

Companies Act - Auditors Perspective

CA. Jayesh Gandhi

Agenda

- ▶ Appointment of Auditors
- ▶ Challenges in CARO reporting
- ▶ Securities premium
- ▶ Share application money
- ▶ Free reserves & DRR
- ▶ Merger / acquisition
- ▶ Consolidated financial statements
- ▶ Expected Credit Loss
- ▶ Key audit matters
- ▶ NFRA

Appointment of Auditors

- ▶ Auditor can be appointment for 5 years tenure at AGM
 - ▶ Audit Committee (AC) recommendations to be considered for all auditor appointments
 - ▶ AC to consider any order/ proceeding relating to professional conduct pending against proposed auditor before ICAI/ any Court/ any authority
 - ▶ Show-cause notice by ICAI/RoC should not be taken as pending proceeding
- ▶ Board to document reasons for not accepting Audit Committee recommendation
 - ▶ Section 177(8) requires such disclosures in Board report
 - ▶ This will create pressure on Board to accept AC recommendation
- ▶ Ratification of appointment by members is now not required at each AGM after recent amendment
 - ▶ Any change in auditor before 5 years will be treated as removal of auditor
 - ▶ For resignation of auditors before the expiry of the term will require reasoning to be filled with RoC
- ▶ Casual vacancy
 - ▶ Board to fill vacancy within 30 days
 - ▶ If vacancy is due to resignation, approval is required in General Meeting within 90 days of Board's recommendations

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.50 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

For any change in status of a Company, when the rotation is required ?

Independence norms

- ▶ 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 lakh
 - ▶ If threshold is exceeded, corrective action will have to be taken by the auditor within 60 days
- ▶ Is indebted to the Company or its subsidiary, holding, associate or fellow subsidiary in excess of Rs 5 lakhs
- ▶ 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 lakh

For branch auditors same rule applies

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
- ▶ Restrictions also apply to auditee's **holding** and **subsidiary** companies, whether located within or outside India
- ▶ Permissible services must be approved by Board/Audit Committee

CARO Applicability

CARO 2016 shall apply to EVERY COMPANY, including a Foreign Company except:

- ▶ Private company not being a holding or a subsidiary company of a public company:
 - ▶ With paid up capital and reserves and surplus not more than Rs 1 crore
 - ▶ Having borrowings from any bank or any financial institution not exceeding Rs 1 crore anytime during the year and
 - ▶ Having total revenue not exceeding Rs 10 crores
- ▶ Banking Companies
- ▶ Insurance Company
- ▶ Companies Incorporated with Charitable objects(Section 8)
- ▶ One Person company as defined under section 2(62) of the 2013 Act
- ▶ Small Company as defined under 2(85) of the 2013 Act

- ▶ **ICFR applicability**
 - ▶ Not applicable to One person company or small company and
 - ▶ Private company having turnover of less than Rs. 50 crores as per latest audited FS and borrowings of less than Rs. 25 crores at anytime during the FY

Challenges in CARO reporting

Clause 3 (iii)

The Company has not granted any loans, secured or unsecured, to companies, firms, Limited Liability Partnerships or other parties covered in the register maintained under section 189 of the Companies Act, 2013

- ▶ Section 184(1) and section 189 (2) requires directors and KMPs to give general notice of their interest in other entities
- ▶ Under the Companies Act 1956, the details of such entities were required to be incorporated in the register maintained under section 301. It is not clear, whether the same is required to be incorporated in the register maintained under section 189 of the current act
- ▶ If section 189 requires only contracts or arrangements covered under section 184 and section 188, one may have to consider entities with more than 2% shareholding of directors/KMPs
- ▶ Loan given to subsidiary companies whether gets covered ?
- ▶ Interest free loan given to subsidiary, whether to be considered as prejudicial?

