/shareholders, etc. At the same time, an NED does not form part of the executive management team.

In accordance with the Higgs Report published by the British government in 2003, NEDs are expected to play key role in the following areas:

(I) **Strategy:** NEDs should constructively challenge and contribute to the development of strategy.

(II) **Performance:** NEDs should scrutinise and monitor the performance of management.

(III) **Risk:** NEDs should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.

(IV) **People:** NEDs are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing and where necessary removing senior management, and in succession planning.

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4 For the purposes of this publication, other non-executive directors, i.e., non-executive directors, other than independent directors, are referred to as “NED.”
**Woman director**

The 2013 Act requires prescribed class of companies to have at least one woman director on the board. In accordance with the Act, existing companies meeting the prescribed criteria need to comply with the requirement within one-year.

The Directors’ Appointment Rules contain criteria for appointment of woman director which is similar to what was proposed under the draft rules. See table 6 below.

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<tr>
<th>Company</th>
<th>Directors’ Appointment Rules</th>
<th>Draft Rules</th>
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<tr>
<td>Listed companies</td>
<td>All companies</td>
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<table>
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<tr>
<th>Non-listed public companies meeting either of the following two criteria</th>
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<tr>
<td>Paid-up share capital</td>
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<tr>
<td>Turnover</td>
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Under the draft rules, non-listed public companies, which met the prescribed criteria, were given three year timeframe to comply with the requirement. This time limit has been removed from the Directors’ Appointment Rules.

The Directors’ Appointment Rules also require the following:

- A newly incorporated company, which meets the prescribed criteria, needs to appoint a woman director within six months from the date of its incorporation.

- The board needs to fill-up any intermittent vacancy of a woman director at the earliest but no later than the immediate next board meeting or three months from the date of such vacancy, whichever is later.

RC49 also requires all listed companies to have at least one woman director on the board. RC49 is applicable from 1 October 2014 and does not allow any transitional provision to meet this requirement. This suggests that all listed companies will need to have at least one woman director on their board, on or before 1 October 2014. However, non-listed public companies meeting the prescribed criteria will need to appoint a woman director within one year from the date of enactment of the 2013 Act, i.e., they need to appoint woman director by 31 March 2015.

**Practical issues and perspectives**

In accordance with the Directors’ Appointment Rules one of the criteria for appointment of woman director in non-listed public companies is that the company has paid-up share capital of ₹100 crore or more. For this purpose, will the paid-up share capital include non-convertible preference shares also? Will the securities premium received on issue of shares also be included in the paid-up share capital?

Section 2(64) of the 2013 Act defines the term “paid-up share capital” to mean “such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid-up in respect of shares issued and also includes any amount credited as paid-up in respect of shares of the company, but does not include any other amount received in respect of such shares, by whatever name called.” (Emphasis added)
In accordance with section 2(84) of the 2013 Act, share means a share in the share capital of a company and includes stock. In accordance with section 43, share capital of a company can be of two kinds, viz., equity share capital and preference share capital. It does not differentiate between convertible and non-convertible preference shares. Moreover, the definition of “total share capital,” given in the Definition Rules, to include paid-up equity share capital and convertible preference share capital is relevant only for the definition of terms subsidiary company and associate company. The same definition cannot be used for any other purpose.

Hence, we believe that for the appointment of woman director, paid-up share capital includes paid-up equity share capital and paid-up preference share capital, whether convertible or not. Also, from the words highlighted in section 2(64), it appears that paid-up share capital includes only amount received toward face value of shares. Amount received toward securities premium is not included in the paid-up share capital. Also, the share application money pending allotment is not included in the paid-up share capital.

An explanation to the criteria for appointment of woman director states that “for the purposes of this rule, it is hereby clarified that the paid-up share capital or turnover, as the case may be, as on the last date of latest audited financial statements will be taken into account.” In this regard, the following issues need to be considered:

- Let us assume that a company is getting its quarterly financial statements, prepared in accordance with AS 25 (either full or condensed), audited. Does it require the company to consider the paid-up share capital or turnover, as the case may be, in quarterly financial statements to decide whether applicability criteria are met?

- In the case of annual financial statements, there is always some time-lag between the year-end and the date on which audited financial statements are available. Should the company continue using previous year financial statements in the interim?

