Companies Act 2013 – Rules now notified

The new landscape

The Ministry of Corporate Affairs (MCA) has notified most of the sections and has largely operationalised the Companies Act 2013 (2013 Act). This is a landmark legislation with far-reaching consequences on all companies incorporated in India. The MCA has also published Rules relating to several chapters, and the remaining ones in respect of the notified sections are expected to be released by 31 March 2014. All of the notified sections of the new Companies Act 2013 are either already effective or will be effective from 1 April 2014.

Key highlights

- Depreciation rates in the 2013 Act are indicative in nature. Revenue-based amortisation permitted for toll road intangible assets under service concession
- With respect to related parties in relation to the company, the coverage of related parties rationalised to include only Directors and key managerial personnel of the company and its holding company, and not its subsidiary and associate companies. Further, senior management personnel are no longer covered as related parties
- Definition of relative changed to cover fewer relationships
- Limits for approaching the shareholders to seek an approval for related party transaction has been revised upwards such that shareholder approval is a higher bar
- Exemption for inter-corporate loans and guarantees for wholly owned subsidiaries and guarantees, in respect of certain loans to subsidiaries subject to certain conditions
- The limits for appointment of internal auditor, women director, Independent Director and setting up of committees have undergone a change
- Definition of total share capital in the context of meaning of subsidiary and associate now includes only equity and convertible preference share capital
- Scope of internal control seems to have been restricted to those with reference to financial statements as against covering operational aspects as well
- E-voting is now mandatory for listed companies and other companies having less than 1000 shareholders.
Key changes in final rules

Related party transactions

The 2013 Act places a lot of emphasis on related party transactions. The 2013 Act, in keeping with the spirit of raising the bar on governance, prescribes rather onerous requirements for related party transactions. The final Rules make several important changes summarised as under:

• The draft Rules had a very wide coverage of related parties spanning holding, subsidiary, and associate companies. The final Rules rationalise the coverage to include only directors and key managerial personnel or his/her relative in relation to the company and its holding company. It does not include directors and key managerial personnel of subsidiary and associate companies. Further, the definition of related parties in the draft Rules included senior management personnel (one level below the board) including functional heads under related parties. This requirement has been dispensed with in the final Rules.

• The definition of relative has undergone a change, and now covers only eight relationships as against the fifteen relationships in the draft Rules. Third generation of relatives – grandparents and grandchildren have been excluded from the list of relatives. However, the concept of financially dependent relatives has not been considered in the final Rules.

• In relation to the approval of the Board for related party transactions – management needs to provide basis of pricing and other commercial terms, as well as factors considered in determining the price and other related aspects considered irrelevant by them. This will compel management to maintain details and rationale in relation to determining the pricing and other terms of every transaction in order to demonstrate whether prices are at arm’s length.

• The limits for obtaining prior approval of shareholders vide special resolution has undergone a change with the limits being enhanced in several cases. For example, the threshold limits for sale, purchase and supply of goods which was the higher of 5 per cent of annual turnover or 20 per cent of net worth, has been revised to more than 25 per cent of annual turnover, and in case of selling and buying property and availing or rendering of any services, the limit has been changed from 5 per cent of annual turnover or 20 per cent of net worth, to more than 10 per cent of net worth. This is a positive move to enhance the limits, since lower limits would have meant that companies would have had to approach the shareholders for their prior approval, for most related party transactions that are not at arm’s length or not in the ordinary course of business.

• No relief has been provided in the final Rules for transactions between fellow subsidiaries and transactions with a joint venture, where all the shareholders would be precluded from voting on the transactions.

KPMG in India’s observation

We welcome the changes made in relation to the coverage and definition of related parties. This is expected to ease the administrative burden on companies of tracking wide ranging relationships, as well as seeking pre-approvals for transactions that are not in ordinary course of business or not at arm’s length without diluting the intent of the Act. Further, extensive reporting of related party transactions to the regulators and shareholders will entail transparency in the process. However, the fact that the definition of relative still does not bring in the concept of financial dependency could continue to pose implementation challenges.

The requirements to obtain pre-approval from audit committee, board and shareholders might inhibit related party transactions to be undertaken swiftly and might call for advance planning by companies. Companies will have to put in place processes and systems to track related parties and transactions in order to be fully compliant with the requirements.
Inter-corporate loans and investments

Section 185 of the 2013 Act, amongst other matters, states that no company shall, directly or indirectly, advance any loan to any other person in whom the Director is interested, or give any guarantee or provide any security in connection with a loan taken by any other person in whom the director is interested. The expression ‘any other person in whom the director is interested’ could potentially cover amongst others, a subsidiary company. This created hardship for corporates who wanted to lend to or provide guarantees on behalf of their subsidiaries for genuine business purposes. The MCA partly addressed this in their recent circulars. The final Rules exempts loans made by, guarantees given or security provided by a holding company to its wholly owned subsidiaries, from the requirements of section 185. Further, guarantee given or security provided by a holding company to a bank or financial institution for the purpose of loan taken by any subsidiary is also exempt. These loans should, however, be utilised by the subsidiary company for its principal business activities.

