Workshop on Companies Act 2013

10 June 2017

Contents

Section 1

Appointment and rotation of auditors

Appointment of auditors – section 139

- Instead of reappointment at each AGM, auditor to be appointed for a block of five years
- Reappointment needs to be ratified at each AGM
- Appointment shall be made taking into account the recommendations of the Audit committee/Board
- At each AGM, members will have option to
  - rotate Audit partner/team
  - appoint joint auditor
- Maximum of 20 companies (including private limited companies) can be audited by an individual Auditor
- Auditors need to provide a written consent and also indicate whether they satisfy the criteria provided in Section 141
- Firm includes a LLP incorporated under the Limited Liability Partnership Act, 2008

Duties and Liabilities of auditors – section 143 and 147

Companies Act 2013

Duties

- Auditor to report on specified matters, in the audit report
- Responsibility to report offence involving fraud to the Central government
- NFRA can specify additional matters for reporting

Liabilities

- Contravention of provisions punishable with fine not less than Rs 25,000 up to Rs 500,000
- In case of wilful or contravention done knowingly or with wilful intent to deceive, imprisonment unto one year and fine not less than Rs 100,000 but which may extend upto Rs 2,500,000
- If convicted, also liable to refund remuneration and liable to pay damages (to company, statutory bodies or authorities) arising out of the incorrect reporting

Enhanced auditor responsibilities – section 143

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

NFRA would be the new regulator

Disqualification and independence criteria– section 141

Disqualifications

Provisions relating to auditor independence made more stringent

- Business relationship
- Officer/employee of company (or partner of /in employment of such person)
- Auditor in more than 20 Companies
- Convicted by Court
- Body corporate, other than LLP
- Consulting and specialised Services
- Holding security of /interest in or indebted to company/its subsidiary/associate / holding company /subsidiary of its holding company exceeding Rs one lakh/Rs five lakhs
- Person whose relative is Director/KMP of company
- Full time employment elsewhere

Eligibility

- Chartered Accountant
- Firm, with majority partners as CA's

Non-audit services – section 144

- Generally similar to Sarbanes Oxley Act in the US
- Prohibition extends to holding and subsidiary companies
- Covers auditor and related entities
- Transition period – one year
- All non-audit services to be approved by the Audit Committee or Board

Rotation of auditors – section 139

- Mandatory auditor rotation
  - Companies covered by rotation (Listed companies, unlisted public companies with paid up share capital > Rs 10 crores, private limited companies with paid up share capital > Rs 20 crores, all companies having public borrowings from banks/financial institutions or public deposits > Rs 50 crores)
- While a partnership firm would be eligible for two consecutive five year terms, an individual auditor would be eligible for only one such term
- Term prior to commencement of New Act will be retrospectively reckoned for computing 5-10 year validity
- After completion of audit engagement term, the Auditor will be subject to a continuous five-year cool off period
- Incoming auditor cannot be an associate or from same network as the outgoing auditor
- If a partner who is in charge of an audit firm and also certifies the financial statements of a company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years

Rotation of auditors – section 139 *(Continued)*

- Transition period of three years set to implement the change
- Where a company has appointed two or more persons as joint auditors, the rotation shall be done in such a manner that all of the joint auditors do not complete their term in the same year

International scenario

- Views are sharply divided on whether rotation improves the effectiveness of audit
- Internationally rotation of auditors is restricted to public interest entities
- European Union has recently proposed rotation rules for member countries
- Currently, only Italy and Netherlands has mandatory rotation of auditors. However, subsidiaries of foreign companies having their primary listing overseas are exempted from rotation in Italy
- It has been abandoned in Spain, Brazil and Korea after having been adopted for most public companies
- Regulators in the United States evaluated the auditor rotation post the Enron debacle and concluded that mandatory audit rotation need not increase auditor independence

