Companies Act 2013

Impact on Accounting and Auditing

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Agenda

Key provisions of the Companies Act 2013 relating to:

- Financial Statements
- Consolidation
- Audit and Auditors
Effective Date

Accounts, audit and auditor related provisions were made effective from 1 April 2014

MCA clarification dated 4\textsuperscript{th} April, 2014:
Financial statements and audit reports relating to financial years that commenced prior to 1 April 2014 will be governed by the provisions, rules and schedules of Companies Act, 1956

All other provisions of the above chapters however apply from 1 April 2014
Key changes relating to financial statements
Financial year

► All companies to follow uniform financial year, i.e., 1 April to 31 March

► Transitional period
  ► Existing companies required to align its financial year within 2 years of commencement of new law

► Exception/ exemption
  ► Holding or subsidiary of a company incorporated outside India and required to follow different financial year for consolidation of financial statements outside India
  ► Tribunal’s approval required
Financial year

Key impacts

- Financial year cannot be longer or shorter than 12 months
- No need for separate tax financial statements
- Impact on industries in cyclical/seasonal businesses
- Practical challenges for directors, audit committee members and auditors

Potential issues

- Exemption is not automatic – Need to apply to tribunal
- No exemption for Indian associates or joint ventures
- For foreign subsidiary of Indian parent, CFS will be prepared in India
  - Hence exemption for different financial year cannot be availed
- Relief contained in AS 21, AS 23 and AS 27 to use different period financial statements may become irrelevant for Indian subsidiaries, associates and joint ventures
Key provisions

- Currently notified AS to prevail until new AS prescribed by Central Government/NFRA
- Format of financial statements completely in line with revised schedule VI
- Additional requirements prescribed for preparation of consolidated financial statements
- New Act defines the term financial statements to include:
  - Balance Sheet
  - Profit & Loss
  - Cash Flow Statement
  - SOCIE, if applicable
- One person, small and dormant company exempt from preparing cash flow statement
Financial statements

Key impacts

- Exemption from preparation of cash flow statement under the Act is different from AS 3

- More companies to prepare cash flow statement under the new Act

- Till AS 3 is amended, stricter of two requirement will apply
  
  E.g. one person company with a turnover greater than Rs. 50 crores is not required to prepare cash flow statement under the Act
  
  However, it will prepare cash flow statement as required by AS 3

- The requirement to prepare SOCIE will apply only under Ind-AS
## Financial statements

<table>
<thead>
<tr>
<th></th>
<th>Listed companies</th>
<th>Turnover &gt; 50 crores</th>
<th>Turnover =&lt;2 crores (or higher amount as prescribed)</th>
<th>Turnover &gt; 2 crores (or higher amount as prescribed)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current requirement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Flow Statement</td>
<td>√</td>
<td>√</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>SOCIE</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td><strong>New requirement</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash Flow Statement</td>
<td>√</td>
<td>√</td>
<td>X</td>
<td>√</td>
</tr>
<tr>
<td>SOCIE (where applicable)</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
</tr>
</tbody>
</table>
New depreciation schedule: Component accounting

- **Depreciation** is defined as systematic allocation of depreciable amount of an asset over its **useful life**.

- Useful life is:
  - Period over which an asset is expected to be available for use, or
  - Number of production/similar units expected to be obtained from its use by the entity

- **Component accounting**: Useful life of part of an asset to be determined separately
  - If its cost is significant vis-à-vis total cost of the asset
  - Its useful life is different from the remaining parts

Thus, each such significant part must be depreciated over its respective useful life.

- **Transitional provisions**
  - WDV to be depreciated over the remaining useful life determined as per Sch II.
  - If remaining life is nil as per Sch II, WDV to be adjusted with retained earnings
New depreciation schedule: Overview

- Prescribes useful lives of various assets instead of SLM/ WDV rates
- Useful lives prescribed for tangible assets
- Residual value not to exceed 5% of original cost
- No separate rate for double/ triple shift; depreciation to be increased by
  - 50% for the period of double shift use
  - 100% for the period of triple shift use
- No lives prescribed for intangible assets
  - Accounting Standards to govern amortisation of intangible assets
  - BOT/BOOT/other PPP assets to be amortised @ actual revenue/total estimated revenue
- Useful lives/residual values higher than those prescribed permitted
  - Provided justification is disclosed in financial statements
- Companies regulated by any other law, e.g., electricity companies
  - Useful live/residual value prescribed by regulatory body to prevail
New depreciation schedule: key impacts

