The Companies Act, 2013: A Significant Milestone....

Finally, the youngest Minister of Corporate Affairs has been successful in bringing the much awaited fresh perspective in the Corporate Law to its logical conclusion. It would only be fair to acknowledge several positive indications in the Companies Act, 2013 (referred to as the new Act), including self-regulation and appropriate empowerment. Overall it is a genuine attempt and a much awaited overhaul with the changing environment and forward thinking. Implementation and transition to comply with the new law would need regulatory support and change in the mindset. Corporates would need significant preparation and groundwork to abide by the law in substance. It is also necessary that the regulatory authorities ensure adequate monitoring and enforcement mechanism, in the absence of which the objective may not be achieved. Read on…

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The new Act contains only 470 clauses compared to 658 sections in the erstwhile Act. However, there appears to be more than 300 clauses that are subject to substantive rules to be prescribed. A combination of the proposed Act and the related Rules may turn out to be larger than the existing law. Timely response of the regulatory authorities to the challenges posed by multiple interpretations and related administration, would make implementation easier and is of utmost

importance. Besides the Ministry of Corporate Affairs (MCA), the role of several credible organisations like The Institute of Chartered Accountants of India (ICAI) and the Indian Institute of Corporate Affairs (IICA), etc. would be important in supporting and building capacity. Similarly, the industry bodies like CII, PHD Chambers, FICCI and ASSOCHAM, etc., would also need to be proactive in communicating the corporate voice and bridging the expectation gap effectively. It would be necessary for authorities like SEBI to agree to uniformity of principles, instead of carrying diverse thoughts, unless necessary, to bring in clarity and ensure better implementation. For instance, SEBI, in the Listing Agreements, may like to synchronise required composition of Board of Directors and Audit Committees; limit on the number of directorships; roles and responsibilities of independent directors; definition of related parties; concept of vigil mechanism, etc., in line with those prescribed in the Companies Act, 2013. All this would encourage the willing corporates in ensuring an effective and better implementation.

On the flip side, with an enormous amount of Rules and additional guidance to be prescribed, it may sound as if the Rules would override the basic law. It may lead to litigations, fighting for the form and ultimately diluting the substance. It is desirable that the MCA takes a pragmatic view by clearly distinguishing between *'inadvertent non-compliances due to sheer volume and possible multiple interpretations' and 'wilful non-compliances'*.

Though the new Act seems to be enthusiastic in spelling out accountability and reporting by the directors, it also encourages and provides necessary freedom and enough room for self-regulation. These are adequately reflected at several places in the form of removing bureaucratic approval process by the Central Government for various corporate actions, e.g., related party transactions, increase in number of directors, managerial remuneration, loans to directors, etc. However, there are clear expectations of better corporate governance, e.g., substantive disclosures to stakeholders, significant role of independent directors, transparency in related party transactions, etc. Importance to transparency is clearly reflected by way of disclosure requirements in the Directors' Responsibility Statement, which would need to include assurance on adequacy and effectiveness of internal financial controls; compliance with applicable laws and regulations; risk management policies and CSR initiatives; and manner of evaluation of annual performance of Boards/committees/individual directors. A combination of these disclosures would help investors in understanding the status of governance, compliance and operational effectiveness. Besides prescribing the composition of the board of directors and audit committees, the new Act mandates inclusion of a woman director (for companies to be prescribed) and a director on the Board who has been in India for at least 182 days in the previous calendar year. These provisions indicate empowerment and operational effectiveness of management. In order to ensure that the directors devote adequate attention, the limit on number of directorships in public companies has been reduced to 10. However, the overall number has been increased to 20 as compared to 15 at present.

Freedom by way of self-governance is followed by stricter penal provisions for non-compliances. The stakeholders have also been empowered to initiate actions, e.g., introduction of class action suit is an extremely powerful tool towards protection of interest of investors. Similarly, there are severe penalties for insider trading. Such empowerment and significant penal provisions will bring in investor confidence and also a fear amongst those charged with governance to stay away from unethical practices to a large extent. For an effective implementation, it is important that there are adequate enforcement procedures and action against non compliances.