Implementation issues – Auditors

- Clarification on the meaning of investment advisory services, investment banking services and management services, which services an auditor cannot provide to its audit clients
- Section 141 disqualifies an auditor if he or his relative holds any security or interest in a company or is indebted or has given guarantee or provided security in excess of prescribed limits. The term ‘relatives’ is very wide (parents, son/son’s wife, daughter/daughter’s husband, brother, sister) and covers even financially independent relatives over whose actions the auditor may have no control
- Even private companies have been included to calculate the maximum limit of 20 companies which an auditor can audit. Will significantly restrict the number of companies that can be audited

Implementation issues – Auditors appointment

- The Rules specify that the appointment of an auditor should be ratified at every annual general meeting. In case the appointment is not so ratified, the Board shall appoint another auditor. It is not clear whether the non-ratification would amount to removal of the auditor or automatic termination – since the process for giving effect to both is different under the Act
- Term of appointment within transitional period - whether for a block of years or one year at a time
- Can Joint auditor be appointed within the transitional period ?
- Lack of clarity on triggering of rotation: Whether any time during the year evaluating the amount of paid up capital and borrowings exceed the limit will trigger the rotation or should be considered amount outstanding at the year end.
- Paid up capital – whether this should include preference capital
- Whether cash credit/bank overdraft is covered within the definition of borrowings?
- Company not covered by mandatory firm rotation may get covered if its borrowings cross the threshold limit for the first time.

Implementation issues – Audit Report

- How does the auditor determine financial transactions/ matters which have adverse effect on the company's functioning?
- The requirement of 'internal financial controls' is not explained in the context of the auditors' responsibility in relation to his audit report. What is the auditor required to do to enable him issue the report?
- Would the above apply to CFS considering that section 129 mandates the preparation of CFS?

Section 2

CARO 2016

Section 3

Fraud Reporting

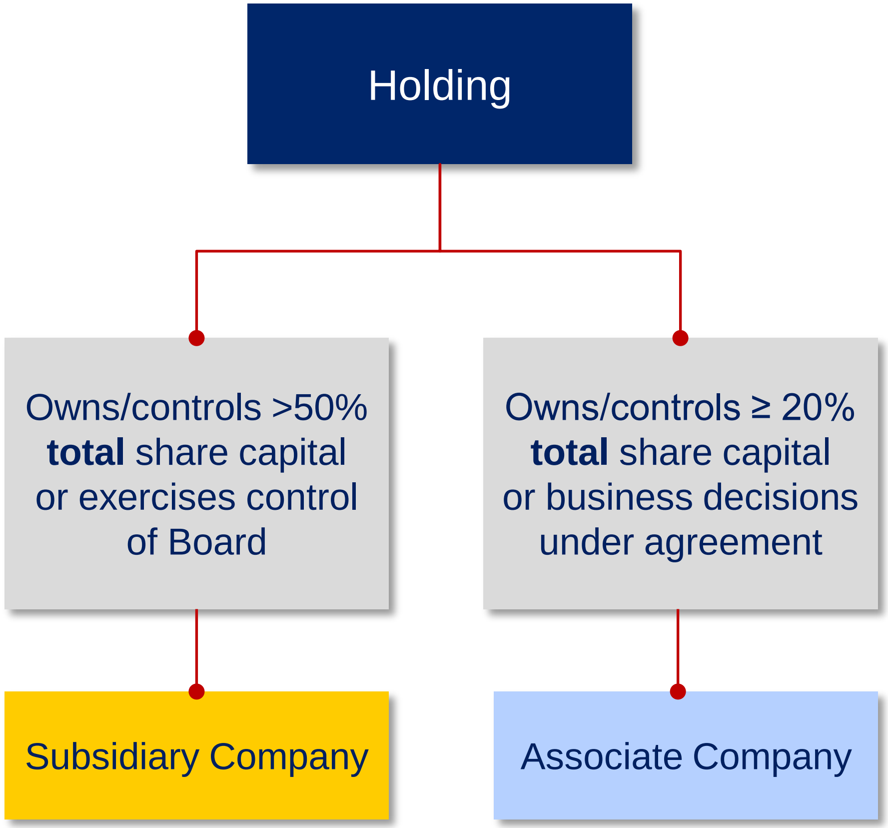
Section 4

Consolidated Financial Statements

KEY DEFINITIONS

Subsidiary, Associate and Joint Venture companies now redefined

Subsidiary / Associate : section 2(6) and 2(87)



Requirement

a. AS 21/23 conditions now in contradiction with the Act. Holding > 50% /20% of ‘nominal equity share capital' now replaced with 'total share capital‘

b. Associate: No rebuttable presumptions. Includes joint venture

Subsidiary, Associate and Joint Venture companies now redefined *(Continued)*

Subsidiary *has been defined in the Act as follows:*

“a “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) ………………..

