Companies Amendment Act, 2017

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Introduction

Among the recent major legal reforms, Companies Act, 2013 is considered as the most comprehensive reform with an objective of aligning the Companies Act with the international laws. The simplification of Companies Act was well received, but still the industry faced multiple implementation challenges. To address concerns of all stakeholders, the Ministry of Corporate Affairs (MCA) constituted the Companies Law Committee, which invited representations and comments. The representations were analysed, and this mammoth task was concluded in a short period of time. The recommendations of this Committee were referred to a Standing Committee, for further examination. Accordingly, the Companies (Amendment) Bill, 2017 was passed by Lok Sabha in July 2017, later approved by Rajya Sabha in December 2017 and finally received the Presidential assent on January 2018. This article is an effort to summarise some key amendments.

Key Amendments

1) Definitions

The following definitions have been amended, in order to provide more clarity and address interpretational difficulties:

- Holding Company
- Subsidiary
- Associate
- Joint Venture
- Net Worth
- Free Reserves
- Turnover
- Debentures
- Interested Directors
- Key Managerial Persons

Among the listed items, the most noteworthy being, changes in definition of Subsidiary and Associate. The concept of "voting power" is introduced as against the existing concept of "total share capital". Prior to amendment the control over "total share capital" was considered as the basis for evaluation subsidiary and associate relationship, however, post the amendment the control over "voting rights" are to be considered as the basis for evaluation.

Another important amendment is the definition of Key Managerial Personnel (KMP). In order to provide flexibility to companies to designate whole time officers has KMP, the amendment Act provides authority to the Board to designate other officers of the Company, not more than one level below directors, who are in whole-time employment, as KMP of the Company.

2) Loans and Investments

The industry had always been critical on the practical application of Section 185, and the MCA had always tried to address the concerns through several notifications and circulars. In order to cover them comprehensively, the Amendment Act provides that the prohibitions/restrictions under Section 185 will not apply in cases where:

- Loan given by Company to MD or WTD as part of scheme extended to all employees of the Company, pursuant to a scheme approved by members by a special resolution
- Company provides loan in the normal course of business and the interest rate is not less than yield of Government securities.
- Loan made by Holding Company to Wholly Owned Subsidiaries (WOS) and Guarantee or security provided by Holding Company to WOS.
- Guarantee or Security provided by Holding to subsidiary company.

In respect of application of Section 186, the Rules notified under 2013 Act had an overriding effect. The Amendment Act, has addressed this concern by providing relaxation under the Rules in the Act itself. Accordingly, the requirement to obtain approval of the members by special resolution will not apply. However, the Company shall disclose such loans, guarantee, security or acquisition in the financial statements.

Section 180(1)(c) dealing with on powers of Board, required that a special resolution has to be passed by the Company for borrowing money if such borrowing exceeds the aggregate of paid-up share capital and free reserves. The Amendment Act includes securities premium also along with paid-up share capital and free reserves for calculation of the maximum permissible limit.

3) Related Party Transactions

Under the 2013 Act, the definition of Related Party in Section 2(76), an associate company is a related party to the investor. However, for the associate company, the investor was not considered as related party. The Amendment Act fixes this anomaly and now, both investor and associate company should be treated as related to each other.

Section 188 dealing with obtaining approval by passing an ordinary resolution of unrelated approvals for RPT's created many practical difficulties, particularly in case of closely held entities with 2 or 3 shareholders. The Amendment Act now specifies that where 90% or more members are relatives of the promoter or are related parties, all shareholders will be entitled to vote on the ordinary resolution.

Section 188 stipulates that where a related party transaction is entered by a director or any employee without requisite approvals / ratifications, then such contract is voidable at the option of the Board. The Amendment Act now specifies that in addition to being voidable at the option of the Board, the contract will be voidable at the option of the shareholders also.

Section 177 requires Audit Committee to pre-approve all RPT's. However, Section 188 requires Board approval for specific transactions only. The Amendment Act clarifies that if the Audit Committee does not approve transactions not covered under Section 188, suitable recommendation needs to be made to the Board and accordingly, the Board will need to consider and approve such transactions, even if they are not explicitly covered under Section 188.

The Amendment Act has addressed a major concern. Transactions between Holding Company and Wholly owned subsidiaries will not require approval of Audit Committee. However, if the transaction requires Board approval under Section 188, then approval of Audit Committee would also be required.

Additionally, relaxation is also extended to transactions where a Director or officer of the Company may enter into an RPT for an amount not exceeding INR 1 Crore, without Audit Committee approval. However, such transactions are to be ratified by the Audit Committee within 3 months from the date of the transaction. In the absence of ratification, the transaction will be voidable at the option of the Audit Committee and every director of officer concerned will indemnify company against any loss incurred by it.

