

7.1 STATUTORY AUDITS

7.1.1 Requirement of Rotation

i. Is rotation of auditors mandatory for all sorts of companies?

No. The requirement for rotation of auditors is provided in Section 139(2) of CA, 2013. The section provides that every listed company and such class of companies as prescribed by way of rules shall comply with the requirement for rotation of the auditors. Rule 5 of the Companies (Audit and Auditor) Rules, 2014 provides for the classes of companies and excludes one person companies and small companies from compliance of the sub-section. The class of companies include:

- a.* unlisted public companies having paid up share capital of rupees ten crores or more;
- b.* private limited companies having paid up share capital of rupees twenty crores or more;
- c.* companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more

Therefore all listed companies and the companies mentioned in a. to c. above will have to comply with the requirement for rotation of auditors.

ii. Is rotation of auditing partner mandatory under the CA, 2013?

CA, 2013 does not lay down any mandatory rotation of the auditing partner. In this regard, Section 139(3) of the CA, 2013 merely empowers the members

to prescribe for rotation of auditing partner and his team at such intervals as they may deem appropriate.

It is pertinent to note here that the RBI, vide its circular dated 10th November, 2014 revised the regulatory framework for NBFCs¹²¹, including changes in the corporate governance regime. As per the revised framework on corporate governance, the RBI Guidelines for 'Rotation of partners of the statutory auditors audit firm' dated December 12, 2005, which was currently recommendatory, has been made mandatory for all non-deposit taking NBFCs (NBFC-D) and systematically non-deposit taking (NBFC-ND-SI) i.e. those NBFCs with asset size of Rs. 500 crores and above.

Accordingly, all NBFC-D and NBFC-ND-SI are mandatorily required to rotate the partners of the auditing firm appointed to conduct the statutory audit of the NBFC, every 3 years so that same partner does not conduct audit of the company continuously for more than a period of 3 years. However, the partner so rotated will be eligible for conducting the audit of the NBFC after an interval of 3 years, if the NBFC, so decides. Companies may incorporate appropriate terms in the letter of appointment of the firm of auditors and ensure its compliance.

iii. Assuming a person is an auditor in the company for 10 years already. What is the maximum term for which the individual can be the auditor in the same company under CA, 2013? Would the answer be any different if it was an auditing firm and not an individual?

Section 139(2) provides for the provisions with regard to rotation of auditors for certain class of companies only. Thus if the company does not belong to such prescribed class, rotation of auditors will not be mandatory and such an auditor (who has served for more than 10 years) can continue in office as such, without any limitation.

Where the company falls within the prescribed classes of companies to which auditor rotation is applicable, an individual auditor can be appointed for one term of five consecutive years and a firm can be appointed for two terms of 5 consecutive years.

Second *proviso* to section 139(2) provides a company with a transition period of three years' to comply with the provisions of the sub-section from the commencement of the Act.

121 <http://rbi.org.in/scripts/NotificationUser.aspx?Id=9327&Mode=0>

Rule 6 of the Companies (Audit and Auditors) Rules, 2014 states that while ascertaining the term for appointment, the preceding financial years for which the auditor has been the auditor shall also be taken into consideration. That is to say, the existing term of being auditor shall also be taken into consideration.

In pretext of the above, where an auditor has been an auditor for ten years already, he can be the auditor to the company for another three years. In this case for the auditor firm as well, the firm can continue to be auditors for three more years (*i.e.* utilising the transitional period).

iv. For how many more years can an auditing firm be appointed as auditors if the existing term has been for 4 years already (assuming the company is required to comply with rotation requirements)?

The auditing firm can be appointed for 6 more years as the auditor of the company. The 6 year term can be broken into a term of 1 year and then a term of 5 years.

v. What would be the position if an auditing firm was appointed as auditors of a company in the last financial year i.e. 2013-14 (assuming the company is required to comply with rotation requirements)?

The office of the auditor would have concluded at the end of the ensuing annual general meeting. The auditor can be appointed for a term of 9 more years. The 9 years can be split into one term of 4 years and one term of 5 years.

vi. Where the rotation requirements are not applicable to a company, can an auditor be appointed for a term of one year only?

Irrespective of the applicability of rotation requirements under section 139 (2) on a company, section 139(1) is applicable to all companies. Section 139 (1) states that every company needs to appoint an auditor at the first annual general meeting who shall hold office till the conclusion of the sixth annual general meeting *i.e.* one fixed term of 5 consecutive years. There is no transition period for applicability of section 139(1) and therefore, every company will have to appoint an auditor for a term of five years only.

vii. What would be the tenure for appointment of Statutory Auditor in a private limited company and unlisted public company which does not qualify for the class of companies as mentioned in Section 139(2) of the CA, 2013?

Section 139(1) of the Act which is applicable to all companies, irrespective of size, provides that an auditor shall be appointed *'who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting'* i.e. for a fixed term of 5 years, subject to ratification at every general meeting.

Sub-section (2) of the Section 139 requires mandatory rotation of auditors for certain classes of companies only, as mentioned in Question of 7.1.1 above.

In the present case, the private company and unlisted public company falls outside the purview of Section 139(2) of the Act; hence the mandatory rotation will not be applicable to these companies.

However, this does not mean that Section 139(1), which is applicable to all companies, shall not apply to such companies. Hence the tenure of auditors appointed by the said companies would have to be for a continuous period of 5 years, subject to ratification at every AGM.

viii. A company has paid-up capital is less than Rs. 10 crores. In other words Section 139(2) relating to rotation of auditors does not apply to the company. The auditors of the company have been there since 1990. In line with the Corporate Governance processes, the company has passed a resolution at its shareholders' meeting (for the FY 2013-14) appointing its auditors for a period of three years. It may be noted that the company proposes to change its auditors after the said period of three years. Is the above in compliance with the provisions of CA 2013?

Section 139(1) mandatorily requires appointment for 5 years. There is no transition time for section 139(1). Unlike independent directors, where appointment upto 5 years is allowed, in case of auditors, it is mandatorily 5 years. Therefore the company will have to appoint the auditor for a term of five years.

7.1.2 Eligibility for appointment/re-appointment

i. What are the pre-conditions for the auditor to be re-appointed at the annual general meeting?

The pre-conditions for re-appointment of the auditor at the annual general meeting are provided for in section 139(9) of CA, 2013 and are as follows:

- a.* The auditor has not suffered any disqualification during the term;

- b. The auditor has not provided a notice in writing of his unwillingness to be appointed; or
- c. A special resolution has not been passed at the meeting expressly providing that he shall not be re-appointed or appointing some other auditor.

ii. Whether the previous tenure of the auditor in the company shall be counted for their appointment under the CA, 2013 where section 139(2) is not applicable?

Where the company does not fall under the category of companies prescribed under Section 139(2) of the CA, 2013 read with the Rules made thereunder, the previous tenure of the auditor in the company shall not be counted for their appointment.

iii. There are several threshold limits provided for, with respect to holding security in the company by auditors or his relatives, being indebted or providing guarantee to the company. Explain the limits and who are they applicable on.

Section 141 of CA, 2013 states that a person shall not be eligible for appointment as an auditor of a company, if he or his relative or partner:

- a. Holds security of or interest in the company and such other entities enumerated below;
- b. Is indebted to the company and such other entities enumerated below;
- c. Provides guarantee or security in connection with any indebtedness of any third party to the company and such other entities as enumerated below.

