Foreword

Dear reader,

I am pleased to share with you our publication “Understanding Companies Bill 2012 - Analysis of Accounting, Auditing and Corporate Governance changes”.

The Bill takes a significant step in strengthening Corporate Governance with introduction of key provisions around duties and liabilities of Directors / Independent directors, Auditor rotation, establishment of Serious Fraud Investigation Office (SFIO), constitution of National Financial Reporting Authority (NFRA), Class action suit, Corporate Social Responsibility (CSR) etc.

We are hopeful that the Companies Bill 2012 will soon become an Act once it is passed in the Rajya Sabha and it receives the final assent from the President of India. The new enactment is a milestone event for the Indian corporates with far-reaching consequences.

The full impact of the Companies Bill is not yet clear, as many matters will be covered by rules or circulars, which will be issued later. Some examples are a full list of relatives covered under various sections, class I, II, III companies with respect to applicability of useful lives for depreciation, various matters relating to eligibility of auditors such as amount of indebtedness or nature of business relationships that is permitted, clarity on jurisdiction and constitutionality of proceedings (in the matters of professional and other misconduct by the members of ICAI) by NFRA under the companies bill and disciplinary board/committee under the CA act, mandatory appointment of internal auditor for such class or classes of companies as may be prescribed etc.

The impact of the new pronouncement should not be underestimated and companies and other stakeholders should start examining its impact and swift action.

We are getting close to 1 million registered companies in India. A strong company legislation is therefore imperative. However, the efficacy of the new enactment will depend on how well it is implemented.

The Ministry of Corporate Affairs (MCA) will play a major role to ensure that there is clarity and consistency in understanding the new legislation. The MCA will have to proactively issue circulars and clarifications so that constituents do not have any difficulty in implementation and the changes are implemented in the right spirit.

While there are several amendments in the new bill, we have categorized the key changes into five important areas for ease of your reading (a) accounts, (b) audit, (c) corporate governance, (d) related party transactions, (e) loans, investments and mergers and amalgamations.

I hope that you will find this publication useful in understanding some key provisions of the new legislation. We welcome your feedback on this publication.

Yours sincerely,

Neville Dumausia
Partner and National Leader
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Financial year

Overview and key changes

1. The existing Companies Act defines the term “financial year” as “the period in respect of which any profit and loss account of the body corporate laid before it in AGM is made up, whether that period is a year or not.” The Companies Act also provides that the financial year of a company will normally not exceed 15 months. However, a company can extend it to 18 months, after getting special permission from the registrar.

   According to the Companies Bill, the financial year of a company will be the period ending on 31 March every year.

2. Under the Companies Bill, a company, which is a holding or subsidiary of a company incorporated outside India and is required to follow a different financial year for consolidation of its financial statement outside India, may apply to the tribunal for adoption of a different financial year. If the tribunal is satisfied, it may allow the company to follow a different period as its financial year.

3. All existing companies will need to align their financial year with the new requirement within two years from the commencement of the new law.
Key impact

1. All companies, except companies, which are holding/subsidiary of foreign company and exempted by the tribunal, will need to follow 1 April to 31 March as their financial year. Consequently, they will not be allowed to have a period longer or smaller than 12 months as financial year. Though the tribunal can provide exemption for some companies from following a uniform accounting year, listed companies in particular for purposes of better peer comparison can still choose to follow a uniform year and not seek exemption.

2. The Income-tax Act requires all companies to follow 1 April to 31 March as their previous year, for tax reporting purposes. The requirement of the Companies Bill is consistent with the Income-tax Act and will eliminate the requirement to prepare separate tax financial statements.

3. Companies in industries with cyclical/seasonal businesses, e.g., sugar industry, will not be able to reflect the results of one production cycle in a single set of financial statements.

4. Though majority companies already follow 1 April to 31 March as their financial year, adoption of uniform financial year for all companies may create practical challenges for directors (including independent directors), audit committee members and auditors. For example, a listed company is required to submit its audited annual results to the stock exchange within two months from the end of each financial year. Hence, most of the activities will be concentrated in these two months.

Potential issues

1. A company, which is a holding/subsidiary of a foreign company requiring consolidation outside India, will have an option to follow a different period as “financial year.” However, this option is not automatic. Rather, it will need to seek specific approval from the tribunal. This may create additional administrative hurdles, both for the company as well as the tribunal. Further, it is also not clear what guidelines the tribunal will consider to grant the exemption.

2. A company with a foreign subsidiary will be allowed to adopt a different financial year only if it is required to follow a different financial year for preparation of CFS outside India. In case of a foreign subsidiary, CFS will generally be prepared for India purposes. Hence, an Indian company with a foreign subsidiary may not be able to adopt a different financial year. However, if the foreign subsidiary is also a holding company and has to prepare a CFS for a different financial year, then the tribunal may consider exempting the ultimate parent in India from adopting a uniform financial year.

3. It appears that the tribunal will grant exemption to follow different financial year to a company only if it is a holding or subsidiary of a company incorporated outside India and is required to follow a different financial year for preparation of CFS outside India. However, a company, which is an associate/joint venture of the company incorporated outside India or has an associate/joint venture outside India, will not be eligible for similar exemption. This is despite the fact that associates and joint ventures are also required to be included in CFS.

4. In accordance with AS 21, AS 23 and AS 27, a parent company can use financial statements of subsidiaries, associates and joint ventures 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. This requirement is contained in the Companies Accounting Standard Rules. This is a subordinate legislation and cannot override the requirements of the Companies Bill. Hence, the relief contained in these three standards becomes irrelevant with respect to the subsidiaries, associates and joint ventures, which are established as companies in India, except in some cases as explained in the example below:

Parent company P has subsidiary S and associate A, all companies incorporated in India. In this scenario, one will typically expect all companies to follow uniform financial year, namely, 1 April to 31 March, and the financial statements for the same period will be used to prepare CFS. However, it may so happen that associate A is a subsidiary of the foreign parent FP. Hence, A can apply to the tribunal for following different financial-year. If the tribunal grants such permission to A, Parent company P may have to use the financial statements of A drawn up to a different reporting date for the application of the equity method.
Overview and key changes

1. Under the existing Companies Act, the Central Government has constituted an advisory committee known as the “National Advisory Committee on Accounting Standards (NACAS)” to advise the Central Government on the formulation and laying down of accounting policies and accounting standards for adoption by companies. The NACAS may also advise the Central Government on other accounting/auditing related matters referred to it. Under the Companies Bill, NACAS will be replaced by the NFRA. The NFRA will:

   (a) Make recommendations to the Central Government on the formulation and laying down of accounting and auditing policies and standards for adoption by companies or class of companies and their auditors

   (b) Monitor and enforce the compliance with accounting standards and auditing standards

   (c) Oversee the quality of service of the professions associated with ensuring compliance with such standards, and suggest measures required for improvement in quality of service, and

   (d) Perform such other functions relating to clauses (a), (b) and (c) as may be prescribed.

2. The NFRA will:

   (a) Have the power to investigate, either suo moto or on a reference made to it by the Central Government, for such class of bodies corporate or persons, the matters of professional or other misconduct committed by any member or firm of chartered accountants, registered under the CA Act. No other institute or body will initiate or continue any proceedings in such matters of misconduct where the NFRA has initiated an investigation.

   (b) Have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, while trying a suit, in respect of the following matters:

      (i) Discovery and production of books of account and other documents, at such place and at such time as may be specified by the NFRA

      (ii) Summoning and enforcing the attendance of persons and examining them on oath

      (iii) Inspection of any books, registers and other documents

   (iv) Issuing commissions for examination of witnesses or documents.

(c) Have power to impose strict penalties if professional or other misconduct is proved.

3. After examining the recommendation of the NFRA, the Central Government may prescribe standards of accounting and/or standards on auditing or any addendum thereto, as recommended by the ICAI. Till the time, any auditing standards are notified, standards of auditing specified by the ICAI will be deemed to be the auditing standards.

Key impact

NFRA will act as regulator for members registered under the CA Act working in companies as well as auditors. Hence, it may also take action against the company officials if they are chartered accountant and fail to perform their duties.

While the Bill states that till the time, any auditing standards are notified, standards of auditing specified by the ICAI will be deemed to be the auditing standards. However, similar provision does not exist for the accounting standards. In other words, for accounting standards to become mandatory they have to be issued by the NFRA.

Potential issue

The Companies Bill requires that no other institute or body will initiate or continue any proceedings in such matters of misconduct where the NFRA has initiated an investigation. The CA Act also requires the Disciplinary Board/Committee to deal with the matters of professional and other misconduct by the members of the ICAI. This may create constitutionality and jurisdiction issue which needs to be addressed.

The outcome of investigation by NFRA under the Bill vis-à-vis disciplinary proceedings under the CA Act can be different. Under the CA Act, all misconducts by the members are categorized into the First and the Second Schedule. Depending on the nature of misconduct, maximum fine can be either ₹1 lakh or ₹5 lakh. Similarly, the maximum period for which a member’s name can removed from the register of member can be either 3 months or life time. In contrast, under the Companies Bill, minimum penalty for an audit firm is ₹10 lakh, but this may extend to ten times of the fees received. Also, the NFRA can debar either the concerned member or the entire firm from practicing as a member of the ICAI for a minimum period of six months. However, the NFRA may extend this period upto 10 years.
Financial statements

Overview and key changes

Currently, neither the Companies Act nor any notified AS defines the term “financial statements.” However, the Companies Act requires all companies to prepare the balance sheet and the profit and loss account, to place the same before the AGM. In addition, notified AS 3 requires companies, which are not SMCs, to prepare cash flow statement.

The Companies Bill defines the term “financial statements” to include:

(i) Balance sheet as at the end of the financial year,
(ii) Profit and loss account for the financial year,
(iii) Cash flow statement for the financial year,
(iv) Statement of change in equity, if applicable, and
(v) Any explanatory note forming part of the above statements.

For one person company, small company and dormant company, financial statements may not include the cash flow statement.

Like the Companies Act, the Companies Bill also contains a format for preparation and presentation of financial statements. Except for addition of general instructions for preparation of CFS, the format of financial statements given in the Companies Bill is the same as the revised Schedule VI notified under the existing Companies Act.

Key impact

1. The exemption from preparation of cash flow statement given under the Companies Bill is different from that under notified AS. Given below is the comparison:

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<td>Dormant company</td>
<td>Not a criterion for identification as SMC.</td>
<td>Exempted from preparing cash flow statement.</td>
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The Companies Bill requires more companies, e.g., companies with turnover between ₹2 crore to ₹50 crore, to prepare cash flow statement.

2. Till the time applicability of AS 3 is amended, companies, which are currently required to prepare cash flow statement, will continue to do so, even if they do not meet the Companies Bill criteria for the preparation of cash flow statement. For example, a one person company with a turnover greater than ₹50 crore though not required to prepare cash flow statement under the Bill, will nonetheless have to prepare cash flow statement as required by notified standards. Though the notified standard is a subordinate legislation, in our view, the stricter of the two requirements will apply.

3. Since the Companies Bill does not lay down any format for preparation of cash flow statement, companies will need to follow AS 3 in this regard. In respect of listed companies, the listing agreement requires the indirect method for preparing cash flow statements. Thus, under the Bill, non-listed companies will have a choice of either applying the direct or indirect method under AS 3 to prepare the cash flow statement. Due to the listing agreement requirement, that choice will not be available to listed companies.

4. The addition of words “if applicable” with SOCIE requirement suggests that the same will apply only under Ind-AS.
Financial statements authentication and board’s report

Overview and key changes

1. Both the Companies Act and the Companies Bill require financial statements to be approved by the board. The existing Companies Act states that the Banking Companies Act will govern signing requirements for financial statements of banking companies. For other companies, financial statements need to be signed by manager/secretary (if any) and at least two directors one of whom will be a managing director. The Companies Bill requires both SFS and CFS of all companies (including banking companies) to be signed at least by the Chairperson of the company if he is authorized by the board, or by two directors out of which one will be managing director and the Chief Executive Officer, if he is a director in the company, the Chief Financial Officer, and the Company Secretary, if appointed.

2. The Companies Bill will require the inclusion of the following additional information in the board’s report, which is not required under the existing Companies Act.

(a) 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
(b) Statement on independence declaration given by independent directors
(c) If a company is required to constitute NRC, company’s policy on directors’ appointment and remuneration including criteria for determining qualifications, positive attributes, independence of a director and remuneration policy for KMP and others
(d) Explanations or comments by the board on every qualification, reservation or adverse remark or disclaimer made by the auditor and by the company secretary in their reports
(e) Particulars of loans, guarantees or investments (refer section titled “Related party transactions”)
(f) Particulars of contracts/arrangements with related parties
(g) A statement indicating development and implementation of risk management policy, including risk which may threaten the existence of the company
(h) Details of policy developed and implemented on CSR
(i) For all listed companies, and every other public company with paid-up share capital as may be prescribed, 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.

3. Directors’ Responsibility Statement will include the following additional information, which is not required under the existing Companies Act.