Related Party Transactions

- ▶ Under clause 3 (xiii), compliance of section 177 and section 188 needs to be reported for RPT
- ▶ Section 177 deals with requirement of Audit Committee (AC)
- ▶ A company needs approval of the Audit Committee, if applicable, on all RPT and subsequent modifications thereto
 - ▶ Approval needed even if RPT are in the ordinary course of business and consummated at arm's length
- ▶ For the Company where there is no requirement for AC, only section 188 requirement will be applicable
- ▶ Section 188 is applicable only for specified transaction and not for all RPT transactions. It means that for transactions other than specified, for the Company where is no AC requirement, no approval is required
- ▶ Specified transactions as per section 188 are as follows:
 - ▶ Sale, purchase or supply of any goods or materials more than 10% of annual turnover or Rs 100 crore whichever is lower
 - ▶ Selling or disposing or buying a property of more than 10% of Networth or Rs 100 crore whichever is lower
 - ▶ Leasing of property of more than 10% of Networth or 10% of annual turnover or Rs 100 crore whichever is lower
 - ▶ Availing or rendering of any services of more than 10% of annual turnover or Rs. 50 crore whichever is lower
 - ▶ Appointment to any office or place of profit having monthly remuneration of more than Rs. 2.5 lakhs
 - ▶ Remuneration for underwriting of subscription of securities or derivatives more than 1% of networth

Related Party Transactions

- ▶ Neither the board approval nor the ordinary resolution of disinterested shareholders needed if the above transactions meet both the criteria:
 - ▶ Transaction is entered into the ordinary course of business
 - ▶ Transaction is at arms' length price
- ▶ For transactions not meeting either of the two criteria, at least approval of the board is needed
 - ▶ It is important for the auditors to ascertain as to how the two criteria are met. It is therefore advisable to have formal reporting to the AC / board in this respect
 - ▶ If specified transactions are beyond the limits specified, approval of members by ordinary resolution is required
- ▶ Members of the company, who are related parties, are not permitted to vote
- ▶ Transactions arising out of Compromises, Arrangements and Amalgamations will not attract the requirements of section 188 of the Companies Act, 2013 and the section 188 is not applicable to private companies

Transactions not in the ordinary course of business

Illustration – as given in SA 550

Complex equity transactions, such as corporate restructurings or acquisitions

Transactions with offshore entities in jurisdictions with weak corporate laws

Sales transactions with unusually large discounts or returns

Transactions with circular arrangements, for example, sales with a commitment to repurchase

Transactions under contracts whose terms are changed before expiry

The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged

Challenges in CARO reporting

Clause 3 (iv)

In respect of loans, investments, guarantees and security whether provisions of section 185 and 186 of the Companies Act, 2013 have been complied with ?

- ▶ Section 186 is applicable even to Private companies
- ▶ ‘Section 186 is applicable to loans to ‘any person’ or other body corporate. ‘Any person’ will not include any individual who is in employment of the company (as per The Amendment Act 2017)
- ▶ Section 185 is not applicable to private companies whose borrowings is less than twice its paid up capital or Rs 50 crore whichever is lower and there is no default in repayment

Loans to directors and subsidiaries

- ▶ 2013 Act prohibits advancing loan to and providing guarantee/ security for loan to any director or person in whom director is interested (Sec-185).
- ▶ Person in whom director is interested includes:
 - ▶ Any body corporate, the board, managing director or manager, whereof is accustomed to act in accordance with the directions or instructions of the board, or of any director or directors, of the lending company
- ▶ No possibility of seeking the Central Government approval to provide prohibited loans/guarantees/ security
- ▶ Restriction on loan does not apply to:
 - ▶ Making of loan to managing/ whole-time director as part of service condition extended by a company to all its employees or pursuant to any scheme approved through special resolution
 - ▶ A company, which in ordinary course of its business provides loans/guarantees/ securities and interest charged is not less than the bank rate declared by RBI
 - ▶ Any loan made, guarantee given or security provided by a holding company to its WOS company
 - ▶ Any guarantee given or security provided by a holding company for loan made by any bank or financial institution to its subsidiary company
 - ▶ Such loans should be utilised by a subsidiary company for its principle business activities