(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. [Section 2(87)]***

The criterion relating to share capital as per the Act is broader than the corresponding criterion under AS 21 which refers only to ownership of more than one-half of the voting power (rather than total share capital). Thus, entities qualifying as subsidiaries under the Act may differ from those so qualifying under AS 21

Subsidiary, Associate and Joint Venture companies now redefined *(Continued)*

The definition of the term ***'Associate company'*** as per the Act (reproduced below) differs from the definition under AS 23, Accounting for Investments in Associates in Consolidated Financial Statements:

"Associate company", in relation to another company, means a company in which that 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 [Section 2(6)]

Explanation – For the purposes of this clause, "significant influence" means control of at least twenty per cent, of total share capital, or of business decisions under an agreement.

This definition refers to 'control' of business decisions; the term 'control' is different from the term 'significant influence'.

Holding and subsidiary relationship: Voting power Vs. total share capital

X Ltd. has investment in equity and preference shares of A Ltd. but does not control its board composition

Particulars	Equity Shares	Preference Shares	Total
	(Voting)	(Non-Voting)	
Total share capital	100	60	160
Shares owned by X Ltd	40	60	100
% ownership of X Ltd	40%	100%	62%
Per 1956 Act (based on equity share capital)			Not a subsidiary
Per 2013 Act (based on total share capital)			Subsidiary
Per AS 21			Not a subsidiary

Consolidated Financial Statements (CFS) required for all companies - section 129 (3)

Applicability

Mandate for all companies to prepare CFS in respect of entities having one or more:

- Subsidiary; or
- Associate; or
- Joint Venture company

Provided that nothing in this section shall apply in respect of CFS by a Company having subsidiary or subsidiaries incorporated outside India ***only*** for the financial year commencing on or after 01 April, 2014.

The CFS should include salient features of the financial statement of the subsidiaries.

Exemptions

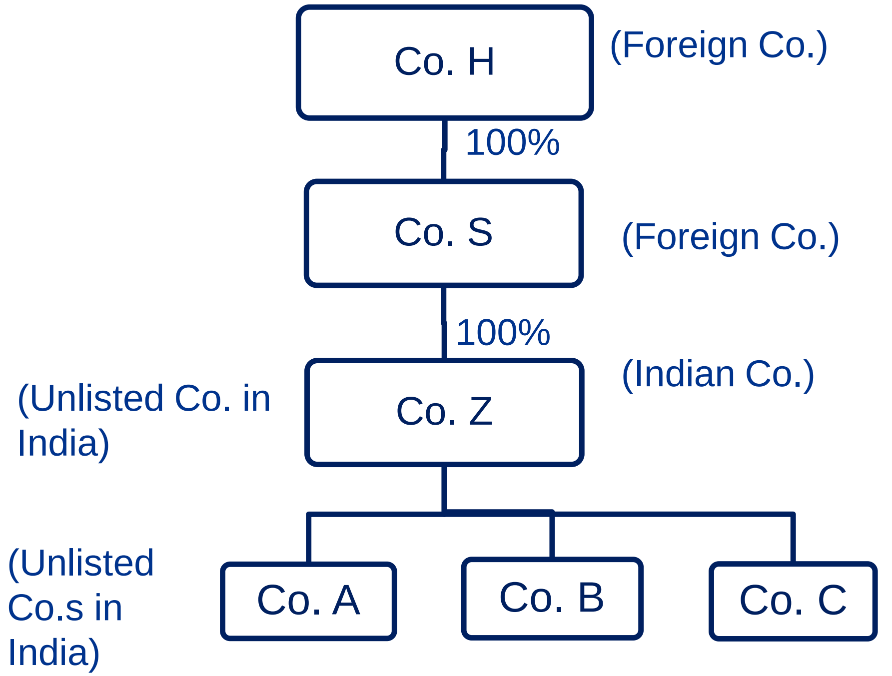
Rule 6 provide exempts from preparing CFS if it meets ***all*** the following conditions:

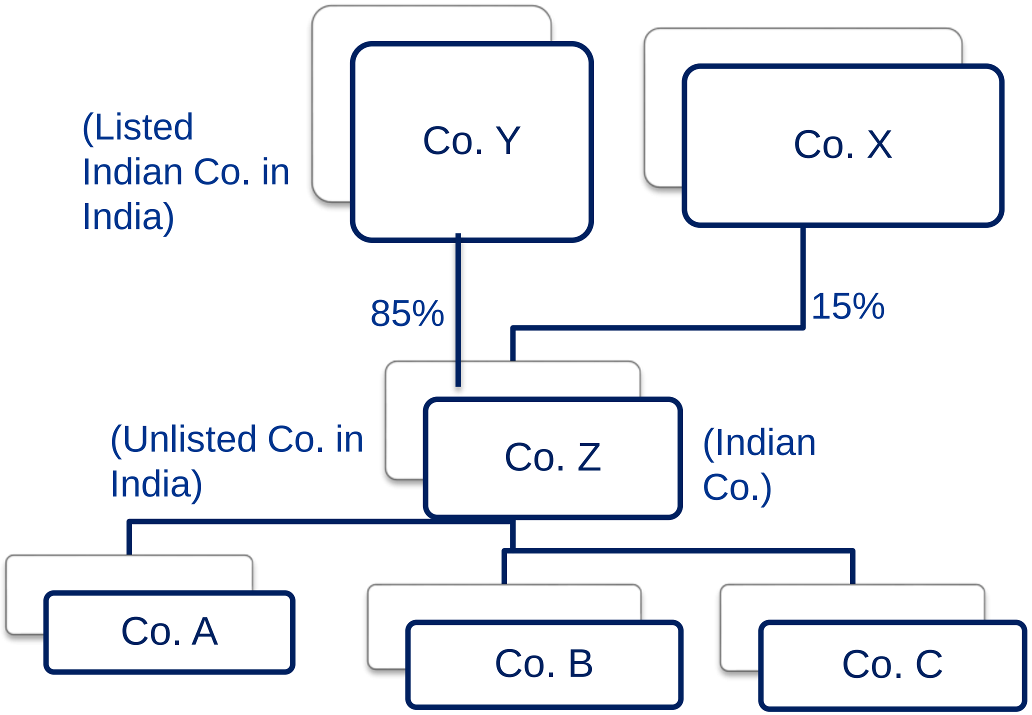
i. It is a subsidiary of another company and all its other members do not object to the company not presenting CFS;

ii. a company whose securities are not listed and are not in the process of listing on any stock exchanges, whether in India or outside India and

iii. Its ultimate or any intermediate holding company files CFS with the ROC which are in compliance with the applicable AS (As per the 2013 Act).

Consolidated Financial Statements (CFS) - section 129 (3) – Examples





Co. Z cannot claim exemption and would be required to file CFS with ROC as both Co. H and Co. S are foreign companies.

Co. Z can claim exemption and would not be required to file CFS with ROC if Co. Y files CFS with ROC and Co. X does not object to Co. Z not presenting CFS.

Implementation issues - CFS

- Apparent conflict between the Accounting Standards and the Act regarding the definition of subsidiary/associate. How would such conflicts be resolved for preparing CFS?
- Should optionally convertible preference shares be excluded for determining a subsidiary?
- The consolidated financial statements should be prepared in the same form and manner as the company’s stand-alone financial statements (*seems to create an inconsistency vis-à-vis AS 21 according to which certain disclosures required in stand-alone financial statements may not be made in CFS – e.g., CIF value/income/expenses in foreign currency etc. However, since the Act would prevail over the standard, the exemptions under AS 21 would not be available once the section comes into force)*

Parent auditor’s consideration

Scenario 1: If parent auditor is not auditor of all the it’s component

- **Relying upon work of other auditor:**

  Principal auditor should comply with requirement of SA 600 “ using the work of another auditor”.

