

Companies Act 2013

Changing governance landscape

June 2014



EY

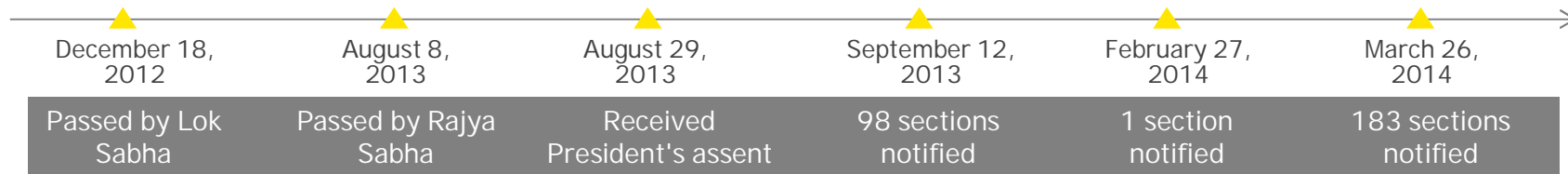
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The New Companies Act 2013: Current status

Implementation timeline:



1

A total of 282 sections and 21 rules have been notified till date

2

Other laws (such as income tax, exchange control laws, securities laws) are in process of being aligned with the provisions of the Companies Act, 2013

3

SEBI has also approved critical changes in the listing agreement to be effective from October 01, 2014 to align the requirement of Companies Act with reference to Clause 49

'Rules are being notified on a periodic basis. Each set of rules provide answers to many questions that are still unresolved'

The New Companies Act 2013: Change Pillars

Accounting and Audit



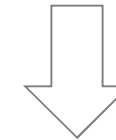
- ▶ Rotation of auditor
- ▶ Accounting Rules
- ▶ Inbound and outbound cross-border transactions
- ▶ New procedures in case of holding and wholly owned subsidiaries, and small companies



Taxation and Structuring

- ▶ Mergers/ Compromises/ Arrangements
- ▶ Capital Restructuring
- ▶ Downstream Investments

Focus for this discussion



Governance



- ▶ Audit Committee
- ▶ Independent Directors
- ▶ ERM, IA, Compliance, Fraud
- ▶ IFC, Related Party, CSR

The New Companies Act 2013 (NCA'13): Governance Play



Board Governance



Independent Directors: Stringent Requirements of the New Schedule IV

- 1 With the introduction of the Companies Act, now both the Listing Agreement and the New Companies Act have rules for Independent Directors
- 2 The Securities and Exchange Board of India is already planning to come out with a new set of rules to replace the existing listing agreement and align better with the New Companies Act

Key Restrictions

- ▶ Should not be related to promoters or directors in the company, its holding, subsidiary or associate company
- ▶ Should not have or had any pecuniary relationship during the two immediately preceding financial years or during the current financial year
- ▶ None of the relatives should have or had pecuniary relationship or transaction with the company - amounting to 2% or more of its gross turnover or total income or Rupees Fifty Lacs in the prescribed timeframe

Independent Directors: Stringent Requirements of the New Schedule IV (Contd.)

Key Restrictions (Contd.)

- ▶ Independent director or relative **should not be KMP** in the prescribed timeframe
- ▶ 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**

Term

- ▶ **5 years plus 5 years** (based on special resolution). Post 10 years, there will be a cool off period of 3 years
- ▶ **Declaration of independence on an annual basis** – more stringent due to relative criteria etc.