(a) For listed companies, directors had laid down internal financial controls and such controls are adequate and were operating effectively
(b) Directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

4. If a company contravenes these requirements, it will be punishable with a fine, which will not be less than `50 thousand and can extend up to `25 lakh. Every officer of the company who is in default will be punishable with imprisonment for a term, which may extend to three years or with fine which will not be less than `50 thousand but which may extend to `5 lakh, or with both.
Analysis of Accounting, Auditing and Corporate Governance changes

Key impact

1. Since the Companies Bill no longer exempts banking companies from signing requirements, they will likely need to comply with the requirements of the Bill as well as the Banking Companies Act. The Banking Companies Act requires that in the case of a banking company, financial statements will be signed by its manager/principal officer and at least three directors if there are more than three directors. If the banking company does not have more than three directors, all directors need to sign the financial statements.

2. Currently, the listing agreement requires that a listed company should lay down procedures to inform board members about the risk assessment and minimization procedures. These procedures need to be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework. However, there is no such requirement for unlisted companies. Hence, many unlisted companies may not have well documented risk management policies. To comply with disclosure requirements concerning risk management, companies will need to develop and document properly their risk management policies. Also, the senior management may need to review its implementation on regular basis.

3. By attesting the financial statements, the CFO will be assuming an onerous responsibility of ensuring that the financial statements are true and fair. Under the existing listing requirements, which is applicable to listed companies only, CFOs do not have to sign financial statements, but have to certify to the board that the financial statements are free of material misstatements. Going forward the CFO, if he is appointed, will have to attest financial statements, and the requirement will apply to both listed and non-listed companies.

Potential issue

Additional disclosures required in the board’s report/Director Responsibility Statement will bring increased transparency and thereby increase stakeholders’ confidence in the company. However, some of these disclosures may sometimes contain commercially sensitive information and disclosure of too much information in the public may put companies in a competitive disadvantageous situation.

Overview and key changes

The Companies Bill will introduce the following key changes:

1. Like the existing Companies Act, the Companies Bill also requires that a company’s report, along with auditor’s report and every other document required by law to be laid before the general meeting, will be sent to every member, trustee for debenture holders and other entitled persons, not less than 21 days before the date of the meeting. Considering the requirement to prepare CFS, the Companies Bill requires CFS also to be circulated.

2. Like the existing Companies Act, the Companies Bill also allows listed companies to circulate a statement containing the salient features of above documents in the prescribed form (known as AFS).

3. Under the Companies Bill, the Central Government may prescribe the manner of circulation of financial statements for companies with such net worth and turnover as may be prescribed. Such clause does not exist under the Companies Act.

4. Currently, the listing agreement requires all listed companies to maintain a functional website containing basic information about the company, including financial information. However, it does not specifically require companies to place complete financial statements on the website. The Companies Bill will require a listed company to place its financial statements, including CFS, if any, and all other documents required to be attached thereto, on its website.

5. Every company (including unlisted companies) with one or more subsidiaries will:

   (a) Place separate audited accounts in respect of each of its subsidiary on its website, if any

   (b) Provide a copy of separate audited financial statements in respect of each of its subsidiary, to a shareholder who asks for it.
Key impact

The Companies Bill does not mandate unlisted companies to have their website. Rather, they are required to place financial statements of subsidiaries on the website, if they have one. The Companies Bill, however, does not mandate unlisted companies to place their own SFS or CFS on the website, even if they have one. Many companies may choose to do so on their own.

Potential issue

The Companies Bill allows listed companies to circulate a statement containing salient features of all the documents, which are required to be circulated. Since these companies will also be required to prepare and circulate CFS, it will allow them to prepare and circulate CFS also in the abridged format. However, clause 32 of the listing agreement states that companies will be required to publish full CFS in the annual report. Hence, the following two views seem possible:

(i) To comply with clause 32, a company will need to circulate complete CFS with AFS prepared for SFS. Thus, an abridged version of CFS is not permitted.
(ii) Clause 32 requires CFS to be published in the annual report. However, it does not state that complete CFS should be circulated to all shareholders.

We suggest that the SEBI may clarify this issue.

Overview and key changes

1. Currently, the MCA circular allows a company to reopen and revise its accounts after their adoption in the AGM and filing with the registrar to comply with technical requirements of any other law to achieve the objective of exhibiting a true and fair view. The revised annual accounts are required to be adopted either in the EGM or in the subsequent AGM and filed with the registrar. The Companies Bill contains separate provisions relating to:

   (a) Re-opening of accounts on the court/tribunal's order
   (b) Voluntary revision of financial statements or board's report

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

2. 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.

3. 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

4. If it appears to directors that financial statements/board's report do not comply with the relevant Companies Bill requirements, 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.

5. 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.

6. 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.
7. If copies of financial statements/report have been sent to members, delivered to the registrar or laid before the general meeting, revisions must be restricted to corrections arising from non-compliances stated at 4 above and consequential changes.

8. A company will not revise its financial statements/board’s report more than once in a year.

9. The Central Government may make further rules as to the application of these requirements.

Key impact

1. While the Companies Bill sets out a three-year time limit for voluntary revision of financial statements/board report, no such time limit has been prescribed for re-opening of accounts due to the court/tribunal’s order.

2. Revision/reopening of financial statements for a period earlier than immediately preceding financial year may impact financial statements for subsequent years also.

3. Recently, the SEBI has issued a Circular, which empowers it to require revision of financial statements, if the audit report is qualified. One may argue that the provisions of the Companies Bill concerning revisions/reopening of accounts are broader in the concept. Hence, they are expected to help in addressing legal issues that were expected to arise due to the implementation of the SEBI Circular.

Potential issues

1. In case of voluntary change in accounting policy, error and reclassification, Ind-AS requires that the comparative amount appearing in the current period financial statements should be restated. To help companies in complying with this requirement once Ind-AS become applicable, the MCA may clarify as to how Ind-AS requirement will work vis-à-vis the Companies Bill provision concerning re-opening/revision of previous year financial statements.

2. 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 seems likely that in these cases, a company may be able to voluntarily revise its financial statements for earlier periods after taking prior approval of the tribunal, to give effect to the court scheme from the appointed date.

Overview and key changes

1. Currently, only clause 32 of the listing agreement mandates listed companies to publish CFS. Neither the existing Companies Act nor AS 21 requires other companies to prepare CFS. Under the Companies Bill, a company with one or more subsidiaries will, in addition to SFS, prepare CFS.

2. CFS will be prepared in the same form and manner as SFS of the parent entity.

3. The requirements concerning preparation, adoption and audit will, mutatis mutandis, apply to CFS.

4. For this requirement, the word “subsidiary” includes associate company and joint venture.

5. Schedule III of the Companies Bill, which lays down the format for preparation of financial statements, contains the following general instructions for preparation of CFS:
   (i) Where a company is required to prepare CFS, the company will mutatis mutandis follow the requirements of this Schedule.
   (ii) Profit or loss attributable to “minority interest” and to owners of the parent in the statement of profit and loss will be presented as allocation for the period. “Minority interests” in the balance sheet will be presented within equity separately from the equity of the owners of the parent.
   (iii) A statement containing information such as share in profit/loss and net assets of each subsidiary, associate and joint ventures will be presented as additional information. Currently, the MCA circular requires information, such as, capital, reserves, total assets and liabilities, details of investment, turnover and profit before and after taxation, to be disclosed for subsidiaries only.
   (iv) A company will disclose the list of subsidiaries or associates or joint ventures, which have not been consolidated along with the reasons for non-consolidation.

Key impact

1. All companies, including unlisted and private companies, with subsidiaries will need to prepare CFS. They need to gear up their financial reporting process for the same.

2. For all companies, CFS should comply with notified AS. This will impact companies that are currently preparing CFS only according to IFRS, based on option given in the listing agreement. Those companies will have to mandatorily prepare Indian GAAP CFS, and choose to retain preparing IFRS CFS on a voluntary basis or stop preparing the same.

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3. A company may need to give all disclosures required by Schedule III to the Companies Bill, including statutory information, in the CFS. It may be argued that AS 21 (explanation to paragraph 6) had given exemption from disclosure of statutory information because the existing Companies Act did not mandate preparation of CFS. With the enactment of the Companies Bill, this position is likely to change. Also, the exemption in AS 21 may not override Schedule III because there is no prohibition on disclosure of additional information and the two requirements can co-exist.

The collection of statutory information for foreign subsidiaries is likely to be challenging and companies need to gear-up their system for the same.

4. Restrictions regarding reopening/revision of financial statements, after adoption at AGM, will apply to CFS also.

5. Unlike IAS 27, the Companies Bill does not exempt an intermediate unlisted parent from preparing CFS. Preparation of CFS at each intermediate parent level is likely to increase compliance cost. In our view, this may be one area where the MCA may consider providing relaxation to the intermediate parent at a future date.

Potential issue

The explanation, which states that “the word subsidiary includes associate company and joint venture,” is not clear. Apparently, the following two arguments seem possible:

(i) A company needs to consolidate associates and joint ventures in accordance with the notified standards. In other words, CFS is prepared only when the group has at least one subsidiary. When CFS is prepared, associates and joint ventures are accounted for using equity/proportionate consolidation method.

(ii) A company needs to apply equity method/proportionate consolidation to its associates and joint ventures even if it does not have any subsidiary. In other words, CFS will be prepared when the company has an associate or joint venture, even though it does not have any subsidiary. The associate and joint venture will be accounted using the equity/proportionate consolidation method in the CFS.

The first view seems more aligned to the requirements of notified AS. The second view can be supported if the intention of the law maker was to require a company to apply equity method/proportionate consolidation method to its associates and joint ventures even if it does not have any subsidiary. In our view, it may be appropriate for the ICAI and MCA to provide clarification on this issue.

Overview and key changes

1. The existing Companies Act does not define the term “control.” It explains the meaning of terms “holding company” and “subsidiary” as below:

A company will be deemed to be a subsidiary of another company if, but only if:

(a) The other company controls the composition of its board of directors, or

(b) The other company:

(i) Where the first-mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respects as the holders of equity shares, exercises or controls more than half of the total voting power of such company,

(ii) Where the first-mentioned company is any other company, holds more than half in nominal value of its equity share capital, or

(c) The first-mentioned company is a subsidiary of any company, which is the other’s subsidiary.

2. Notified AS 21 defines the terms “control” and “subsidiary” as below:

“Control:

(a) The ownership, directly or indirectly through subsidiary(ies), of more than one-half of the voting power of an enterprise, or

(b) Control of the composition of the board of directors in the case of a company or of the composition of the corresponding governing body in case of any other enterprise so as to obtain economic benefits from its activities.”

“A subsidiary is an enterprise that is controlled by another enterprise (known as the parent).”

Control vs. subsidiary
3. The Companies Bill defines the terms “subsidiary” and “control” as below:

“‘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 at its own or together with one or more of its subsidiary companies.”

“‘Control’ shall include the 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.”

Key impact

There are differences between the definitions of the “control” and “subsidiary” given in the existing Companies Act, AS 21 and the Companies Bill. The likely impact or otherwise of differences will depend on resolution of potential issues.

Potential issues

1. Apparently, the definition of term “control” given in the Companies Bill is broader than the notion of “control” envisaged in the definition of the term “subsidiary.” In accordance with definition of “subsidiary,” only board control and control over share capital is considered. However, the definition of the “control” suggests that a company may control other company through other mechanism also, say, management rights or voting agreements. This will raise an issue whether a company should consider definition of “control” in identifying subsidiaries for consolidation and other purposes.

The definition of the term “control” used in the Companies Bill appears to be based on the definition given in the SEBI Takeover Code. It also appears that the MCA has defined this term to avoid a scenario where a company controls the other company through indirect/ proxy mechanism to avoid potential legal issues. In addition to the definition of the term “subsidiary,” the Bill uses the term “control” at certain other places also, e.g., definition of the terms “manager” and “promoter;” clause 144 dealing with “Auditor not to render certain services” clause 216 dealing with “Investigation of ownership of the company” and clause 241 dealing with “Application to Tribunal for relief in cases of oppression.” It may be argued that definition of the term “control” is relevant for these purposes. The term “subsidiary” should be interpreted as defined in the Bill, without consideration of how control is defined.

2. The definition of “subsidiary” refers to control over more than one-half of total share capital, without differentiating between voting and non-voting shares. Hence, an issue is likely to arise where a company has issued shares with differential voting rights. To illustrate, let us assume that A Limited has the following share ownership in B Limited:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Equity shares (voting rights)</th>
<th>Preference shares (non-voting)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total share capital of B Limited (nos.)</td>
<td>1,000,000</td>
<td>600,000</td>
<td>1,600,000</td>
</tr>
<tr>
<td>Shares owned by A Limited</td>
<td>550,000</td>
<td>100,000</td>
<td>650,000</td>
</tr>
<tr>
<td>% ownership and control</td>
<td>55%</td>
<td>16.67%</td>
<td>40.625%</td>
</tr>
</tbody>
</table>

A Limited controls 55% equity share capital of B Limited, i.e., shares with voting rights. However, on inclusion of non-voting preference shares, this holding comes down to 40.625%. In this case, B Limited is a subsidiary of A Limited for the purposes of consolidation in accordance with AS 21. However, based on definition of “subsidiary,” one can argue that A Limited does not control one-half share capital of B as required by the Bill.