Section 2(40) of the 2013 Act defines the term ‘financial statements’ to include, among other matters, balance sheet as at the end of the financial year, P&L for the financial year and cash flow statement for the financial year. This suggests that audited financial statements for the completed financial year should be considered to decide the applicability. Further, we believe that a company should use only Indian GAAP financial statements for this purpose.

The use of the word “latest audited financial statements” indicates that till the time audited financial statements for the immediately preceding financial year are ready and available, a company may continue using the earlier period financial statement to determine if the applicability criteria are met. Thus, a company could delay the appointment of the woman director by delaying the issuance of audited financial statements within the prescribed time limits in the 2013 Act.

Interestingly, neither the 2013 Act nor the rules give any time limit to comply with the requirement for appointment of woman director if the company meets the prescribed criteria at a later date, i.e., the date subsequent to the commencement of the 2013 Act. To illustrate, let us assume that on 1 April 2014, ABC Limited (non-listed public company) did not meet the prescribed criteria for appointment of woman director. Two years later, these criteria are met. In such cases, no time limit is given for complying with this requirement. It appears that ABC may need to appoint a woman director immediately.
Independent directors

The 2013 Act states that every listed company will have at least one-third of total number of directors as independent directors, with any fraction to be rounded off as one. In addition, the 2013 Act empowers the Central Government to prescribe minimum number of independent directors for other class of public companies.

In accordance with the Gazette Copy of the 2013 Act, existing companies meeting the prescribed criteria need to comply with the requirement within one-year.

The draft rules stated that public companies covered under the prescribed class should have at least one-third of the total number of its directors as independent directors. In the Directors’ Appointment Rules, minimum number of directors for non-listed public companies meeting prescribed criteria has been changed to 2, irrespective of the board size. Also, the criteria for appointment of independent directors have changed in the Directors’ Appointment Rules. See table 7 below.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Directors’ Appointment Rules</th>
<th>Draft rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>All listed companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of independent directors</td>
<td>1/3rd of board size</td>
<td>1/3rd of board size</td>
</tr>
<tr>
<td>Non-listed public companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No. of directors</td>
<td>Two</td>
<td>1/3rd of board size</td>
</tr>
<tr>
<td>Criteria - either of the following</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paid-up share capital</td>
<td>₹10 crores or more</td>
<td>₹100 crores or more</td>
</tr>
<tr>
<td>Turnover</td>
<td>₹100 crores or more</td>
<td>₹300 crores or more</td>
</tr>
<tr>
<td>Aggregate outstanding loans, debentures and deposits</td>
<td>Exceeding ₹50 crores</td>
<td>Exceeding ₹200 crores</td>
</tr>
</tbody>
</table>

The Directors’ Appointment Rules also require the following:

- Any class of companies, for which a higher number of independent directors has been specified in the law for the time being in force, will comply with the requirements specified in the law.

- If a company covered under this rule is required to appoint higher number of independent directors due to the composition of its audit committee, such higher number of independent directors will apply to the company.

The board needs to fill-up any intermittent vacancy of an independent director at the earliest but not later than the immediate next Board meeting or three months from the date of such vacancy, whichever is later.

The Directors’ Appointment Rules rules also state that a non-listed public company, which ceases to fulfil any of the three conditions laid down in the rule for three consecutive years, will not be required to comply with these provisions until such time as it meets any of the conditions.

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The Directors’ Appointment Rules rules also state that director, if any, appointed by the small shareholders will be treated as independent director provided that such director meets the criteria for being independent director and gives requisite declaration.

Revised clause 49

RC49 requires that where the Chairman of the board is a non-executive director, at least one-third of the board should comprise independent directors. In case the Chairman is an executive director, at least half of the board should comprise independent directors. Since the requirement under RC49 is stricter, a listed company will need to comply with RC49 requirements. Some other key differences between the 2013 Act and RC49 are given below:

- **Board of subsidiary companies:** RC49 requires that the board of all material non-listed Indian subsidiaries of a listed parent company will have at least one independent director from the board of the parent company. There is no such requirement under the 2013 Act.

- **Meaning:** Meaning of the term “independent director” given in RC49 contains most of the attributes prescribed in the 2013 Act. RC49, however, contains the following additional criteria:
  1. The person should not be a material supplier, service provider or customer or a lessor or lessee of the company
  2. The person should not be less than 21 years of age.

- **Nominee directors:** Both under the 2013 Act and RC49, nominee director is not treated as an independent director.

