Walker Chandiok & Co LLP

The Companies Act, 2013

The dawn of a new era

Towards Better Governance

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Presented by:

Khushroo B. Panthaky

Senior Partner

Walker Chandiok & Co LLP

Companies Act, 2013

The dawn of a new era…

Corporate Governance – Agenda

- Introduction
- Salient features
- Key highlights of the provisions on Accounts, Audit and Auditors
- Other key draft Rules

Companies Act 2013 – Introduction

- passed by the **Lok Sabha** on 18 Dec 2012;
- passed by the **Rajya Sabha** on 8 Aug 2013, without any modification;
- received **President's assent** on 29 August 2013;
- **replaces** around 60 year old Companies Act, 1956 and becomes the **Companies Act, 2013;**
- **fine print** to be defined by **Rules**, currently on MCA website;
- **simple yet complex** - sections reduced from 650+ to 470, however, **over 300 places** in the Companies Act, 2013 where it mentions of **rules;**
- expected to be **implemented in phases** - provides flexibility for different effective dates for different sections;
- **98 Sections notified** with immediate effect.
- SEBI has rolled out **Revised Clause 49** of Listing Agreement with Stock Exchanges for listed companies.

Companies Act 2013 – Salient features

The new legislation with 29 Chapters, 470 Clauses and 7 Schedules aims at:

- enhancing **transparency**;
- enhancing **protection measures** for investor and minority shareholders;
- having stringent **Corporate Governance** measures;
- **CSR** initiatives introduced;
- **greater responsibility** on auditors;
- having **business friendly** corporate regulations;
- bringing in **e-governance** measures;
- **improving accountability** in India's corporate sector.

The Companies Act 2013 AND Revised Clause 49 of Listing Agreement

Towards

Better

Governance

Corporate Governance – Introduction

Narrow definition

A **set of relationships** between the company and shareholders, directors and management.

Beneficiary of good governance - The **Shareholders**

Broad definition

Looking to the **implicit and explicit relationships** of the company with employees, creditors, consumers, distributors, Govt. Authorities and local communities

Beneficiary of good governance - Every **Stakeholder**

Need for Robust Corporate Governance

Responsibility towards internal and external stakeholders

Easier access to capital (FII, Venture Capital Funds, Foreign markets)

Global CompetitivenessCreating **long-term trust** between Companies and Investors

Promote Corporate Fairness, Transparency and Accountability

Risk Management and Monitoring

Rationalizing the **Decision Making** procedures

Efficiency in operations and other business processes

What really went wrong GLOBALLY

Spate of high profile **corporate frauds and collapses** in the U.S and Europe;

Executive compensation **grossly disproportionate** to corporate results;

Misuse of corporate funds;

Trading on **insider information**, particularly by managers exercising stock options;

Misrepresentation of true earnings and financial conditions of companies; and

Obstruction of justice by concealing activities or destroying evidence.

Evolution of Corporate Governance - GLOBALLY

The UK published the **Cadbury Report** and the ‘**Code of Best Practices’** in Corporate Governance in 1992 and it later culminated in the **Turnbull Guidelines** in September,1999.

The **Sarbanes Oxley** (SOX) legislation was introduced in the U.S in July, 2002.

The **Higgs Report / Tyson Report** - 2003

Other legislations on Corporate Governance were introduced in many countries.

Evolution of Corporate Governance in INDIA

December 1995: CII sets up **task force** to design voluntary code of corporate governance

April 1998: CII releases "**Desirable Corporate Governance**: A Code"

May 1999: SEBI sets up the **Kumar Mangalam Birla Committee**

February 2000: **Clause 49 introduced** pursuant to Kumar Mangalam Birla Report

Key aspects of **financial disclosures, independence of boards** etc. were picked up from the Sarbanes Oxley Act.

2002: DCA sets up **Naresh Chandra Committee** - Report recommends **financial** and **non-financial disclosures** and **independent** auditing and board oversight of management (Draft Companies Bill)

Broad Scope of Corporate Governance

The **structuring of Boards**, such as the ratio of Independent Directors and mandating its responsibilities .