The MCA may clarify that definitions in the Bill are relevant for legal/regulatory purposes. For accounting purposes including preparation of CFS, definitions according to the notified AS should be used.
Definition of the term “associate”

Overview and key changes
The existing Companies Act does not define the term “associate” or “associate company.” Notified AS 23 defines the term “associate” as “an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor.”

The Companies Bill defines the term “associate company” as below:

“‘Associate company,’ in relation to another company, means a company in which the other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.”

The explanation to the definition states that for the purposes of this clause, “significant influence” means control of at least 20% of total share capital, or of business decisions under an agreement.

Key impact
The likely impact, because of differences in the definitions, will depend on resolution of potential issues.

Potential issues
1. In accordance with the explanation in the Bill, the term “significant influence” means control over 20% of business decisions. In our view, control over business decisions is an indicator of subsidiary, rather than associate. It appears that the definition in the Bill “controls 20% of business decisions” is wrongly described. The right way to describe it would have been “has significant influence over all critical business decisions” and “significant influence is evidenced by 20% voting power, representation on the board, or through other means.”

2. In accordance with notified AS 23, there is a rebuttable presumption that holding of 20% or more of voting power of investee constitutes significant influence. However, in certain circumstances, a company may demonstrate that 20% share ownership does not constitute significant influence. The Companies Bill does not recognize such possibility.

3. AS 23, Ind-AS and IFRS recognize that even if a company does not hold 20% shares in other company, significant influence can be evidenced in other ways as well, e.g., through representation on board of directors or through material transactions with investor. This aspect is not covered in the definition in the Bill.

The MCA may clarify that definitions in the Bill are relevant for legal/ regulatory purposes. For accounting including preparation of CFS, definitions as per the notified AS should be used.

Depreciation

Overview and key changes
1. The existing Companies Act requires depreciation to be provided on each depreciable asset so as to write-off 95% of its original cost over the specified period. The remaining 5% is treated as residual value. Further, Schedule XIV to the Companies Act prescribes SLM and WDV rates at which depreciation on various asset need to be provided. Other key aspects impacting depreciation under the existing Companies Act are as below:

(a) In accordance with AS 6, depreciation rates prescribed under Schedule XIV are minimum. If useful life of an asset is shorter than that envisaged under Schedule XIV, depreciation at higher rate needs to be provided.

(b) The MCA has issued a General Circular dated 31 May 2011, which states that for companies engaged in generation/supply of electricity, rates of depreciation and methodology notified under the Electricity Act will prevail over the Schedule XIV to the Companies Act.

(c) The MCA amended Schedule XIV in April 2012. The amendment prescribes amortization rate and method for intangible assets (toll roads) created under BOT, BOOT or any other form of PPP route (collectively, referred to as “BOT assets”). In accordance with the amendment, such intangible assets will be amortized using amortization rate arrived at by dividing actual revenue for the year with total estimated revenue.

(d) Schedule XIV provides separate depreciation rates for double shift and triple shift use of assets.

(e) According to a Circular issued by the MCA, unit of production (UOP) method is not allowed.

(f) Assets whose actual cost does not exceed ₹5 thousand are depreciated @ 100%.

(g) The ICAI Guidance Note on Treatment of Reserve Created on Revaluation of Fixed Assets clarifies that for statutory purposes, such as, dividends and managerial remuneration, only depreciation based on historical cost of the fixed assets needs to be provided out of current profits of the company. Accordingly, the Guidance Note allows an amount equivalent to the additional depreciation on account of the upward revaluation of fixed assets to be transferred to the statement of profit and loss from the revaluation reserve.
2. The key requirements of the Companies Bill (particularly, Schedule II) are listed below:

(a) No separate depreciation rate is prescribed for intangible assets. Rather, the same will be governed by notified AS.

(b) Depreciation is systematic allocation of the depreciable amount of an asset over its useful life.

(c) The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value.

(d) The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

(e) All companies will be divided into the following three classes to decide application of depreciation rates:

(i) Class of companies as may be prescribed and whose financial statements comply with the accounting standards prescribed for such class of companies. –

These companies will typically use useful lives and residual values prescribed in the schedule II. However, these companies will be permitted to adopt a different useful life or residual value for their assets, provided they disclose justification for the same.

(ii) Class of companies or class of 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 or useful lives and residual values prescribed by the relevant authority for depreciation purposes.

(iii) 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 the proposed Schedule.

(f) Useful life specified in the Schedule II to the Companies Bill is for whole of the asset. Where 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.

(g) No separate rates are prescribed for extra shift depreciation. 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.

(h) There is no specific requirement to charge 100% depreciation on assets whose actual cost does not exceed ₹5 thousand.

(i) Useful lives of fixed assets prescribed under the Companies Bill are different than those envisaged under Schedule XIV. For instance, the useful life of “buildings other than factory buildings and other than RCC frame structure” prescribed under Schedule XIV is approximately 58 years, whereas the same under the Companies Bill will be 30 years. The useful life for general furniture and fittings will be reduced from 15 to 10 years. Separate useful lives have been introduced for many items of plant and machinery used in specific industries, e.g., useful lives have been prescribed for machinery used in the telecommunications business, manufacture of steel and non-ferrous metals, which are not currently laid down in Schedule XIV.

(j) From the date of the Companies Bill coming into effect, the carrying amount of the asset as on that date:

(a) Will be depreciated over the remaining useful life of the asset according to the Bill

(b) After retaining the residual value, will be recognized in the opening retained earnings where the remaining useful life is nil.

Key impact

1. The useful life of an asset can be the number of production or similar units expected to be obtained from the asset. This indicates that a company may be able to use UOP method for depreciation, which is currently prohibited for assets covered under Schedule XIV.

2. Companies, covered under class (i) above, will be able to use different useful lives or residual values, if they have justification for the same. It appears that this provision is aimed at ensuring compliance with Ind-AS 16 for such companies. However, they are likely to be able to start using this option immediately, and need not wait for Ind-ASs to become applicable.
3. Companies will need to identify and depreciate significant components with different useful lives separately. The component approach is already allowed under current AS 10, paragraph 8.3. Under AS 10, there seems to be a choice in this matter; however, the Companies Bill requires application of component accounting mandatorily when relevant and material.

4. The application of component accounting is likely to cause significant change in accounting for replacement costs. Currently, companies need to expense such costs in the year of incurrence. Under the component accounting, companies will capitalize these costs, with consequent expensing of net carrying value of the replaced part.

5. In case of revaluation, depreciation will be based on the revalued amount. Consequently, the ICAI guidance may not apply and full depreciation on the revalued amount is expected to have significant negative impact on the statement of profit and loss.

6. In case of assets with a nil remaining useful life on the date the Companies Bill comes into effect, the transitional provisions require that the carrying amount is written off to retained earnings. In other words, the carrying value never gets charged to the P&L account.

7. Overall, many companies may need to charge higher depreciation in the P&L because of pruning of useful lives as compared to the earlier specified rates. However, in some cases, the impact will be lower depreciation, i.e., when the useful lives are much longer compared to the earlier specified rates, such as metal pot line, bauxite crushing and grinding section used in manufacture of non-ferrous metals.

**Potential issues**

1. The recent amendment to the existing Schedule XIV of the Companies Act regarding depreciation of BOT assets is not contained in the Companies Bill. Rather, it is stated that depreciation of all intangible assets will be according to notified AS. In context of IFRS, the IFRIC and IASB have already concluded that revenue-based amortization is not appropriate, because it reflects a pattern of the future economic benefits being generated from the asset, rather than a pattern of consumption of the future economic benefits embodied in the asset. However, no such clarification has been provided in the context of notified AS. Consequently, it seems unclear at this stage whether infrastructure companies will be entitled to use revenue-based amortization under AS 26 after the enactment of the Companies Bill. The ICAI may provide an appropriate clarification on this matter.

2. The transitional provision requiring remaining carrying value to be depreciated over remaining useful life can provide very harsh outcomes. For example, consider that the remaining carrying value is 60% of the original cost, whereas the remaining useful life is one year. In this scenario the entire 60% will be depreciated in one year. However, if in this example, the remaining useful life was nil, the entire 60% would be charged to retained earnings.

To illustrate, it may be noted that the Companies Bill has reduced useful life of the “buildings other than factory buildings and other than RCC frame structure” from 58 to 30 years. A company was depreciating such building in accordance with the useful life envisaged in the Schedule XIV to the Companies Act. If the company has already used building for 30 or more years, it will charge the remaining carrying value to the retained earnings. However, if the company has previously used building for less than 30 years, say, 29 years, it will need to depreciate the remaining carrying value over the remaining useful life (which in this case happens to be one year period) and charge to P&L.
Utilization of securities premium

Overview and key changes

1. Both the existing Companies Act and the Companies Bill require that where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the premium received will be transferred to the “securities premium account.” The existing Companies Act permits the same utilization of securities premium to all companies. Under the Companies Bill, utilization of securities premium will be restricted for certain class of companies as may be prescribed and whose financial statement need to comply with the accounting standards prescribed for such class (referred to as “prescribed class” in this section). Given below is the comparative analysis:

<table>
<thead>
<tr>
<th>Purposes</th>
<th>Companies Act</th>
<th>Companies Bill</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Prescribed class</td>
<td>Others</td>
</tr>
<tr>
<td>Issue of fully paid equity shares as bonus shares</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Issue of fully paid preference shares as bonus shares</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Writing off preliminary expenses of the company</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Writing off equity share issue expenses</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Writing off preference share issue expenses</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Writing off debenture issue expenses</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Providing for premium payable on redemption of preference shares/ debentures</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Buy-back of its own shares or other securities</td>
<td>Yes (section 77A)</td>
<td>Yes</td>
</tr>
</tbody>
</table>

2. The Companies Bill also states that prescribed class of companies will provide for the premium, if any, payable on redemption of preference shares out of their profits, before the shares are redeemed.

3. For prescribed class of companies, the premium, if any, payable on redemption of any preference shares issued on or before the commencement of the Companies Bill will be provided for either out of the profits of the company or out of the company’s securities premium account, before such shares are redeemed.

Key impact

It appears that the Central Government has made changes regarding utilization of securities premium to align accounting with Ind-AS. Nonetheless the impact will be felt immediately in Indian GAAP financial statements, because many companies use the securities premium account to write off redemption premium relating to debentures, preference shares and foreign currency convertible bonds.

Potential issue

Except preference shares, no transition provisions have been prescribed for companies impacted by the change. We believe that where no transitional provisions are prescribed, the change will apply to utilization of securities premium after the enactment and will not cover past utilization.

Companies that have debentures redeemable after the enactment at a premium, can make a provision for such premium for the expired period and adjust the same to the securities premium account before the Bill is enacted. The prescribed class of companies may not be able to adjust the premium, after the Bill is enacted.
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Declaration and payment of dividend

Overview and key changes

1. As in the existing Companies Act, the Companies Bill also states that a company will not declare/pay dividend for any financial year except:
   (a) Out of profits of the company for that year after depreciation
   (b) Out of accumulated profits for any previous financial year(s) arrived at after providing for depreciation
   (c) Out of both
   (d) Out of money provided by Central Government/state government for payment of dividend in pursuance of any guarantee given by them.

2. Under the Companies Act, the Central Government is empowered to allow a company to declare/pay dividend for any financial year out of the profits arrived at without providing for depreciation, if the Government believes that it is necessary to do so in public interest. However, such power does not exist under the Bill.

3. Currently, a company needs to transfer the following percentage of its profit to reserves if it declares dividend at a rate exceeding 10%. However, it is allowed to transfer an increased amount to reserves, subject to compliance with the prescribed rules.

<table>
<thead>
<tr>
<th>Rate of dividend</th>
<th>Transfer to reserve - % of current profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not exceeding 10%</td>
<td>Nil</td>
</tr>
<tr>
<td>10.0% to 12.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>12.5% to 15.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>15.0% to 20.0%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Exceeding 20.0%</td>
<td>10.0%</td>
</tr>
</tbody>
</table>

The Companies Bill states that a company may, before declaration of dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to its reserves. Hence, the matter has now been left to the discretion of respective companies.

4. The existing Companies Act states that the board may declare interim dividend and that the requirements concerning final dividend, to the extent relevant, will apply to interim dividend also. The Companies Bill contains the following specific requirements for interim dividend:
   (a) 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 such interim dividend is sought to be declared.
   (b) 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.

5. New rules are yet to be framed to declare dividends out of accumulated profits earned in earlier years and transferred to reserves.

6. Under the Bill, no dividend on equity shares can be declared if the company fails to comply with the provisions relating to acceptance and repayment of deposits.
Issue of bonus shares

Overview and key changes

The existing Companies Act does not contain explicit requirements on issue of bonus shares. However, regulations 96 and 97 of Table A of the Companies Act, deal with the capitalization of profits and reserves. These two regulations do not specifically prohibit capitalization of revaluation reserve.