Subject to certain threshold limits as provided for in Rule 10 of the Companies (Audit and Auditors) Rules, 2014 and enumerated in the chart below:

	Author	Relative of Author	Partner of Auditor
Holds security in the company	Any amount	Rs. 1 Lakh	Any amount
Provided guarantee/security to the company/subsidiary/holding/associate/fellow subsidiary	Rs. 1 Lakh	Rs. 1 Lakh	Rs. 1 Lakh
Indebted to the company/subsidiary/holding/associate/fellow subsidiary	Rs. 5 Lakhs	Rs. 5 Lakhs	Rs. 5 Lakhs

Figure 40: Thresholds prescribed under CA, 2013 for auditors

Further the auditor must ensure that these thresholds are to be maintained with the following entities:

- a. Company
- b. Subsidiary Company
- c. Holding Company
- d. Associate
- e. Fellow subsidiary

iv. The audit committee of PQR Limited concluded the meeting to recommend to its Board to appoint M/s. ABC as its statutory auditors. It was brought to its notice in the same meeting that some proceedings against the said firm are pending before the Institute of Chartered Accountants of India or the National Financial Reporting Authority or Tribunal or any Court of law. Advise the audit committee on the matter in the light of the provisions of the CA, 2013.

Section 141(3)(h) of CA, 2013 provides that a person would be disqualified from being appointed as an auditor only if he is *convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction*. In this case the proceedings are pending final order. Hence M/s ABC can be appointed as auditor of PQR Ltd.

v. The Companies which fall within the purview of Section 139(2) of CA, 2013 have been provided with a transition time of 3 years to comply with the said provisions. What about other companies to whom the section is not applicable on the commencement of CA, 2013 but subsequently becomes applicable by virtue of limits provided in Rule 5 of Companies (Audit & Auditors) Rules, 2014. Will the time transition of 3 years be applicable to such companies? Or do they need to make fresh appointment in this year itself?

As per second proviso to Section 139(2) of CA, 2013 every company, *existing on or before the commencement of this Act which is required to comply with provisions sub-section (2) shall comply with the requirements within 3 years from the date of commencement of this Act*.

Therefore, the transition time available for such companies is till 31st March, 2017. Any company to which the section becomes applicable subsequent to commencement of Act, needs to comply with the same before 31st March, 2017.

vi. M/s. D & Co. is the existing auditors of ABC Limited. Mr. L, Mr. M and Mr. N are 3 partners of the firm. If one of the relatives of Mr. L is indebted to the company, or has given guarantee/security to the company on behalf of third person, considering the provisions of the CA, 2013, can the firm continue to be the auditors of the Company?

Yes, provided the threshold limit of such indebtedness or guarantee as provided by Section 143(3) of CA, 2013 read with rule 10(2) of Companies (Audit and Auditors) Rules, 2014, is not breached. Section 141(3) read with Rule 10(2) and (3) of the Companies (Audit and Auditors) Rules, 2014 provides that a relative or the partner of the auditor is indebted to the company for an amount of not less than Rs. 5 lakhs or has extended guarantees/securities to the company on behalf of a third party for an amount exceeding Rs. 1 lakh.

vii. Will the answer to the above questions change if the relative is replaced by one of the partners?

No the limits mentioned in (b) are same for the partners as well.

viii. For the purpose of considering qualification of auditor, should subsidiaries, associates or holding of such company be considered?

Yes, as the company should evaluate whether the person or firm has a business relationship, except such commercial transactions exempted under Rules, with the holding company or subsidiary company or associate company or a sister concern.

ix. Assuming an audit firm has already completed 12 years in a company. In terms of the Rule 6(3) of Companies (Audit and Auditors) Rules, 2014 they can be appointed for 3 more years. Is the appointment necessarily have to be for 3 years at the next AGM or can the company choose to appoint them for maximum of three terms of one year each?

The transition time of 3 years is only under section 139(2). However, companies cannot overlook section 139(1) which requires appointment of auditor for a block term. Hence, harmoniously reading sections 139(1) and 139(2), the audit firm will have to be appointed for a term of 3 years rather than for three terms of one year each.

x. M/s. ABC & Co is a Chartered Accountancy firm specialized in auditing. XYZ Limited is one of the existing clients of the firm. XYZ limited re-appointed them as their statutory auditor for the F.Y. 2014-15. Company is of the view that once appointed, auditor will continue to hold office till the conclusion of next AGM. As per the provisions of the CA, 2013, is the company's contention correct?

Section 139(1) of the CA, 2013 states that any individual or firm appointed under the Act, shall hold office from the conclusion of that meeting upto the conclusion of its sixth general meeting subject to the ratification of such appointment in every AGM. Hence, the company's contention does not hold good as the auditor has to be appointed for a term of five years. However, in case the company belongs to such class of companies wherein mandatory rotation of auditors is applicable, the period for which the firm has held office as auditor prior to the commencement of the Act shall be taken into account.

xi. M/s. D & Co. is the existing auditors of ABC Limited. Mr. L, Mr. M and Mr. N are 3 partners of the firm. One of the relatives of Mr. L holds securities in the ABC Limited. Considering the provisions of the CA, 2013, can the firm continue to be the auditors of the company?

Yes. Section 141(3) read with Rule 10(1) of the Companies (Audit and Auditor) Rules, 2014 provides that a relative of an auditor may hold securities in the company of face value not exceeding Rs. 1 Lakh. Hence, M/s. D&Co. will not be disqualified from being the auditors of ABC Limited so long as the relative is holding security of ABC Limited of the face value of not more than Rs. 1 lakh.

In case the value of the securities held exceeds Rs. 1 lakh, the same needs to be liquidated within 60 days of acquisition of interest, i.e. corrective action needs to be taken for the auditor not to suffer any disqualification under section 141.

xii. Will the answer to the above questions change if the same securities are held by one of the partners?

As per Section 141(3) of the CA, 2014, a person holding securities in the company cannot be appointed as an auditor of the company. Thus, the firm in the present case will be disqualified from being appointed as auditors of the company. Exemption is only for the relatives and not the partner himself.

xiii. What is construed to be a business relation for the purpose of disqualification under section 141 of CA, 2013?

Section 141(3)(e) of the CA, 2013 lays down that a person or a firm shall be disqualified from being appointed as an auditor in a company if he/it has, whether directly or indirectly, any '*business relationship*' with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company.

The term '*business relationship*' has been explained in Rule 10(4) of the Companies (Audit and Auditors) Rules, 2014 to be construed as follows –

the term “business relationship” shall be construed as any transaction entered into for a commercial purpose, except –

- (i) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;*
- (ii) 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.*

Therefore, any transaction other than such transactions entered into on ordinary course of business and at arm's length price or in the nature of professional services shall be taken to be a business relation.

xiv. Which entities should the auditor avoid having a business relation with to ensure it does not suffer a disqualification?

Section 141(3)(e) provides that the auditor should avoid having business relationship the following entities:

- a. Company*
- b. Subsidiary company*
- c. Holding company*
- d. Associate*
- e. Fellow subsidiaries*
- f. Fellow associates*

xv. Can a person having a business relationship with the company be appointed as the auditor of the company in following scenarios:

a. Relationship consists of tax consultancy to one of the subsidiaries of the company?

Since the transaction is that of rendering professional service and is not in the negative list provided in section 144, the person can be appointed as auditor in the company.

b. Relationship is in nature of providing investment consultancy to one of its subsidiaries?

No. Section 144 of CA, 2013 prohibits rendering investment advisory services, directly or indirectly by the auditor either to the company or through its holding or subsidiary company.

c. Relationship is of providing tax return filing services to the company?

Section 141(3)(e) restricts the auditor from having business relationship with the company or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company.

