The Companies (Amendment) Act, 2017- Analysis of Significant Provisions

The Companies (Amendment) Act, 2017 has reduced the harshness of the original provisions of the Companies Act, 2013. It aims to strengthen the good governance, corporate democracy and enables the ease of doing business. The Government had in the year 2015 set up Company Law Committee under the chairmanship of the then Secretary of the Ministry of Corporate Affairs. The author, as the then President of the ICAI, had the privilege to be a member of this committee. Many recommendations of the Committee have found place in the law. This article deals with the significant amendments relating to auditors, audit committee, related party transactions and the managerial remuneration. Read on to know more…

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Annual Ratification of the Appointment of Auditors Not Required

Section 139(1) provides that the shareholders at the Annual General Meeting (AGM) shall appoint an auditor of a company, for a consecutive period of five years, and that his appointment shall be ratified

every year at the AGM. The first proviso to the said sub-section requires the company to place the matter relating to such appointment, for ratification by the members in each AGM. It was pointed out by the Institute of Chartered Accountants of India (ICAI) that where the shareholders choose not to ratify the auditor's appointment as per Section 139 (1), it would be akin to removal of the auditor and provisions of Section 140(1) should come into play. The sub-Section (1) of Section 140 provides for a special resolution and previous approval by the Central Government for removal of the auditor. There is an inconsistency due to the two provisions, wherein removal would require a special resolution and approval of the Central Government while removal through non-ratification would need a resolution.

This anomaly has now been removed by omission of the proviso to sub-Section (1) of Section 139. The auditor once appointed for a period of five years can be removed only by following the procedure prescribed under Section 140 of the Act. This will strengthen the independence of the auditors.

Clarificatory Amendment in 141(3)(i)

Clause (i) of sub-Section (3) of Section 141 provides that any person whose subsidiary, or associate company, or any other form of entity is engaged on the date of appointment, in the services prohibited by Section 144, shall be disqualified from being appointed as an auditor. Apprehensions were raised that the language of Section 141(3) (i) was such that a firm which was engaged in any of the activities mentioned in Section 144 anywhere in the world, and was rendering any such service to companies other than the auditee company, could not be appointed as an auditor of a company in India, even if such services were rendered to an entity which was totally unconnected with the auditee company.

Now the amendment provides clarity that the disqualification is only where the services mentioned in Section 144 of the Act are provided to the company, its holding company or its subsidiary company.

Auditors of Holding Company to Have Access to Associates and Joint Ventures

The first proviso to sub-Section (1) of Section 143 Act provides that the auditor of a holding company shall also have the right to access the books of accounts of subsidiary companies, in connection to the consolidation of accounts. In view of this, it was suggested by the ICAI that the auditor of the holding company should also have the right of access to accounts and records of a joint venture/ associate company, in connection with the consolidation of accounts of such entities with the holding company.

The clause (i) of sub-Section (3) of Section 143 has been amended to provide that the auditors to report on the internal financial controls with reference to the financial statements and not with respect to the internal financial controls system. The Guidance Note issued by the ICAI is on the same lines.

This suggestion has been accepted and the word "associate" has been inserted. The "associate" is defined in sub-Section (6) of Section 2 to include the joint venture. Accordingly, the auditor of a holding company will have the right of access to the books of the associate and joint ventures in so far as it relates to the consolidation of its financial statements.

Reporting on Internal Financial Controls with Reference to Financial Statements

Clause (i) of sub-Section (3) of Section 143 required the auditor to state in his report whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

This has to be read with clause (e) of sub-Section (5) of Section 134 on the Directors' Responsibility Statement which also defines internal financial controls. Clause (viii) of sub-rule (5) of rule 8 of Companies (Accounts) Rules, 2014 requires the Board Report to give details in respect of adequacy of internal financial controls with reference to the financial statements.

It was explained by the ICAI that auditing internal financial control systems by auditors would be an onerous responsibility. It was also expressed that the auditors responsibility should be limited to the auditing of the systems with respect to financial statements only.

The clause (i) of sub-Section (3) of Section 143 has been amended to provide that the auditors to report on the internal financial controls with reference to the financial statements and not with respect to the internal financial controls system. The Guidance Note issued by the ICAI is on the same lines.

With reference to loan to directors, the provisions of Section 185 of the Act had become very restrictive. They were hampering the normal business transactions. The earlier section has now been deleted and a new section has been inserted.

Rationalisation of the Penalties

One of the often-quoted criticisms of the Companies Act, 2013 was that the penalties have become too stringent. The penalties need to be distinguished between procedural mistakes as against the fraudulent acts committed to defraud the investors. While none has sympathies for the frauds committed, lenient view needs to be taken for procedural errors.