4) Corporate Social Responsibility (CSR)

The Amendment Act clarifies that the requirement to constitute a CSR committee and compliance with the CSR provisions (Section 135) will apply based on networth / turnover / profit criteria based on financials of immediately preceding financial year. The Amendment Act replaces the terms "during any financial year" with "during the immediately preceding financial year".

The "average net profits" calculated under Section 198 should be used to evaluate the limits for the purpose of CSR. In addition to matters specified under Section 198, the CSR rules requires reduction of profits from overseas branches and dividends income. To address this apparent conflict, the Amendment Act, states that the Central Government may prescribe sums that are not be included for calculating net profit under Section 135.

The Amendment Act clarifies that the provisions of CSR shall apply to all foreign companies if it meets the prescribed criteria for its Indian business.

5) Board Matters and Corporate Governance

Having received several suggestions that the Board Report contains lengthy information which are already available to shareholders in various forms, the Amendment Act now relaxes information to be provided in the Board Report. The Extract of annual returns was originally mandated to be filed along with the Board Report. The Amendment Act states that instead of filing an extract, the web address / link of the annual return hosted on the website of the company shall be provided in the Board Report.

In regard to the requirement for atleast one of the Directors to stay in India for a period of not less than 182 days, the Amendment Act clarifies that the requirement would be for the financial year and not the calendar year. Additionally, it also clarifies that the residency requirement is not the current financial year and not the previous financial year.

Section 167 specifies that if a person attracts disqualification under Section 164(2), such director's office becomes immediately vacant in all the Companies where such person is a director. Particularly, in the defaulting company, all directors would be deemed to have vacated office. New persons appointed in defaulting company would also attract such a disqualification. Owing to significant challenges faced by defaulting companies and its directors, the Amendment Act clarifies that if a person attracts disqualification under Section 164(2), the office of director becomes vacant in all companies except the defaulting entity. Additionally, the incoming directors of such defaulting companies will not incur disqualification for a period of 6 months from the time of appointment.

Section 149 dealing with appointment of Independent Directors (ID) specifies that the ID or his relatives shall have no pecuniary relationship with the Company, its holding, subsidiary or associate company. The Amendment Act brings in a concept of materiality and prescribes criteria / limits in relation to director's remuneration as a % of his total income, holding interest, indebtedness, provision of security or guarantee and any other pecuniary relationship. This is aimed at easing the burden of ensuring independence for companies as well as its ID.

Section 177 requires listed entities and class of companies to constitute an Audit Committee. Accordingly, compliance gets largely triggered to listed companies or public companies meeting the threshold specified. However, it was noted that private companies which have listed their debt securities also were required to constitute an Audit Committee. To address this issue, the Amendment Act states that instead of Listed Companies, Listed Public Companies should be required to constitute an Audit Committee. Similar amendments are also prescribed in case of constitution of Nomination and Remuneration Committee (NRC). Additionally, the Amendment Act requires that instead of carrying out evaluation of every director's performance, NRC should specify a methodology for evaluation of performance of the Board, its committees and every individual director. Such evaluation should either be carried out either by the Board, the NRC or an independent external agency. The NRC would then review the implementation and compliance of the evaluation system.

Section 178 required the remuneration policy to be disclosed in the Board's report. The Amendment Act now requires the policy to be placed in the website of the Company. The salient features of the policy along with changes and web address, is to be disclosed in the Board Report.

6) Dividend

As per Section 123 of the Act, a Company may declare interim dividend during the financial year out of the surplus in the P&L Account and out of the profits of the financial year in which such interim dividend is proposed. The language indicates that some “profits” in the financial year is required to declare dividend. Assuming a scenario where a company has huge surplus in the P&L but has made a loss in the interim period, the wordings of the Act indicate that the Company cannot declare dividend since it has incurred losses in the interim period. To address this, the Amendment Act clarifies that interim dividend may be declared out of the surplus in the P&L Account or out of the profits of the financial year in which such interim dividend is proposed or out of profits generated in the financial year till the quarter preceding the date of declaration of the interim dividend. However, if a Company incurred losses, the rate of dividend cannot be higher than the average dividends declared by the company in the immediately preceding three financial years.

7) Financial Reporting

Section 26 requires, that in case of an Initial Public Offering (IPO), the offer document shall include P&L account for a period of 5 preceding financial years. In order to simplify the contents in the prospectus, the Amendment Act specifies that financial information contained in the offer document shall be specified by SEBI in consultation with the Central Government.

Section 130 dealing with re-opening of accounts specifies that the Tribunal would give suitable notices to certain regulatory authorities for their comments before passing an order under this section. The Amendment Act has now provided that in addition to the parties mentioned in the section, the Tribunal would also give notices to any other person concerned for presenting their view. Additionally, no time limit was provided for re-opening of books of accounts. The Amendment Act, states that the re-opening shall be made for a period of 8 preceding financial years. This requirement is aligned with the requirement relating to maintenance of books of accounts by companies.