Rule 10(4) of the Companies (Accounts and Audit) Rules, 2014, defines business relationship as any transaction entered into for a commercial purpose, except –

- (i) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;
- (ii) 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.

Since providing of tax returns is not in the negative listed items, and provided this transaction is in the ordinary course of business of the company at arm's length price, the auditor can be appointed in the company.

xvi. Where an auditor has been convicted of a fraud, can he be re-appointed in the same company?

Section 141 (3)(h) of the CA, 2013 provides that an auditor shall be disqualified to be appointed/ re-appointed as an auditor in the same company unless ten years have elapsed from the date of such conviction involving fraud. Further

if such an auditor has suffered such disqualification after his appointment to office as an auditor, he shall vacate his office as such auditor.

xvii. Can an auditor convicted of fraud be re-appointed as auditor for any company?

The auditor shall be disqualified to be appointed/re-appointed as such in any company unless ten years have elapsed from the date of such conviction involving fraud.

xviii. Company A has 3 subsidiaries – B, C, and D. X Associates is a firm of Chartered Accountants, and the same conducts audit of all the group companies.

Following questions have been drawn up based on the above facts –

- a. X Associates were appointed as the auditors of Company A for the first time in the FY 2007-08. As per the Companies (Audit and Auditors) Rules, 2014, the firm can be appointed for a maximum of 3 years more. The company wishes to appoint the firm in the ensuing AGM for 3 years. Instead of appointing for a block of 3 years, can the company re-appoint separately every year?**

No, compliance with Section 139(1) is mandatory and there is not transition time for the same. Thus, auditors will have to be appointed for a block of 3 years subject to ratification at every AGM.

- b. X Associates were appointed as the auditors of Company B for the first time in the FY 2011-12. As per the Companies (Audit and Auditors) Rules, 2014, the firm can be appointed for a maximum of 7 years more. Can the auditor be re-appointed for 3 years to co-incide with the appointment of the auditors in its holding company A? What is the maximum period for which they can be re-appointed at ensuing AGM?**

No, auditors will be needed to be appointed for a block of 5 years subject to ratification at every AGM and thereafter for 2 years.

- c. X Associates were appointed as the auditors of Company C for the first time in the FY 2010-11. As per the Companies (Audit and Auditors) Rules, 2014, the firm can be appointed for a maximum of 6 years more. Can the Auditors be re-appointed for lesser term lesser than 5 years to co-incide with the appointment of the auditors in its holding company A? What is the minimum period for which the company needs to re-appoint them?**

In view of the same, the auditors are eligible to be appointed for 6 years. Thus, in compliance of section 139(1) auditors will be appointed for block of 5 years subject to ratification at every AGM and thereafter for 1 year.

- d. X Associates were appointed as the auditors of Company D for the first time in the FY 2013-14. Can the Auditors be re-appointed for lesser term lesser than 5 years to co-incide with the appointment of the auditors in its holding company A? What is the minimum period for which the company needs to re-appoint them?**

Yes, as Section 139(1) applies to every company and there is no transition time to comply with the same, the company will have to appoint auditors for a block of 5 years subject to ratification by shareholders at every AGM.

xix. The company wishes to engage its Statutory Auditors in carrying out the audit of the Company's Employees' Gratuity Fund for the FY 2014-2015. Will the said service be covered within the scope of negative lists of services under section 144 of CA, 2013? Does the prior approval of the Board needed before engaging them as gratuity auditor?

The said service will not be covered in the negative listed items under section 144 of CA, 2013. Also, the Gratuity Fund is separate from the company and its audit is completely separate from the audit of the company and does not have to be authorised by the company at all.

xx. M/s. ABC & Co. is a Chartered Accountancy firm specialised in auditing. XYZ Limited, a public limited company is one for the existing clients of the firm since last 10 years.

- a. XYZ limited is of the view that M/s. ABC & Co. cannot be re-appointed as their statutory auditor for the FY 2014-15. Comment upon the same.**

Section 139(2) read with Rule 6(3)(i) of the Companies (Audit and Auditors) Rules, 2014 clearly states that the existing tenure of the firm before the commencement of the Act shall be counted for the purpose of computing the consecutive tenure of ten years. However, second proviso to Section 139(2) of CA, 2013 provides for a term of three years to comply with the provisions of the sub-section. Hence, owing to the

transition period, the existing auditors may be appointed for a term of three more years.

- b. Assuming M/s. ABC & Co. is the auditor since last 4 years. Up to which financial year, can the firm continue to be auditor of the company?**

In this case, the audit firm can be appointed in the company for six more years i.e upto FY 2020-21.

- c. Say the auditor completes their tenure according to the provisions of the CA, 2013, what will be the time period until which they cannot be re-appointed by the XYZ Limited?**

Proviso to Section 139(2)(b) of CA, 2013 specifies a cooling period of five years from the completion of such term of the auditor.

- d. Will your answers be the same, if it was an individual instead of a firm?**

In case the auditor is an individual, our answers for (a) and (c) will remain the same. However, in case of response to (b), such individual serving as an auditor for last 4 years will be eligible to continue as auditor for 3 more years only in terms of Section 139(2) read with Rule 6(3) of the Companies (Audit and Auditors) Rules, 2014.

xxi. The auditors of one of the company's subsidiaries have expressed their unwillingness to be re-appointed as the auditors of that company at the ensuing AGM. Accordingly, that company proposes to appoint another firm as their statutory auditors. It may be noted that the retiring auditors have not completed their tenure prescribed in Section 139(2) of the CA, 2013. Considering that the retiring auditors have expressed their unwillingness to be re-appointed, is a special notice from one of the members for appointing another audit firm (other than the retiring auditor) as the statutory auditors, required in terms of Section 140(4) of the Companies Act, 2013 required? Further, is the company required to pass a special resolution in terms of Section 139(9) of the CA, 2013?

Since, the statutory auditor has expressed his unwillingness to continue as the auditor of the company and will resign and it will result in casual vacancy in the office of the auditor.

Since it is casual vacancy by way of resignation, the Board and where the company has an audit committee shall recommend another auditor. The appointment of the recommended auditor shall be approved at the general meeting convened within three months from recommendation of the board and shall hold office till the conclusion of next annual general meeting. There is no need for a special notice in the present case.

xxii. A company is not falling under the criteria of section 139(2) of CA, 2013. In such case what will be tenure of re-appointment of retiring auditors in the ensuing Annual General Meeting?

Section 139(1) clearly provides that the auditor appointed in an annual general meeting holds office from the conclusion of that meeting till the conclusion of the 6th annual general meeting to be held thereafter, counting the meeting in which he was appointed as the first meeting. Thus, the tenure of the every auditor to be appointed or re-appointed shall be of 5 years. Also, the section is applicable to every company.

In case the appointment of an auditor is not ratified by the shareholders at annual general meeting as required under proviso to Section 139(1), what recourse does the company have?

Explanation to Rule 3(7) of Companies (Audit and Auditors) Rules, 2014 states that if the appointment of an auditor is not ratified by the members of the company, the Board shall appoint another individual or firm as the auditor of the company in pursuance of procedure laid down in the CA, 2013.

xxiii. X Ltd. is having Joint Statutory Auditors M/s. S.S. and M/s. C.S. Section 139 of the CA, 2013 provides for appointment of Statutory Auditors for a period of 2 terms of 5 consecutive years subject to ratification by the shareholders at every Annual General Meeting (AGM). CA, 2013 provides that while considering the re-appointment, the tenure of holding of the office as Auditors prior to the commencement of the Act shall also be taken into account. Both the Auditors have served the Company for a period of two financial years which ends at the ensuing AGM.

xxiv. Considering the above new provisions of Section 139 of CA, 2013 both the Auditors have 3 years balance period but X Ltd. want to re-appoint them from the conclusion of the ensuing AGM to the conclusion of the next AGM i.e. for one Financial Year only. Whether X Ltd. can do so?