Penalties Against Auditors

The penalties prescribed under Section 140 and 147 have now been related to the audit fees. This would benefit the firms rendering services particularly to the Small and Medium companies.

The most significant amendment is in clause (ii) of sub-Section (3) of Section 147 of the Act. Prior to the amendment the said clause provided that an auditor convicted under sub-Section (2) of Section 147 was liable to pay damages to the company, statutory bodies or authorities or ***to any other person*** (emphasis supplied). This is now restricted to shareholders and creditors of the company.

Be that as it may, the consequences of audit mistakes are humungous.

Audit Committee

The audit committee under Section 177(4)(iv) is required to approve or modify transactions of the company with related parties. There was a lack of clarity among stakeholders on the extent of responsibility entrusted to the Audit Committee including on whether it had independent approving powers or has to pre-approve and give its recommendations to the Board.

The Audit Committee has been specifically mandated to approve or modify all related party transactions. This has to be, however, read harmoniously with the provisions of Section 188, which entrust the Board and the shareholders with the responsibility of approving specified related party transactions.

Now second proviso to clause (iv) of sub-Section (4) of Section 177 has been inserted to provide that in case of transactions, other than transactions referred to in Section 188, and where Audit Committee does not approve the transactions it shall make the recommendations to the Board. It is also provided that the provisions of this clause shall not apply to transactions between the holding company and its wholly owned subsidiary.

This is similar to the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 where also the related party transactions between a holding company and its wholly owned subsidiaries do not require the approval of the Audit Committee.

Thus, the existing requirement for the Audit Committee to pre-approve all related party transactions, subject to approval by Board or shareholders as required under Section 188 continues. For transactions not covered under Section 188, the Audit Committee may give its recommendation to the Board in case it is not approving a particular transaction.

There were suggestions to allow ratification by the Audit Committee within three months from the date on which such transaction was entered, without obtaining the prior approval of the Audit Committee inadvertently. Subject to safeguards, it would be similar to the flexibility provided under Section 188 to the Board and the shareholders. However, concerns of possible misuse of this flexibility have been suitably addressed by prescribing an upper threshold of Rupees One Crore on such transactions. These amendments are contained in the third proviso to clause (iv) of sub-Section (4) of Section 177.

The private companies which list their debt securities were also required to appoint Audit Committees. Although SEBI had given an exemption to such private companies, but sub-Section (1) of Section 177 required all the listed companies to comply with the provisions regarding the audit committees. Now the said sub-section (1) has been amended. Accordingly, the provisions of the Audit Committee will no longer apply to the private companies which have their debt securities listed.

Loans to Directors

The provisions of Section 185 of the Act had become very restrictive. They were hampering the normal business transactions. The earlier section has now been deleted and a new section has been inserted.

Loans, including loans represented by book debts, guarantees, or security given to following persons which was not permitted earlier can now be given:-

(a) Any private company of which such director is a member or director;
(b) Any body corporate of which not less than twenty five percent of the total voting power is exercised or controlled by such a director;
(c) Any body corporate, the Board of directors, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the Board, or any director or directors of the lending company.

Now such loans can be given to the above named entities subject to compliance with the following two conditions:-

(a) Special resolution is passed by the shareholders. The explanatory statement should be containing full particulars of such loans; and
(b) Such loans to be used for the principal business activities of such companies.

In case of most of the business groups, the transactions within the private companies is quite common. For a private company to receive a loan from another company is exempt from the provisions of acceptance of public deposits. But the restriction to the lending company under Section 185 of the Act had created impediments to such normal business transactions. Now with the amendment in the law, the major difficulty being faced by the private companies has been removed. The additional two conditions imposed will certainly strengthen the good governance.

The prohibition on loans to the directors of the company, its holding company, partners, relatives of directors and the firms in which such directors or relatives are partners, will continue.

Loans and Investments by Company

Section 186 imposes restriction on the loans and investments made by a company. Sub-Section (2) provides that not more than sixty percent of the paid up capital and free reserves and securities premium account or one hundred percent of its free reserves and securities premium account can be advanced as loans or by way or investments. If these limits are to be exceeded, sub-Section (3) requires a special resolution to be passed by the shareholders.

A new sub-Section (3) has been inserted. The proviso to the sub-Section (3) provides that the requirements of special resolution will not be applicable for investments made in wholly owned subsidiary or loans and guarantees given to wholly owned subsidiary or a joint venture company.

With Amendments to Section 197, far reaching changes have been made in the Managerial Remuneration. To make the law business friendly, the powers given to the government to approve the managerial remuneration has been done away with.