Loans and investments by a company

- ▶ All investment or loans or giving loans or providing guarantees/security to other body corporate requires unanimous board resolution
- ▶ If total investment, loans and guarantees exceeds higher of the following, special resolution of members is required:
 - ▶ 60% of paid up capital, free reserves and securities premium or
 - ▶ 100% of free reserves and securities premium
- ▶ 2013 Act extends restriction for provision of loan to/ guarantee/ security on behalf of any person or entity also
- ▶ In case of default in repayment of loan to public financial institution, their prior approval is required if it is beyond the limit specified
- ▶ Rate of interest cannot be lower than prevailing yield on one year, three year, five year or ten year Government security closest to tenor of loan even for WOS
- ▶ Full disclosure required in the financial statements of the loans given, investments made or guarantee given/ security provided along with purpose
- ▶ Investment in mutual funds are not covered under this section as it is not a body corporate or person

Challenges in CARO reporting

Clause 3 (xvi)

Whether the company is required to be registered under section 45-IA of the Reserve Bank of India Act, 1934 and if so, whether the registration has been obtained.

- ▶ Registration with RBI is required if the Company is carrying NBFC activities
- ▶ As per RBI Act, if the company's financial assets constitute more than 50% of the assets and income from financial assets constitute more than 50% of the gross income, Company will be treated as carrying NBFC activities
- ▶ Financial assets include all investments including mutual funds investments, outstanding loan, etc,
- ▶ RBI has clarified that bank deposits will not be considered as financial assets
- ▶ One needs to be careful in case of holding company structure or companies not having substantial other activities or new companies in the initial stage
- ▶ For holding company, it is better to get registered as NBFC – CIC (core investment company) so that section 186 is not applicable and as CIC enjoys lot of exemptions from provisions applicable to NBFC

Utilization of securities premium

Purpose	Companies Act, 2013	
	IND AS Companies	Others
Issue of fully paid equity shares as bonus shares	√	√
Issue of fully paid preference shares as bonus shares	X	√
Writing off preliminary expenses	X	√
Writing off equity share issue expenses	√	√
Writing off preference share/ debenture issue expenses	X	√
Providing for premium payable on redemption of preference shares/debentures	X	√
Buy- back of its own shares or other securities	√	√

Share application money

- ▶ Section 42 provides that in case private placement securities need to be allotted within 60 days of receipt of share application money. Otherwise the money needs to be refunded within 15 days with interest.
- ▶ Companies (Acceptance of Deposits) Rules, 2014, provides exemption for share application money
- ▶ Previously many companies used to keep share application money for a long period of time. Now the said rules provide that if the application money is not refunded within 15 days from non allotment within 60 days of receipt of application money, it will be treated as public deposits. The money needs to be refunded in cash and not in any other form
- ▶ Under previous Rules, any amount received by a private company from its director or its shareholders were treated as exempt deposits provided declaration to the effect that money has not been paid out of borrowings
- ▶ The new Rules provide exemption only for its directors and relatives

Free Reserves

- ▶ Free reserves means reserves as per the latest audited balance sheet but will not include
 - ▶ Unrealised gains, notional gains or revaluation of asset or
 - ▶ Any change in carrying amount of asset or of a liability recognised as equity, including surplus in P&L on measurement of the asset or liability at fair value
- ▶ Unrealised loss will not be considered for calculation of free reserves but unrealised gain will be considered.
- ▶ As per IND AS, there will be many assets and liabilities which will require fair valuation as at balance sheet date, the effect of which would have been taken to P&L. As per above definition, it requires an adjustment for arriving at free reserves. This may cause practical difficulties to identify and monitor such items on a regular basis
- ▶ The items which are going into OCI also need to be reviewed for considering as part of free reserves
 - ▶ Actuarial gain or loss on defined benefit plans – to be considered
 - ▶ Fair value adjustment to equity – not to be considered

Debenture redemption reserve (DRR)

- ▶ Company is required to create DRR out of profits available for payment of dividend for purpose of redemption of debentures
- ▶ No DRR is required for All India Financial Institutions and Banks
- ▶ For NBFC DRR of 25% of the value of debentures needs to be created for debentures issued through public issue and no DRR will be required if issued privately
- ▶ For other companies DRR will be 25 % irrespective of debentures issued publicly or privately
- ▶ Money market instruments such as commercial papers, certificate of deposit, etc., are not to be treated as debentures