► Companies may choose to adopt higher/ lower useful life if the same can be justified
  ► Depreciation across companies may vary even within the same industry

► Companies may follow any suitable method of depreciation
  ► It may be possible to follow the unit of production method which is currently specifically prohibited

► No specific requirement to charge 100% depreciation on assets whose actual cost does not exceed Rs. 5000

► Principles of component accounting introduced
  ► AS-10 and AS-6 may need to be revised accordingly
## New depreciation schedule: key impacts

### Comparison of useful life for certain assets

<table>
<thead>
<tr>
<th>Assets</th>
<th>Schedule II</th>
<th>Schedule XIV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buildings (other than factory buildings) Other than RCC Frame Structure</td>
<td>30</td>
<td>58</td>
</tr>
<tr>
<td>Plant &amp; Machinery (General)</td>
<td>15</td>
<td>21</td>
</tr>
<tr>
<td>Computers and data processing units</td>
<td></td>
<td></td>
</tr>
<tr>
<td>▶ Servers and networks</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>▶ End user devices, such as, desktops, laptops, etc.</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>Office equipment</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Furniture &amp; Fittings</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>Motor Vehicles</td>
<td>8</td>
<td>10</td>
</tr>
<tr>
<td>Continuous Process Plant</td>
<td>25</td>
<td>18</td>
</tr>
</tbody>
</table>
## Utilization of securities premium

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Companies Act, 1956</th>
<th>Companies Act 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Specified class</td>
<td>Others</td>
</tr>
<tr>
<td>Issue of bonus shares</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Writing off equity share issue expenses</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Writing off debenture issue expenses</td>
<td>✓</td>
<td>X</td>
</tr>
<tr>
<td>Writing off preliminary expenses</td>
<td>✓</td>
<td>X</td>
</tr>
<tr>
<td>Providing for premium payable on redemption of preference shares / debentures</td>
<td>✓</td>
<td>X</td>
</tr>
</tbody>
</table>

The above restrictions for prescribed class (yet to be prescribed) of companies will bring their accounting treatment in line with AS.

**Issue:** It is still not clear if above restriction will be prospective or retroactive
National Financial Reporting Authority (NFRA)

- Central Government to setup a central regulatory authority for various accounting and auditing matters under the Act
  - Chairperson/ full-time members to be independent of audit/consultancy firms during appointment and upto 2 years thereafter
  - To be headed by an eminent expert appointed by Central Government

- Role/ responsibilities:
  - Make recommendations to the Central Government on formulation of accounting and auditing standards and policies
  - Monitor and enforce compliance with accounting and auditing standards
  - Oversee the service quality of professions associated with ensuring compliance with such standards and suggest measures for improvement
  - Provide consultation to the Central Government on ordering additional matters to be included in the Auditor’s Report
  - Investigate matters of professional misconduct by CAs
National Financial Reporting Authority (NFRA)

► Current Status

► Provisions relating to NFRA are yet to be notified
► Rules clarify that Accounting Standards (AS) under the 1956 Act will continue until new AS are prescribed by Central Government
► Until NFRA is constituted, Central Government may prescribe AS as recommended by ICAI in consultation with NACAS
► ICAI will continue to perform its existing functions for the time being
  ► Formulation of Accounting and Auditing Standards
  ► Monitoring and enforcing compliance with Accounting and Auditing Standards
  ► Disciplinary proceedings
Re-opening of accounts

► **Under Order of Court/Tribunal**

Re-opening of accounts may be ordered by Court/Tribunal only on application by the Central Government, Income-Tax Authorities, SEBI, Other Regulatory Body or Authority and where:

- Accounts were prepared in a fraudulent manner
- Company’s affairs were mismanaged casting a doubt on reliability of financial statements

► **Voluntary Revision**

Voluntary revision of financial statements/ board report permitted for any of the 3 preceding financial years

- Detailed reasons required to be disclosed in the board report
- Company needs to obtain specific approval from Tribunal for restatement
- Central Government to make rules including those relating to auditor’s functions for revisions