On a related note, the final Rules exempts a company’s investment in a wholly owned subsidiary, loan or guarantee given or security provided to its wholly owned subsidiary company or a joint venture company, from calculating the limits prescribed under section 186. This change brings the new section in line with the provisions of the erstwhile Act.

KPMG in India’s observation

The changes in the final Rules address the concerns and genuine hardship that companies faced in financing their subsidiaries. The new requirements provides safe harbour with respect to both loans and guarantees given by a holding company to its wholly owned subsidiaries.

Definition of subsidiary and associate

In order to determine whether a company is a subsidiary or associate, the 2013 Act requires consideration of not just equity share capital but also preference share capital of the investee company. The definition of subsidiary and associate refers to investor’s holding in total share capital of the company. The final Rules have defined total share capital as including equity share capital as well as convertible preference shares. The MCA has not clarified whether both optionally and compulsorily convertible preference shares are to be considered.

KPMG in India’s observation

Excluding redeemable preference shares from the definition of total share capital is a positive development, especially since redeemable preference shares are more akin to debt than equity. However, it would have assisted if the MCA had specified the treatment of optionally convertible preference shares.
Governance and monitoring framework

The 2013 Act makes several changes in the governance framework of companies and requires additional measures to be put in place by companies and also aligns itself with certain good international practices. The 2013 Act places heightened emphasis on Independent Directors and internal audit function. The key changes are summarised as under.

- Unlisted public companies will now be required to appoint at least two Independent Directors as against the requirement of the draft Rules to have at least one third of directors on the board as Independent Directors. The final Rules also provide that if companies are required to appoint more than two independent directors in order to comply with any regulation or to comply with the requirement of minimum number of Independent Directors for constituting an audit committee, then such increased number of directors will be the minimum number of Independent Directors to be appointed.

- Further, the thresholds related to paid up capital, turnover, and borrowings applicable for appointment of Independent Directors, constitution of audit committee and nomination and remuneration committee, in unlisted public companies have also undergone a change. (Refer Table 1)

- As per the 2013 Act, a director was disqualified from being appointed to the Board of Directors if convicted in any offence and not just an offence under the Companies Act. The final Rules clarify that if a Director is disqualified from being appointed to the Board of Directors only if the director is convicted in an offence committed under the Companies Act.

- The final Rules require all listed companies to appoint an internal auditor. In addition, unlisted public companies were also required to appoint an internal auditor if certain criteria related to share capital, turnover and outstanding borrowings were achieved. The final Rules now also require private limited companies to appoint internal auditors based on the turnover and borrowings criteria. (Refer Table 2)

- The criteria applicable for unlisted public companies for appointment of internal auditor have also undergone a change with a new turnover criteria introduced in addition to the other criteria provided in the draft Rules. (Refer Table 3);

- The final Rules have also clarified that the internal auditor may or may not be an employee of the Company and that non practicing Chartered Accountants can also be appointed as internal auditors.

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**Table 1 - Criteria for appointment of Independent Directors, Audit Committee and Nomination & Remuneration Committee**

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Final Rules</th>
<th>Draft Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid up capital; or</td>
<td>≥INR10 crore</td>
<td>≥INR100 crore</td>
</tr>
<tr>
<td>Turnover; or</td>
<td>≥INR100 crore</td>
<td>≥INR300 crore *</td>
</tr>
<tr>
<td>Aggregate outstanding loans, debentures, deposits</td>
<td>&gt;INR50 crore</td>
<td>&gt;INR200 crore</td>
</tr>
</tbody>
</table>

*Applicable only for Independent Directors

**Table 2 - Appointment of internal auditor for private companies**

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Final Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover; or</td>
<td>≥INR200 crore</td>
</tr>
<tr>
<td>Outstanding loans or borrowings from banks or public financial institutions at any point of time during the preceding financial year</td>
<td>≥INR100 crore</td>
</tr>
</tbody>
</table>

**Table 3 - Appointment of internal auditor in unlisted public companies**

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Final Rules</th>
<th>Draft Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid up share capita; or</td>
<td>≥INR50 crore</td>
<td>≥INR10 crore</td>
</tr>
<tr>
<td>Turnover; or</td>
<td>≥INR200 crore</td>
<td>-</td>
</tr>
<tr>
<td>Outstanding loans or borrowings from banks or public financial institutions at any point of time during the preceding financial year; or</td>
<td>≥INR100 crore</td>
<td>&gt;INR25 crore</td>
</tr>
<tr>
<td>Outstanding deposits at any point of time during the preceding financial year</td>
<td>≥INR25 crore</td>
<td>≥INR25 crore *</td>
</tr>
</tbody>
</table>

*Deposits accepted

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**KPMG in India’s observation**

Having a responsible and professional Independent Directors and internal auditors could go a long way in boosting investor confidence.