In the case of listed entities, the earlier SEBI DIP Guidelines and now the SEBI ICDR regulations requires that bonus issue will be made out of free reserves built out of genuine profits or share premium collected in cash only and prohibits capitalization of revaluation reserves. The Guidance Note on Availability of Revaluation Reserve for Issue of Bonus Shares issued by the ICAI states that a company is not permitted to issue bonus shares out of reserves created by revaluation of its assets. Similar requirements are contained in AS 10 as well. However, the Supreme Court has held in Bhagwati Developers v Peerless General Finance & Investment Co. (2005) 62 SCL 574 that an unlisted company can issue bonus shares out of revaluation reserve.

The Companies Bill states that a company can issue fully paid up bonus shares to its members out of free reserves, securities premium and capital redemption reserve. However, a company cannot issue bonus shares by capitalizing revaluation reserve.

The Bill also imposes certain pre-conditions for issuance of bonus shares, such as:

(i) Articles of association should authorize the bonus issue
(ii) On the recommendation of the board the general body meeting should authorize the issue of bonus shares
(iii) There should be no default in payment of statutory dues to employees
(iv) There should be no default in payment of principal and interest on fixed deposits or debt securities issue
(v) Partly paid shares outstanding on the date of allotment should be fully paid-up prior to issue of bonus shares
(vi) Bonus shares should not be issued in lieu of dividend
(vii) Any additional conditions as may be prescribed

Registered valuers

Overview and key changes

1. The Companies Bill has introduced the concept of valuation by a registered valuer. If a valuation is required to be made in respect of any property, stocks, shares, debentures, securities, goodwill or any other asset (referred to as the assets) or net worth of a company or its liabilities under the Companies Bill, it will be valued by a person with such qualifications and experience and registered as a valuer in a manner as may be prescribed. The audit committee, and in its absence the board, will appoint the registered valuer and decide the terms and conditions of appointment.

2. In case of non cash transaction involving directors, etc., the notice for approval of the resolution by the company or holding company in general meeting will include the value of the assets calculated by a registered valuer.

3. The registered valuer so appointed will:

(a) Make an impartial, true and fair valuation
(b) Exercise due diligence
(c) Make valuation in accordance with rules as may be prescribed
(d) Not undertake any valuation of any asset(s) in which he has any direct or indirect interest or becomes so interested at any time during or after the valuation of assets

Key impact

The Companies Bill requires registered valuer to be involved only for valuation required under the Bill. There is no requirement for involving registered valuer in other cases. In case, certain valuations are to be used for dual purposes, companies will likely need to involve registered valuers. Otherwise, the same asset may get valued differently for different purposes.

Potential issue

Since notified AS will also be part of the Companies Bill, it appears that this requirement will also apply to valuations required under the same. However, it is not absolutely clear whether this requirement will apply to actuarial valuation required under AS 15.

Also, some companies have in-house capabilities to perform certain fair valuation, for example, fair valuation of real estate. In these cases, the Companies Bill will still require involvement of registered valuers.
Appointment of auditors

Overview and key changes

1. Currently, the auditor is appointed on an annual basis and holds office only till conclusion of the next AGM. Under the Bill, a company will appoint auditor at its first AGM. The auditor so appointed will hold its office till the conclusion of the sixth AGM.

2. Though the auditor will be appointed for five years, the matter relating to such appointment will be placed for ratification at each AGM.

3. Before appointing/re-appointing an auditor, a company will obtain the following:

   (a) Written consent of the auditor to such appointment, and

   (b) A certificate from the auditor that the appointment, if made, will be in accordance with the conditions as may be prescribed. The certificate will also indicate whether the auditor satisfies eligible criteria for such appointment.
4. If no auditor is appointed/re-appointed at the AGM, the existing auditor will continue to be the auditor of the company.

5. Currently, the listing agreement requires that the Audit Committee constituted by a listed company should make recommendation to the board for appointment/re-appointment/replacement of statutory auditors. For non-listed entities, no such requirement is applicable. Under the Bill, all companies, which are required to constitute an Audit Committee, will need to appoint an auditor after taking into account the recommendations of such committee.

Key impact

1. The Companies Act and the Companies Bill require an approval from the Central Government to remove an auditor from his office before expiry of term. Since under the Bill, an auditor will be appointed for a five-year term, companies will need to comply with the onerous requirement of taking an approval from the Central Government to remove the auditor during this term. Also they will need to pass a special resolution at the general meeting. This requires companies to consider long-term perspective while appointing an auditor.

2. The prescribed class of non-listed companies, which are required to constitute Audit Committee, will also need to consider recommendations of the Committee for appointing auditors.

Rotation of auditors

Overview and key changes

1. Listed companies and companies belonging to prescribed class of companies will not 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

2. 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. This restriction will also apply to the audit firm, which has common partner(s) with the outgoing audit firm at the time of appointment.

3. Every company, covered by these requirements, will need to comply with the above requirements within three years from the date of commencement of new law.

4. In addition to rotation of auditor, members of a company may decide that:
   (a) Auditing partner and his team will be rotated at specific intervals, or
   (b) The audit will be conducted by more than one auditor (joint auditors).
The RBI requires all banks, including banking companies, to rotate auditors every four years. The IRDA requires all insurance companies to rotate auditors every five years. After completing the term, two years cooling off period is required. Other than that, currently, neither the Companies Act, nor other laws require Indian companies to rotate their auditors.

Key impact

1. All listed companies, particularly companies, which have long-term relationship with auditors, need to gear-up for rotation. This will help companies to work closely with proposed auditors and ensure compliance with strict independence requirements upfront.

2. In the first year of audit rotation, senior management of the company will likely need to spend more time with the new auditor so as to familiarize the new auditor with their systems and processes.

3. Many global companies have listed subsidiaries in India. Typically, they prefer firms, which are part of common network, as their global auditors. This is expected to create some challenging situations.

4. As a result of rotation, the learning curve experience available to previous auditors will not be available to the new auditors, who may have to understand the business of the company, its systems and processes, from scratch. Therefore, cost of audit is likely to increase both for companies and audit firm. Various global studies, including study conducted by the US General Accounting Office, demonstrate this.

Potential issues

1. In accordance with the Bill, a listed/prescribed company will not appoint or re-appoint an audit firm as auditor for more than two terms of five consecutive years. Companies will need to comply with this requirement within three years from the application of the new law. An issue is likely to arise as to how the years of service before enactment of new law should be considered for rotation. The following two views seem possible.
   - An audit firm may not hold office as an auditor of a listed company or of a company covered under prescribed class of companies for more than 10 years. However, companies have been given a three-year time frame to meet this requirement. If this view is accepted, an audit firm, which has already completed seven or more years of service, can continue to hold office for three more years. An audit firm, which has completed six years of service on the date of enactment, can continue to hold office for four more years.
   - In accordance with the Companies Bill, an audit firm can have two maximum terms of five consecutive years each. Under the Companies Act, the company has appointed auditors for term of one year each. Hence, the same is not considered for deciding the auditor rotation. In other words, the rotation requirement will apply prospectively.

   We suggest that the MCA may provide an appropriate clarification on this matter.

2. For banking companies, the RBI requires auditor rotation every four years. For insurance companies, the IRDA requires auditor rotation every five years. Since these are more stringent requirements, the same will prevail over the Bill.

   Similarly, an option given in the Companies Bill may not override more stringent requirements prescribed by other regulators. For instance, under the Companies Bill, members of a company can decide whether they wish to appoint joint auditor. However, IRDA mandates joint audit in case of insurance companies. In this case, IRDA requirement will prevail over the option given in the Companies Bill.

3. The Bill states that if no auditor is appointed/re-appointed at the AGM, the existing auditor will continue to be the auditor of the company. We believe that this provision will not apply if an auditor has already completed its maximum tenure (5/10 years) as auditor. In such a case, it should be mandatory for the company to appoint a new auditor.
Independence/ prohibited services

Overview and key changes

1. Under the Companies Bill, an auditor will be allowed to provide only such other 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

2. In case of an audit firm, the above restrictions also apply to rendering of service by:
   - Audit firm itself
   - All of its partners
   - Its parent, subsidiary or associate entity
   - Any other entity in which the firm or any of its partner has significant influence/control, or whose name/trade mark/brand is used by the firm or any of its partners

3. If prohibited, non-audit services are being rendered to a company on or before the commencement of the Bill, the auditor will need to comply with the above restrictions before the end of the first financial year after the enactment of the Companies Bill.

Key impact

1. Traditionally, companies have engaged auditors to provide a range of non-audit services. This is because an auditor, due to its continuous engagement with the company, is in a better position to provide these services.

2. The Companies Bill does not make any distinction between PIEs and Non-PIEs or based on the size/materiality of the company being audited. Hence, the restrictions are likely to apply equally in all cases. This is at variance from independence requirement being followed in other parts of the world, including the US.

Potential issue

It is clear that the above restrictions will prohibit an auditor from rendering certain prescribed non-audit services to the company and its holding or subsidiary company in India. What is not clear is whether the above restriction will apply to rendering of non-audit services by the auditor or its network firm wherever located to the auditee's holding company or subsidiary located outside of India.

We believe that the requirements of the Bill cannot be extended to a jurisdiction beyond India. Hence, providing non-audit services to the auditee's holding company or subsidiary located outside of India either by the auditor or its network firm will not be prohibited.

The Companies Bill, while prohibiting auditor, to render certain services does not define the terms such as investment advisory services and management services, which are likely to be subject to varying interpretations.

For example, based on the IFAC Code of Ethics for Professional Accountants, one can argue that “management services” means “assistance for carrying out such services for the company which are the responsibilities of the management.” The term “management responsibilities” means “leading and directing an entity, including making significant decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources.” Hence, the auditor should not step into management shoes. It will be useful if the MCA provides clarity on the meaning of such terms to avoid diverse practices.
Eligibility, qualification and disqualifications

Overview and key changes

<table>
<thead>
<tr>
<th>No.</th>
<th>Topic</th>
<th>Companies Act</th>
<th>Companies Bill</th>
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</thead>
<tbody>
<tr>
<td>1.</td>
<td>Individual</td>
<td>Only if the person is a chartered accountant</td>
<td>Similar requirement.</td>
</tr>
<tr>
<td>2.</td>
<td>Firm</td>
<td>All the partners practicing in India should be qualified for appointment.</td>
<td>Majority partners practicing in India should be qualified for appointment.</td>
</tr>
<tr>
<td>3.</td>
<td>LLP</td>
<td>Not eligible for appointment</td>
<td>Eligible for appointment if it meets criteria similar to the firm.</td>
</tr>
</tbody>
</table>

Disqualifications for the appointment

Both under the Companies Act and the Companies Bill, the following persons are not eligible for appointment as an auditor of the company:

(a) A body corporate
(b) An officer or employee of the company
(c) A person who is a partner, or who is in the employment, of an officer or employee of the company.

1. Holding of security
   - A person holding security in the company is not eligible for appointment.
   - A person will not be eligible for appointment if he himself, his relative (term not fully defined) or partner holds any security or interest in the company, its subsidiary, holding or associate company or subsidiary of such holding company.
   - However, the relative may be allowed to hold security or interest in the company with face value not exceeding `1 thousand or the amount as may be prescribed.

2. Indebtedness/ guarantee/security
   - A person who is indebted to the company for an amount exceeding `1 thousand, or who has given any guarantee or provided any security in connection with third person's indebtedness to the company for an amount exceeding `1 thousand is not eligible for appointment.
   - A person will not be eligible for appointment if he himself, his relative or partner is indebted to the company, its subsidiary, holding or associate company or subsidiary of such holding company, in excess of such amount as may be prescribed.
   - A similar disqualification has also been provided in case of guarantee given or security provided in connection with indebtedness of third person.

3. Business relationship
   - No restrictions.
   - A person or firm will not be eligible for appointment, if it, directly or indirectly, has business relationship (of such nature as may be prescribed) with the company, its subsidiary, its holding, or associate company or subsidiary of such holding company or associate company.

4. Relative’s employment
   - No restrictions.
   - A person, whose relative is a director or is in the employment of the company as a director or key managerial personnel (KMP), will not be eligible for appointment.

5. Full-time employment
   - A person who is in full time employment elsewhere is not eligible for appointment.
   - Similar requirement exists under the Companies Bill also.

6. Limit on maximum number of companies
   - No company or its board will appoint/ reappoint a person or firm as its auditor, if such person or firm, at the date of appointment, hold appointment as auditor of more than 20 companies. However, private companies are not included in the maximum cap of 20 companies.
   - A person or a partner of a firm will not be eligible for appointment/reappointment, if such person or partner at the date of appointment, holds appointment as auditor of more than 20 companies. Private companies are included in the maximum cap of 20 companies.

7. Fraud
   - No restriction.
   - A person will not be eligible for appointment, if he 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.