Manner of Selection

- ▶ To be selected from a **data bank maintained by a body, institute or association**, as may be notified by the Central Government

Independent Directors: Things to Consider

- 1 **Availability of independent directors** – given prescribed and unlisted public limited companies also required to have Independent Directors; maximum number of directorships being limited to 20 (out of which not more than 10 can be the public limited companies)
- 2 Tracking **periodic independence of the Independent Directors**; given stringent rules around relatives etc.
- 3 Given now Independent directors are not eligible for Stock Options (ESOP); **treatment of stock options granted in the past and remaining outstanding at the date of enactment**

Audit Committee (Section 177): Requirements under the NCA'13 vs. the Listing Agreement and CA'1956

	Section 177 (NCA'13)	Listing Agreement	Section 292 A (CA'1956)
Applicability	Listed company and such other class of companies, as may be prescribed	All listed companies	Every public company having paid up capital not less than Rs.5 crore
Composition	Minimum 3 directors with independent directors forming a majority	Minimum 3 directors. Out of this, 2/3rd will be independent directors	Minimum 3 directors. Out of this, 2/3rd will be directors other than managing or whole time directors
Financial knowledge of members	Majority members, including Chairperson, should have ability to read and understand the financial statements	All members should be financially literate and at least one member should have accounting or related financial management expertise	No specific provision

Audit Committee (Section 177): New Expectations

- 1 Approval or any subsequent modification of related party transactions
- 2 Scrutiny of inter-corporate loans and investments
- 3 Monitoring the end use of funds raised through public offers and related matters instead of just reviewing the monitoring report
- 4 Evaluation of internal financial controls and risk management systems

Board of Directors: Requirements

- 1 Minimum one director required who stayed in India for at least 182 days in previous calendar year
- 2 Prescribed class of companies to have at least one woman director. One year transition period
- 3 Every public listed company shall have at least one-third of the total number of directors as Independent Directors
- 4 Maximum no of directors - 15. However, through special resolution the limit can be increased. However, no central government approval is required as was in CA'1956
- 5 Limitation of liability specified for the non-executive directors - no such limitation under section 1956 Act

Key additions through the 'Directors Responsibility Statement' - Compliance, IFC, Risk Management, CSR, Related Parties, Loans etc.

Board of Directors: RAIN Perspective

	NCA'13	RAIN – Present scenario
Duration of stay in India	Minimum one director who stayed in India for at least 182 days in previous calendar year	RAIN Industries Limited (RAIN) is meeting this requirement
Woman Director	Woman director is mandatory in case of a listed company and for other public companies with paid up capital of at least Rs.100 crores OR turnover of at least Rs.300 crores	RAIN Industries Limited (RAIN) will have to comply with this requirement
Maximum no. of Directors	Maximum 15 directors for all companies. Special resolution at general meeting is required for further increase	RAIN Industries Limited (RAIN) is meeting this requirement
Directorship restriction	A person can hold directorship in maximum 20 companies, out of this not more than 10 companies can be public companies	RAIN needs to evaluate this from the perspective of independent directors. SEBI is in the process of introducing additional restrictions.
Duties of Directors	Duties of directors have been specifically prescribed in the new Act	Directors need to ensure compliance

Internal Audit



Internal Audit: Requirements of the New Section 138

1 Internal Auditor is to be appointed by:


- ▶ Every listed company;
- ▶ Every public company having a paid up share capital of Rupees 10 crores or more; and
- ▶ Every other public company which has any outstanding loans or borrowings from banks or public financial institutions exceeding 25 crore rupees or which has accepted deposits of 25 crore rupees or more at any point of time during the last financial year.

2 Internal auditor shall be:

- ▶ Either a chartered accountant; or
- ▶ A cost accountant; or
- ▶ Such other professional as may be decided by the Board to conduct internal audit of the functions and activities of the company

3 Periodicity and reporting:

- ▶ 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

- 
- *Board, Management, Independent Directors etc., are expected to seek greater comfort from IA on areas of compliance, fraud, internal controls, risk management etc., to comply with their fiduciary responsibilities*
 - *Internal Auditors covered under class action suit and IA documents might be called as an evidence in class action suits*

Enterprise Risk Management



ERM: Who All Are Responsible?