The new Act thrusts significant moral responsibility on independent directors to objectively discharge their functions. While regulation may only provide indicative guidance, corporate governance is a state of mind and the responsibility lies with those who deal with public resources. The expectation is to look beyond vested interests in order to safeguard the stakeholders. The new Act mandates rotation of independent directors by way of restricting their tenure to a maximum of 5 consecutive years, with an additional tenure of 5 years by way of special resolution. The period would

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The new Act poses significant emphasis on the independence of auditors. Principles like rotation of auditors in case of listed companies (other companies may be prescribed) are in that direction. It may still be debatable whether rotation of auditors would objectively address the concerns regarding their independence and whether it would result in an approach balanced with efficiency and quality. The new Act provides a mechanism of appointment of auditors for a block of 5 years instead of reappointment at every AGM. Rotation of auditors and extended reporting responsibilities are likely to increase the cost of audit of financial statements under the new regime. Concept of rotation of auditors has not been extended to government companies. Auditors would have extended reporting responsibilities regarding internal financial controls and frauds in a company. Besides this, there would be several prohibited services which Chartered Accountants would not be able to provide to their audit clients. Non-audit services would require approval from the audit committee/Board.

The onus to prove that the related party transactions are at an arm's length and are in the ordinary course of business, gets shifted to the management. The new Act removes the government approval regime. The coverage of related party transactions has also been enlarged for better governance.

While the new Act provides significant powers to the stakeholders in several areas, it has been cautious and has tried to avoid undue harassment to corporates in procedures like compromise/arrangements/ amalgamations. Stakeholders would need to fulfil minimum eligibility criteria/threshold to raise any objections to such schemes. This would avoid frivolous litigations and unnecessary delays.

The new Act also makes sense in terms of synchronising the size of a business and corresponding applicability of law, without over-regulation. This would encourage unorganised business structures to become part of a corporate regime, with better resources and enhanced growth opportunities. The New Act contains several concepts and forms of entities, e.g., one-person company; different forms of private companies; listed and unlisted public companies; dormant companies, etc. Besides this, the new Act also recognises larger association of persons.

The concept of corporate social responsibility (CSR) may sound a bit imposing. However, it appears to be an appeal to seek support to enhance a social infrastructure. By way of making CSR a part of the regulation, the Government looks up to the capable corporate world, based on the prescribed criteria, to genuinely fulfil its responsibility and create social projects to help society. Since the New Act states that *"The Board of…....company …….shall ensure that the company spends, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years……",* it appears that the CSR spend would be a mandatory requirement. However, the New Act also states that if the company fails to spend such amount, the Board shall, in its report specify the reasons for not spending the amount. Therefore, it seems that although the intent of the Board has to make all efforts to spend the specified amount towards CSR, if, for any reason, the same could not be successfully achieved, it would be the responsibility of the Board to make adequate disclosures. This is a wonderful example of self-governance. It would be embarrassing for any corporate to disclose a complete failure of its CSR plan despite the regulatory requirement of a well-defined and established CSR Committee; appointment of an independent director on the committee; formulation of a CSR policy and the proposed activities; duly recommended amount of CSR expenditure to be incurred; monitoring the policy from time to time; and the Board's responsibility to ensure that the activities included in the CSR policy are undertaken. It also appears that purely monetary contributions to comply with the CSR norms may not be encouraged. Possible deductibility for taxation purposes may be a motivating factor to an extent.