- **Stock options:** Both under the 2013 Act and RC49, an independent director is not entitled to any stock option in the company. However, neither the 2013 Act nor RC49 provide any clarity as to how a company should deal with stock options granted in the past and outstanding at the date of enactment. One argument is that a company may need to cancel/forfeit these options immediately. It may be appropriate for the MCA/SEBI to clarify this matter.

- **Limit on number of directorship:** RC49 requires that a person can serve as an ID in not more than 7 listed companies. If the person is whole-time director in any other listed company, then he can serve as an ID in not more than 3 listed companies. The 2013 Act does not contain any separate restriction on number of directorship for IDs. However, it is pertinent to note that the 2013 Act restricts the number of directorship for an individual to 20. Out of total 20 companies, number of public companies in which a person can be appointed as a director cannot exceed 10.

- **Tenure and rotation requirement:** Under the 2013 Act, an independent director holds office for a term up to 5 consecutive years on the board of a company. He is eligible for reappointment on passing of a special resolution by the company. However, no independent director can hold office for more than 2 consecutive terms of five years each. Under the 2013 Act, this provision will apply prospectively. An independent director that completes two terms will be eligible for appointment after the expiry of three years of ceasing to become an independent director; provided during that period of three years, he remains independent with respect to that company.

RC49 also contains similar provision for independent directors’ rotation, except that rotation requirement is not entirely prospective. RC49 states that a person, who has already served as an ID for five or more years in a company as on 1 October 2014, will be eligible for appointment, on completion of present term, for one more term of up to five years. Since the requirement under RC49 is stricter, a listed company needs to comply with the same.

- **Limitation of liability:** RC49 states that an independent director will be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently with respect of the provisions contained in the Listing Agreement. The 2013 Act also contains similar protection clause.
Audit Committee

The 2013 Act requires each listed company and such other class of companies, as may be prescribed, to constitute the Audit Committee. In the Board Rules, thresholds for constitution of the committee have been made more stringent vis-à-vis the draft rules (see table 8 below). These changes in the criteria will require more companies to constitute the Audit Committee.

<table>
<thead>
<tr>
<th>Company</th>
<th>Board Rules</th>
<th>Draft Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed companies</td>
<td>All companies</td>
<td>All companies</td>
</tr>
<tr>
<td>Non-listed public companies meeting either of the following criteria</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paid-up share capital</td>
<td>₹10 crores or more</td>
<td>₹100 crores or more</td>
</tr>
<tr>
<td>Turnover</td>
<td>₹100 crores or more</td>
<td>No such criterion</td>
</tr>
<tr>
<td>Aggregate outstanding loans, or borrowings, or debentures or deposits</td>
<td>₹50 crores or more</td>
<td>₹200 crores or more</td>
</tr>
</tbody>
</table>

Due to the use of the word “or” in the third criterion for non-listed public companies, there seems to be a confusion whether a company needs to consider loans separately, debentures separately and deposits separately or they should be considered in totality. In our view, from the use of the word “aggregate,” it is clear that all of them have to be considered together. To illustrate, a non-listed public company, which has outstanding bank loan of ₹20 crores, outstanding debentures of ₹23 crores and outstanding deposits of ₹12 crores, has met third criterion under the Board Rules. Hence, it needs to constitute the Audit Committee.

Revised clause 49

RC49 requires all listed companies to constitute the Audit Committee. Given below is an overview of differences relating to the Audit Committee between the 2013 Act and RC49:

- Under the 2013 Act, an audit committee comprises of minimum of three directors with independent directors forming a majority. RC49 requires the audit committee to comprise of minimum three directors with two-third members being independent directors.

- The 2013 Act requires that majority of audit committee members including its chairperson should have an ability to read and understand the financial statement. In contrast, RC49 requires that all members should be financially literate and at least one member should have accounting or related financial management expertise.

- RC49 requires that the Chairman of the Audit Committee should be an independent director. It also requires the Chairman of the Audit committee to attend the AGM to answer shareholder queries. No such requirement exists under the 2013 Act,
Nomination and Remuneration Committee

Both the 2013 Act and RC49 require all listed companies to constitute NRC. The 2013 Act empowers the Central Government to prescribe additional class of companies, which need to constitute NRC. In the Board Rules, thresholds for constitution of NRC have been made more stringent vis-à-vis the draft rules (see table 9 below). These changes in the criteria will require more companies to constitute NRC.