8. Provision of services other than audit service
   - Discussed elsewhere in this publication
   - Discussed elsewhere in this publication (refer section titled "Independence / prohibited services")

In addition, the Companies Act contains a general requirement that a person will not qualify for appointment as auditor of a company if he is disqualified, by virtue of one or more of the above disqualifications, for appointment as auditor of any other body corporate which is that company's subsidiary or holding company, or a subsidiary of that company's holding company, or would be so disqualified if the body corporate was a company.
Key impact

1. The Companies Bill prescribes significant additional restrictions on appointment of auditor. This will require both the company as well as auditor to track these aspects closely and exercise strict measures to avoid potential issues. For example, a person will not be eligible for appointment if his relative or partner is indebted to the company, its subsidiary, holding or associate company, or subsidiary of such holding company etc. or holds securities of those companies. If the government prescribes a long list of relations and any of these relatives inadvertently enter into a disqualifying transaction with the company, its subsidiary, holding or associate company, etc., it may require the auditor to vacate his/her office immediately. Any such situation can create significant practical difficulties for the company.

While prescribing covered relationship, the Central Government may like to consider the fact that a person may not be able to control/ influence 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. Consider an estranged relative, who is financially independent. He or she can buy shares in a company audited by the person to whom he or she is related and deliberately or inadvertently disqualify the person from being the auditor of the company. Hence, instead of listing specific relationship, the Central Government may explain that clause (iii) in definition of the term “relative” will mean “financially dependent person.” “Financially dependent person” can be explained to include any other persons and/or their spouses who received more than half of their financial support for the most recent financial year from the concerned person.

2. The existing Act does not include private companies in the maximum limit of 20 companies per partner. However, the ICAI has fixed maximum limit that a person/ partner cannot audit more 30 companies, including private companies, per year. Under the new Bill, even private companies will be included in the maximum limit of 20 companies that may be audited by a partner. If the Companies Bill becomes enactment it will prevail over the ICAI requirement. This will significantly reduce the eligibility of a person to be appointed as auditor. A company should obtain certificate of compliance with this requirement from the proposed auditor, before agreeing to appoint the said person as auditor.

Potential issues

1. In the context of disqualification, certain provisions refer to person as well as firm; while other provisions refer to person and his relative. For example, point 3 in the above table prohibits an auditor, whether person or firm, from entering into a business relationship. However, there is no such restriction on relatives. Also, this clause does not restrict partners from having business relation with the company. In contrast, point 1 above prohibits person, his relative and partner from having indebtedness; however, there is no such restriction on the firm. This is likely to give rise to the following key issues:

   (a) Whether restrictions, which refer to “person” only, are applicable to individual auditor and not the firm or its partners?

   (b) Whether the restrictions applicable to firm will also apply to partners in the firm? If yes, will that restriction apply only to the partner auditing the company or all partners in the firm?

   (c) Since the restriction on business relationship refer only to person and firm, it seems that the same is not likely to apply to relatives of the person.

The MCA needs to provide appropriate clarifications on these matters.

2. In the context of point 3 above, it is very important as to which business relationships will be prohibited by the government. It is expected that normal or arms length business relationship will not be prohibited. If this is not done, it may create practical challenges, both for the company and the audit firm. For example, it would be unacceptable to prohibit an auditor from buying a soap that its client has produced from a super market or from using mobile services that its client is providing in normal course of business at arm’s length price.

3. Whether consolidated financial statements will be regarded as a separate entity for computing the limit of 20 companies? It can be argued that SFS and CFS belong to the same company and the restriction is prescribed in terms of number of companies and not number of financial statements. This suggests that SFS and CFS will be regarded as one company. However, each subsidiary, associate or joint venture company in the group audited by the firm will be treated as separate company.

4. The full impact of the provisions are not yet clear, as the rules are yet to be fully developed in many areas, such as, in defining the term relative or prohibited business relationships or the amount of indebtedness, etc. As suggested earlier, the Central Government may explain that clause (iii) in definition of the term “relative” will mean “financially dependent person.”
Removal/resignation of the auditor

Overview and key changes

1. A company can remove the auditor before expiry of his five-year term only by passing special resolution at an AGM and after obtaining prior approval from the Central Government.

2. If an auditor resigns from the company, it will file, within a period of 30 days from the date of resignation, a statement with the company and the registrar, indicating reasons and other facts regarding resignation. No such requirement exists under the current Companies Act.

3. The Tribunal is likely to direct a company to change its auditors, if it is satisfied that the auditor has, directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud. The Tribunal may pass such order either *su o mot o* or on an application made to it by the Central Government or by any person concerned. The existing Companies Act does not contain this provision.

Key impact

The intention of the regulator seems to be to bring more transparency and accountability both for companies and auditors. Though there is no change in the requirement for the Central Government approval to remove an auditor before expiry of the term, the auditor will be appointed for a term of five consecutive years under the new law. Hence, a company will not be able to change its auditors for five years, without getting the Central Government approval.

Reporting responsibilities

Overview and key changes

1. Considering specific requirement to prepare and audit CFS, the Companies Bill requires that the auditor of a holding company will have the right of access to the records of all its subsidiaries in so far as it relates to consolidation requirements.

2. The auditor’s report will include the following key additional matters (compared to current reporting requirements):
   
   (a) Observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company. Also, such observations/comments will be read in the AGM and can be inspected by any member. Currently, the Companies Act requires the observations or comments of the auditors with any adverse effect on the functioning of the company to be given in bold/italic in the audit report.

   (b) Whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls. Currently, the requirement under the CARO to report on internal control matters is limited. It requires an auditor to comment on whether the company has an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services.

3. In the existing Companies Act, auditors are required to report on fraud in the CARO report. The Bill also requires that if the auditor, in the course of audit, 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 such time and manner as may be prescribed.
4. The requirement to maintain confidentiality by auditors with respect to client matters, does not apply to reporting matters under any regulation.

5. Currently, the Companies Act entitles but does not require an auditor to attend AGM. Under the Companies Bill, it will be mandatory for the auditor or its authorized representative, who is also qualified to be appointed as an auditor, to attend the AGM, unless exempted by the company.

Key impact

1. Any negative comment or reporting on the internal controls or fraud may have significant legal consequences including winding-up and cause reputational damage to the company.

2. Reporting responsibilities of the auditor will increase significantly. For example, the auditor will be required to report on adequacy and functioning of internal financial control system in all areas. To avoid any adverse comment in the auditor’s report, the management will need to ensure adequacy and effectiveness of internal financial control in all the areas.

3. According to SA 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management, the auditor obtains an understanding of internal control relevant to audit for designing its audit procedures, but not for expressing an opinion on the effectiveness of internal control. Hence, reporting on internal financial control beyond the CARO requirement does not fall within the scope of normal audit procedures. Rather, the auditor will need to perform additional procedures. This may increase time and cost involved in the audit.

4. In accordance with SA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements, the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. The auditor needs to maintain an attitude of professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist. However, due to inherent limitations of an audit, there is an unavoidable risk that some material misstatements will not be detected. Hence, the auditor’s responsibility to report on fraud will not absolve the board or audit committee of its responsibilities.

Potential issues

1. The requirement pertaining to reporting on “financial transactions or matters” is not clear. One interpretation is that the auditor is required to report whether any of the financial transaction or other matters can have an adverse impact on the functioning of the company. If this is correct, the auditor may need to comment on propriety of transactions in order to meet its reporting obligations. In our view, the intention of the regulator is not to require an auditor to challenge and report on management’s judgment and propriety with respect to business decisions. We suggest that the MCA/ICAI may provide further clarification/guidance on the matter.

2. In case of fraud, the Companies Bill does not state that auditor’s reporting responsibility will arise only in case of material frauds. This indicates that the auditor may need to report all frauds to the Central Government noticed/detected during the course of audit, irrespective of its size. It will be more appropriate if the government frames rules to require only material frauds to be reported.

3. Though the auditor has been given the right of access to records of all subsidiaries pertaining to consolidation requirements, no such right has been granted in the context of associates and joint ventures.

4. It appears that all new reporting requirements will apply to the audit of CFS also.

5. Under the existing Companies Act, auditors are required to report on various matters in the CARO report. At this stage, it is unclear what the reporting responsibilities will be under the new legislation.
Penalties on auditor

Overview and key changes

On contravention of law

1. If an auditor of a company contravenes any of the requirements concerning appointment/rotation, powers and duties, prohibited services or signing of audit report, the auditor will be punishable with a fine, which will not be less than ₹25 thousand but may extend to ₹5 lakh.

2. If an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he will be punishable with imprisonment for a term, which may extend to one year and with fine which will not be less than ₹1 lakh but which may extend to ₹25 lakh.

3. Where an auditor has been convicted under point no 2 above, he will be liable to:
   
   (i) Refund the remuneration received by him to the company, and

   (ii) Pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.

4. 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 Bill or in any other law for the time being in force, for such act will be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

Prosecution by NFRA

5. NFRA may investigate either suo moto or on a reference made to it by the Central Government on matters of professional or other misconduct by any member/firm of chartered accountants. If professional or other misconduct is proved, NFRA has the power to make order for:
   
   (a) Imposing penalty of:

   (i) Not less than ₹1 lakh but which may extend to five times of the fees received, in case of individuals, and

   (ii) Not less than ₹10 lakh but which may extend to ten times of the fees received, in case of firms.

   (b) Debarring the member or the firm from engaging himself or itself from practice as member of the ICAI for a minimum period of six months or for such higher period not exceeding ten years as may be decided by the NFRA.

Class action

6. Members or depositors or any class of them may claim damages or compensation or demand any other suitable action from or against the auditor including audit firm of the company for any improper or misleading statement made in his audit report or for any fraudulent, unlawful or wrongful act or conduct. Where the members or depositors seek any damages or compensation or demand any other suitable action from or against an audit firm, the liability will be of the firm as well as of each partner who was involved in making any improper or misleading statement of particulars in the audit report or who acted in a fraudulent, unlawful or wrongful manner.

Limited Liability Partnership

7. The CA Act has been amended to allow audit firms to function as LLPs. Under the Companies Bill, if 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 audit firm is held responsible jointly and severally with the erring partners. Based on these liability provisions, benefits of the LLP form of partnership is not likely to be available to audit professionals in the case of a fraud or fraudulent behavior.
Cost accounting and audit

Overview and key changes

1. On the lines of the Companies Act, the Companies Bill empowers the Central Government to require specified class of companies to maintain cost accounts and get cost audit done. Given below are some key changes:

   (a) No specific approval of the Central Government will be required for appointment of the Cost Auditor.

   (b) Since most of the requirements concerning statutory auditor are also applicable to the cost auditor, key changes explained for statutory audit will apply in case of cost audit also.

   (c) Cost auditor will submit its report to the board of directors, instead of the Central Government. The board will submit the report to the government, along with full information and explanation on each reservation/qualification.

   (d) The cost auditor will need to comply with the cost auditing standards, issued by the ICWAI.
Corporate Social Responsibility

Overview and key changes

1. The Companies Bill 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.

2. The CSR committee will consist of three or more directors, out of which at least one director will be an independent director.

3. The CSR committee will:
   (a) Formulate and recommend to the board, a CSR policy, which will indicate the activities to be undertaken by the company
   (b) Recommend the amount of expenditure to be incurred on the activities referred to in the CSR policy
   (c) Monitor CSR policy from time to time

4. The board will ensure that company spends, in every financial year, at least 2% of its average net profits made during the three immediately preceding financial years. For this purpose, the average net profit will be calculated in accordance with the clause 198.

5. The company will give preference to local area and areas around where it operates, for spending the amount earmarked for CSR activities.

6. The board will approve the CSR policy and disclose its contents in the board report and place it on the company’s website.
7. If a company fails to spend such amount, the board will, in its report specify the reasons for not spending the amount.

8. Schedule VII of the Bill sets out the activities, which may be included by companies in their CSR policies. These activities relate to (a) eradicating extreme hunger and poverty (b) promotion of education (c) promoting gender equality and empowering women (d) reducing child mortality and improving maternal health (e) combating HIV, AIDS, malaria and other diseases (f) ensuring environmental sustainability (g) employment enhancing vocational skills (h) social business projects (i) contribution to certain funds and other matters.

Currently, there is no mandatory requirement on companies to spend any part of their profit on CSR activities. The MCA has issued “Guidelines on Social, Environmental & Economic Responsibilities of Business,” for voluntary adoption by companies. In addition, the SEBI has mandated top-100 listed entities, based on market capitalization at BSE and NSE, to include business responsibility report in their Annual Report.

Key impact

1. The Companies Bill does not prescribe any penal provision if a company fails to spend amount on CSR activities. The board will need to explain reasons for non-compliance in its report.

2. The Companies Bill has set threshold of `5 crore net profit for applicability of CSR requirements. In comparative terms, this seems to be on lower side vis-à-vis net-worth and turnover thresholds of `500 crore and `1,000 crore, respectively. This may result in companies getting covered under the CSR requirements, even when they don’t meet net-worth/ turnover criteria.