Section 134 originally required the CEO to sign the financials only if such person is a director of the Company. However, CFO and CS were mandated to sign the financials. The Amendment Act has clarified the in case the Company does not have a managing director, the CEO being a KMP is responsible for the management of the Company. Accordingly, a CEO is mandated to sign the financial statements, irrespective of whether he or she is a director or not.

Some more important changes concerning financial reporting are as follows:

- The requirement to place the financial statements of subsidiaries in the website shall apply to listed entities only and shall not apply non-listed entities.
- If a listed company has a foreign subsidiary which is required to prepare consolidated financials in line with the requirement of its jurisdiction, then there is no requirement to host separate standalone financial statement of step down subsidiaries in the website of the listed entity.
- If the listed entity's foreign subsidiary is not required to get its financials audited, the listed entity shall host the unaudited financials of such foreign subsidiary in its website. However, if the unaudited financials is in another foreign language, the translated version in English should also be placed in the website.

The 2013 Act brought in the concept of uniform financial year. However, it allowed holding and subsidiary companies of entities abroad to follow a different accounting year provided such companies have sought the approval of the NCLT. This exemption was not available for associates and Joint Ventures of foreign entities. The Amendment Act, provides this exemption to Associates and Joint Ventures also to apply to the NCLT for approval.

8) Audit

As per Section 139 an auditor is appointed for a period of 5 years. However, such appointment is ratified by the members each year at the AGM. The 2013 Act was however silent on implications of non-ratification by members in the AGM. Accordingly, a view had emerged that non ratification would tantamount to removal of Auditor and thereby enable the board to appoint another auditor to be further approved by the members by an ordinary resolution. Conversely, there was another view that such removal would trigger Section 140 requiring approval of Central Government and a special resolution by the members. The Amendment Act has dealt with this inconsistency by removing the requirement for annual ratification, in order to promote auditor's independence. Accordingly, removal of auditor is possible only through Central Government approval and special resolution at general meeting.

Section 143 provided the auditor the right to access books of accounts of subsidiaries for the purpose of preparation of CFS. However, such access was not available to the books of associates and joint ventures. The Amendment Act has now provided clarity that the auditor has the right to books of associates and joint ventures also.

Section 143(3) deals with the auditor's reporting requirement in regard to internal financial controls. Constant doubt existed whether the term the reporting was applicable for financial and business controls. Thought the Guidance note issued by ICAI clarified that the reporting was limited to financial controls only, there was no suitable amendment in the Act. The Amendment Act has now amended Section 143(3) clarifying that reporting by auditor applies to adequacy and operating effectiveness of internal financial controls with respect to financial statements only.

9) Managerial Remuneration

Section 197(1), requires public companies to obtain approval of shareholders and Central Government for providing managerial remuneration of it is in excess of 11% of the net profits of the Company. The requirement of Central Government approval has been done away with by the Amendment Act. However, the Company requires to obtain approval from banks, public financial institutions, non-convertible debentures if case of any default in payments to them before approval of shareholders through an ordinary resolution. Additionally, for exceeding the limits prescribed for individual directors, the Amendment Act requires approval through special resolution and not ordinary resolution as required under 2013 Act.

Readers are cautioned - The removal of the requirement of Central Government approval has been made as an amendment in the principal section, but similar amendment has not been effected in Schedule V. Clarity is awaited in this regard.

Section 193(8) requires companies to exclude profits from sale of investment to be excluded for calculation of profits for managerial remuneration. The Amendment Act clarifies that such exclusion need not be made for investment companies as it forms part of their principal business activity.

Section 198(4) requires the brought forward losses for any year beginning on or after the commencement of 2013 Act to be to be reduced while arriving at net profit for the for the purpose of managerial remuneration. The Amendment Act clarifies that all brought forward losses relating to any year which have not been set off are to be reduced while arriving at net profit.

The 2013 Act did not specify the time limit within which the directors are to refund the excess remuneration received. It only specified that the amount will be held by them in trust. The Amendment Act however, clarifies that the director shall refund the excess remuneration within a period of 2 years of such lesser period prescribed by the Company.

The Amendment Act also mandates the Auditor to comment on whether the managerial remuneration has been paid or provided with the requisite approvals as mandated by the provisions of Section 197 read with Schedule V. If not, the amount involved, and steps taken by the Company to securing refund should be stated. This reporting is in addition to the reporting required under CARO, 2015.

Conclusion

We welcome the clarificatory changes made by the Companies Law Committee through the Amendment Act, 2017. The principal objective has been to ease compliance norms, at the same time maintain the spirit in which the 2013 law was enacted. Implementation difficulties have been reasonably addressed and more importantly various provisions have been harmonized with provisions within the Act as well as other important Acts.

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