Board procedures and **constitution** of different committees like the audit committee, shareholders' grievances committee etc.

Documented **Code of Conduct**

Related Party Transactions

Disclosure of **financial information** and institutionalizing **Risk Management** and **Internal Control Frameworks** - CEO and CFO made responsible for financials.

Legal Compliance framework and reporting to the Board

Whistle blowers policy.

Governance

Key changes under Companies Act, 2013 - Board composition

- Mandatory to have:
  - one **resident director** and
  - one **woman** director (class of companies to be prescribed)
- **similar requirements** under **Clause 49** for woman directors but to be complied with effect from **1 October 2014**, whereas 2013 Act provides a transition period of one year, ie. 1 Apr 2015
- Prescribed companies to have **whole-time KMP**, including MD, CEO, CS and CFO
- Directors on resignation to inform ROC of **detailed reasons** for his **resignation**
- **Academic and professional qualification** for audit committee members prescribed

Governance

Key changes – Board Composition (Contd)

- Board of listed entities to have **1/3** of the board as **independent Directors**

Rules

- Listed companies **within 1 year and** other public companies having paid-up capital of **INR 100 crore** or more or turnover of **INR 300 crore** or more **within 3 years** to have a **Woman Director**
- Listed company and every other company having a paid-up **share capital of INR 5 crore** or more to have **Whole-Time KMP**

Governance

Key changes -- Independent Directors (ID)

- Definition stricter than SEBI requirement – prohibits **any direct** and material (> INR 5mn) indirect pecuniary relationships
- Applies to **listed** + **other classes** of companies
- Fixed tenure – **two terms of 5 years** and no periodic retirement by rotation; cooling off period of 3 years
- Insulated from **liability** - liable only in respect of such acts of omission/ commission which had occurred **with their knowledge** and **with their consent** or **connivance**.
- **Prospective application** for tenure computation

Governance

Key changes - Directors and Directorships

- Maximum no. of directors **increased to 15** from 12.
- Any further increase subject to **shareholder's approval** through special resolution
- **No CG approval** needed for increase
- No change in the **minimum no.** of directors
- Maximum no. of directorship **increased to 20 from 15** including alternate director.
- Public company directorship restricted to **not more than 10**

Governance

Key changes - Directors and Directorships

Revised Clause 49

- **more restrictive** on the limit on number of directorships for Independent Directors, i.e. **maximum 7** listed companies
- the **tenure already served** by an ID in the past too shall be considered. Thus, an ID who has already served for five years or more in a company shall be eligible for reappointment for **only one more term of up to five years**
- to be complied with effect from **1 October 2014**

Governance

Key changes

Disqualification of Directors - additional grounds provided

- Person convicted of an offence dealing **with related party transactions** at any time during the preceding 5 years;
- Director to vacate office if he **remains absent** from all the board meetings held during 12 months
- **Directorship in private co**. too under ambit of disqualification on ground of:
  - non-filing of FS or annual return for any continuous 3 years; or
  - failure to repay deposits or redeem debentures; or
  - failure to pay interest due or pay dividend declared and such failure continues for 1 year or more

Governance

Key changes - General Meeting and Board meeting

- **First AGM be held within 9 months** from closure of its first FY, instead of 18 months from the date of incorporation
- A report on AGM to be prepared and **filed with ROC within 30 days** of the conclusion of the AGM
- **7 days prior notice** to every director for board meeting
- **4 board meetings a year** and gap between two meetings not to exceed 120 days
- **Meeting through video conferencing** or **other audio visual** means allowed provided
  - such participation is capable of **recording and recognizing**
  - CG may **prescribe matters** to be conducted only at **physical convened meetings**

Governance

Key changes - Audit Committee (AC)

- AC made **mandatory for listed and prescribed class** of companies
- AC should consist of **minimum 3 directors with IDs forming majority.**
- The chairperson and the majority of the members of the AC should have the **ability to read and understand the financial statements** (referred as “financially literate” under the Listing Agreement).