3. Due to determination of average net profit in accordance with clause 198, actual expenditure on CSR activities for a company may be higher/ lower than 2% of its average net profit for the past three years determined in accordance with the P&L.

Potential issues

1. It is not absolutely clear whether a company will need to create provision in the financial statements toward unspent amount if it fails to spend 2% amount of the CSR activities in a particular year. We believe that the resolution of this issue may depend upon the legal/ other consequences, which may follow, if a company fails to spend the requisite amount in a particular year. For example, if a company can get away with an explanation in the board’s report and need not make good past shortfall in the future period, there may be no need to create provision. However, if the company needs to incur the amount currently unspent in future periods legally, a provision in accordance with AS 29 may be needed.

2. Questions may arise with regard to tax deductibility of expenditure incurred on CSR activities. One argument is that it is in the nature of allocation of profit and, therefore, will be not allowed as deduction for tax purposes. However, the counter argument is that there is a legal obligation on the company to incur such expenses though they are determined as % of net profit. Non-incurrence of these costs may have legal/ other regulatory implications on the company. Also, from financial reporting perspective, it will be treated as expense and not distribution of profit. Hence, it should be allowed as deduction for computation of taxable income. In certain past cases also, voluntary CSR expenses have been treated as tax deductible. To avoid legal complications, the CBDT may clarify that CSR expense will be treated as allowable expenditure under section 37 of the Income-tax Act.
Serious Fraud Investigation Office

Overview and key changes

1. Currently, the SFIO has been set-up by the Central Government under resolution No. 45011/16/2003-Adm-I dated 2 July 2003. Under the Companies Bill, statutory status will be conferred upon the SFIO. Till the time SFIO is established under the Bill, the SFIO previously set-up by the Central Government will be deemed to be SFIO under the Bill.

2. The Central Government may assign investigation into the affairs of a company to SFIO (i) on receipt of a report of the registrar or inspector, (ii) on intimation of a special resolution passed by a company that its affairs are required to be investigated, (iii) in public interest, or (iv) on request from any department of the Central Government/ state government.

3. Where any case has been assigned by the Central Government to SFIO for investigation, no other investigating agency of the Central Government/state government will proceed with investigation in such cases.

4. If authorized by the Central Government, SFIO will have the power to arrest in respect of certain offences, which attract the punishment for fraud. Those offences will be cognizable and the person accused of any such offence will be released on bail only upon fulfilling stipulated conditions.

5. Investigation report of SFIO filed with the special court for framing of charges will be deemed as a report filed by a police officer.

6. Stringent penalties are prescribed for fraud-related offences.

7. SFIO will share any information or documents, with any investigating agency, state government, police authority or income-tax authorities, which may be relevant or useful for them in respect of any offence or matter being investigated by them under any other law.

Class Action

Overview and key changes

Unlike a securities class action suit in the US, where a class of securities-holder can ask for compensation/damages for loss caused to them by the acts of company or its management in violation of applicable regulations, there was no specific provision available under the existing Companies Act to ask for market based compensation or damages by class of shareholders or depositors or prospective investors.

The companies Bill has taken a step to protect interest of investors and has introduced class action proceeding under section 37 and 245 of the Bill.

1. Requisite number of members or depositors or any class of them may file an application before the National Company Law Tribunal (NCLT), if they are of opinion that the Management or control of the affairs of the company are being conducted in a manner prejudicial to interests of the Company or its members or depositors.

2. The Companies Bill under clause 245 provides right to the members and depositors, having common interest, to form a group and initiate class action suit against defaulting company, directors, officers, experts, auditors and partners of the audit firms for claiming compensation or damages. The suit can be initiated by the members and / or depositors if they collectively believe that the management or conduct of the affairs of the company is being conducted in a manner prejudicial to the interests of the company or its members or depositors. Clause 245 (1) of the Bill provides that at least 100 members / depositors or members / depositors representing prescribed % of the total number of members / depositors or holding prescribed % of the total share capital / deposits can file an application before the Tribunal for seeking the following order

   a) restrain the company and its directors to act in contravention to its articles, memorandum, resolution or provisions of the Act.

   b) Initiate action for claiming damages and compensation against the company, its directors (including Independent Directors), auditors (including audit firm and Partners involved), experts /advisor/consultant or any other person for any improper or misleading statement or any fraudulent, unlawful or wrongful act or conduct.

3. Section 37 of the bill also provides that a suit may be filed or any other action may be taken under section 34 or section 35 (deals with criminal and civil liability for misstatement in the prospectus) or section 36 (deals with
fraudulently inducing persons to invest money) by any person, group of persons or any association of persons affected by any misleading statement or the inclusion or omission of any matter in the prospectus. Action could be initiated against the specified persons under the bill

a) Director of the company at the time of the issue of the prospectus;
b) any person who has authorised himself to be named and is named in the prospectus as a director of the company,
c) a promoter of the company;
d) any person who has authorised the issue of the prospectus; and
e) any person who is an expert referred to in sub-section (5) of section 26.

Key impact

1. In addition to the compensation or damages which could be granted by the Tribunal under clause 245(1)(vii), Clause 245 (7) provides that if any company or person fails to comply with an order passed by Tribunal then the company and every officer who has defaulted same shall be punishable with:
   a) Fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees and
   b) Every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years and with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees.

Section 2(60) defines “Officer who is in default” and includes under clause (vi) every director, in respect of a contravention of any of the provisions of this Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the Board or participation in such proceedings without objecting to the same, or where such contravention had taken place with his consent or connivance not been committed.

2. In addition to the compensation which can be claimed by the affected group of subscribers under clause 35 of the Bill, they can also proceed to take criminal action against the company, its directors and promoters, individuals who consented to be Directors as part of the prospectus, person who authorized to release the prospectus and experts under clause 447 of the Bill. Clause 447 of the Bill provides that “any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud”. Further, where the fraud in question involves public interest, the term of imprisonment shall not be less than three years.

Potential issues

1. Compensation for misstatements: In the US, there is a legally accepted presumption that the price of shares in an open and developed market is a reflection of all material information that is publicly available in the marketplace about those shares, including false and misleading information issued by a company. We will have to wait to see how Tribunal will view similar claims in India as the clause 37 and clause 245 does not restrict the claim to be made only for the material misstatements. There is high probability that subscribers / members may make claims based on any misstatements made by the company or its directors or officers or auditors made available through prospectus, reports or press release based on efficient market theory.

2. Litigation funding: While the concept of Plaintiff’s BAR as prevalent in the US is not allowed to be formed in India due to restrictions on Advocates in India from charging contingent fees by the Bar Council of India. There is however growing interest of international ligation funds to get involved in Indian litigations and share part of the gains from the settlement or compensation amount received through large scale claims. Further, the Bill also provides that the Investors Protection fund can be used for meeting litigation cost of filing class action suits under clause 37 and clause 245 of the Bill.

3. Litigation cost of defendants: The bill also does not provide for a looser to pay for litigation cost of defendant. Maximum cost that can be ordered to be paid by Tribunal for frivolous and vexatious claim capped to One Lac rupees. This will encourage various class actions suits against the companies and may cause reputation risks and litigation cost for defending even frivolous claims.

4. Inadequate coverage under D&O insurance cover: There will be need to review the coverage of the D&O cover from the sum insured and also eventualities covered especially if the Directors and officers are found to be guilty under clause 447 of the Bill or insolvency of the company.
Directors

Overview and key changes

1. Under the Companies Bill, each company will need to have minimum one director who stayed in India for at least 182 days in the previous calendar year. The Companies Act does not contain this requirement.

2. The Companies Bill will require prescribed class of companies to have at least one woman director on the board. Existing companies will be given a one-year transition period to comply with this requirement.

3. Under the Companies Act, a public company either with (a) paid-up capital of ₹5 crore or more, or (b) 1,000 or more small shareholders, may have a director elected by the small shareholders. Under the Company Bill, only listed companies will be given an option to have one director elected by the small shareholders.

4. Under the Companies Act, a public company or a private company, which is a subsidiary of a public company can have a maximum of 12 directors or the number mentioned in its Articles. Any further increase in the number of directors requires an approval from the Central Government. Under the Companies Bill, this limit has been set at 15 and will be applicable to all companies. For any further increase in number of directors, a company will need to pass a special resolution at its General Meeting. There will not be any need to obtain an approval from the Central Government.

5. Under the Companies Act, a person cannot hold directorship in more than 15 companies. Under the Companies Bill, a person will be able to become director of 20 companies. However, out of this, not more than 10 companies can be public companies.

6. Keeping in view the fiduciary capacity of directors, the Companies Bill has prescribed duties of directors. A director of the company will (i) act in accordance with the articles of the company, (ii) act in good faith to promote the objects of the company, (iii) exercise his duties with due and reasonable care, skill and diligence, (iv) not get involved in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company, (v) not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates, and (vi) not assign his office.

Independent directors

Overview and key changes

1. Currently, clause 49 of the listing agreement requires that a board of a listed company will have an optimum combination of executive and non-executive directors with not less than 50% of the board comprising non-executive directors. It also provides 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.

The Companies Bill states that every listed company will have atleast one-third of total number of directors as independent directors, with any fraction to be rounded off as one. Unlike the listing agreement, the Companies Bill does not contain any specific requirement for 50% independent directors if the Chairman of the board is an executive director.

2. Under the Companies Bill, the Central Government will have the power to prescribe minimum number of independent directors in other class of public companies. The Companies Act does not contain any such requirement.

3. The meaning of the term “independent director” given in the Companies Bill contains most of the attributes prescribed in the listing agreement. The Bill, however, contains certain additional criteria, e.g.:

   (a) An independent director should be a person of integrity and possess relevant expertise and experience.

   (b) The language used in clause 49 suggests that a person to be appointed as “independent director” should not have any material pecuniary relationship/transactions with the company, its promoters, its directors or its holding company, its subsidiaries and associates, which will affect independence of the director. The listing agreement does not specify any particular timeframe to be considered in this regard. However, the Companies Bill states that such relationship should not have existed either in the current financial year or immediately preceding two years.

   Also, the Companies Bill covers all pecuniary relationships, instead of material pecuniary relationships covered under the listing agreement.
(c) A person will not be eligible to be appointed as “independent director,” if parties listed in (b) above have/had pecuniary relationship/transactions exceeding prescribed amount with a relative of the said person. The listing agreement does not prohibit appointment based on pecuniary relationship/transactions with relatives.

(d) Clause 49 prohibits a person from being appointed as “independent director,” if that person is/was a partner/executive in statutory audit firm, internal audit firm, legal firm and/or consulting firm(s), which have association with the company. The Companies Bill also prohibits a person from being appointed as “independent director” if that person’s relative is/was a partner/executive in the said firm.

(e) Under the Companies Bill, the Central Government may prescribe additional qualifications for an “independent director.”

(f) Clause 49 states that the nominee directors appointed by an institution, which has invested in or lent to the company, is deemed to be an independent director. The Companies Bill, however, states that an independent director will be a director other than the nominee director.

(g) In accordance with the Companies Bill, an independent director should not be a Chief Executive or director, by whatever name called, of any non-profit organization, which receives 25% or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds 2% or more of the total voting power of the company.

4. The Companies Bill requires that every independent director, at the first meeting of the board in which he participates as a director and thereafter at the first meeting of the board in every financial year or whenever there is any change in the circumstances which may affect his status as an independent director, will have to give a declaration that he meets the criteria of independence. The listing agreement requires that an independent director, prior to the appointment, disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed.

5. The Companies Bill requires that the independent director may be selected from a data bank maintained by a body, institute or association, as may be notified by the Central Government.

6. Under the Companies Bill, an independent director will not be entitled to any stock options in the company. Under the listing agreement, there is no such prohibition. Rather, maximum limit on stock options granted to independent directors can be fixed by shareholders’ resolution.

Key impact

1. The SEBI may need to amend the listing agreement to bring it in line with the Companies Bill. Till such time, listed companies will need to follow the requirement of the listing agreement/Companies Bill, whichever is more stringent.

2. Considering additional criteria prescribed in the Companies Bill, many listed companies may need to revisit appointment of their independent directors.

3. The Companies Bill lays down various restrictions, on the person as well as its relatives, for being eligible to be appointed as independent director. If the government prescribes a long list of relations, the company, the person who is or seeking to be an independent director and the relatives of such person will have to keep track of this, to ensure compliance on a going forward basis. For example, a company cannot appoint any person as an independent director if that person or his relative is/was a partner/executive in the preceding three financial years in the firm of auditors of the company.

Potential issues

1. In accordance with the Bill, an independent director should be a person of integrity and possess relevant expertise and experience. However, it does not elaborate the relevant experience or expertise, which a company will consider. This will require each company to exercise its judgment.

2. The Bill states that an independent director will not be entitled to any stock option. The Bill is not clear as to how a company will deal with stock options granted in the past and which are outstanding at the date of its enactment. It seems possible that a company will likely need to cancel/forfeit these stock options immediately.
Understanding Companies Bill 2012

Code of conduct for independent directors

Overview and key changes

The listing agreement requires the board of directors to lay down a “Code of Conduct” for all board members and the senior management of the company. The code is to be posted on the company website and all board members and senior management personnel are required to affirm compliance with the same on an annual basis.