► The above provisions are however yet to be notified
Key changes relating to consolidation
Consolidated financial statements (CFS)

► Preparation of CFS mandatory for all companies having subsidiaries
  ► Currently, unlisted companies are not required to prepare CFS

► All requirements pertaining to preparation, adoption and audit will also apply to CFS

► For preparation of CFS, the term “subsidiary” includes associate and joint ventures
  ► Companies without any subsidiary but having only associates and/or joint ventures will also need to prepare CFS – this conflicts with AS-21

► Statutory format for preparing standalone financial statements mandated for CFS as well
Following additional disclosures required in CFS:

- Amount and percentage of net assets and profit/loss of each subsidiary, associate and JV vis-à-vis consolidated net assets have to be disclosed indicating Indian or foreign entity separately.

- A statement containing salient features of the financial statements of Associates and Joint Ventures will also have to be prepared.
  - Currently such statement is required only for Subsidiaries.

- Format of such statement has also been specified in the Rules.
Consolidated financial statements (CFS)

► Potential issues

► The terms “Control”, “Subsidiary” and “Associate” are defined very differently as compared to Accounting Standards (AS)
  ► It was not clear which definition would prevail for determining which entities would get consolidated

► Central Government may provide for the manner of consolidation of accounts
  ► This may result in a method of consolidation different from notified AS

► Clarifications

► The rules clarify that consolidation will have to be done in accordance with applicable Accounting Standards and Schedule III
  ► Meaning of the terms “control”, “subsidiary” and “associate” as per AS to be applied for consolidation
  ► Method of consolidation shall be as per AS only
Key changes relating to the auditor
Qualification and remuneration

Who can be appointed

- Only a Chartered Accountant is eligible for appointment as auditor
- A firm with majority of partners practising in India may be appointed as auditor
  - The existing law requires all partners to be practising in India
- Where limited liability partnership is appointed, only partners who are chartered accountants authorized to act and sign as auditors may be appointed as auditor

Auditor remuneration

- To be fixed in general meeting or in a manner determined therein
- In addition to audit fee, it will also include:
  - out of pocket expenses
  - cost of facilities extended to him
Appointment and tenure of auditors

- 5 years tenure introduced instead of current system of annual appointment at every AGM
  - Audit Committee recommendations to be considered for all auditor appointments
  - Audit Committee to consider any order or proceeding relating to professional conduct against proposed auditor pending before ICAI or any Court or any competent authority

- Ratification of appointment by members required at every AGM
  - Ratification shall be carried out by way of ordinary resolution
  - In case of non-ratification, Board shall appoint another auditor

- Where no auditor is appointed or re-appointed at any AGM, the existing auditor will continue (provided max. tenure not exceeded)
  - Currently non-appointment of auditor at AGM results in vacancy which Central Government is required to fill
Rotation of auditors

The following class of companies cannot appoint or re-appoint an audit firm as auditor for more than 2 terms of 5 consecutive years (1 term of 5 consecutive years in case of an individual auditor)

- all listed companies
- all unlisted public companies having paid up share capital of Rs.10 crore or more
- all private limited companies having paid up share capital of Rs.20 crore or more
- all companies having paid up share capital below aforesaid threshold limits, but having public borrowings from financial institutions, banks or public deposits of Rs.50 crores or more.

After completion of the above term:

- Cooling-off period of 5 years
Rotation of auditors

► Rotation to apply retrospectively
  ► Period for which a firm held office as auditor prior to commencement of the Act would be counted for calculating 10 consecutive years

► Restriction to apply to the audit firm which has common partner(s) with the outgoing audit firm at the time of appointment

► Incoming audit firm shall not be eligible if such firm is associated with the outgoing auditor or audit firm under the “same network” of audit firms.
  ► “Same Network” has been defined to include firms operating hitherto or in future, under the same brand name, trade name or common control

► If a partner who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm:
  ► Such other firm will also be ineligible for appointment for 5 years
Rotation of auditors

► “Consecutive Years” has been defined to mean all the preceding financial years for which the firm has been the auditor until there has been a break by 5 years or more

► In case of joint audit, companies to ensure that all joint auditors do not complete their term in the same year