- **Reporting:**

  Should provide necessary reference about the work performed by other auditor under ‘other matter paragraph’ in consolidated audit report.

Scenario 2 : If a component is not subject to audit

- **Reporting:**

  Principal auditor should evaluate qualitative and quantitative factors of component not subject to audit and should consider effect of the same while reporting on CFS as modified opinion or other matter paragraph as appropriate.

Scenario 3 : If a component is excluded from CFS

- **Reporting:**

  If the a component is excluded from CFS for reason other than those allowed under applicable framework then should modify his report appropriately.

Section 5

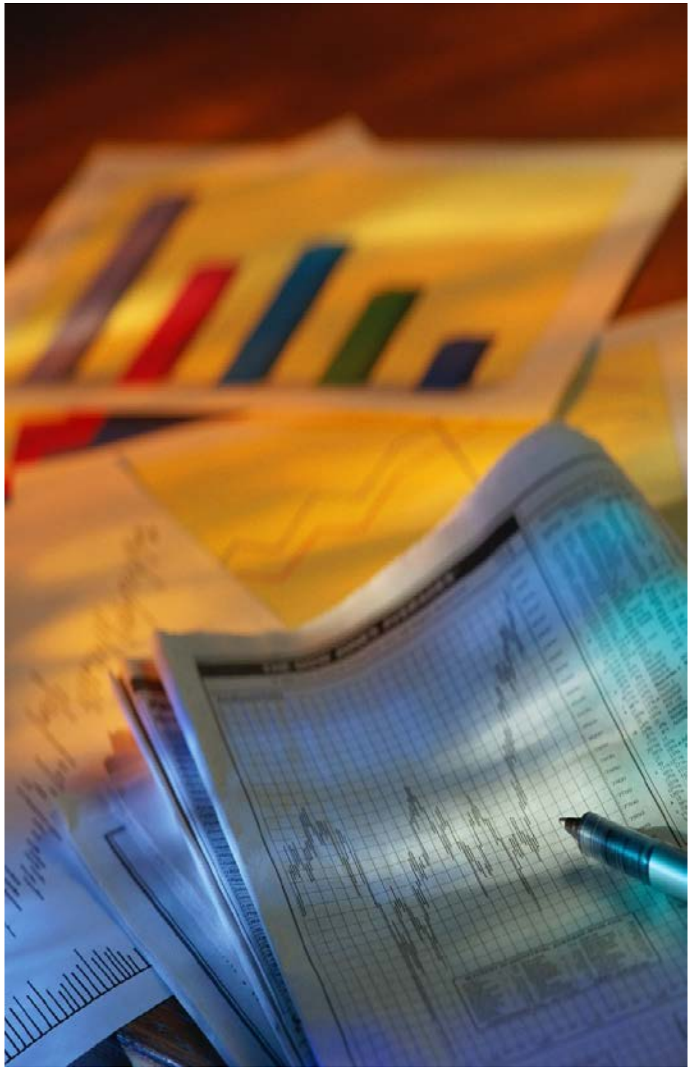
Depreciation- Schedule II

Financial Reporting - Depreciation – Schedule II

Companies Act 2013

Depreciation

- Increased significance on useful life and residual values (benchmark – max. 5% of original cost)- companies can choose life and residual value that is different from Schedule II
- Justification required in case, ‘useful life’ or residual value is different from ‘Schedule II’.
- No particular method for providing depreciation.
- No specific provision for items up to INR 5000;
- Depreciable amount of an asset is the cost of an asset or other amount substituted (fair valued/ revalued) less residual value;
- Guidance note issued by ICAI on revaluation of fixed asset has been withdrawn