Mergers / Acquisition

▶ Effective date of merger/acquisition

- ▶ As per section 232, a scheme of arrangement is required to mention appointed date, which shall be deemed to be the effective date.
- ▶ Section 232 (3) provides obtaining certificate from Company auditor to confirm the accounting treatment given in the scheme is in line with accounting standards
- ▶ If court has specified any other date, then that date will be the effective date
- ▶ As per IND AS 103, Business Combination,
 - ▶ Effective date will be the acquisition date which will be the date on which company obtains the control of the acquiree.
 - ▶ Date of control will be generally the date on which acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree
- ▶ If the effective date is not in line with IND AS 103, ITFG requires Company to disclose the fact in the FS and reporting by the auditor as EOM

Consolidated financial statements

- ▶ Definition of subsidiary, joint venture and associate company under the Companies Act are different than definition under IND AS, such as for potential voting rights
- ▶ For preparation of CFS, one needs to apply principle of consolidation as per IND AS
- ▶ For other purposes, definition under Companies Act shall be applied
- ▶ Only listed companies are required to place subsidiary financial statements on its website. However, both listed and non-listed companies are required to provide subsidiary financial statements to a member of the Company who demands for it

Expected Credit Loss (ECL)

- ▶ ECL is different from incurred loss approach followed in earlier GAAP
- ▶ Credit losses are defined as the difference between the contractual cash flow due to the entity and cash flow that entity expect to receive
- ▶ Difference is discounted either at original effective interest rate or any other appropriate adjusted discounted rate
- ▶ ECL can be computed by 2 approaches: 1) General approach 2) Simplified approach
- ▶ General Approach: which is mainly used by banks, NBFC etc...
 - ▶ $ECL = EAD \times PD \times LGD \times D$
where EAD = Exposure at Default (Outstanding balance along with interest)
PD = Probability of Default (expected % of default over the period)
LGD = Loss Given Default (% of loss on the basis of expected recovery)
D = Discounting factor (for present value)
- ▶ Simplified approach is based on historical ageing experience. For each ageing bucket estimated % of non recovery is determined considering past experience and movement in ageing bucket over the period of time. This approach is generally used for Trade receivables and other receivables.

Key Audit Matters (KAM)

- ▶ As auditors, SA 701 requires auditors to communicate with those charged with governance:
 - ▶ Matters that has determined by auditors to be a KAM
 - ▶ Communicate preliminary views about KAM at the time of discussing planned scope and timing of audit with the management and audit committee
 - ▶ Further discussion during the course of audit when communicating about audit findings
- ▶ Determination of KAM is based on the results of the audit or evidence obtained throughout the audit.
- ▶ Benefits of KAM includes:
 - ▶ Enhanced communication between auditors and investors, as well as those charged with corporate governance
 - ▶ Increased user confidence in audit reports and financial statements
 - ▶ Increased transparency, audit quality, and enhanced information value
 - ▶ Increased attention by management and financial statement preparers to disclosures referencing the auditor's report
 - ▶ Renewed auditor focus on matters to be reported that could result in an increase in professional skepticism
 - ▶ Enhanced financial reporting in the public interest

NFRA

- ▶ National Financial Reporting Authority (“NFRA”) was notified as an independent regulator of accounting and auditing on March 21, 2018
- ▶ **Role of NFRA**
 - ▶ Recommendations on formulation and laying down of accounting and auditing policies and standards for adoption by companies or their auditors
 - ▶ Monitor and enforce compliance with accounting and auditing standards
 - ▶ Oversee the quality of service of the professions associated with ensuring compliance with such standards and suggest measures required for improvement in quality of service

NFRA

▶ Powers of NFRA

- ▶ Power to investigate either suo moto or on reference made to it by Central Government
- ▶ No other body to initiate or continue proceeding which is taken up by NFRA
- ▶ Same powers as are vested in a civil court under the Code of Civil Procedure, 1908
- ▶ Power to make order for imposing penalty and debarring member or the firm from engaging himself or itself from practice as member of ICAI