1 Director's Responsibility Statement: Sec 134

- ▶ As per Sec.134, Board of Directors' report to include a statement indicating the development, implementation of risk management policy, and identification of risks that threaten the existence of the business

2 Responsibility of the Audit Committee: Section 177

- ▶ As per Sec. 177, **Audit Committee to evaluate internal financial controls and risk management systems of the company**

3 Responsibility of the Independent Director: Schedule IV

As per Schedule IV, the Code for Independent Directors requires them to:

- ▶ bring an independent judgment to bear on the **Board's deliberations, especially on issues of risk management, strategy, performance, etc.**
- ▶ satisfy themselves on the integrity of financial information, that financial controls, and **the systems of risk management are robust and defensible**

4 SEBI – Clause 49 (VI)

- ▶ The company shall lay down procedures to inform Board members about **the risk assessment and minimization procedures**
- ▶ The Board shall be responsible for **framing, implementing and monitoring the risk management plan** for the company
- ▶ The company shall also constitute a **Risk Management Committee**

ERM: How can Internal Audit help?

- 1 Evaluate risk exposure relating to the organization's governance, operations and information systems regarding achievement of strategic operations
- 2 Evaluate adequacy and effectiveness of controls in responding to the risks regarding achievement of strategic objectives
- 3 Recommend for improvement in Risk Management and control environment
- 4 Quality assurance on risk management policy

'Strengthening the Risk Management framework'

Compliance Management



Compliance Management

1

The Directors' Responsibility Statement, as stated in the Act:

- ▶ Section 134 (5) The Directors' Responsibility Statement referred to in clause (c) of sub-section (3) shall state that the directors:
 - had devised proper systems to ensure compliance with the provisions of all applicable laws; and
 - that such systems were adequate and operating effectively

'This is a new requirement and was not their in the Companies Act 1956'

2

Responsibility of the Company Secretary:

- ▶ Section 205 (1) The functions of the company secretary shall include a report to the Board about compliance with the provisions of this Act, the rules made thereunder and other laws applicable to the company

'This is a new section in the NCA'13

3

SEBI Clause 49 (IX)