Rules - Threshold for audit committee –

- **Listed** companies and
- Every other **public company**
  - having paid up capital of INR 100 crore or more; or
  - outstanding loans/borrowings/debentures/deposits > INR 200 crore.

Governance

Key changes - Audit Committee (cont'd)

- Roles and responsibilities include:
  - recommendation for **appointment, remuneration and terms** of appointment of auditors of the company,
  - review and monitor the **auditor's independence and performance,** and **effectiveness of audit process**,
  - examination of the **financial statement** and the **auditors' report** thereon,
  - **approval or any subsequent modification** of transactions of the company with related parties

Governance

Key changes - Audit Committee (cont'd)

- Roles and responsibilities include (Contd):
  - –scrutiny of i**nter-corporate loans and investments,**
  - –**valuation of undertakings or assets** of the company, wherever it is necessary,
  - –evaluation of **internal financial controls** and **risk management systems,**
  - –**monitoring the end use of funds** raised through public offers and related matters.

- The AC shall have **authority to investigate into any matter** specified above or **matter referred to it by the Board.**

Governance

Key changes - Nomination and Remuneration committee

- Mandatory in case of **listed and other prescribed classes** of companies
- Composition of the committee would include **three or more non-executive directors** of which **at least one-half shall be IDs.**
- Shall **formulate the criteria** for determining Qualifications, positive attributes and independence for a director
- Shall **recommend to the Board a policy, relating to the remuneration** for the directors, key managerial personnel and other employees

Governance

Key changes - Stakeholders Relationship Committee

- Mandatory if the number of shareholders, deposit holders, debenture holders and other security holder **exceeds 1000** at any time during a FY;
- Composition as determined by the **board**

Corporate Social Responsibility (CSR) Committee

- Companies meeting certain conditions **should constitute a CSR committee** of the Board, consisting of **minimum of three directors**
- CSR committee should consist of **minimum of one ID**
- The CSR committee to **formulate and monitor CSR policies** and the same will be discussed in Board’s report.

Governance

Key changes - Board's Report - made more informative and includes extensive disclosures:

- Extracts of the **annual return**;
- Recommendations of the **audit committee not accepted** by the Board with reasons;
- Compliance declaration by the IDs on their **compliance;**
- **CSR Policy** developed and implemented;
- Statement indicating the manner in which **annual evaluation** has been made by the Board of its **performance, its committee** and **individual directors** (listed entities);
- Development / implementation of **risk management policy**;
- Policy on **director's appointment and remuneration, ratio of remuneration** to each director to the median employee's remuneration;

Governance

Key changes - Board's Report - made more informative and includes extensive disclosures (Contd):