The Companies Bill lays down detailed “Code for independent directors” containing detailed guidelines for professional conduct, roles and responsibilities. The company and independent directors are required to comply with the same. Some key examples of guidelines are:

(a) Uphold ethical standards of integrity and probity
(b) Act objectively and constructively while exercising his duties
(c) Exercise responsibilities in a bona fide manner in the interest of the company
(d) Devote sufficient time and attention to his professional obligations for informed and balanced decision making
(e) Not allow any extraneous considerations to vitiate his objectivity and independent judgment
(f) Not abuse his position to the detriment of the company or its shareholders or for personal advantage
(g) Bring an objective view in the evaluation of the performance of board and management
(h) Safeguard the interests of all stakeholders, particularly the minority shareholders
(i) Undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company
(j) Keep themselves well informed about the company and the external environment in which it operates
(k) Satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.
(l) Seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice and opinion of outside experts
(m) Pay sufficient attention and ensure that adequate deliberations are held before approving related party transactions and assure themselves that the same are in the interest of the company
(n) Report concerns about unethical behavior, actual or suspected fraud or violation of the company’s code of conduct or ethics policy.

Key impact

Most of the attributes of independent directors prescribed in the Companies Bill are qualitative in nature. Therefore, it may not be possible to demonstrate compliance or otherwise with these criteria. Accordingly, it is possible that these aspects may become subject matter of significant debate.
Liabilities of independent director

Overview and key changes
Under the Bill, an independent director and a non-executive director not being promoter or KMP, 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. There is no such provision under the Companies Act; however the MCA has included such provision vide general circular no. 8/2011 dated 25 March 2011 directing all the RDs, ROCs and OLs to spare the independent directors and nominee directors from routine prosecution under the Companies Act.

Audit committee

Overview and key changes
1. Under the Companies Bill, each listed company and such other class of companies, as may be prescribed, will constitute an audit committee. Currently, the Companies Act requires all public companies with paid-up capital of not less than ₹5 crore to constitute an Audit Committee. The listing agreement requires all listed companies to constitute an audit committee.

2. Under the Companies Bill, an audit committee will comprise minimum of three directors with independent directors forming a majority. Under the Companies Act, audit committee should consist of minimum three directors of which two-third members will be directors, other than managing/whole-time directors. The listing agreement requires the audit committee to comprise minimum three directors with two-third members being independent directors.

3. The Companies Bill requires that majority of audit committee members including its chairperson will have an ability to read and understand the financial statement. There is no qualification prescribed under the existing Companies Act. In contrast, the listing agreement requires that all members should be financially literate and at least one member should have accounting or related financial management expertise.

4. The existing companies are allowed a one-year timeline for reconstituting its audit committee in accordance with the new requirements.

5. The existing Companies Act does not define role and responsibilities of the audit committee in detail; rather, it states that the board will determine the terms of reference. The listing agreement lists down the role of the audit committee in detail. The Companies Bill prescribes certain specific responsibilities of the audit committee and states that the board of directors will prescribe further terms of reference. Some key additional responsibilities prescribed in the Bill vis-à-vis listing agreement include:

   (a) To review and monitor the auditor’s independence and effectiveness of the audit process
   (b) Approval to any new or any subsequent modification to transactions of the company with related parties
   (c) Scrutiny of inter-corporate loans and investments
(d) Valuation of undertakings or assets of the company, if necessary

(e) Monitoring the end use of funds raised through public offers and related matters instead of reviewing the monitoring report prepared by the monitoring agency.

6. Each listed company and such other class of companies, as may be prescribed, will establish a vigil mechanism for directors and employees to report genuine concerns. The vigil mechanism will provide for adequate safeguards against victimization of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases. Under the listing agreement, “whistle blower policy” is a non-mandatory requirement.

7. In case of any contravention of these requirements, the company will be punishable with a fine, which will not be less than ₹1 lakh but which may extend to ₹5 lakh. Every officer of the company who is in default will be punishable with imprisonment for a term, which may extend to one year or with fine, which will not be less than ₹25 thousand but which may extend ₹1 lakh or with both.

Key impact

1. Non-listed companies, which belong to class of companies as prescribed by the government and thereby required to constitute an audit committee, will need to revisit the composition in light of new requirements.

2. Prima facie, it appears that the composition of audit committee constituted as per clause 49 of the listing agreement will be in compliance with the Companies Bill requirement. However, any change in independent directors, due to independent director qualification criteria discussed earlier, will trigger change in the composition of the Audit Committee as well.

Other committees

Overview and key changes

Nomination and remuneration committee

1. Under the existing Companies Act, Schedule XIII requires the approval by the remuneration committee for payment of managerial remuneration when a company has no profits or inadequate profits. The listing agreement contains provisions regarding NRC as a non-mandatory requirement. The Companies Bill will mandate all listed companies and such other class of companies as may be prescribed to constitute NRC.

2. The NRC will consist of three or more non-executive directors out of which not less than one half will be independent directors.

3. The NRC will identify persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down. NRC will recommend to the board their appointment and removal. It will also carry out an evaluation of every director’s performance.

4. The NRC will formulate criteria for determining qualifications, positive attributes and independence of a director and recommend to the board a policy, relating to the remuneration for the directors, KMP and other employees. Such policy will be disclosed in the board’s report.

Stakeholders Relationship Committee

1. The board of a company, which consists of more than 1,000 shareholders, debenture-holders, deposit-holders and any other security holders at any time during a financial year will constitute an SRC. The SRC will comprise a chairperson who will be a non-executive director and such other members as may be decided by the board.

2. The SRC will consider and resolve the grievances of security holders of the company.

3. Currently, the listing agreement requires listed companies to constitute a board committee under the chairmanship of a non-executive director. Such committee specifically looks into the redressal of shareholder and investors complaints. This committee is designated as ‘Shareholders/Investors Grievance Committee.’

Key impact

Publication and public availability of policy for remuneration to directors, KMPs and other employees in the board report is likely to put a company in a competitive disadvantageous situation.
Internal audit

Overview and key changes

1. The existing Companies Act does not require companies, except producer companies, to appoint internal auditor and have internal audit done. However, paragraph 4(vii) of the CARO requires an auditor to report on the following:

“In the case of listed companies and/or other companies having a paid-up capital and reserves exceeding ₹50 lakh as at the commencement of the financial year concerned, or having an average annual turnover exceeding ₹5 crore for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business.”

The Companies Bill states that such class or class of companies, as may be prescribed, will appoint an internal auditor to conduct internal audit of the functions and activities of the company.

2. Such internal auditor will either be a chartered accountant or a cost accountant, or such other professional as may be decided by the board.

3. The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board.

Key impact

The Companies Bill does not require a company to appoint only an external agency to get internal audit done. A company may either engage external agency or have internal resources to conduct internal audit.
Definition of relative

Overview and key changes

The Companies Bill 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 existing Companies Act also explains the term “relative” in a similar manner. It has prescribed a list of persons (see next page) who will be treated as relative under (iii) above.

Related party transactions, loans and investments
### Definition of related party

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The Central Government has still not prescribed list of relations that will be covered under the Companies Bill. The discussion elsewhere in this publication suggests that this definition is likely to have significant impact on aspects such as appointment, qualification and disqualification of auditor and independent directors. While prescribing covered relationship, the Central Government should consider this aspect and the fact that a person may not be able to control/influence 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.

Hence, instead of listing specific relationship, the government may explain clause (iii) above to mean “financially dependent person.” “Financially dependent person” can be explained to include any other persons and/or their spouses who received more than half of their financial support for the most recent financial year from the concerned person. Consider an estranged relative, who is financially independent. He can buy shares in a company audited by the person to whom he is related and deliberately or inadvertently disqualify the person from being the auditor of the company.

### Overview and key changes

The Companies Bill defines the term “related party” to mean:

(i) A director or his relative

(ii) KMP or his relative

(iii) A firm, in which a director, manager or his relative is a partner

(iv) A private company in which a director or manager is a member or director

(v) A public company in which a director or manager is a director or holds along with his relatives, more than 2% of its paid-up share capital

(vi) 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 is given in the professional capacity

(vii) Any person on whose advice, directions or instructions a director or manager is accustomed to act, except if advice is given in the professional capacity

(viii) Any company which is:

(A) A holding, subsidiary or an associate company of such company; or

(B) A subsidiary of a holding company to which it is also a subsidiary;

(ix) Such other person as may be prescribed

This term is not defined currently under the Companies Act. However, notified AS 18 defines the term “related party” by stating that “parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.” According to AS 18, it will apply only to the following list of relations:

(a) Enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries)

(b) Associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture
(c) Individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual

(d) KMP and relatives of such personnel, and

(e) Enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

Key impact

From the above, it is clear that definition of the term “related party” under AS 18 and the Companies Bill is different. However, the likely impact that these differences will have may vary on case-to-case basis. For example, “a firm, in which a director, manager or his relative is a partner” and “a private company in which a director or manager is a member or director” will be identified as related parties under the Companies Bill but perhaps not under AS 18.

The Companies Bill defines the term related party to control/regulate related party transactions and investor protection. AS 18 definition is relevant from disclosure in the financial statements perspective. The MCA may clarify that definitions in the Bill are relevant for legal/regulatory purposes. For financial statement purposes, definition as per the notified AS should be used. We believe that aligning the definitions in the near term will be a useful exercise to consider by the MCA.

Related party transactions

Overview and key changes

Like the existing Companies Act, the Companies Bill states that a company will not enter into certain transactions unless its board has given its consent for entering into such transactions. However, there are many differences between the requirements of the existing Act and the Bill. Given below is an overview of key changes:

1. The Companies Act states that a company with a paid-up share capital of not less than ₹1 crore will not enter into specified contracts, except with the previous approval of the Central Government. The Companies Bill does not require any government approval. Rather, it states that in the following cases, a related-party transaction can be entered into only if it is approved by a special resolution at the general meeting:
   (i) The company has paid-up share capital, which is not less than the prescribed amount, or
   (ii) Transactions not exceeding the amount, as may be prescribed

   No member of the company who is a related party can vote on such special resolution.

2. Under the Companies Bill, the Central Government may prescribe additional conditions for entering into related party transactions.

3. Under the Companies Act, restrictions apply only to transactions with specified persons/party, namely, a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director. In contrast, the Companies Bill will cover all persons covered in the definition of the term “related party”.

4. Under the existing Companies Act, restrictions apply only to the following two transactions:
   (a) Sale, purchase or supply of any goods, material or services
   (b) Underwriting the subscription of any shares in, or debentures of, the company

   In addition, the Companies Bill will also cover the following related party transactions:
   (a) Selling or otherwise disposing off or buying property
   (b) Leasing of property
   (c) Appointment of agent for purchase or sale of goods, material, services or property
   (d) Related party’s appointment in the company, its subsidiary companies and associate companies
(e) Underwriting the subscription of derivative on securities of the company.

5. Under the Companies Bill, the above restrictions will not 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. Similar exemption is there in the Companies Act also.

6. The Companies Bill requires that every contract or arrangements entered into with a related party will be referred to in the board’s report to shareholders, along with justification for entering into such transactions. This disclosure is currently not required.

Key impact

1. There will not be requirement to obtain an approval from the Central Government for entering into related party transactions. Rather, companies will need to pass special resolution at the general meeting, if relevant criteria are met. Interested members will not be entitled to vote on such resolution. Whilst this provision is likely to ensure closer scrutiny by shareholders of related party transactions, the minority group of shareholders could still be a silent spectator.

2. Even if a company has entered into related party transaction at arm’s length, it appears that the same will need to be referred to in the board’s report, along with justification for entering into the transaction. The disclosure requirement is also likely to cover non-cash transactions involving directors (covered elsewhere), if they are entered into with a related party.

Potential issue

The Companies Bill states that a company will not enter into certain transactions unless its board has given its consent for entering into such transactions. In certain cases, an approval by special resolution at general meeting will be required. In this context, the proviso states as below:

“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.”

Ideally, an approval by special resolution should be required for transactions where amount involved is not less than the prescribed amount. There seems to be a drafting error in this clause. The MCA may take care of the same while prescribing final rules.

Restriction on non-cash transactions involving directors

Overview and key changes

1. The Companies Bill contains a new requirement to the effect that without prior approval of the company in a general meeting, a company will not enter into an arrangement by which:

(a) A director of the company or its holding, subsidiary or associate company or a person connected with him acquires or is to acquire assets for consideration other than cash, from the company, or

(b) The company acquires or is to acquire assets for consideration other than cash, from such director or person so connected,

2. If the director or connected person is a director of the holding company, an approval will also be required by passing a resolution in the general meeting of the holding company.

3. Any arrangement entered into by a company or its holding company without getting requisite approval will be voidable at the instance of the company unless:

(a) The restitution of any money or other consideration which is the subject matter of the arrangement is no longer possible and the company has been indemnified by any other person for any loss or damage caused to it, or

(b) Any rights are acquired bona fide for value and without notice of the contravention of the provisions of this section by any other person.