- ▶ CEO/CFO certification

Compliance Management: Things to Consider

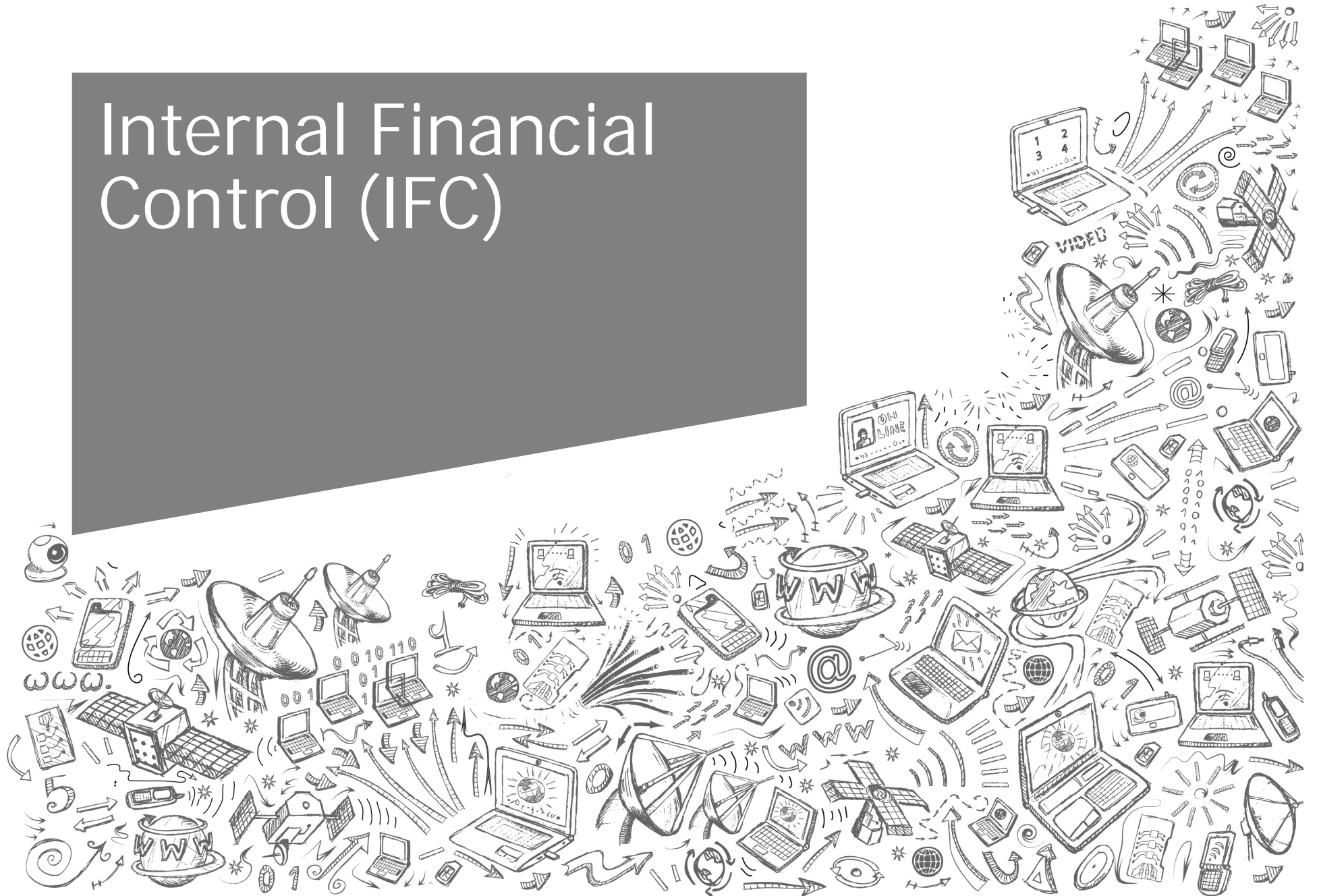
1 Are all compliance requirements known/identified?

2 Does robust compliance programme exists and is documented?

- ▶ Clear communication of intent by the governing body & top management
- ▶ Compliance policy is articulated and published
- ▶ Structures & committees exist for oversight and review. Responsibility for compliance outcome is clearly defined

3 Is an independent structure in place to gauge assurance on results of the compliance program on periodic basis?

Internal Financial Control (IFC)



IFC: What is “IFC” under the NCA’13?

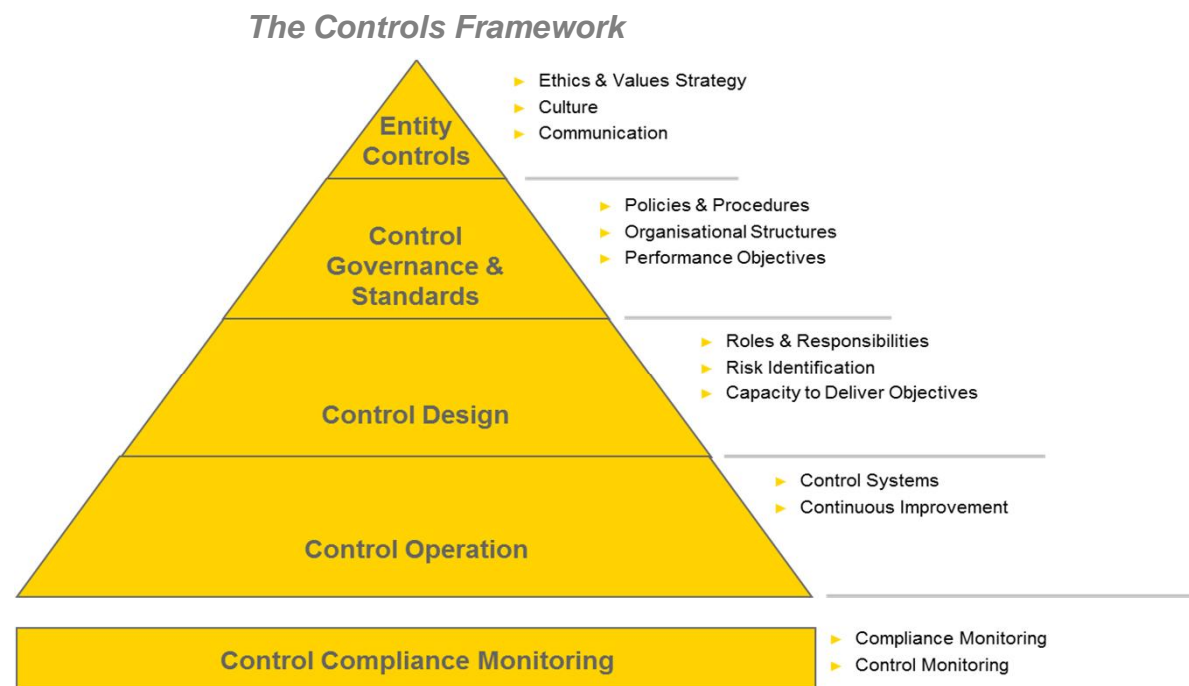
“The term “IFC” means the *policies and procedures* adopted by the company for ensuring the *orderly and efficient conduct of its business*, including adherence to company’s policies, *the safeguarding of its assets*, *the prevention and detection of frauds and errors*, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information”

