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Implications of Companies Act, 2013

Accounts, Audit and Auditors

The Companies Act, 2013: An overview

The Companies Act, 2013 ('2013 Act'), enacted on 29 August 2013 on accord of Hon'ble President's assent, has the potential to be a historic milestone, as it aims to improve corporate governance, simplify regulations, enhance the interests of minority investors and for the first time legislates the role of whistle-blowers. The new law will replace the nearly 60-year-old Companies Act, 1956 ('1956 Act').

The 2013 Act provides an opportunity to catch up and make our corporate regulations more contemporary, as also potentially to make our corporate regulatory framework a model to emulate for other economies with similar characteristics. The 2013 Act is more of a rule-based legislation containing only 470 sections, which means that the substantial part of the legislation will be in the form of rules. There are over 180 sections in the 2013 Act where rules have been prescribed and the draft rules were released by the MCA in three batches. It is widely expected that the 2013 Act and indeed the rules will provide for phased implementation of the provisions and in line with this, 98 sections of the 2013 Act have been notified and consequently the corresponding section of the 1956 Act cease to be in force.

The 2013 Act contains a number of provisions which have implications on accounts, audit and auditors. In this bulletin, we analyse some of the key provisions and have also identified certain action steps and challenges associated with the implementation of these provisions for the companies to consider.

"The Companies Act will also mean a transformation of the audit profession in the country, with thousands of listed companies needing to change their audit relationships. I certainly hope auditor rotation doesn't become a sham and this is where audit committees will have a critical role to play to ensure due opportunity is been provided to multiple service providers to pitch for the work."

- David Jones
Partner & Practice Leader, Assurance
Walker, Chandiok & Co.

Accounts

Key changes and requirements	Analysis and implications

Consolidated financial statements and definition of significant influence

Key changes and requirements

The 1956 Act does not require preparation of consolidated financial statements ('CFS'). However, listed entities are required to prepare CFS (as per SEBI regulations). The 2013 Act mandates preparation of CFS for all companies which have one or more subsidiaries. Further, the definition of a subsidiary as per the 2013 Act includes associates and joint ventures.

In addition, the 2013 Act:

- prescribes the format (similar to existing revised schedule VI of the Act) for preparation of CFS
- requires minority interest to be presented separately within equity on the balance sheet

The 2013 Act defines the term significant influence as "control of at least 20 percent of total share capital or of business decision under an agreement". This definition differs from the existing notified accounting standards, as per which significant influence is defined as "the power to participate in financial and/or operating policy decisions of the investee but not control over those policies".

Analysis and implications

The requirement to prepare CFS is largely consistent with internationally accepted practices. However, internationally, such requirements apply only to listed companies; and unlisted intermediate entities are generally exempted.

The existing Indian and international accounting practices do not require preparation of CFS when the Company has investments only in associates and joint ventures (no subsidiaries).

The requirement to present minority as part of equity is currently not required under the existing Indian accounting practices. However, the international practices are consistent with the 2013 Act.

With regards the definition of significant influence, we note that the standing committee recognised the difference and concluded that in due course the accounting standards will get aligned to the definition in the 2013 Act. However, this change could potentially result in divergence with internationally accepted practices.

Financial year

Key changes and requirements

As per the 1956 Act, it is a company's /body corporate's election to choose the financial year. The 2013 Act provides that the financial year for all companies and body corporates should end on 31 March. However, exemption may be granted at the specific request of the reporting entities where the financial statements of such entities are required for consolidation outside India. A transition period of two years has been provided for this change.

Analysis and implications

The 2013 Act eliminates the current flexibility in having a financial year different than 31 March, as well as in making amendments to the year-end to suit requirements.

Action steps

Consolidated financial statements & definition of significant influence

- Immediate task is to assess the number of additional financial statements required specially as consolidation is also required at intermediate levels.
- Increase in efforts and costs, for example in IT/ ERP systems, without providing much benefits to privately held companies.
- Implications for difference in definition of significant influence may require evaluation and may have an impact for companies.