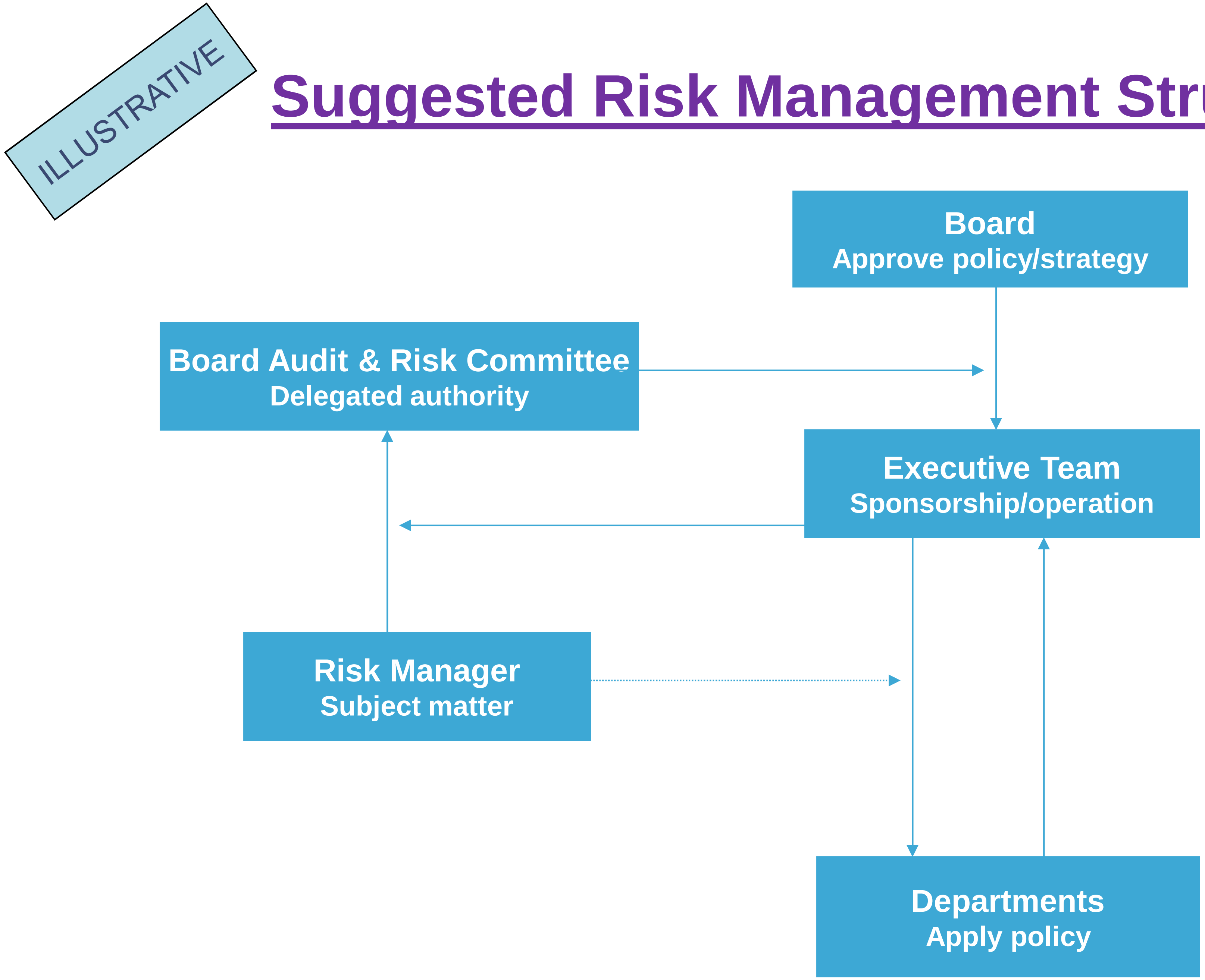
- **Material changes and commitments**, affecting company's financial position subsequent to the year end; to which the financial statements relate and the date of the reports;
- Related party transactions **not in the ordinary course of business** and not at arm's length basis