<table>
<thead>
<tr>
<th>Company</th>
<th>Board Rules</th>
<th>Draft Rules</th>
<th>RC49</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed companies</td>
<td>All companies</td>
<td>All companies</td>
<td>All companies</td>
</tr>
<tr>
<td>Non-listed public companies meeting either of the following criteria</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paid-up share capital</td>
<td>₹10 crores or more</td>
<td>₹100 crores or more</td>
<td>NA</td>
</tr>
<tr>
<td>Turnover</td>
<td>₹100 crores or more</td>
<td>No such criterion</td>
<td>NA</td>
</tr>
<tr>
<td>Aggregate outstanding loans, or borrowings, or debentures or deposits</td>
<td>₹50 crores or more</td>
<td>₹200 crores or more</td>
<td>NA</td>
</tr>
</tbody>
</table>

Both the 2013 Act and RC49 requires that NRC will comprise of three or more non-executive directors, out of this, at least one-half should be independent directors. RC49 specifically requires that the Chairman of NRC should be an independent director; however, there is no such requirement under the 2013 Act.

The 2013 Act allows the chairperson of the company (whether executive or non-executive) to be appointed as a member of the NRC. However, the person cannot chair NRC. RC49 does not give such an option.
Vigil mechanism

Under the 2013 Act, each listed company and such other class of companies, as may be prescribed, need to establish a vigil mechanism for directors and employees to report genuine concerns. In addition to listed companies, the draft rules required the following companies to establish vigil mechanism:

- Companies which accept deposits from the public
- Companies which have borrowed money from banks and public financial institutions in excess of ₹50 crore.

The Board Rules retain the same criteria. These requirements are strict and would cover many private companies that have borrowed money from banks and public financial institutions in excess of ₹50 crore.

Under the Board Rules, a company will oversee the vigil mechanism in the following manner:

- Companies, which are required to constitute an audit committee, will oversee the mechanism through the audit committee. If any of the members of the audit committee have a conflict of interest in a given case, they should recuse themselves and others members should deal with the matter.

- For other companies, the board will nominate a director to play the role of audit committee to whom other directors and employees may report their concerns.

The Board Rules require that vigil mechanism will provide for adequate safeguards against victimization of employees and directors using this mechanism. Also, in exceptional cases, a company should give such employees/directors a direct access to the Audit Committee Chairperson or the director playing the Audit Committee role, as the case may be.

The Board Rules provide that in the case of repeated frivolous complaints being filed by a director or an employee, the audit committee or the director playing the audit committee role may take suitable action against the concerned director or employee including reprimand.

RC49 also contains similar requirements for establishment of vigil mechanism. However, it does not specify as to how a listed company will oversee such mechanism. Also, it does not contain any specific provision for taking action in the case of repeated frivolous complaints being filed by a director or an employee.

Subsidiary companies

With regard to corporate governance of subsidiary companies, RC49 contains the following specific requirements:

- The board of a material non-listed Indian subsidiary of a listed parent company will have at least one independent director from the board of the parent company.
- The Audit Committee of the listed parent company will also review the financial statements, in particular, the investments made by the non-listed subsidiary company.
- The minutes of the board meetings of the non-listed subsidiary company will be placed at the board meeting of the listed parent company. The management should periodically bring to the attention of the board of the listed parent company, a statement of all significant transactions and arrangements entered into by the non-listed subsidiary company.
- The company will formulate a policy for determining “material” subsidiaries and such policy will be disclosed to the stock exchanges and in the Annual Report.
- A company will not dispose of shares in its material subsidiary which will reduce its shareholding (either on its own or together with other subsidiaries) to less than 50% or cease the exercise of control over the subsidiary without passing a special resolution in its general meeting.
- Selling, disposing and leasing of assets amounting to more than 20% of the assets of the material subsidiary will require prior approval of shareholders by way of the special resolution.

Similar requirements do not exist under the 2013 Act.
Internal audit

The 2013 Act requires such class or classes of companies, as may be prescribed, to appoint an internal auditor to conduct internal audit of the functions and activities of the company. The draft as well as Accounts Rules require all listed companies to appoint internal auditor. In the Accounts Rules, the threshold for appointment of internal auditor by non-listed public companies has changed. Under the Accounts Rules, private companies meeting prescribed criteria are also required to appoint internal auditor. This was not required under the draft rules. Table 10 provides comparison of the two criteria.