Financial year

- Companies with a financial year-end different than 31 March will have to re-align the books (except for certain entities and where an exemption is granted)

Accounts

Key changes and requirements	Analysis and implications
Restatement of financial statements	
Currently under existing accounting practices, a Company cannot restate its previously issued financial statements to correct for an error or misstatement. Any errors/ misstatement are corrected for in the current period financial statements and disclosed. The 2013 Act provides for the following: • mandatory restatement: in case of fraud and when a Court/ the Tribunal passes an order for restatement • voluntary restatement: - to comply with accounting standards with the approval of the tribunal	The concept of restatement is new and is an internationally required practice. Further, SEBI has recently mandated that it may require companies to restate financial statements in case of justified audit qualifications. Accordingly, the provision under the 2013 Act will enable the implementation of the SEBI requirements.
Estimated useful life of assets	
The 1956 Act provides for minimum useful lives of fixed assets. For a class of companies, to be prescribed, the 2013 Act removes the minimum thresholds and provides indicative useful lives and residual values under Part C of Schedule II to the 2013 Act. Any variation from the indicated life needs to be justified. There is no transition period provided for this change and the change needs to be applied prospectively. If on the date of implementation of the 2013 Act there is no useful life left for an asset with carrying value on transitioning, the same may be adjusted through opening reserves. In case of other companies the useful life of an asset may not be longer than the indicated/ prescribed useful life. The 2013 Act has introduced separate category for industries such as (a) civil construction, (b) telecommunication, (c) exploration, production and refining oil and gas, etc.	It appears that the 2013 Act suggests that for a certain class of companies, to be prescribed, the useful life shall not normally be different than that indicated in the 2013 Act; deviations are allowed but would need to be justified. Other companies are not permitted to have a useful life which exceeds the prescribed/ indicated life. This may lead to different useful life for the same asset by similar companies. We also believe that such provisions are restrictive and are indirectly pushing companies to follow the useful life as indicated in the 2013 Act instead of making an appropriate assessment of the useful life of the asset.

Action steps

Restatement of financial statements

Companies need to carefully consider the implications of restatement provisions and its impact, e.g. where there are audit qualifications, instances of fraud, prior period adjustments etc.

Estimated useful life of assets

The useful lives of several tangible and intangible assets are significantly lower than the lives prescribed under erstwhile Schedule XIV. Hence, management shall assess the useful lives based on the prescribed indicative useful life and the disclosures.

Audit and Auditors

Key changes and requirements

Tenure and re-appointment of auditors

Auditors appointed in an annual general meeting ('AGM') shall hold office from the conclusion of that meeting until the conclusion of the ensuing sixth AGM (subject to ratification by members at every AGM).

As per the 2013 Act, before the expiry of the term of appointment, the company may remove the auditors (subject to special resolution and prior approval from Central Government) and the auditors, as well, have the right to resign.

Further, the Tribunal either *suo-moto* or on an application made to it by Central Government or by any person concerned, if it is satisfied that the auditor of a company has acted in a fraudulent manner or abetted or colluded in any fraud by the company or in relation to the company/its directors/officers; may direct the company to change its auditors. The individual or firm, against whom such an order is issued by the Tribunal, shall not be eligible to be appointed as auditor of any company for five years in addition to other penal actions.

An auditor/ audit firm is eligible for re-appointment after expiry of five years since completion of the previous tenure.

An audit firm having common partner (s) with another firm which has completed its term is not eligible for re-appointment for a period of five years from the completion of the other firm's term.

Analysis and implications

The proposal may result in effectively protecting the tenure of the auditor for five years by including stringent provisions on removal of auditors. While rotation (as discussed below) affects the long-term continuity of the company-auditor relationship, the five-year appointment, brings in stability for a limited period.

However, this ratification provision does affect company's/ stakeholders' discretion to change the auditor before the expiry of the term.

The Tribunal's authority to *suo-moto* change the auditor and consequent ineligibility of such auditor, to act as an auditor for any company is quite punitive and could be disruptive to the audit profession. This could result in disproportionate punishment for a minor intentional / unintentional act and could potentially shut down large accounting firms overnight.