Governance

Key changes - Directors responsibility statement

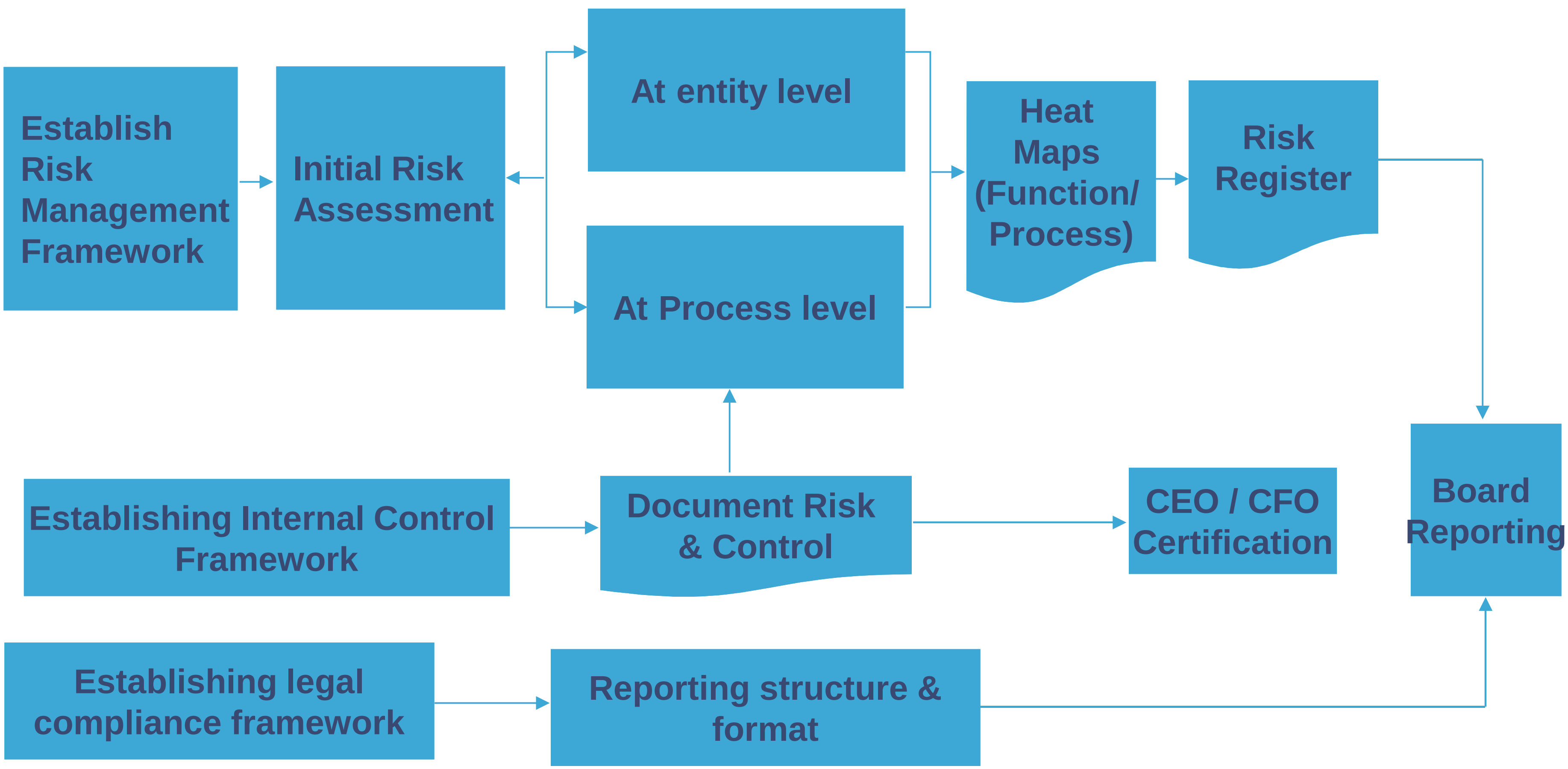
- The 2013 Act has included the following additional matters in the Directors' responsibility statement:
  - In case of listed company, the directors had laid down **internal financial controls** to be followed by the company and that they are **adequate and operating effectively;**
  - The directors have **devised proper systems to ensure compliance** with all applicable laws and such systems are adequate and operating effectively.

Suggested Risk Management Structure



ILLUSTRATIVE

Recommended solution to structure EWRM for compliance under Clause 49



Governance

Key changes - Related party transactions

- As against the term “relative” defined under the 1956 Act, the 2013 Act defines the term “**related party” for the first time**.
- **No approval of CG** is required for **entering into** related party transactions
- **No approval of CG** is required for **appointment of any director** or any other person to any office or place of profit.
- All related party transactions which are **not in the ordinary course of business** or not at arm’s length basis should be **approved by the Board**.
- Every contract or arrangement e**ntered into with a related party shall be referred to in the Board's report** along with the justification for entering into such contract or arrangement.