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Accounts Rules</th>
<th>Draft rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed companies</td>
<td>All companies</td>
<td>All companies</td>
</tr>
<tr>
<td>Non-listed public companies meeting either of the following criteria</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paid up Share capital during the preceding financial year</td>
<td>₹50 crores or more</td>
<td>₹10 crores or more</td>
</tr>
<tr>
<td>Turnover during the preceding financial year</td>
<td>₹200 crores or more</td>
<td>No such criteria</td>
</tr>
<tr>
<td>Outstanding loan/borrowing from bank or public financial institutions at any time during the preceding financial year</td>
<td>₹100 crores or more</td>
<td>₹25 crores or more</td>
</tr>
<tr>
<td>Outstanding deposits at any time during the preceding financial year</td>
<td>₹25 crores or more</td>
<td>₹25 crores or more</td>
</tr>
<tr>
<td>Private companies meeting either of the following criteria</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Turnover during the preceding financial year</td>
<td>₹200 crores or more</td>
<td></td>
</tr>
<tr>
<td>Outstanding loan/borrowing from bank or public financial institutions at any time during the preceding financial year</td>
<td>₹100 crores or more</td>
<td>No private company was covered.</td>
</tr>
</tbody>
</table>

The Accounts Rules also require the below:

- An existing company, which meets the prescribed criteria, will comply with the requirements within six months from the commencement of this section.
- The Audit Committee or the Board, in consultation with the internal auditor, will formulate the scope, functioning, periodicity and methodology for conducting internal audit.

**Practical perspectives**

A perusal of the 2013 Act read with the Accounts Rules indicates that a company may either engage external agency or have internal resources to conduct internal audit. Further, a firm not registered with the ICAI may also be appointed as internal auditor.
Beginning of a new era
Key requirements of the 2013 Act concerning mergers, amalgamation and reconstruction are given below:

- A company will file a scheme with Tribunal for approval for (i) reduction in share capital, (ii) making compromise/arrangement with creditors and members, and (iii) merger/amalgamation of companies.

- Subject to the RBI approval, both inbound and outbound cross-border mergers and amalgamations between Indian and foreign companies will be permitted. However, the overseas jurisdictions where cross-border mergers and amalgamations are allowed will be notified.

- An application can be made to the tribunal for making compromise or arrangement involving CDR. Any such scheme should, among other matters, include:
  (i) A report by the auditors of the company to the effect that its fund requirements after the CDR will conform to liquidity test based on the estimates provided by the board of directors.
  (ii) A valuation report in respect of the shares and the property and all assets, tangible and intangible, movable and immovable, of the company by a registered valuer.

- The tribunal will not sanction a scheme of capital reduction, merger, acquisition or other arrangement unless the accounting treatment prescribed in the scheme is in compliance with notified AS and a certificate to that affect by the company’s auditor has been filed with the tribunal. Hence, compliance with notified AS will be mandatory for all companies.

- A transferee company will not hold any shares in its own name or in the name of trust either on its behalf or on behalf of its subsidiary/associate companies. The 2013 Act will require such shares to be cancelled or extinguished. This will prohibit creation of any treasury shares under the scheme.

- In case of merger/amalgamation of companies, the following documents should also be circulated for meeting proposed between the company and concerned persons:
  (i) Report of the expert on valuation, if any
  (ii) Supplementary accounting statement if the last annual financial statements of any of the merging company relate to a financial year ending more than six months before the first meeting of the company summoned for approving the scheme.
The merger of a listed company into an unlisted company will not automatically result in the listing of the transferee company.

Only persons holding not less than 10% of the shareholding or having outstanding debt not less than 5% of total outstanding debt can raise objections to the scheme.