Section 139(1) provides that a company is required to appoint its statutory auditors for a block of 5 consecutive years. Section 139(2) of the CA, 2013 allows a company to appoint an audit firm for 2 terms of 5 consecutive years and a transition time of 3 years to comply with the same i.e. upto the year 2017.

There is transition time for section 139(2), but there is none for section 139(1). Thus on a combined reading of sections 139(1), 139(2) and Rule 6(3), the time frame of 5 years under section 139(1) stands reduced to a block of 1, 2, 3, or 4 years, as may be applicable. Therefore, the appointment is for a block of 1, 2, 3 or 4 years.

Now, if the company appoints the existing auditor for 1 or 2 years, it becomes clear that the company has opted to avail a shorter transition time for implementing section 139(2) and therefore, has decided to re-appoint the existing auditor for a term of 1 or 2 years as the company may determine. At the AGM of 2015 or 2016, as may be applicable, the auditor can thereafter be re-appointed for one more term of 5 years only.

xxv. Further to the query above, if M/s. S.S who will be appointed for a period of two years at the ensuing AGM, what will be the procedure of the removal of M/s. S.S. before the expiry of the said term of two year.

There may be two ways of removing M/s. S.S. before their term:

- (a) The company may not ratify the appointment of the said auditors in the next AGM.
- (b) The procedure laid down under Section 140 of the CA, 2013 may be followed. This would include receiving a special notice, prior approval of the Central Government and passing of a special resolution.

xxvi. Circular to section 212 permitted circulation of consolidated accounts and exempted attachment of subsidiary companies. Section 136 provides for sending financial documents including consolidated accounts to shareholders etc. Whether subsidiary's accounts are exempted to be sent in the Annual Report?

For the current financial statements, we are going by CA, 1956. Therefore we will comply with section 212. Going forward, subsidiary accounts don't have to be sent but the same has to be uploaded on the website of the holding company. Where any shareholder requests for a copy of separate audited financial statements of each subsidiary, the same has to be furnished.

xxvii. If the auditors are appointed for a block of 3 years, is their appointment has to be ratified every year also?

Auditors appointed under section 139(1) will be appointed for 5 years and that shall be subject to ratification by shareholders every year. Further to comply with section 139(2), the company has a transition time of 3 years to comply with the same.

The beginning of Section 139(1) says *Subject to provisions of this chapter.....* the auditor is to be appointed for five years.

Thus, if the company is appointing auditors for a block of 3 years, it means that either company is making use of the transition time or the Audit firm has been functioning as an Auditor of the Company for almost past 7 years.

Therefore, the appointment (even though if it is for a block of 3 years due to restrictions stated in Section 139(2) will be subject to ratification by shareholders every year.

xxviii. M/s. ABC & Co. is a Chartered Accountancy firm specialised in auditing. XYZ Limited, a public limited company is one of the existing clients of the firm. XYZ limited re-appointed them as their statutory auditor for the F.Y. 2014-15. The company is of the view that once appointed, the auditor will continue to hold office till the conclusion of next AGM. As per the provisions of the CA, 2013, is the company's contention correct?

Section 139 of the Act, states that any individual or firm appointed under the Act shall hold office from the conclusion of that meeting up to the conclusion of its sixth general meeting subject to the ratification of such appointment in every AGM. Hence, the Company's contention does not hold good as the auditor has to be appointed for a term of five years.

However if XYZ fall within the limits of Section 139(2) of the CA, 2013, the mandatory rotation will apply and a transition period of 3 years will be available to the company, during which it can appoint ABC & Co. for a term of less than 5 years subject to the number of years ABC has been the statutory auditor of the Company prior to the enforcement of the CA, 2013.

- (c) **M/s. ABC & Co. is a Chartered Accountancy firm specialised in auditing. XYZ Limited, a public limited company has appointed the firm as its statutory auditors since last 10 years. XYZ Limited is of the view that M/s. ABC & Co. cannot be re-appointed as their statutory auditor for the F.Y. 2014-15. Is the view of the company correct?**

Section 139(2) read with Rule 6(3)(i) of the Companies (Audit and Auditors) Rules, 2014 clearly provides that the existing tenure of the statutory auditors of a company before the commencement of the Act shall be counted for the purpose of determining the rotation of auditors. However, Section 139(2) provides for a transition time of three years for complying with the provisions of the section. Reference is also drawn to Illustration 2 to Rule 6 of the Companies (Audit and Auditor) Rules, 2014 which explicitly provides that an audit firm which has served the company a period of more than 10 years can be appointed for another 3 years *i.e.* the transition period provided under Section 139(2) of the CA, 2013.

Accordingly the existing auditors may be appointed for a term of three more years, in case it falls in the threshold limits under section 139(2) of CA, 2013. In case the company is not covered by section 139(2), then the M/s ABC & Co. can be appointed for a term of 5 years.

- (d) M/s. ABC & Co. is the auditor since last 4 years; up to which financial year, can the firm continue to be auditor of the company?**

As per Illustration 2 to Rule 6 of the Companies (Audit and Auditor) Rules, 2014, the audit firm can be appointed in the company for six more years *i.e.* upto FY 2020-21

- (e) Say the auditor completes its tenure according to the provisions of the CA, 2013, what will be the time period until which they cannot be re-appointed by the same company?**

As per Section 139(2) of the CA, 2013, a cooling off period of five years has been provided before a retiring auditor is re-appointed post the completion of present term of the auditor

- (f) Will your answers be the same, if it was an individual instead of a firm?**

Yes, the answer would still be the same.

- (g) On the expiry of the tenure of existing auditors (M/s. ABC & Co.), XYZ Limited, a public limited company considers to appoint M/s. PQR & Co. as their new auditors. Both the audit firms have a common partner Mr N. Considering the provisions of the CA, 2013, can PQR be appointed as the auditors of XYZ Limited?**

No, PQR & Co. is ineligible for being appointed as the statutory auditors of the company. This is explicitly provided in the second

proviso to section 139(2) of the CA, 2013, which provides that no audit firm shall be appointed as auditors of a company if that audit firm has common partners to the other audit firm whose tenure has expired in a company in the immediately preceding financial year.

In this case the tenure of ABC & Co., having common partners with PQR & Co., has expired in the immediately preceding financial year pursuant to which PQR is proposed to be appointed. Thus, PQR is thus not eligible to be appointed as statutory auditors of the company.

(h) Will the answer to the above change if there is no common partner but both firms operate under one network/brand?

The answer will not change. As per Rule 6(3)(ii) of the Companies (Audit and Auditors) Rules, 2013 read with *Explanation 1*, the incoming auditor shall not be eligible for appointment if the auditor or audit firm is under the same network of audit firms. The term same network includes firms operating under same brand name and thus PQR will not be eligible to be appointed.

(i) Will the answer to the above questions change if the same securities are held by one of the partners?

The threshold limit for holding securities in the company is available to only the relatives of the auditor and not to the partners or the auditor himself. Hence if any of the partners of the audit firm holds any security in the company, the auditor will suffered disqualification.

(j) A multi-disciplinary firm consist of 10 partners where 8 are Chartered Accountants, 1 Company Secretary and 1 Cost Accountant. Is the firm eligible for appointment as auditor? (presuming ICAI regulations permitting the same).

