

Getting your “Act” together:

Top 10 actions for promoters and senior management from the new Companies Act and revised Clause 49

The Companies Act, 2013 is a reality and it is now time to act. Out of 470 sections and 29 chapters, 282 sections are already in force and final Rules on 19 chapters have been released that are effective from 1 April 2014. SEBI has made similar changes to Clause 49 of the Listing Agreement that are effective 1 October 2014, much sooner than the transition dates as provided by the Act.

Amongst changes introduced by the Act, several are simply procedural. However, there are some that are burdensome to implement, and some that call for immediate action. In our opinion, planning now will provide strategic advantage while embracing the new legislation in both letter and spirit. Following is Grant Thornton India LLP's list of the 'Top 10' action points which promoters and senior management of listed and large companies should consider important, and some of which need to be addressed as a matter of urgency.

No.	Requirement	Resulting from	Urgent (U)/ Important (I)	Compliance with effect from	
				Listed companies	Large unlisted companies
1	Related party transactions	Clause 49; Companies Act	U, I	1 October 2014	1 April 2014
2	Internal controls	Companies Act	U, I	1 April 2014	1 April 2014
3	Mandatory audit firm rotation	Companies Act	U, I	Latest for the audit of financial year beginning 1 April 2017	Latest for the audit of financial year beginning 1 April 2017
4	Changes to corporate structure	Companies Act	U, I	1 April 2014	1 April 2014
5	Duties of directors	Companies Act	I	1 April 2014	1 April 2014
6	Director for small shareholders	Companies Act	I	Available from 1 April 2014	Available from 1 April 2014
7	Lady director	Clause 49; Companies Act	U, I	1 October 2014	1 April 2015
8	Independent directors	Clause 49; Companies Act	I	5 years with effect from 1 October 2014	5 years with effect from 1 April 2014
9	Audit committee	Clause 49; Companies Act	I	1 October 2014	1 April 2014
10	CSR	Companies Act	I	1 April 2014	1 April 2014

Source: Grant Thornton India LLP research

01 Related Party Transactions (RPTs)

The Act mandates that all RPTs, even those in the ordinary course of business and at arm's length, are approved by the Audit Committee. If not in ordinary course or not at arm's length, RPTs also require Board approval, and should be disclosed in the Board's report along with justifications for entering into such RPTs. Further, shareholders' approval (through a special resolution where interested party cannot vote) may also be required if the company has a capital more than Rs 10 crore and the related party transactions meet quantitative threshold vis-à-vis turnover and net worth. Further, for listed companies under the revised Clause 49, there is a new definition of 'related party' which is significantly broader than that under the Act, and there are similar approval requirements without any exemption for RPTs in the ordinary course of business and at arm's length.

ACTION: Evaluate all RPTs, and establish triggers for necessary approvals. Consider implications of the related party concerned not being eligible to participate in the approval vote.

02 Internal Controls

Directors in the Board report need to state if they have laid down internal financial controls to be followed and whether there are proper systems to ensure compliance with the provisions of 'all' applicable laws and, if such controls and systems are adequate and have been operating effectively. This requirement establishes India's very own equivalent of SOX 404 (Section 404 of the Sarbanes-Oxley Act, USA). However, unlike SOX 404 which includes in its scope only internal controls over financial reporting, the Act has gone further and includes company-wide controls for orderly and efficient conduct of its business.

ACTION: This is a significant new compliance requirement, particularly when coupled with the requirement for auditors to also attest to the design and operating effectiveness of such internal financial controls. In order for Directors to confirm the effectiveness of design and operation of controls, and to avoid adverse comments in the auditors' report, immediate steps need to be taken to appoint an internal team or an external firm to ensure compliance. It should also be noted that compliance is not only required as of 31 March 2015 but also throughout the year beginning 1 April 2014.

03 Mandatory Audit Firm Rotation (MFR)

The Companies Act provides for MFR for all listed and certain class of unlisted companies such that audit firms completing a maximum term of 10 years need to be rotated out on 31 March 2017, with a minimum 5-year cooling-off period thereafter. Prohibited non-audit services that cannot be provided by the audit firm have also been significantly enhanced.