The new Act provides opportunities to corporates for cross-border expansions and mergers including reverse mergers. Certainly the RBI would play an important role in framing rules for implementation. Also there are several simplified procedures, e.g.,

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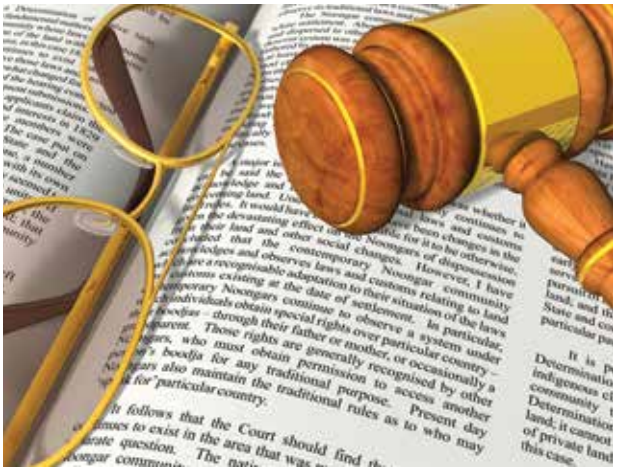
merger of wholly-owned subsidiary company without court approvals, which would provide significant relief from prolonged and avoidable regulatory process.

The new Act has included a concept of Registered Valuer. Valuations required in terms of the provisions of the new Act would be carried out by a Registered Valuer. Eligibility criteria to be a Registered Valuer would be prescribed.

Accounting under the new regime would reflect a strong international flavour with introduction of mandatory consolidation of financial statements. It appears that the domestic and international investor community was longing for requisite information of real ownership structure/financial position and a clear identity of a corporate. The significant counts of subsidiaries and other associated companies, along with web of circular transactions, largely in closely-held private companies, were the easiest tools of camouflaging. Fortunately, SEBI could bring in some sanity in case of listed companies. However, out of a total of around 12.9 lakh companies in India, there are around 11.7 lakh private companies, with few thousands listed companies. The new Act intends to ensure a very clear disclosure of real ownership and impact of transactions within commonly controlled ownership structures. Amendment in the definition of subsidiary company is a logical and substantive move, which is likely to significantly increase the number of companies liable to prepare consolidated financial statements. This would be a credible move towards converging with international accounting standards, which primarily recognise consolidated financial statements instead of standalone accounts. In order to avoid conflicts and divergent practices, it seems that regulatory will bridge the gap between definitions as per the new Act (e.g., subsidiary; associate; joint venture, etc.) and in the accounting standards.

The new Act also contains provisions for reopening/recasting the financial statements of earlier years at the instance of the Central Government or various other regulatory authorities in case the relevant earlier accounts were prepared in a fraudulent manner or the affairs of the company were mismanaged during the relevant period, casting a doubt on the reliability of the financial statements. Presently, under the Indian GAAP, any corrections relating to the prior years are undertaken in the current period financial statements, without reopening or recasting the prior years.

The concept of uniform financial year, barring few exceptions, would help in better comparability



and understanding. The new Act poses restrictions on multiple layers of subsidiaries, except in certain specific circumstances. This is another step to ensure transparency in case of chain structures without substance. The underlying rules would hopefully provide adequate directions for implementation and also the transitional provisions for existing structures.

The new Act continues to prescribe estimated maximum lives of depreciable assets. As a part of self-governance, such decisions could have been left to the management to avoid possible thumb rules. For instance, in case of a continuous process plant, the estimated maximum life of 8 years (as compared to 18 years as per the previous law) may need to be revisited. Reduction in lives of fixed assets may lead to a significant burden on the statement of profit and loss of several corporates. Component accounting has been specifically mandated by the new Act. It has been conscious to provide transitional provision to avoid a sudden impact in the first year of applicability, though pertaining to the past due to amended estimates.

Concerns have been rightly expressed on the creation of structures like the National Financial Reporting Authority (NFRA). NFRA sounds to be a strict monitoring mechanism which will have investigative powers into the professional or other misconduct committed by Chartered Accountants and even debarring them from practice for a period of up to 10 years in case such misconduct is proved. The ICAI is rightly pursuing the issue with the Ministry of Corporate Affairs.

I am sure the regulatory would be conscious of the language used in the new Act and would provide adequate clarity to avoid any conflicts or interpretational challenges. Substance over form would be important.■