Yes. As per section 141(2) of the CA, 2013, a multi-disciplinary firm can be appointed as the auditors of the company, provided that only the partners who are chartered accountants are authorised to act and sign on behalf of the firm. However the firm should be constituted as an LLP and no other body corporate.

(k) M/s. ABC & Co. a Chartered Accountancy firm having 2 partners is currently engaged in the audit of 40 companies. It has been approached by PQR Private limited and X Ltd (Listed) for accepting assignment as statutory audit. Can ABC & Co. accept such appointment?

Section 141(3)(g) of CA, 2013 provides that a person or partner cannot be appointed as auditor of more than 20 companies other than one

person companies, dormant companies, small companies and private companies having a paid up share capital of less than one hundred crore rupees. In case ABC has 2 partners each engaged in the audit of 20 companies other than exempted companies ABC & Co. cannot accept the appointment in either of the two companies. However in case any of the existing 20 companies includes exempted companies, ABC & Co. Can accept the appointment.

(I) M/s. PQR & Co., a Chartered Accountancy firm is engaged in the audit of ABC Limited. For the F.Y. 2014-15 the firm issues an Independent Audit Report to the company. An independent person while going through the Annual Report of the company identifies the following points missing in the Audit report.

a. The effect of pending litigations on its financial position?

In accordance with Rule 11(a) the Auditor's Report should have disclosed the impact of any pending litigation on the financial position of the Company. In case there are no pending litigations the same should have been marked as 'Nil' or 'No pending litigations'.

b. Whether the company has made provision for foreseeable losses of the company on long-term contracts including derivative contracts?

Only material foreseeable losses of the company on long-term contracts including derivative contracts is required to be disclosed under Rule 11(b).

c. Company has adequate internal financial controls system in place and the operating effectiveness of such controls?

As per Section 143(3) of CA, 2013, the audit report is required to disclose whether the Company has adequate internal financial controls system in place and the operating effectiveness of such controls.

d. Company has not spent the required CSR amount?

Disclosure to this effect is required to be made in the Board's Report and not the Auditors' Report, in accordance with Sections 134 (3) and 135 (2) of the CA, 2013 read with Rule 8 of Companies (Corporate Social Responsibility Policy) Rules, 2014.

7.1.3 Process for appointment

i. What is the process of consideration of persons for appointment as an auditor?

Rule 3 of the Company (Audit and Auditors) Rules, 2014 sets down the process for appointment of an auditor. The chart below illustrates the process flow:

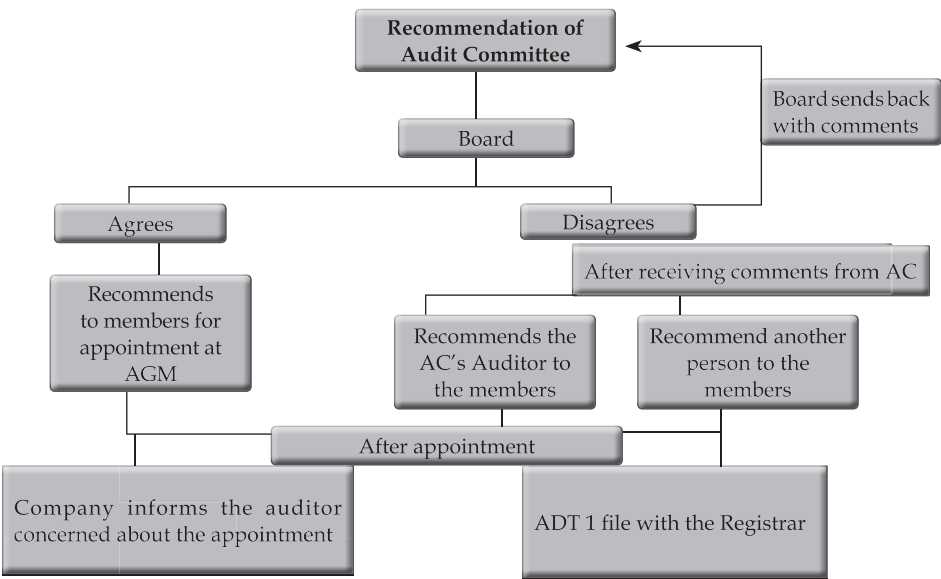


FIGURE 41: PROCESS TO APPOINT AN AUDITOR

The audit committee makes recommendations to the Board on the auditor. The Board in turn recommends the audit committee recommended individual or such other individual as the board deems appropriate, to the members for appointment at the meeting. Once the members at the general meeting appoint the auditor, the company shall file ADT 1 with the registrar within 15 days of such appointment.

Also, while the appointment is made for a term of 5 consecutive years, the ratification of appointment shall be placed before the members at every annual general meeting.

ii. How is the remuneration of the auditor ascertained?

The Board is empowered to fix the remuneration of the first auditor. Thereafter, section 142 of CA, 2013 provides that the remuneration of the auditor shall be fixed at the general meeting or in such manner as may be determined

therein. The members may at the general meeting resolve to empower the Board to fix the remuneration of the auditors, as deemed appropriate by them.

7.1.4 Casual Vacancy

i. What all scenarios may lead to casual vacancy in the office of the auditor?

Sections 139 to 147 provide for the provisions applicable to statutory auditors. These sections provide for various circumstances whereby there could be a casual vacancy in the company. The scenarios are illustrated in the graph below:

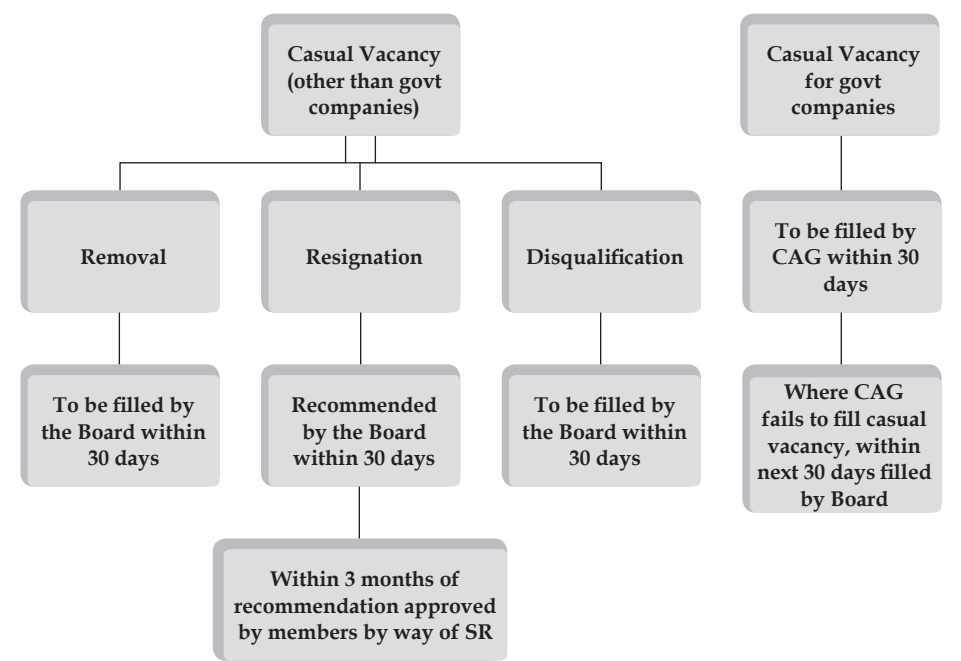


FIGURE 42: VARIOUS SCENARIOS FOR CASUAL VACANCY OF AUDITORS

As can be viewed from the above illustration, in case of companies where the auditor is not appointed by the Comptroller and Auditor General of India, casual vacancy may be caused due to:

- a. Removal of the auditor – The company or the members may have caused the removal of the auditor. This may result in casual vacancy before the conclusion of the term.