Action steps

- Companies to make an assessment of the timing for change of existing auditors in line with the amendments;
- Companies to involve audit committees up-front in developing an internal system for assessment of eligible firms for appointment;
- Management and audit committee to plan for seamless transition of auditors.

Audit and Auditors

Key changes and requirements	Analysis and implications

Mandatory rotation

In case of listed companies (or a company belonging to such class or classes of companies as may be prescribed) the term of appointment of an individual auditor/ an audit firm is restricted to a period of five years/ ten years. An auditor/ audit firm should mandatorily rotate at the expiry of the term. Shareholders, at their discretion, may determine that an audit partner may rotate at such interval as may be resolved by them, or that the audit may be conducted by more than one auditor (joint audit). There is a transition period of three years, from date of enactment of the 2013 Act, to comply with this requirement.	Mandatory rotation is a new concept and is expected to change the Indian audit market structure significantly as several large companies have retained their auditors for more than 10 years. Mandatory rotation could possibly result in both positive and negative influences on the quality of the financial reporting processes and on overall audit quality. Few jurisdictions have established mandatory auditor rotation requirements, accordingly its feasibility and practicability is debatable because the extent of information about its potential impact is not readily available. While the potential benefit of mandatory rotation is enhanced auditor objectivity, it will also likely have an effect on overall cost, conduct and timing. The debate and the comment letter received in US and EU does not support implementation of auditor rotation without conducting further studies. A sudden introduction of such a requirement may disrupt the audit market and the industry as a whole. The implications could be far reaching and cannot be commented at this point in time.

Whistle blower – Fraud reporting

The 2013 Act provides that the auditor should immediately inform the Central Government within a, to be prescribed, timeframe and manner if he has reason to believe that an offence involving fraud is being or has been committed against the company by its officers or employees.	The term "Fraud" as defined under the 2013 Act is very wide and perhaps encompasses every act of omission or commission. It will be interesting to understand how these requirements will work considering that auditors are also the gatekeepers of the accounting and internal controls of the company. Further, there is no materiality limits set under the 2013 Act for reporting to the Central Government. The 2013 Act may require an auditor to report even trivial matters, making it an ineffective exercise.

Action steps

- Companies should assess as to whether a change in auditors is required and prepare for the transition accordingly. This may result in increased cost.
- Auditors would need to be vigilent to comply with the new requirements and companies should consider their own whistle-blower policies and procedures.

Audit and Auditors

Key changes and requirements	Analysis and implications
Eligibility	
Under the 1956 Act, a Chartered Accountant holding a certificate of practice or a firm of Chartered Accountants (only) can be appointed as auditor(s) of a company. The 2013 Act, in addition, proposes that a firm wherein a majority of the partners practicing in India are qualified for appointment, may be appointed to be an auditor of a company. Where a firm, including a Limited Liability Partnership ('LLP'), is appointed as an auditor of a company, only partners, who are chartered accountants are permitted to act and sign on behalf of the firm.	The introduction of LLP as an auditor and ability to operate with partners who are not Chartered Accountants is a welcome change and in line with international practices. This will also pave the way for multi-disciplinary partnership firms.
Disqualifications	
The 2013 Act includes the following additional disqualification: • Any person who has a business relationship with the company/ its subsidiary/associate/its holding company/subsidiary or associate of its holding company (business relationship disqualification); • A person whose relative is a non-executive/ executive director or key managerial personnel of the company; • A person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction; • A person who is in full-time employment elsewhere; • Any person whose appointment will result in the person being the auditor of more than 20 companies; and • Any person whose subsidiary or associate or any other form of entity is engaged in providing non-audit services as on the date of appointment (non-audit services disqualifications).	Some of the disqualifications seem to be quite punitive and may be difficult to implement. It is not clear what would constitute a business relationship. The current language appears to be including routine business transactions at an arm's length or even immaterial transactions which may have no effect on the company-auditor relationship. Further it can have very wide connotations, as a routine vendor relationship or any relationship with a distantly related entity such as a fellow subsidiary may disqualify the firm to be appointed as an auditor. Further, the cooling off/ transition period has not been defined by the 2013 Act. It is also not clear whether a person/firm that is engaged in providing non-audit services is disqualified to be the auditor of any company or such person/firm is disqualified to be the auditor of only the company to which such non-audit services are rendered. Further, it seems that the non-audit services may be provided in the year of the appointment without affecting eligibility, provided the engagement is terminated prior to the date of the appointment.