Governance

Key changes –

Related party transactions

- Every contract or arrangement e**ntered into with a related party shall be referred to in the Board's report** along with the justification for entering into such contract or arrangement.
- For the companies with the prescribed share capital, **no contract or arrangement or transactions exceeding prescribed amount, shall be entered into** with its related party, unless, approved by the shareholders of the company by way of a special resolution.

Governance

Rules

Related party transactions

- Company having a paid-up share capital of **INR 1 crore or more**; or
- Transaction or transactions to be entered into:
  - **exceeds 5%** of the annual turnover or **20%** of the net worth of the company as per the last audited financial statements of the company, whichever is higher,
  - relates to appointment to any office or place of profit at a monthly remuneration **exceeding INR 1 lakh**
  - is for a remuneration for underwriting the subscription of any securities or derivatives thereof of the company **exceeding INR10 lakh**

Governance

Related party transactions

Revised Clause 49

- also **defines** the term "related party“ and where such definition is **significantly broader** than that under the 2013 Act
- the **Companies Act exempts** transactions in the **ordinary course of business and at arm’s length basis** from approval requirements. However, the new SEBI requirements mandates that **all related party transactions** shall require **prior approval** of the audit committee
- all **material related party transactions** shall also require approval of the **shareholders through special resolution** and the related parties shall **abstain from voting** on such resolutions

Governance

Key Changes

Other miscellaneous provisions

- **Duties** of directors defined for the first time
- **Significant penalties** laid down for directors for defaults. The instances for levying penalties have increased substantially.
- New clause has been introduced with respect to **prohibition of insider trading** of securities under the 2013 Act.
- The definition of **price sensitive information** also included.
- **No person** including any director or KMP of a company **shall enter into insider trading** except to any communication required in the ordinary course of business or profession or employment or

Governance

Key Changes - Other miscellaneous provisions

- **Whistleblower mechanism** – all listed companies to set up a vigil mechanism for directors and employees to report genuine concerns
- **Class action suits** can be filed by a requisite number of members or depositors with NCLT **against the company/its management/ or a section of its shareholders** for damages or compensation if they are of the opinion that the **management** or **conduct of the affairs** of the company are being conducted in a manner **prejudicial** to their interest.

What CEOs Feel – CG Survey by Grant Thornton

Nomination Committee to **lead appointment** of Independent Directors – *(now a law)*

Clearly a ‘one size fits all’ approach would not work in any country

Adoption of CG is **more in form and less in spirit** - *(a reality)*

Formal and tailored program for induction of directors

Quality of Audit Committee meetings needs improvement

(improvement seen in many listed cos)

No policy for rotation of the Audit Committee members

What CEOs Feel - Going Ahead - CG Survey by Grant Thornton

Need for **stronger regulatory review** and enforcement

Oversight and monitoring of compliances need improvement

Skill sets of the Audit Committee members to match with Company's requirements

Risk Management practices can be more robust

Internal Audit be more effectively used as a monitoring tool

Advantages of a well developed CG Framework

Increased confidence of investors - especially foreign investors, as we now have one of the **best developed** mandatory Corporate Governance Codes.

Streamlining of financial / risk management / legal compliance **reporting frameworks,** resulting in efficiencies of operation.

Greater transparency of corporate proceedings and an internal check through a **whistle blowers policy** - has been adopted by the larger corporations and is now mandatory for listed companies.

Increased **shareholder value**.

Issues & Challenges in INDIA for compliance of CG

Competency and awareness of TCG to review adequacy of compliance with legal requirements and risk management framework;

Lack of comfort and confidence in ensuring and certifying adequacy of internal control systems

Degree of financial literacy – purely subjective

Adequacy of remuneration of IDs considering their efforts, time spent and risks involved in being on the Boards.

Proximity with promoters / management – independence issues

Age factor for certain Independent Directors

Independent Directors' **willingness and ability** to speak their mind out

Lack of availability of **skilled and reputed IDs,** post certain past events;

Form and substance – always a challenge and distant from realities

Walker Chandiok & Co LLP

Thank you very much