- b.* Resignation by the auditor – Where the auditor places his resignation before the company to discontinue as the auditor of the company, it may result into casual vacancy.
- c.* Disqualification suffered by the auditor during the term – Section 144 (4) clearly states that where an auditor has suffered disqualification mentioned in section 144(3) it may lead to casual vacancy in the office of the auditor.

7.1.5 Resignation/Removal of Auditors

i. What are the ways in which an auditor may be removed from his office?

Where an auditor is to be removed before the expiry of the term, it can be done in the following ways:

- a.* The board may pass a resolution for removal of the auditor. Once the resolution is passed, the auditor will be given a reasonable opportunity of being heard on the matter. Within 30 days of the resolution passed by the Board, an application has to be made to the Central Government in Form ADT-2 to be filed in Form GNL-1 for removal of the auditor. Once the approval from Central Government is received, the company must within 60 days of such approval, pass a special resolution at a general meeting for removal of the auditor.
- b.* A special notice (in terms of the provisions of section 115 of CA, 2013) is received by the company from the members requiring another auditor to be appointed other than the retiring auditor, at the annual general meeting. Where such a notice is received the auditor may make a representation to the company on the matter. The process for such removal is graphically explained below.
- c.* On an application made by the Central Government, if the Tribunal is of the opinion that the auditor must be changed, the Tribunal may direct the company to appoint another auditor in his place.
- d.* Where at an annual general meeting the auditor's appointment is not ratified by the members, it shall result in removal of the auditor.

The process for removal of auditor, as explained in point b above is illustrated below:

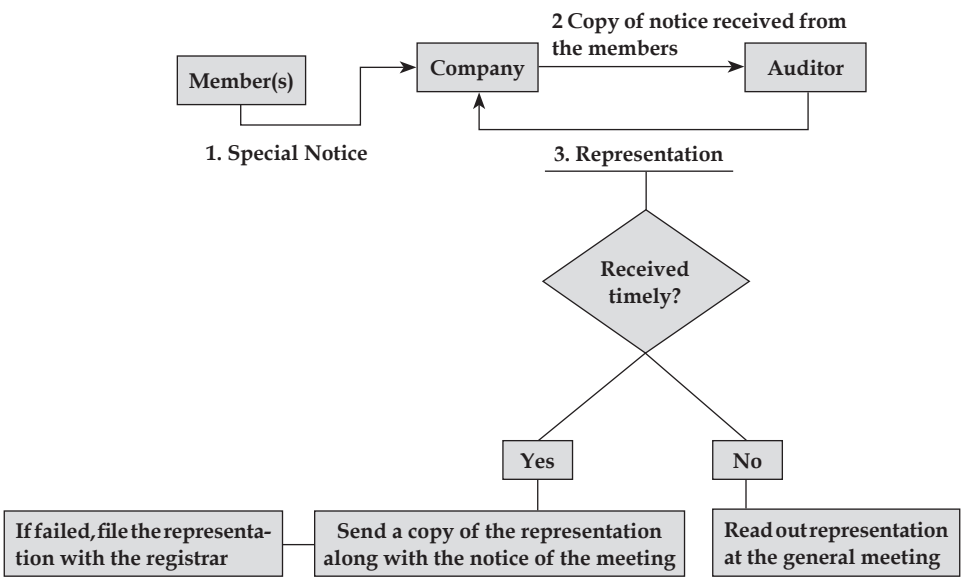


Figure 43: Process for removal of auditor

ii. Where an auditor is an outgoing auditor or has expressed unwillingness to continue as an auditor but the company is unable to find another auditor to hold office in place of the outgoing auditor, what shall the company do?

Section 139(10) of CA, 2013 states that where at any annual general meeting no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company. The intent of the provision is that a company cannot be auditor-less. Therefore in a situation where a company is facing practical difficulty to replace an auditor, the existing auditor shall continue to hold office.

iii. M/s. ABC & Co., a Chartered Accountancy firm is duly appointed as the statutory auditor of XYZ limited. During the F.Y. 2014-15 the auditor resigns.

a. What are the additional provisions which the auditor needs to comply with in respect of his resignation?

As per section 140(2) of CA, 2013 the auditor who has resigned is required to file a statement with the Registrar and with the company in Form ADT-3, as an attachment to Form GNL-2, within 30 days from the date of resignation. In the case of resignation of auditors from a government company or any other company owned or controlled,

directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, the resigning auditor shall also file the statement ADT-3 with Comptroller and Auditor-General of India, indicating the reasons and other facts as may be relevant with regard to his resignation.

b. Are there any penal provisions in case of non-compliance by the auditor?

As per section 140(3) of CA, 2013 in case of non-compliance of the above mentioned provisions, auditor shall be punishable with fine which shall not be less than Rs. 50,000/- but which may extend to Rs. 5 Lakhs.

iv. Assuming a case, where the limit of 20 companies has been exhausted by the outgoing auditor, pursuant to which he is intending to not get re-appointed as auditor in the present company. Will the provisions of section 139(10) be still applicable?

One of the disqualification conditions mentioned in section 141(3)(g) for an auditor is that an auditor cannot hold appointment in more than 20 companies other than one person companies dormant companies, small companies and private companies having paid-up share capital less than one hundred crore rupees (*vide* Exemption Notification dated 05-06-2015). The provisions of section 139(10) allows an existing auditor to continue to hold office but by virtue of section 144(4) he will suffer disqualification if he is allowed to hold office. In such a situation the intent needs to be seen.

The law, by way of the provision under Section 139(10) provided for the leeway to companies to appoint the same outgoing auditor in a situation where there is practical difficulty in replacing the auditor. Having said this, one cannot apply the disqualification in such a situation.

7.1.6 Negative Listed services

i. Section 144 provides for negative list of the services that an auditor cannot provide. What if prior to the commencement of the Act, the auditor was providing for such services?

Proviso to section 144 provides a year's time to companies to comply with the provisions of the section. So where the auditor or auditor firm was pro-

viding any of the negative listed services as on 1st April, 2014, they must stop providing such services 31st March, 2015 *i.e.* by the close of first financial year from the date of such commencement.

ii. Can any of the relative of an individual auditor of a company provide such negative listed services to the company?

The section clearly provides that the negative listed services cannot be provided by the auditor *directly or indirectly* to the company or its holding company or subsidiary company. Explanation to the section provides that the term *directly or indirectly* includes services provided by the auditor himself or through relatives or such other persons connected or associated with the auditor or any other entity on which the auditor has significant influence or control or whose name or trade mark or brand is used by such individual.

Thus neither the auditor himself, nor his relative can provide such negative listed services to the company, its holding or subsidiary company.

iii. Is providing services of filing of tax returns, TDS returns in professional capacity taken to be negative list service under section 144?

The negative listed services under section 144 do not include services rendered with regard to filing of tax returns or TDS returns. Hence the auditor can render such services to the auditee company.

iv. Which companies shall an auditor concern himself with for determining the ineligibility of providing negative listed services?

Section 144 of the CA, 2013 provides that an auditor shall not, either directly or indirectly, render any of the negative listed services to:

- (i) The Company;
- (ii) Its holding company; or
- (iii) Its subsidiary company.

v. M/s. ABC & Co. a Chartered Accountancy firm is engaged in the statutory audit of XYZ Limited. Apart from the audit services, the company is considering to take investment advisory services directly from the auditors.

a. Is the auditor allowed to give such services to the company?

No. Section 144 of CA, 2013 prohibits the statutory auditors of the company from providing investment advisory services to the company.