Action steps

Audit firms may need to consider the additional disqualification requirements. Further, companies may need to evaluate their auditors and selection process to comply thereof.

Audit and Auditors

Key changes and requirements	Analysis and implications
Restriction on number of audits	
The 1956 Act and the Institute of Chartered Accountants of India ('ICAI') restrict the number of companies in which a person/ firm can be appointed as auditor. An individual cannot be appointed as auditor for more than 30 companies. Further, an individual cannot be appointed as auditor for more than 20 public companies and of which not more than 10 companies should have a paid up share capital of more than Rs 25 lakh. In case of a firm, such ceiling is determined for every partner of the firm. The 2013 Act provides guidance on the nature of companies that should be excluded for this purpose. The 2013 Act restricts the number of audits to 20 companies for an individual/ partner.	The 2013 Act does not provide any restrictions based on nature/ size of the companies. Now private companies will also be considered for calculating the limit of 20 audits per partner.
National Financial Reporting Authority (NFRA)	
Under the 2013 Act, National Financial Reporting Authority (NFRA) (replaces existing National Advisory Committee on Accounting Standards) to make recommendations to the Central Government on laying down auditing and accounting standards applicable to companies. NFRA to monitor and enforce compliance with auditing and accounting standards. NFRA will have the power to make orders imposing penalty for professional or other misconduct by the auditors.	The constitution of the NFRA and powers being conferred upon the NFRA will bring in a significant change to the current structure of standard setting regulations.
Penalties and prosecution	
In case if the auditor has contravened any of his duties, he shall be punishable as below: • required to refund the remuneration • pay damages to the company, statutory bodies/authorities or any other person for losses arising as a result of incorrect or misleading statements in his audit report • pay a fine which shall not be less than Rs 25,000 but which may extend to Rs 5 lakh Further, if the above contravention is with an intention to deceive the company or its shareholders or its creditors, tax authorities or any other person concerned or interested in the company, then he is also punishable with an imprisonment of a term which may extend up to one year and a minimum fine of Rs 1 lakh, which may extend to Rs 25 lakh.	The term "intention to deceive" or "any other person concerned or interested in the company", 'improper or misleading statement of particulars', 'any likely act' wrongful act or conduct' are vague and subject to wide interpretation which might result in unnecessary litigations. Potential unlimited liability on auditor may result in adverse impact on auditing profession and may give rise to long disputes and increase audit costs. Also, there could be an unlimited liability to the firm for an act of a partner. Firm should ideally have been held liable only when there is systemic failure in firm's process and hence this seems a disproportionate punishment for an individual act.

Audit and Auditors

Key changes and requirements	Analysis and implications
Penalties and prosecution (Cont'd)	
Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this 2013 Act or in any other law for the time being in force, for such act shall be of the partner or partners of the audit firm and of the firm jointly and severally and such partner or partners of the audit firm shall also be punishable in the following manner: • imprisonment for a term not less than six months and may extent up to ten years, provided that where the matter involves public interest, the minimum term will be three years; and • fine for an amount ranging from one to three times the amount involved in the fraud Similarly where a person has subscribed for securities of a company on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained loss or damage as a consequence, the company and certain specified person (includes director, promoter and experts) are liable to pay compensation to every person who has sustained loss or damage. Experts may include auditors. Where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to the above shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.	Overall it seems that auditor's or the audit firm's liabilities are significantly disproportionate to the level of involvement and currently drafted in a manner which may potentially lead to a litigious environment. This requirement results into auditor's being held liable to every person and the liability is not limited to his involvement and work performed. This also seems disproportionate. Also the reference' by an expert or advisor or consultant is very broad and vague and could result in wide and unintended interpretations of the intent of the clause.
Class action suits	
Unlike the 1956 Act, the 2013 Act provides for class action suits, which will allow a requisite number of members or depositors with common interest, in a matter, to file an application in the National Company Law Tribunal ('NCLT') against the company/its management/its auditors 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.	Class action suit provides empowerment to minority stakeholders to come together and seek action against the experts, advisors and auditors of the company for any oppression or mismanagement. However in the absence of significant anti-abuse provisions in the implementation rules, this can be misused. The new risks and liabilities will infuse more responsibility into the role of an auditor.