Section 134 (5) (e) – new definition



IFC: What Does the New Definition Mean?

“The expanded coverage and focus goes way beyond the ‘Financial Reporting Controls’ and focus on ‘all the elements’ of a Controls Framework including Tone at the Top, Policies and Procedures, Operating Controls, Controls Design, Controls Monitoring etc.”



IFC: Who All Are Responsible?

1 Director's Responsibility Statement: Sec 134

- ▶ Shall state that the directors, in the case of a listed company, **had laid down IFCs to be followed by the company and that such IFCs are adequate and were operating effectively**

3 Responsibility of the Independent Director: Schedule IV

- ▶ Satisfy themselves on the **integrity of financial information and that financial controls and the systems of risk management are robust and defensible**

4 The Auditor's report: Section 143

- ▶ Shall state whether the company has **adequate IFCs system in place and the operating effectiveness of such controls**

2 Responsibility of the Audit Committee: Section 177

- ▶ Act in accordance with the terms of reference specified in writing by the Board which shall, inter alia, **include evaluation of IFCs** and risk management system.
- ▶ Call for the comments of the auditors about **internal control systems before their submission to the Board** and may also discuss any related issues with the internal and statutory auditors and the management of the company

5 Responsibility of Directors: Section 134

- ▶ **Defining IFCs**, as well as, reporting that such internal controls are adequate and operating effectively

IFC: Non-Compliance Consequence



Section 134 : Every officer [2(59)] of the Company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than Rupees Fifty Thousand but which may extend to Rupees Five Lakh, or with both



2(59) "officer" includes any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the Board of Directors or any one or more of the directors is or are accustomed to act

IFC: How can Internal Audit help?

- 1 Evaluate the adequacy and effectiveness of IFCs in responding to risks within organization's governance, operations and information systems regarding the:
 - ▶ reliability and integrity of financial and
 - ▶ operational information; and
 - ▶ effectiveness and efficiency of operations and programs

- 2 Suggest improvements for enhancing the robustness of IFCs



'Ensure compliance to NCA'13

Fraud and Vigil



Fraud and Vigil: Who All Are Responsible?