► Members of the company are further empowered to require
  ➢ Audit firm to rotate the audit partner and his team at such intervals as resolved by them, or
  ➢ Joint audit

► Transitional provision
  ➢ Every company covered by these requirements will need to comply with these requirements within 3 years from the date of commencement of new law i.e. April 1, 2014
Removal/ resignation of auditors

► Auditor appointed may be removed from his office before expiry of his term:
  ► By a special resolution of the company, and
  ► After obtaining prior approval of the Central Government

► An auditor who has resigned from the company:
  ► To file a statement indicating reasons and other facts with regard to his resignation within 30 days
Removal of auditors by Tribunal

- Tribunal may direct change of auditors, if it believes that:
  - Auditor has acted in a fraudulent manner, directly or indirectly, or
  - Abetted or colluded in any fraud by or in relation to the company, or its directors or officers
  - Tribunal may pass the order *suo-moto*, or on application of Central Government or any person concerned

- Auditor against whom an order is passed by Tribunal
  - Cannot be appointed auditor of any company for 5 years from order date
  - May be imprisoned for upto 10 years and fined upto 3 times the amount of fraud involved

- Pending litigation in the Supreme Court, provisions relating to the Tribunal have not yet been notified
Independence norms and related issues

- Auditors’ independence requirements significantly widened
  - May result in ineligibility in a large number of cases

- A person is not eligible for appointment as auditor if the **person or, his relative or partner**:  
  - **Holds any security or interest** in the company, its subsidiary, holding, associate or fellow subsidiary  
    - **Relative** may hold security/interest of face value not exceeding **Rs 1 lac**

- **Is indebted to the company** or its subsidiary, holding, associate or fellow subsidiary in excess of **Rs. 5 lacs**

- **Has given guarantee or provided any security** in connection with the indebtedness of any third person to the company or its subsidiary, holding, associate or fellow subsidiary in excess of **Rs. 1 lac**
“Relative” is defined to include:

- Members of HUF
- Spouse
- Father (including step-father)
- Mother (including step-mother)
- Son (including step-son)
- Son's wife
- Daughter
- Daughter's husband
- Brother (including step-brother)
- Sister (including step-sister)

Potential issues:

- Financially independent relatives not excluded
- Auditor may be disqualified due to investments made inadvertently by such relatives
- Intentional investment by estranged relative may disqualify the auditor
- Difficult to administer and manage such information
Independence norms and related issues

- Persons not eligible for appointment as auditor also include:
  - Person or firm having **business relationship** with the company, its subsidiary, holding, associate, fellow subsidiary or subsidiary of associate company whether **directly or indirectly**
  
  - **Business relationship** has been defined as
    - Professional services permitted to be rendered under the CA Act, and
    - commercial transactions which are *in the ordinary course of business of the company* at arm’s length price - like sale of products or services to the auditor, *as customer, in the ordinary course of business*, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses
Independence norms and related issues

- Potential issues and possible clarifications
  - The Term ‘**Directly or indirectly**’ is undefined. Definition of such term u/s 144 may be used for this purpose: “rendering of services by the firm itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity in which the firm or any partner of the firm has significance influence or control, or whose name or trade mark or brand is used by the firm or any of its partners”
  - Hence, restriction of business relationship will extend to **affiliated entities** as well
  - A strict literal interpretation of the term “**and such other similar businesses**” does not appear to be the intention
  - Should be interpreted to mean “any business” as long as the transaction is at arm’s length
Independence norms and related issues

Potential issue

In order to be exempt, the commercial transactions must not only be at arm's length but must also be in the ordinary course of business for both the auditee company and the auditor

Example 1

An audit client which is not a developer but has extra office space,

The auditor cannot take it on rent even if he pays the market rate for it since such transaction is not in the company's ordinary course of business

Example 2

If an audit firm wants to hire office space, that will be in the audit firm's ordinary course of business

If a partner wants to buy residential space from a developer audit client, it may be restricted since it is not in the auditor's ordinary course of business

If unintentional, MCA should issue a clarification
Independence issues – Auditor not to render certain services