Component accounting to be mandatory

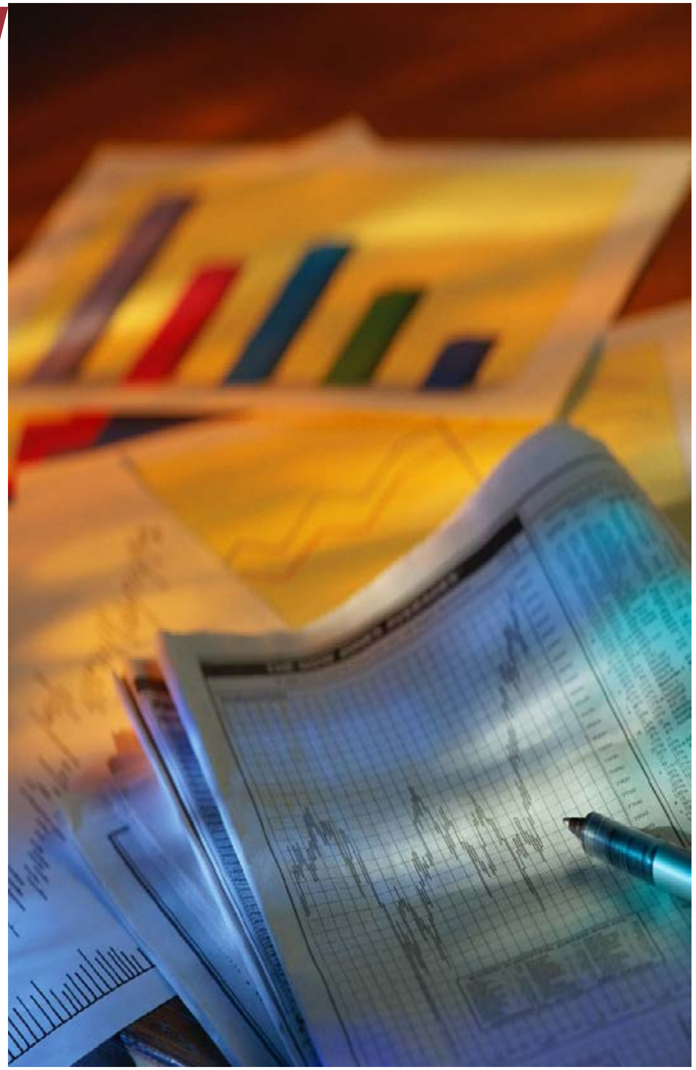
Financial Reporting - Depreciation – Schedule II *(Continued)*

Depreciation

- Many items of plant and machinery with general rate under Schedule XIV governed by special rate.
- Geographical location: There can be different useful life for similar asset but situated in different geographical location, e.g., a building in coastal area will have lesser useful life than situated in other location
- CPP is defined - a plant which is required and designed to operate 24 hours per day.
- Extra shift depreciation does not apply to CPP and asset marked as NESD

Amortization

- Provisions of Accounting Standards would be applicable for amortization of intangible except road created on ‘BOT’ or any other form of PPE



Implementation issues – Depreciation

Component accounting - 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 shall be determined separately.

An example could be a commercial aircraft which, for depreciation purposes, may be viewed as comprising (i) airframe, (ii) aero engine(s), and (iii) interiors.

- Component approach requires more detailed record-keeping - fixed assets register will need to separately record (i) component X and (ii) the rest of the machine. For this purpose, the total cost of the machine will need to be split in

- In many cases, an entity acquires an asset for a fixed sum without knowing the cost of the individual components. In such case, the cost of individual components would need to be estimated either with reference to current market prices (if possible), in consultation with the seller or contractor, or using come other reasonable method of approximation (e.g. relative values).

- Identification of components and split of total cost and useful life may also require involvement and assistance of technical experts.

Implementation issues – Depreciation

- Wide divergence between Schedule II and Income-tax depreciation rates
  - IT rates and company law rates should be similar (except for accelerated depreciation under tax laws to stimulate capital investment in certain assets)

Challenges Ahead

Challenges Ahead

- Greater Reporting Requirements for Auditors
- Redefining roles and responsibilities
- Punishment for Non Compliances
- Emphasis on Fraud Prevention and Detection

Q&A

Thank you

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