Potential issue

The Bill does not explain who will be treated as person connected with director.
Loans to directors and subsidiaries

Overview and key changes

Like the existing Companies Act, the Companies Bill contains restrictions on advancing any loan, including any loan represented by a book debt, to any director 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. Given below is an overview of key differences:

1. Under the existing Companies Act, prohibited loans/guarantees can be made with the approval of the Central Government. Under the Bill this possibility does not exist.

2. Unlike the existing Act, the Companies Bill does not contain any specific exemption/exclusion with regard to loan given by a private company or by a holding company to its subsidiary or for guarantee given or security provided by a holding company in respect of any loan made to its subsidiary company.

3. Under the Companies Bill, restrictions on making loan/giving guarantee/providing security will not apply to the following.

   (a) Making of a loan to the managing/whole-time director either as part of service condition extended by the company to all its employees, or pursuant to any scheme approved by the members by a special resolution.

   (b) A company, which in the ordinary course of its business provides loans or gives guarantees or securities for the due repayment of any loan and in respect of such loans an interest is charged at a rate not less than the bank rate declared by the RBI.

The existing Act does not contain this exemption.

4. The Companies Bill provides for more stringent penalty and imprisonment for contravention.

Key impact/potential issue

In the absence of specific exemption/exclusion, it appears that a holding company will not be able to give loan to/guarantee/security on behalf of its subsidiary. This is likely to create significant hardship for many companies. Our experience of dealing with many group structures indicates that in many cases, a subsidiary may not be able to raise finance without the support of the holding company.

Loans and investments by company

Overview and key changes

1. The Companies Bill introduces a new requirement that a company cannot make investment through more than two layers of investment companies. However, this requirement will not affect:

   (a) A company from acquiring another company incorporated outside India if such other company has investment subsidiaries beyond two layers according to the law of that country

   (b) Subsidiary company from having any investment subsidiary for the purpose of meeting the requirement of any law for the time being in force.

In accordance with the Bill, “Investment Company” means a company whose principal business is the acquisition of shares, debentures or other securities.

2. Like the existing Companies Act, the Companies Bill also prohibits a company from giving loan to, giving guarantee or providing security in connection with a loan to any other body corporate or acquiring securities of any other body corporate, exceeding the higher of:

   (a) 60% of its paid up share capital, free reserves and securities premium, or

   (b) 100% of its free reserves and securities premium.

Under the existing Act, the above restriction is applicable only in connection with provision of loan to/guarantee/security on behalf of other body corporate. The Companies Bill will extend this restriction to provision of loan to/guarantee/security on behalf of any person or entity.

3. Both the existing Act and the Bill allow companies to provide loan/give guarantee/security exceeding the above limit if they take prior approval by means of a special resolution passed at the general meeting. In exceptional cases, the existing Act allows companies to provide guarantee in excess of the limit without taking prior approval; however, the same needs to be confirmed at the general meeting within 12 months. This option will not be available under the Companies Bill.

4. The Companies Bill contains new requirement that a company will disclose to the members in the financial statements the full particulars of loans given, investments made or guarantee given or security provided and the purpose for which the loan or guarantee or security is proposed to be utilized by the recipient of the loan or guarantee or security.
5. Under the Companies Act, the rate of interest on loan cannot be lower than the prevailing bank rate, i.e., the standard rate made public under section 49 of the Reserve Bank of India Act, 1934. Under Companies Bill, 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.

6. The existing Companies Act exempts the following from these requirements. These exemptions have been dispensed with under the Companies Bill:
   (a) A private company, unless it is a subsidiary of public company
   (b) Loan made by a holding company to its wholly owned subsidiary
   (c) Guarantee given or any security provided by a holding company in respect of loan made to its wholly owned subsidiary
   (d) Acquisition by a holding company, by way of subscription, purchases or otherwise, the securities of its wholly owned subsidiary

Key impact
1. Prohibition on having more than two layers of investment companies may require many groups to reconsider their investment structures. However, it seems that the same restriction/prohibition may not apply on making investment through other than investment companies.
2. Removal of exemption for loans made/guarantee/security given by holding company to/on behalf of its wholly owned subsidiary will create hardship for many subsidiary companies, which are significantly dependent on their parent for financing.
3. Loan given to/guarantee given/security provided on behalf of any person or entity will also be included in the maximum limit.

4. A company will make disclosure regarding full particulars of loan given, investment made or guarantee given along with purpose for which such amount is to be utilized by the recipient of the loan/guarantee/security in the financial statements. Hence, the same will also be subjected to audit.

Potential issue
No specific transitional provisions have been prescribed for new/additional requirements such as restrictions on loans made/guarantee/security given by holding company to/on behalf of its wholly owned subsidiary and prohibition on having more than two layers of investment companies. It is also not clear whether change regarding interest will apply only to new loans or it will apply to existing loans also.

Whilst there are no transitional provisions, it appears that the prohibition applies to future loans/guarantees, and not to one’s that existed at the date of enactment. However, the prohibition may apply when major terms and conditions of existing loans are revised, for example, the tenure of the loan. However, prohibition on having more than two layers of investment companies appears to be a continuing requirement. Hence, one may argue that the same needs to be complied with for existing investments as well.
Disclosure of interest by directors

Overview and key changes

1. Like the existing Companies Act, the Companies Bill also requires interested director to disclose his interest in a contract/arrangement at the board meeting at which such contract/arrangement is being discussed. It also prohibits interested director from participating in such meetings. In addition, the Companies Bill requires a director to disclose his interest in a contract/arrangement entered/proposed to be entered into with:

   (a) A body corporate in which such director or such director in association with any other director, holds more than 2% shareholding of that body corporate, or is a promoter, manager, Chief Executive Officer of that body corporate, or

   (b) A firm or other entity in which, such director is a partner, owner or member.

2. The Companies Bill requires that every director, at the first meeting of the board in which he participates as a director and thereafter at the first meeting of the board in each financial year or whenever there is a change in the earlier disclosure, will disclose his interest in companies, bodies corporate, firms or other association of individuals. Similar requirement with regard to general disclosure of interest in companies, bodies corporate, firms or other association of individuals also exists in the Companies Act.

3. Any contract/arrangement entered into by the company in contravention of the above requirements will be voidable at the option of the company.

4. The Companies Bill provides for stricter penalty and imprisonment for contravention.
Mergers, amalgamation and reconstruction

Overview and key changes

1. As under the existing Companies Act, the 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.

2. The Companies Act does not permit outbound cross-border, i.e., merger of an Indian company with a foreign company. The Companies Bill will allow, subject to RBI approval, both inbound and outbound cross-border mergers and amalgamations between Indian and foreign companies.

3. The Companies Act does not contain any specific provision regarding high court approval of a CDR scheme. However, the Companies Bill states that an application can be made to the tribunal for making compromise or arrangement involving CDR. Any such scheme should, among other matters, include:

   (a) 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.
(b) 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.

4. Currently, SEBI requires all listed companies, while filing 
any draft scheme with the stock exchange for approval, to 
file an auditors’ certificate to the effect that the accounting 
contained in the scheme is in compliance with notified 
AS. There is no such requirement for unlisted companies, 
including subsidiaries of listed companies. However, 
currently MCA requires all RDs to ensure that accounting 
treatment clause in the scheme is in compliance with 
notified AS.

Under the Companies Bill, 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.

5. The Companies Act does not prohibit companies 
from creating treasury shares under the scheme. The 
Companies Bill will prohibit such practices. It requires that 
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. It will require 
such shares to be cancelled or extinguished.

6. In case of merger/ amalgamation of companies, the 
following documents also need to be circulated for meeting 
proposed between the company and concerned persons:
(a) Report of the expert on valuation, if any
(b) 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.

7. The Companies Bill clarifies that the merger of a listed 
company into an unlisted company will not automatically 
result in the listing of the transferee company. There is no 
such requirement under the Companies Act.

8. The Companies Bill will introduce a simplified procedure for 
merger and amalgamation between (i) holding company 
and its wholly owned subsidiary, or (ii) two or more small 
companies. Any such merger can be given effect to 
without the approval of the tribunal, subject to compliance 
with certain other procedures.
9. Under the existing Companies Act, any shareholder, creditor or other interested person can raise objection to a scheme placed before the court if such person’s interests are adversely affected. However, under the Companies Bill, only persons holding not less than 10% of the shareholding or having outstanding debt not less than 5% of the total outstanding debt can raise objections to the scheme.

10. The Companies Bill also states that if, in a scheme of amalgamation/merger, shareholders of the transferor company decide to opt out of the transferee company, provision will be made for payment of the value of shares held by them and other benefits in accordance with a pre-determined price formula or after a valuation is made. The amount of payment or valuation under this clause for any share will not be less than what has been specified under any regulation framed by the SEBI.

Key impact

1. Compliance with notified AS will be mandatory for all companies, including unlisted companies. Currently, certain schemes filed by unlisted companies (including those that are subsidiaries of listed companies) contain accounting treatment, which is not in compliance with notified AS.

2. Currently, certain companies holding treasury shares recognize dividend income and gain/loss arising on sale of treasury shares in the statement of profit and loss. In addition, holding of treasury shares through trust makes free float available to raise finance in future, without going through a lengthy process of issuing additional shares. The Companies Bill prohibits the non-cancellation of treasury shares and hence, the practices referred to above will not be possible.

Potential issues

1. It is not absolutely clear whether the requirement regarding compliance with notified AS will also apply to scheme filed and pending for approval at the date of enactment of the Companies Bill. We believe that the requirement to comply with notified AS will also apply to all pending schemes at the date of enactment of the Companies Bill.

2. Currently, AS 14 recognizes accounting according to the schemes approved by the court and requires certain additional disclosures to be made in the financial statements. In the context of listed companies, SEBI has clarified that mere disclosure according to AS 14 will not be deemed as compliance with notified AS. To avoid any confusion, the MCA should also provide similar clarification.

3. Under the current Indian GAAP, no authoritative guidance is available on certain matters such as accounting for demergers or spin-offs. Based on an analogy taken from other pronouncements, various accounting alternatives seem possible. The ICAI needs to provide appropriate guidance on these matters.

4. In previous court schemes, courts had allowed departures from accounting standards not only at the appointed date, but also going forward. For example, the court would have permitted, writing off of foreign exchange losses directly against reserves rather than through the P&L account. Our view is that the Companies Bill will not have any impact on accounting prescribed in the earlier court schemes, and will apply to all court schemes that are approved after the Bill is enacted.

5. In case of CDR schemes, companies are required to submit a report by the auditors to the effect that the company’s fund requirements after the CDR will conform to liquidity test. This will require auditors to understand and comment upon estimates made by the management for its future business plans. This will require auditors to understand the industry and the company’s business in detail. Also, the ICAI may need to provide appropriate guidance on the subject.

6. In case of CDR schemes, it is mandatory for the company to submit valuation report. Also, the company may need to circulate valuation report, if any, in case of amalgamation schemes. Currently, no valuation standards exist in India. This may result in significant variances between the valuations performed by different valuers. To address this aspect and streamline valuation process, ICAI should issue standards corresponding to IFRS 13.

7. The Companies Bill prohibits creation of treasury shares in merger/amalgamation/reconstruction schemes. Since the Bill is silent on treasury shares already held by companies, it is believed that this restriction will not impact treasury shares previously held by companies.
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| International Accounting Standards | IAS |
| International Federation of Accountants | IFAC |
| International Financial Reporting Standards | IFRS |
| Key Managerial Personnel | KMP |
| Limited Liability Partnership | LLP |
| Ministry of Corporate Affairs | MCA |
| National Advisory Committee on Accounting Standards | NACAS |
| National Financial Reporting Authority | NFRA |
| Nomination and Remuneration Committee | NRC |
| Non Public Interest Entities | Non-PIEs |
| Official Liquidator | OL |
| Public Interest Entities | PIEs |
| Public Private Partnership | PPP |
| Regional Directors | RD |
| Registrar of Companies | ROC |
| Reserve Bank of India | RBI |
| SEBI (Disclosure and Investor Protection) Guidelines 2000 | SEBI DIP guideline |
| SEBI (Issue Of Capital And Disclosure Requirements) Regulation 2009 | SEBI ICDR regulation |
| SEBI (Substantial Acquisition of Shares and Takeovers) Regulations 1997 | SEBI Takeover Code |
| Securities and Exchange Board of India | SEBI |
| Serious Fraud Investigation Office | SFIO |
| Small and Medium Sized Company as defined under the Companies (Accounting Standards) Rules, 2006 | SMC |
| Stakeholders Relationship Committee | SRC |
| Stand-alone Financial Statements | SFS |
| Standards on Auditing issued by ICAI | SA |
| Statement of Change in Equity | SOCIE |
| Statement of Profit and Loss / Profit and Loss Account | P&L account / P&L |
| Straight Line Method | SLM |
| Unit of Production | UOP |
| Unites States | US |
| Written Down Value | WDV |
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