1 Board of Directors

- ▶ Section 177: Applicable companies shall mandatorily establish a vigil mechanism for directors / employees to report concerns or grievances
- ▶ Details of the vigil mechanism established by the company should be disclosed on the website and in the Boards' report
- ▶ Section 134: Report in the Director's responsibility statement, that proper and sufficient care has been taken for maintenance of adequate accounting records in accordance with the provisions of this Act for preventing and detecting fraud and other irregularities

3 SEBI – Clause 49 (II – F)

- ▶ The company shall establish a vigil mechanism for directors and employees to report concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy

2 Independent Directors

- ▶ Schedule IV: Ensuring that the vigil mechanism is functional, adequate and interests of person using this mechanism are not prejudiced
- ▶ Report concerns about unethical behavior or fraud

4 Audit Committee

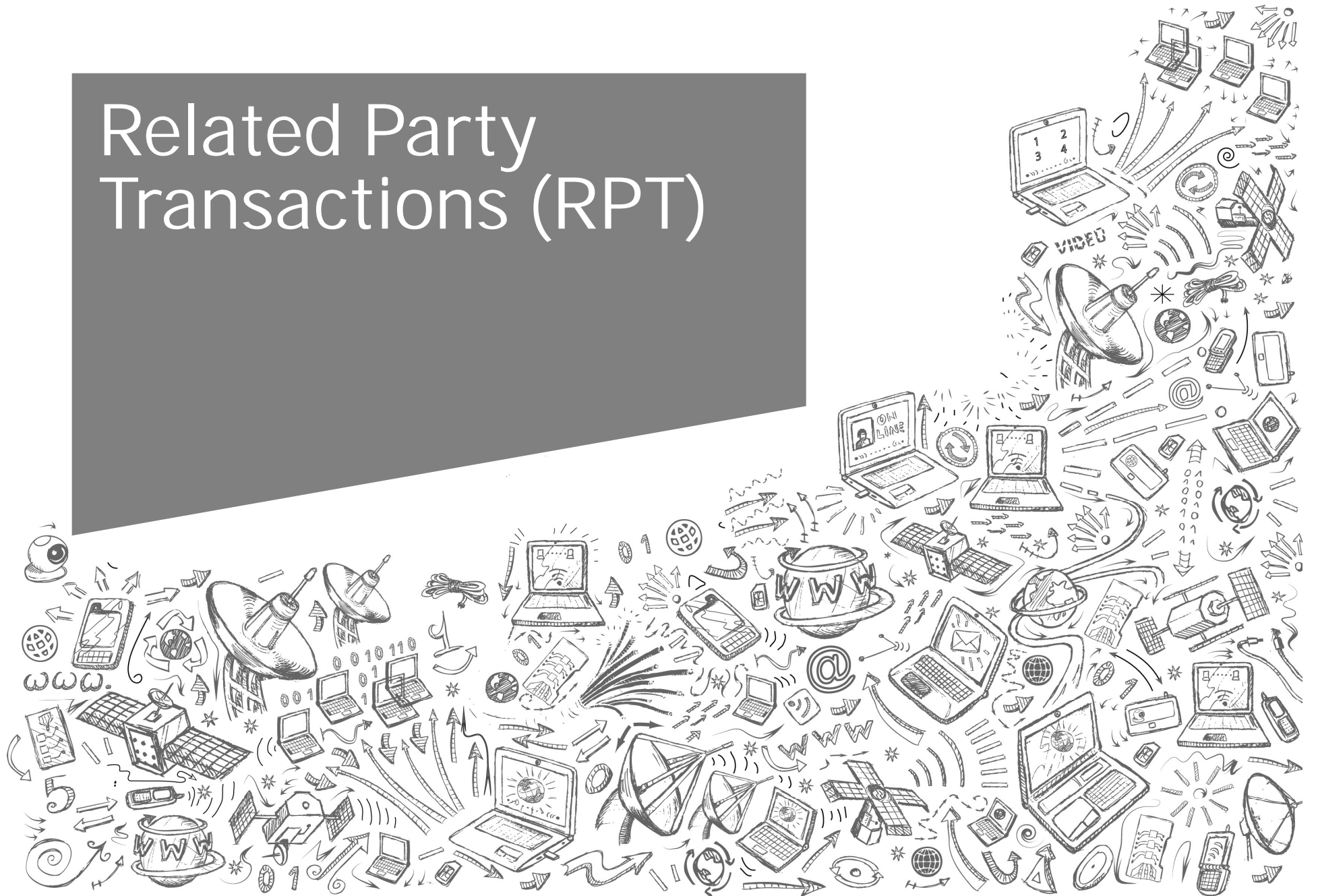
- ▶ Rule 7: To oversee vigil mechanism
- ▶ Section 177: Provide adequate safeguards against victimization of persons who use such mechanism
- ▶ Make provisions for direct access to the Chairperson of Audit Committee in appropriate or exceptional cases