In order to ensure that directors have adequate bandwidth to deal with their enlarged responsibilities, the 2013 Act has put a cap on number of directorships, and the recent decision of SEBI to amend the listing agreement puts a cap on independent directorships as well. All of these can result in a significant demand supply mismatch in the short to medium term till the organisations and the environment matures and all of these requirements become business as usual. With the limits being rationalised in the final Rules, companies may find it somewhat easier to source the right talent to enable directors and internal auditors to discharge their duties diligently.
Useful lives to compute depreciation

The MCA has published an amendment to Schedule II of the 2013 Act (to be notified shortly) to the effect, companies are provided with the option of depreciating assets over their useful lives which could be different from the useful lives prescribed in Schedule II. Further, the determination of residual value could also deviate from the five percent stated in Schedule II. However, if a company chooses to use a useful life or residual value different from the limits indicated in Schedule II, it will be required to disclose a justification for the same in the financial statements. Moreover, the useful life of Continuous Process Plants is now notified to be 25 years from 8 years under the pre-revised Schedule II. The notification also clarified that the amortisation of intangible assets will be in accordance with the applicable accounting standards except for intangible assets created under toll road projects. Such assets are to be depreciated using a revenue based amortisation method. This change reverts back to the position under the erstwhile Companies Act. (Refer Illustration 1).

Illustration 1- Amortisation of intangible assets (Toll Roads)

| Cost of creation of intangible asset | INR500 crore |
| Total period of agreement | 20 years |
| Time used in creation of asset | 2 years |
| Amortisation period of the asset | 18 years |
| Total revenue expected to be generated over 18 years | INR600 crore |
| Actual revenue generated in Year 3 (first year since creation of asset) | INR5 crore |
| Amortisation charge for the year | =INR4.16 crore (5/600*500) |
| Amortisation rate for first year | =0.83 per cent (4.16/500*100) |
| Amortisation charge | =(Actual Revenue for the year / Projected revenue upto end of concession period )* Cost of Asset |

KPMG in India’s observation

We welcome the MCA’s move permitting companies to align their depreciation policy for tangible assets in line with the useful life of the asset, as is the case internationally. Further, the requirement to disclose justification for deviation will also, in a transparent manner, provide reasons to the users of financial statements. Revenue-based amortisation, will maintain status quo for companies having toll road projects.

Internal financial controls

One of the matters prescribed in the final Rules, relating to the matters to be included in the Board report is on the adequacy and operating effectiveness of internal financial controls with reference to the financial statements for all listed companies as well as unlisted public companies having paid up share capital in excess of INR25 crore. Section 134(5)(e) of the 2013 Act, requires the directors’ responsibility statement of listed companies to specifically assert on adequacy and operating effectiveness of internal financial controls. This creates a dichotomy especially for listed companies as to which of these requirements apply. It seems that the final rules aim at rationalising the scope to cover internal financial controls with reference to financial statements but in absence of a change in the relevant section of the 2013 Act the spirit of change might not be implementable.

Other changes

- Additional disclosure requirements included on various financial statement matters.
- In addition to the various other conditions, the final Rules additionally prescribe that companies would be prohibited from issuing any shares with differential voting rights, if they have defaulted on repayment of loans from banks and public financial institutions or interest thereon, payment of dividend on preference shares, payment of statutory dues for employees, or in depositing moneys into the Investor Education and Protection Fund. Since there is no reference period for such default, it appears that any default, even if subsequently rectified, would preclude a company from issuing such shares.
- E-voting is now made mandatory for listed companies and other companies having not less than 1000 shareholders. This could potentially enhance the level of participation by minority shareholders, specifically, the institutional investors.
- The final Rules prescribe additional matters which shall not be considered in a board meeting through video conferencing or other audio visual means like the approval of the prospectus, the Audit Committee Meetings for consideration of accounts; and the approval of the matter relating to amalgamation, merger, demerger, acquisition and takeover.

Conclusion

The 2013 Act is a culmination of several years of discussion on how to shape the corporate law in India. The Act will see the light of day on 1 April 2014. The 2013 Act would provide a fillip to the governance environment in companies. The rationalisation and reliefs provided in the final Rules will go a long way in assisting companies implement this new Act.
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