The provision of the 2013 Act concerning mergers, amalgamation and reconstruction of companies are yet to be notified. The MCA has issued the draft rules concerning these provisions. However, the final rules on this subject are still awaited. The date from which the provisions of the 2013 Act concerning mergers, amalgamation and reconstruction will apply is unknown.
Glossary

10 Lakh 1 Million
1 Crore 10 Million
100 Crore 1 Billion
The Companies Act 1956 1956 Act
The Companies Act 2013 2013 Act
Abridged Financial Statement AFS
Annual General Meeting AGM
AS 5 Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies AS 5
AS 6 Depreciation Accounting AS 6
AS 10 Accounting for Fixed Assets AS 10
AS 11 The Effects of Changes in Foreign Exchange Rates AS 11
AS 21 Consolidated Financial Statements AS 21
AS 23 Accounting for Investments in Associates in Consolidated Financial Statements AS 23
AS 25 Interim Financial Reporting AS 25
AS 26 Intangible Assets AS 26
AS 27 Financial Reporting of Interests in Joint Ventures AS 27
AS 29 Provisions, Contingent Liabilities and Contingent Assets AS 29
AS 30 Financial Instruments: Recognition and Measurement (AS issued by the ICAI and not yet notified) AS 30
Boil Own Operate Transfer BOOT
Built Operate Transfer BOT
Companies (Auditor’s Report) Order, 2003 (as amended) CARO
Corporate Debt Restructuring CDR
Chief Executive Officer CEO
Chief Financial Officer CFO
Consolidated Financial Statements CFS
Clause 41 of the Equity Listing Agreement Clause 41
Company Law Board CLB
Continuous Process Plant CPP
Corporate Social Responsibility CSR
Debenture Redemption Reserve DRR
Expert Advisory Committee of ICAI EAC
Executive Director ED
Extraordinary General Meeting EGM
Employee Stock Option Plan ESOP
Fully Convertible Debenture FCD
Generally Accepted Accounting Principles GAAP
Government of India GI/ Central Government
International Accounting Standards Board IASB
Institute of Chartered Accountants of India ICAI
Independent Director ID
Investor Education and Protection Fund IEPF
International Ethics Standards Board for Accountants IESBA
Code of Conduct issued by IESBA IESBA code
International Financial Reporting Standards IFRS
Beginning of a new era

Income Tax Act, 1961
Indian Accounting Standards notified by MCA as Indian equivalent of IFRS
Ind-AS 24 Related Party Disclosures
Generally Accepted Accounting Principles in India
Insurance Regulatory and Development Authority
Information Technology
Key Managerial Personnel
Equity Listing Agreement
Master Agreement
Ministry of Corporate Affairs
Management Discussion and Analysis
National Advisory Committee on Accounting Standards
Non Banking Financial Company
National Company Law Tribunal
Non-Executive Directors other than Independent Directors
National Financial Reporting Authority
Accounting Standards notified under the Companies (Accounting Standards) Rules 2006 (as amended)
Nomination and Remuneration Committee
Statement of Profit and Loss / Profit and Loss Account
Public Private Partnership
Reserve Bank of India
Revised Clause 49 of the Equity Listing Agreement
Registrar of Companies
Standards on Auditing issued by ICAI
SA 240 The Auditor’s Responsibilities Relating To Fraud In An Audit Of Financial Statements
SA 550 Related Parties
Securities and Exchange Board of India
SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997
Standalone/ Separate Financial Statements
Statement of Change in Equity
The Sarbanes-Oxley Act of 2002 of the US
Transfer Pricing guidelines
United Kingdom
United States
US Securities and Exchange Commission
Written Down Value
The Companies (Accounts) Rules, 2014
The Companies (Appointment and Qualification of Directors) Rules, 2014
The Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014
The Companies (Audit and Auditors) Rules, 2014
The Companies (Corporate Social Responsibility Policy) Rules, 2014
The Companies (Declaration and Payment of Dividend) Rules, 2014
The Companies (Meetings of Board and its Powers) Rules, 2014
The Companies (Share Capital and Debentures) Rules, 2014
The Companies (Specification of Definitions Details) Rules, 2014
The Companies (Registration of Foreign Companies) Rules, 2014

Income-tax Act
Ind-AS
Ind-AS 24
Indian GAAP
IRDA
IT
KMP
LA / Listing Agreement
MA
MD&A
NACAS
NBFC
NCLT / Tribunal
NED
NFRA
Notified AS or AS
NRC
P&L
PPP
RBI
RC49
RoC
SA
SA 240
SA 550
SEBI
SEBI Takeover Code
SFS
SOCIE
SOX
TP guidelines
UK
US
US SEC / SEC
WDV
Accounts Rules
Directors’ Appointment Rules
Managerial Personnel Rules
Audit Rules
CSR Rules
Dividend Rules
Board Rules
SCD Rules
Definition Rules
Foreign Companies Rules
Companies Act 2013

Related parties transactions
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