Related Party Transactions

The second proviso to sub-Section (1) of Section 188 prohibits a member of a company to vote on a resolution approving the related party transactions, if such member is a related party.

Difficulties were experienced in case of companies where all the members were related parties. For instance in a joint venture of two more companies, each party is a related party. In such cases there was a practical difficulty to approve the transactions as envisaged in Section 188. Therefore a new proviso is inserted to the effect that nothing contained in the second proviso shall apply to a company in which ninety per cent, or more members, in number, are relatives of promoters or are related parties.

Managerial Remuneration

Amendments to Section 197

Far reaching changes have been made in the Managerial Remuneration. To make the law business friendly, the powers given to the government to approve the managerial remuneration has been done away with.

The Company Law Committee had recommended that the Schedule may be amended to substitute the requirement to pass a special resolution by shareholders with an ordinary resolution, in cases where the managerial person was not a promoter, and a professional with domain knowledge/relevant experience; and was not related to any director or promoter of the company and did not hold more than two per cent of the paid-up equity share capital of the company or its holding company. In other cases, however, the requirement for special resolution of the shareholders should be retained. The Committee had further recommended that the limits of yearly remuneration prescribed in the Schedule be enhanced. Further, the Committee also recommended that the requirement for government

approval may be omitted altogether, and necessary safeguards in the form of additional disclosures, audit, higher penalties, etc. may be prescribed instead.

These recommendations find place in the amended law. The requirement for the approval of the Central Government has been omitted. This is a very laudable amendment. It reflects the present government's desire to make the law business friendly. More powers have been given to the shareholders and the secured creditors. This is in accordance with the global best practices.

The deletion of the powers of the Central Government could also pose challenge and could cause unintended hardships. For instance, sub-Section (3) of Section 197 permitted the companies to approach the Central Government to pay remuneration more than Schedule V where there were no profits or inadequate profits. Such situation could arise where a company wants to recruit professionals and pay globally competitive remuneration which could be in excess of the provisions contained in Schedule V. However, these powers of the Central Government under sub-section (3) have also been omitted. In such cases, the remuneration will have to be restricted to the provisions contained in Schedule V.

The powers given to the secured creditors will ensure proper checks on any possible misuse of the shareholders democracy. In case of defaults in repayment of public deposits, no further amendment has been considered necessary. The deposit holders can apply to the Tribunal and the Tribunal is already empowered to pass such other orders as it may deem fit under sub-Section (4) of Section 73 of the Act. Care will have to be taken by the Tribunals to ensure that the companies do not pay managerial remuneration in excess of Schedule V where there are defaults in repayment of public deposits.

A new sub-Section (16) has been inserted to provide that the auditor of the company shall, in his report under Section 143, make a statement as to whether the remuneration paid by the company to its directors is in accordance with the provisions of this section. While the reporting responsibility on the auditors is in case of all public limited companies, surprisingly the Board's responsibility is restricted only in case of listed companies. Also, instead of inserting this requirement in Section 197, it would have been better to have amended sub-Section (3) of Section 143 so that all reporting obligations are kept in one section and not scattered across the Act. The Companies (Auditor's Report) Order, 2016 (CARO 2016) in clause (xi) requires the auditor to state the compliance with the provisions of Section 197 read with Schedule V. Now that the reporting requirement has come in the main report, it is quite natural to expect that clause (xi) of the CARO 2016 will be omitted.

There has been a demand from the industry to delete the reporting requirement in sub-Section (12) of Section 197 to report the ratio of the remuneration of each director to the median employee's remuneration. However, no such change has been made.

All pending applications with the Central Government under Section 197 at the time of the commencement of the Amendment Act will abate. The companies will be required to take the necessary approvals within one year.

Amendments in Section 198

Section 198 provides for the calculation of profits for the purpose of Section 197. Sub-Section (3) provides for some of the credits will not be given effect to in making the computation.

A new clause (f) is inserted which provides for any amount representing unrealised gains, notional gains or revaluation of assets are not to be considered for computing the profits for calculation of managerial remuneration.

This seems to take care of the situations arising from the implementation of the Ind AS. It will be useful if there is a proper clarification that the above clause(f) refers to the items included in the Other Comprehensive Income (OCI) and that such items are not to be considered for the purpose of managerial remuneration. This will be in line with the amendments made in Section 115JB of the Income-tax Act by the Finance Act 2017 where it is provided that the Minimum Alternate Tax (MAT) is not to be paid on the items of the OCI. This was one of the recommendations of the Institute of Chartered Accountants of India that the items in OCI should not be subjected to MAT nor should they be available for the calculation of the managerial remuneration.

Conclusion

The present amendments will make the law more practical and implementable. ■