Fraud and Vigil: How can Internal Audit help?

- 1 Assist the Audit Committee in carrying out investigations of the concerns received or carry out reviews to mitigate the possibility of fraud and misconduct
- 2 Evaluate potential for occurrence of fraud and how the organization managed fraud risk
- 3 Recommend improving governance processes to promote ethics, values, accountability

Assist in investigation and evaluation of fraud risks to ensure adherence to NCA'13

Related Party Transactions (RPT)



RPT: Disclosure Requirements under the NCA'13



'Board Report' along with justification for disclosures under Section 188

- Every contract or arrangement entered into under 188 (1) shall be referred to in the Board's report to the shareholders along with the justification for entering into such contract or arrangement



'Financial statement disclosure' for transactions under Section 186 – *full disclosure of the loans, investments, securities and guarantees*



Related Party Disclosures

- Section 188 - Related Party Transactions
- Section 184 - Disclosure of Interest by Director; and
- Section 186 - Loan & Investment by Company



'Registers' for disclosures under section 184 and 188

Section 189 – Registers

- Every company shall keep one or more registers giving separately the particulars of all contracts or arrangements to section 188 applies
- Also applies to disclosure under Section 184(2) - Disclosure of interest by director

RPT: Disclosure Requirements: What Has Changed



1 Boards' report to capture Related Party contract/ arrangement – this was not required as per the Companies Act 1956



What Has Changed?



2 The Boards' report shall also capture the justification of undertaking such Related party transactions

3 Section 186 disclosure around loans, investments etc now through the 'financial statement' – earlier through 'register' (Section 372 A)

- Register of contracts, companies and firms in which directors are interested was always available through Section 301 of the Companies Act 1956
- Section 301 had provision to report all contracts or arrangements to which Section 297 (contracts in which directors are interested) or Section 299 (disclosure of interests by directors)

“Related Parties”: Defined Term

⊗ Not in 1956 Act
 ▲ Some change

Related Parties	2013 Act	1956 Act (294, 294A, 297, 314)
Director of the Company or his relative	✓	✓
Key Managerial Personnel (“KMP”) or his relative	✓	⊗
Senior Management of the Company (All members of management one level below the executive directors, including the functional heads)	✓	⊗
A firm in which such director, manager or relative is a partner	✓	▲
A private company of which director is a member or director	✓	✓
A public company in which a director or manager is a director	✓	⊗
A public company in which a director or manager is a director holds along with his relatives, more than two per cent of its paid-up share capital	✓	▲

“Related Parties”: Defined Term

⊗ Not in 1956 Act
 ▲ Some change

Related Parties	2013 Act	1956 Act
Any corporate body whose Board of Directors, managing director or manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager unless advice is given in a professional capacity	✓	▲
Any person on whose advice, directions or instructions a director or manager is accustomed to act, unless advice is given in a professional capacity	✓	▲
A holding, subsidiary, fellow subsidiary or an associate company of such company along with <ul style="list-style-type: none"> • Their Directors and relatives • Their KMPs and relatives • Their Senior Management 	✓	⊗

RPT Examples: Relative of Director & KMP

A Director of RAIN is also Independent Director sitting on Board of Listed Company (outside RAIN Group) X Limited. Will X Limited be related party of RAIN?

YES. A public company in which a director of the Company is a director will be Related Party

In what other situations, other than sitting on Board, X Limited can be related party of RAIN?