- Auditor cannot render following services to the auditee company, either directly or indirectly:
  - Accounting and Book Keeping services
  - Internal Audit
  - Investment Banking Services
  - Design & Implementation of Financial Information System
  - Outsourced Financial Services
  - Actuarial Services
  - Investment Advisory Services
  - Management Services
  - Any other prescribed services

- Restrictions also apply to auditee’s holding and subsidiary companies
Independence issues – Auditor not to render certain services

Potential issue

The term “management services” has not been defined

Management Services should be viewed as services that involve undertaking responsibility as management

The IESBA Code of Ethics defines “management responsibilities” as: “Leading and directing an entity, including making significant decisions regarding the acquisition, deployment and control of human, financial, physical and intangible resources”

Definition or clarification on the aforesaid lines from MCA is required
Independence issues – Auditor not to render certain services

► The terms “directly or indirectly” is defined to include:
  ► Audit firm or any of its partners
  ► Its parent, subsidiary, associate entity
  ► Any other entity in which the firm/its partner(s) has significant influence or control or whose name/trade mark/brand is used by the firm/its partner(s)

► Hence, restriction of prohibited services will extend to affiliated entities as well

► Transitional provision
  ► Compliance to be ensured before closure of the first financial year after commencement of the new law
Other restrictions

- Persons not eligible for appointment as auditor also include:
  - Person or partner of a firm holding appointment as auditor of more than 20 companies at the date of appointment or re-appointment

- Potential issues
  - Restriction applies to private companies as well
  - Erstwhile Act restricted number of audits to 20 public companies i.e. excluding private companies
  - ICAI restricted the total number of audits to 30 companies (including private companies)
  - Auditors/Audit firms having more than 20 audits per partner will be automatically disqualified, resulting in casual vacancy
  - Will force all companies to search for replacement of such auditors immediately causing significant hardship to both auditor and auditee
  - Insufficient number of CAs practising audit in India to audit all companies
Other restrictions

- Persons not eligible for appointment as auditor also include:
  - Person convicted by a court of an offence involving fraud and 10 years have not elapsed from the date of conviction
    - In case of appointment of partnership firm/LLP, disqualification may be interpreted to apply only to partner concerned and not the entire firm
  - Person whose subsidiary or associate or any other form of entity is engaged on the date of appointment in providing services that an auditor is prohibited to render u/s 144
    - In the absence of any clarification, disqualification regarding prohibited services should be interpreted to apply only if rendered to proposed auditee company
  - Person whose relative is a Director or employed as Key Managerial Personnel in the company
Key penal provisions

- **Penalties for contravention**
  - On contravention of any provision relating to auditor rotation, reporting responsibilities, prohibited services etc. the auditor is punishable with a minimum fine of Rs. 25,000 which may extend to Rs. 5 lacs.
  
  - If such contravention is committed knowingly or wilfully with an intention to deceive the company, its shareholders, creditors or tax authorities he is punishable with imprisonment for a term that may extend to 1 year and with a minimum fine of Rs. 1 lac which may extend to Rs. 25 lacs.

- An auditor convicted as above shall be liable to both:
  - Refund the remuneration received by him to the company, and
  - Pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.
Key penal provisions

► Penalties for fraud
  ► If it is proved that partner or partners of an audit firm have acted in a fraudulent manner or have abetted or colluded in any fraud in relation to or by the company or its directors or officers, the liability, whether civil or criminal as provided in the Act or in any other law in force, shall be of the partner or partners of audit firm and of the firm jointly and severally.

► Clarification
  ► Rules clarify that in case of criminal liability of any audit firm, the liability other than fine shall devolve only on the concerned partner or partners who acted fraudulently or abetted or colluded in the fraud.

► Implications
  ► Clarification issued is only with respect to criminal liability but not civil liability. Hence, joint and several liability of the partners and the firm would be enforced for civil liability, even if all the Partners were not involved in committing fraud.
Class action suit

- Members or depositors may seek damages or suitable action from or against the auditor in connection with any of the following:
  - Any improper or misleading statement in audit report
  - Any fraudulent act or conduct
  - Any unlawful or wrongful act or conduct
    - No distinction has been made between willful or grossly negligent acts and errors caused unintentionally

- Where the auditor is a firm, liability shall be that of
  - the audit firm, as well as
  - every erring partner

- Provisions relating to class action suit are yet to be notified
Thank You