Auditors' report

Key changes and requirements	Analysis and implications

Reporting requirements

In addition to the 1956 Act reporting requirements, the 2013 Act includes the following matters for auditor reporting;

- Adequacy of the internal financial controls system and the operating effectiveness of such controls [in a similar context with respect to directors report, internal financial control has been defined to mean 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].
- Any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith.

It is notable in this context that only for listed entities, in the director’s report, the 2013 Act requires directors to provide a similar report on internal financial controls.

The auditors are subjected to wider and onerous responsibility of providing a comfort on internal controls and on operational effectiveness of the conduct of the business, in addition to the true and fair opinion on financial statements.

There seems be a focus to bring in global best practices in terms of reporting by auditors on the effectiveness of internal control over financial reporting and maintenance of accounting records. However, the terms or language highlighted in these requirements, are subjective and open to wide interpretations. This may adversely affect the scope of the audit and can pose significant implementation challenges. These matters may require additional clarifications in the implementation rules.

Further, for unlisted entities the requirements related to reporting in internal financial controls apply only to auditors and not to the directors which is inconsistent with the company's / director's primary responsibility for implementing such controls.

Scope of audit inquiries/testing may no longer be restricted to financial information and may include more qualitative operational assessments as well.

There may be significant costs associated with implementation of acceptable internal financial reporting controls.

It is not yet clear as to what 'Other matters connected herewith' may include.

Action steps

- Companies to take measures to perform gap analysis of controls currently documented and implemented vis-à-vis enhanced expectations pursuant to the above amendment.
- Companies to develop a comprehensive internal control framework in consultation with auditors and audit committee; and
- Companies to develop training programs for effective implementation of internal financial controls, including training and education of board members.

Non-audit services

Key changes and requirements	Analysis and implications

Restricted services

Currently, whether non-audit services can be rendered to an audit client is determined by applying the Code of Ethics and the Guidance Note on Independence of Auditors issued by the ICAI. Unlike 1956 Act, the 2013 Act contains specific provisions that prohibit auditors of a company to render non-audit services to an audit client (or its holding company or its subsidiary company)

Prohibited non-audit services include:
- accounting and book keeping services;
- internal audit;
- design and implementation of any financial information system;
- actuarial services;
- investment advisory services;
- investment banking services;
- rendering of outsourced financial services; and
- management services.

Other restricted services may be further prescribed.

Transition Period
One year from the date of enactment of the 2013 Act.

The list of prohibited services is quite wide and also vaguely worded. This results in restricting the ability of an audit firm to provide most non-audit services.

Whilst the provision of some non-audit services to audit clients can pose a risk, the objectivity of auditors is not compromised by providing non audit services to audit clients or their holding companies provided that auditors comply with independence standards. Certain non-audit services, for example, services that pose a risk of self-review do impair independence; however there are several non-audit services that do not affect independence. The list provided under the 2013 Act is subject to wide interpretation and may limit auditors in providing valid non-audit services which do not pose any risk of independence.
It should be noted that the list appears to be more restrictive than international practices.

Such restrictions are generally applied to all 'downward affiliates' of the company, as those entities could be considered as being subject to audit (in the context of the parent company's financial statements); however, these restrictions have been extended to the holding company as well.

The requirements appears to be quite onerous and indeed would appear to prohibit an audit firm from providing a wide range of services, even when those are non-material.

Action steps

- Companies may initiate the process to assess independence of external auditors, with regards to any non-audit services provided, within the group;
- Build and implement a framework for regular monitoring and oversight over all audit and non-audit services and service providers;
- Assess the need to empanel additional service providers; and
- Develop a transition plan to comply with the provisions.

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