RAIN's Director along with any of his relatives holds investment in X Limited exceeding 2% of paid up capital



RPT: RAIN Perspective

International Transactions:

- ▶ Procurement of Green Petroleum Coke
- ▶ Interest on loans
- ▶ Corporate guarantees
- ▶ Shared services

Domestic Transactions:

- ▶ Interest on loans
- ▶ Shared services
- ▶ Inter company transactions (e.g. power supply, coke transfer etc.)

RPT: How can Internal Audit help?

- 1 Evaluate the adequacy of RPT manual and recommend for improvement/clarity
- 2 Review whether transactions reported as ordinary are made in ordinary course of business and at arm's length pricing
- 3 Review whether adequate approvals from Board /shareholders are taken in case of specified transactions
- 4 Review whether adequate contracts / arrangements exists and review adequacy of justification for entering into such contract or arrangement

Evaluating the Related Party Transactions as per NCA'13

Corporate Social Responsibility (CSR)



CSR (Section 135): Requirements under the NCA'13

Applicable to all companies that have either of the following in any financial year:

- ▶ Net worth of INR 500 crore or more or;
- ▶ Turnover of INR 1000 crore or more or;
- ▶ Net profit of INR 5 crore or more.

Net profit to be calculated as per Section 198 of the Companies Act

Board level CSR Committee:

- ▶ Comprising of 3 or more directors with at least one independent director,
- ▶ Composition to be disclosed in the annual Board of Directors' report

Responsibilities of the CSR Committee:

- ▶ Formulate and recommend a CSR Policy and amount of CSR expenditure
- ▶ Regular monitoring of the CSR initiatives

Annual spending on CSR by companies:

- ▶ Every financial year, at least 2% of the average net profits made during the 3 preceding financial years
- ▶ Schedule VII indicates activities that can be undertaken by a company.

Responsibilities of the company's Board:

- ▶ Approve and disclose CSR Policy in the annual Directors' Report and on company website
- ▶ Ensure implementation of CSR activities as per the Policy
- ▶ Directors' Report to specify reasons in case the specified amount is not spent

- ▶ Section 134 - Financial Statements, Boards' report - If a company fails to spend CSR amount, the Board shall in its report specify the reasons for not spending the amount.
- ▶ If a company contravenes the provisions of section 134, the company shall be punishable with fine which shall not be less than Rupees Fifty Thousand but which may extend to Rupees Twenty Five Lakh and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than Rupees Fifty Thousand but which may extend to Rupees Five Lakh, or both.

CSR (Section 135): Things to Consider

- 1 What CSR initiatives make the most sense - strategically aligned, differentiated and result oriented?
- 2 What should be a good strategy to implement CSR - Should the programs be managed in-house, through a corporate foundation, partnership with NGOs?
- 3 How do one identify right partners and ensure that they implement the programs effectively and utilize funds for the intended purpose?
- 4 What are the various tax and regulatory implications - tax deductibility of CSR expenditure?
- 5 How should the Board be assured that CSR spend is in line with the Policy? What is an effective way of Board reporting?

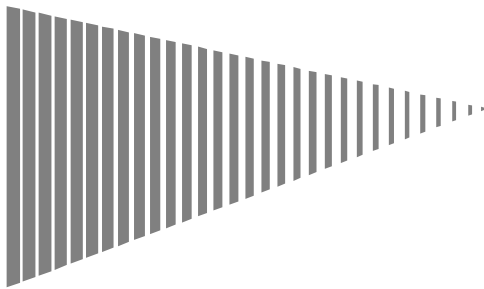
CSR: How can Internal Audit help?

- 1 Review the **implementation effectiveness and compliance to CSR policy** in terms of activities undertaken during the year and spends incurred
- 2 **Recommend improvements in CSR policy, project management of programs, controls around selection of vendors, monitoring implementation, payments etc.**



'Monitor compliance to Section 135'

Thank you



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Building a better
working world