ACTION: Planning for auditor succession should be considered carefully and sufficiently in advance. Testing more than one prospective auditor for smaller group companies immediately, deciding separate audit and non-audit service providers and ensuring they maintain their independence should be considered. Also, the new requirement to mandatorily prepare consolidated financial statements may require the need to evaluate whether the same audit firm should be engaged for all group companies. Data shows maximum accounting errors happen in the first year of an auditor change, and giving multiple potential audit firms exposure in advance would help lower this risk.

Changes to Corporate Structure 04

A. The Act provides restrictions on a company to give loans, guarantees, etc. to any of its directors, including companies in which such individuals are directors or have other interests, other than in the case of wholly owned subsidiaries.

ACTION: An assessment of the offices held by the Directors in other group companies. Funding group companies by way of loans, guarantees, etc. is common practice, and even temporary inability to do so might put key projects and operating activities into jeopardy.

B. Further, the Act provides that a company shall not make investments through more than two layers of investment companies. The term 'investment company' is defined to mean a company whose principal business is the acquisition of shares, debentures or other securities. Whilst, no transition period is prescribed in the Act, the requirement is being interpreted to be applicable only prospectively. The Act now also mandates the preparation of consolidated financial statements and fixes the financial year-end for all companies to be 31 March.

ACTION: Evaluate group structure and capital/ funding structure to realign them to conform to the new requirements, and to minimise compliance burden on consolidation. Real estate, construction, infrastructure companies, and large Groups would particularly need to look into this aspect immediately.

Duties of Directors 05

For the first time, the Act sets out the duties of Directors, and these appear extremely onerous and in some cases open to wide interpretation. For example, duties include that a Director shall act in good faith to promote company's objects to benefit members, company, employees, and the community and for the protection of environment. Also, a Director shall not involve in situations in which he may have direct or indirect conflict of interest.

ACTION: Educate all executive and independent Directors so that they fully understand and comply with these new enhanced duties. Benchmark Board and Committee decisions to ensure they balance the needs of the specified stakeholders. Evaluate any potential current conflicts for all Directors. Consider obtaining or enhancing Directors' and Officers' liability insurance.

Director for Small Shareholders 06

The Act confers powers to small shareholders of a listed company to appoint a Director to represent their interests on the Board.

ACTION: If a company itself opts to appoint such a Director, it is not required to have such Director elected by the small shareholders. Consider using the option to appoint such a Director in order to choose an individual who is professionally competent and otherwise befitting of the company's Board.

07 Lady Director

The Companies Act provides that listed companies and public companies that meet certain criteria should appoint at least one lady as a director (independent or executive) by 1 April 2015, though the revised Clause 49 has a deadline of 1 October 2014 for the same.

ACTION: Considering the short compliance window, companies should actively start looking for a lady director now. Ladies from the promoter family, unless active in the business or suitable, should be avoided, both for reasons of Governance and other practical considerations.

08 Independent Directors

The Act provides the maximum tenure of an independent Director as two consecutive terms of 5 years with past period not being counted. Under the revised Clause 49 past tenure is to be considered for maximum of 5 years, and it has to be complied from 1 October 2014. Thus, an individual who has already served as an independent Director for five years or more in a company as on this date shall be eligible for re-appointment for only one more term of up to five years.

ACTION: Whilst this does not create an immediate issue, one should plan ahead to identify suitable pipeline for future independent Directors. With a cap of 7 listed companies for any one independent Director with effect from 1 October 2014, we expect demand to outstrip supply significantly.

09 Audit Committee

The Act, similar to the requirements of the existing Clause 49, now makes it mandatory for majority of members of Audit Committee including its Chair to have the ability to read and understand financial statements. Further, the role and responsibilities of Audit Committee members have been expanded significantly both under the Act and under the revised Clause 49.

ACTION: Evaluate whether audit committee members meet the aforesaid criteria and will be able to fulfill the responsibilities defined, and in case not, the find suitable replacements before the deadline.

10 Corporate Social Responsibility (CSR)

The Act provides that companies, including amongst others, those with profits more than Rs 5 crore, to constitute a Corporate Social Responsibility (CSR) committee of the Board, contribute 2 percent of their net profit towards CSR or explain reasons for non-compliance, and provides the list of items which are allowed and prohibited for such contribution.

ACTION: Constitute requisite CSR committee, and re-evaluate CSR strategy to comply with the norms, or plan for explanation in the Director's report.

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