- b. Say the auditor is already giving other services to the company which are not allowed as per CA, 2013; can auditor continue to provide such services?**

Pursuant to Section 144 of the CA, 2013 the auditor performing non-audit services prior to commencement of the CA, 2013 which are prohibited under the section may continue to provide such services only upto the closure of the first financial year after the date of the commencement of the section i.e. upto 31st March, 2015.

- c. Say a firm M/s. DEF & Co. approaches the company to provide the aforesaid services. DEF & Co. has no connection with ABC & Co. except that the email ids of employees of DEF & Co are of same domain as of ABC & Co. Will the latter be eligible for appointment?**

Yes, the firm M/s. DEF & Co. will be eligible for providing the non-audit services to the company. Merely having common domain names with the statutory auditors of the company will not be considered as an indirect relationship with the statutory auditors.

vi. Where a company intends to avail certain services from the auditor other than those barred under section 144 of CA, 2013, what sort of approvals will be required by the company?

Section 144 provides that *“An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be....”*

Therefore, where a company has an audit committee and the terms of reference of such committee authorise the committee to approve the performance of non-audit services (except as specifically barred under the section), the committee itself may accord its approval for the said services as envisaged. However, such services should be at arm's length.

7.1.7 Fraud reporting

i. Whether all frauds are to be reported by the auditors under section 143(12) of CA, 2013?

Any act of omission, concealment, misuse of position will be considered to be a fraud under section 447 of CA, 2013. Section 143(12) requires auditors to report fraud to the Central Government where the auditor has reason to believe that a fraud, involving such amounts as prescribed has been committed against the company within such and manner as prescribed. In

case the fraud *involves an amount lesser than what is prescribed* (inserted by Companies (Amendment) Act, 2015), the auditor shall report the matter to the audit committee constituted under Section 177 or to the board in other cases, within such time and manner as prescribed. Companies whose auditors have reported frauds to the audit committee or board, as the case may be shall disclose details of such fraud in the Board's Report. Accordingly, Section 134(3)(ca) has been inserted vide Companies (Amendment) Act, 2015, which requires details in respect of frauds reported by auditors under sub-section (12) of section 143, other than those reported to the Central Government to be attached with the board's report and laid before the general meeting of the company.

However, the Central Government is yet to prescribe any amount in this regard. For the time being Auditors can use their discretion for reporting fraud to Central Government or audit committee/board as the case may be, considering principles of a) materiality of the transaction b) impact it would have on the company, its stakeholders or industry. Manner and time period within which fraud shall be reported by the auditor shall continue to be regulated by Rule 13 of Companies (Audit and Auditors) Rules, 2014, until the Central Government prescribes the manner in this regard.

ii. Whether the auditor be required to report to the Audit Committee or Board the fraud identified by the auditor, even if the matter is required to be reported to the Central Government?

The Companies (Amendment) Act, 2015 has replaced Section 143(12) which now requires auditors to report to the Central Government only those cases of fraud that involve an amount more than what has been prescribed. If the amount involved is lesser, it shall be reported to the audit committee or in case the company does not have an audit committee to the board of directors. When a fraud has been reported to only to the audit committee/board the details of the fraud shall be disclosed in the board's report laid before the general meeting of the company. The Ministry of Corporate Affairs is yet to notify the amount.

Rule 13 of Companies (Audit and Auditors) Rules, 2014 lays down the procedure for reporting the fraud to the Central Government for the purpose of Section 143(12). Since this section has been replaced and there is no corresponding amendment in the rules, the same procedure shall be followed for reporting fraud to the Central Government by the auditor. It requires the auditor to forward his report to the Board or the audit committee, as the case may be, immediately after it comes to knowledge of the auditor, seeking

their reply or observations within forty-five days. On receipt of such reply or observations the auditor shall forward his report and the reply or observations of the Board or the audit committee along with his comments (on such reply or observations of the Board or the audit committee) to the Central Government within fifteen days of receipt of such reply or observations.

In case the auditor fails to get any reply or observations from the board or the audit committee within the stipulated period of forty-five days, he shall forward his report to the Central Government along with a note containing the details of his report that was earlier forwarded to the board or the audit committee for which he failed to receive any reply or observations within the stipulated time.

The report shall be in the form of a statement as specified in Form ADT-4.

iii. Would following be constituted as frequently happening frauds?

- a. Inflated claims of travel & other expenses**
- b. Bogus or fake purchases being accounted**
- c. Instances of capital expenditure being executed without appropriate authorization.**

De minimis non curat lex, this means under common law principles judges will not sit in judgment of extremely minor transgressions of the law. Borrowing the principle to reporting of frauds as well in the present case, section 143 (12) requires the auditors to report the frauds done against the company. The auditors will have to use their prudence to determine the nature of transgressions from law and then report frauds to the Central Government till monetary limits have been prescribed.

Scenarios (a) and (b) are more of such nature where a qualification must be made to the in the audit report. Scenario (c) seemingly may come as a case of fraud. In essence, nature, materiality and continuity of the scenarios have to be assessed to call it a fraud for reporting purposes. Having said that if the auditor is of the view (a) and (b) above are also such transgressions which are of the nature of fraud, such transactions must be reported.

7.1.8 Auditors to attend general meetings

i. Where annual general meeting of two or more companies are held on the same date, how can the auditor make himself attend meetings

of both the companies for which he is the auditor to comply with the provisions of Section 146 of CA, 2013?

Section 146 of CA, 2013 requires all notices and other communications with regard to any general meeting to be forwarded to the auditor and the auditor shall **unless exempted** by the company attend any general meeting either himself or through his authorised representative who shall be qualified to be an auditor himself.

The section states that a company may exempt the auditor from attending the general meeting. In case it is not so exempted, the auditor must, if possible, attend either himself or through authorised representative, attend the general meeting of the companies. The authorised representative must also be qualified to be an auditor i.e. he must be a qualified chartered accountant.

ii. Who should be the addressee to the auditor's report, under CA, 2013?

Under CA, 1956, the auditor's report pertaining to the standalone financial statement was addressed to the members of the company and the consolidated financial statement was addressed to the board of directors of the company.

Under CA, 1956 the auditors were appointed by the members of the company hence the reporting of the standalone financials is also to the members of the company. On the other hand, the requirement of preparing consolidated financial statement came from Clause 32 of the Equity Listing Agreement. The board appointed the auditors to audit the consolidated financial statements hence the reporting of the auditors was to the board.

Section 143(2) of CA, 2013 states that an auditor **shall make a report to the members of the company** on the accounts examined by him and on every financial statements which are required by or under the Act to be laid before the company in the general meeting. Further sub-sections (3) and (4) of section 129 states that the consolidated financial statements shall be laid before the general meeting of the company along with the standalone financials and that the adoption and audit of the consolidated statement shall be done in the same manner as that of the standalone financials.

CA, 2013 mentions that company having subsidiary(s) shall prepare, get audited and adopt the consolidated financials in the same manner in which the standalone financials are being prepared, audited and adopted and shall be addressed to members of the company. Hence, the auditor's report

pertaining to standalone and consolidated statements shall be addressed to the members of the company.

iii. Do the standards on auditing prescribe any guidance on, to whom the auditor's report is to be addressed to?

Para 22 of Standard on Auditing (SA) 700 relating to 'Forming an Opinion and Reporting on Financial Statements' read with Para A.16 of the SA states that the auditor's report is to be addressed to those whom the report is prepared for – either the shareholders or those who are charged with governance of the entity whose financial statements are being prepared. The relevant paras of the SA also state that the law or applicable regulations will specify whom the report is addressed to CA, 2013 specifies the same to be addressed to the members of the company.

7.1.9 Companies (Auditor's Report) Order, 2015

i. By virtue of the powers under section 143(11) of CA, 2013, the Central Government has prescribed the Companies (Auditor's Report) Order, 2015 or CARO, 2015¹²². This is replacing the CARO, 2003. The Order is applicable from what financial year?

The Order is applicable for the financial year commencing from 1st April, 2014.

ii. To what companies is CARO, 2015 applicable to?

CARO, 2015 is applicable to all companies including foreign companies except for banking companies, insurance companies, section 8 companies, one person companies and a certain class of private companies¹²³.

iii. What are the matters to be included in the CARO, 2015 report?

The following matters shall be included in the auditor's report and the auditor is required to give unfavourable or qualifying remarks on the matters:

- a. Maintenance of proper records including quantitative details and situation of fixed assets, physical verification of the fixed assets and material discrepancies found, if any;
- b. Physical verification of inventory carried out by management on regular intervals, procedure for verification and material discrepancies found, if any;

122 http://www.mca.gov.in/Ministry/pdf/Companies_Auditors_Report_Order_2015.pdf

123 Private companies with paid-up capital and reserves of not more than Rs. 50 lakhs and loan outstanding not exceeding Rs. 25 lakhs and turnover not exceeding Rs. 5 crores at any time during the financial year.

- c.* Whether loans have been granted by the company to companies, firms, other parties as covered in register maintained under section 189 of CA, 2013 including amounts received and overdues more than Rs. 1 lakh;
- d.* Whether there are adequate internal control systems commensurate with the size and nature of business of the company;
- e.* Whether the company has accepted deposits under the directives issued by RBI or under sections 73-76 of CA, 2013 along with the compliances with the provisions pertaining to deposits thereof;
- f.* Maintenance of cost records by the company;
- g.* Whether the company has been depositing the undisputed statutory dues with the appropriate authorities and the auditor shall be reporting any dues exceeding six months, for a particular financial year;
- h.* Amounts of income tax, sales tax, service, excise, customs etc. that have not been deposited on account of dispute and the amounts involved thereof;
- i.* Whether due amounts have been transferred to Investors Education and Protection Fund from time to time;
- j.* Whether a company which has been registered for not less than 5 years has accumulated losses that are more than fifty per cent of the networth of the company and whether there have been cash losses in the financial year or year preceding that;
- k.* Whether the company has defaulted on repayment of dues to banks/ financial institution/ debenture holders;
- l.* Whether company has given guarantees prejudicial to the interest of the company;
- m.* Whether term loan applied has been received; and
- n.* Whether any fraud has been reported any the nature of the fraud.

7.1.10 Penalty

i. Where an auditor is found to have acted fraudulently, what are the penal consequences for such an auditor?

As per section 147 where an auditor is found to have wilfully or knowingly deceived the company or its stakeholders he shall be punishable with imprisonment for a term which may extend upto one year and with a fine

which shall not be less than one lakh rupee but may extend upto twenty five lakh rupees.

Further such an auditor will be required to refund the remuneration received from the company and pay for damages to *any* person for loss arising out of incorrect or misleading statement of particulars provided in the audit report.

Further, section 140 (5) states that where the Tribunal *suo motu* or an application made to it by the Central Government, is of the opinion that the auditor has acted in a fraudulent manner it shall direct the company to change its auditors.

7.2 INTERNAL AUDITS

i. What companies are required to appoint an internal auditor?

Rule 13 of the Companies (Accounts) Rules, 2014 requires the following class of companies to appoint an internal auditor:

- (a) Every listed company;
- (b) Every unlisted public company having:
 - a. paid up share capital of fifty crore rupees or more during the preceding financial year; or
 - b. turnover of two hundred crore rupees or more during the preceding financial year; or
 - c. outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year; or
 - d. outstanding deposits of twenty five crore rupees or more at any point of time during the preceding financial year; and
- (c) every private company having-
 - a. turnover of two hundred crore rupees or more during the preceding financial year; or
 - b. outstanding loans or borrowings from banks or public financial institutions exceeding one hundred crore rupees or more at any point of time during the preceding financial year.

ii. Who appoints the internal auditor?

The Board appoints the internal auditor of the company.

iii. Can the appointment of the internal auditor be carried out through circular resolution?

Rule 8 of the Companies (Meeting of Board and its Powers) Rules, 2014 read with section 179 states that the appointment of the internal auditor is to be carried out at the board meeting itself.

iv. What is the qualification requirement for an internal auditor?

There is no qualification requirement prescribed for an internal auditor. The internal auditor may or may not be the employee of the company.

v. Who does the internal auditor report to?

The internal auditor reports to the audit committee. The audit committee or the board may along with the internal auditor formulate the scope, functioning, periodicity and methodology of conducting the internal audit. Further, both the audit committee and the board are required to consider the efficiency of internal control systems and financial controls in the company.

vi. Can the statutory auditor and the internal auditor be the same person?

No, the statutory auditor and the internal auditor cannot be the same person. The statutory auditor cannot be the employee/officer of the company or cannot be such person having business relationship with the company.

7.3 SECRETARIAL AUDITS

7.3.1 Appointment

i. Who can be the secretarial auditor?

Section 204 of CA, 2013 provides that a company secretary in practice shall be a secretarial auditor.

ii. Who will appoint a secretarial audit?

The board shall appoint the secretarial auditor pursuant to the provisions of section 179(3) read with Rule 8 of Companies (Meetings of Board and its Powers), 2014. The company will have to file MGT 14 for appointment of secretarial auditor.

iii. Which class of companies are required to appoint a secretarial auditor?

Section 204(1) read with Rule 9 of Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 state that the following companies will have to appoint a secretarial auditor:

- a. Listed companies;
- b. Public company with a paid-up share capital of Rs. 50 crores or more;
- c. Public company with a turnover of Rs. 250 crores or more.

iv. What is the tenure for which the secretarial auditor is to be appointed?

The law does not prescribe for the term of appointment of a secretarial auditor, unlike that of a statutory auditor. Hence the board may take a decision on the term for which a person may be appointed as secretarial auditor. Presumably appointment may be made for each reporting period, wherein he will lay down his office on submission of his report.

v. What is the period for which the secretarial audit is carried out?

The audit is for a financial year. The report then forms part of the Board's report as well.

7.3.2 Functions

i. What are the functions a secretarial auditor needs to discharge?

Secretarial audit report shall be in the format as provided in MR 3 and shall be annexed to the Board's report pursuant to provisions of Section 134 (3) of CA, 2013. The auditor shall ensure the company has complied with and that proper board process and compliance mechanism is in place and whether the company has complied with corporate laws, SEBI laws, FEMA laws. The auditor shall also review compliances with the laws that may be specifically applicable to the company and report on them same in the audit report.

ii. Who does the secretarial auditor report to?

The secretarial auditor makes the report for the members of the company. This comes clear from the format of the report, Form MR-3, which is addressed to the members of the company.

iii. What is the frequency of secretarial audit?

While the law does not provide for the frequency of the secretarial audit during the financial year, the auditor may determine the manner in which he would like to carry out the audit. This will largely depend on the

period in which he is appointed. For instance, in case the secretarial auditor is appointed early during the financial year, he may spread out the audit process, which may be quarterly or half yearly. The audit report however, is for the financial year.

iv. Is the secretarial auditor required to do fraud reporting, similar to a statutory auditor?

Section 143(12) read with Rule 13 of Companies (Audit and Auditors) Rules, 2014 requires secretarial auditors to also comply with the fraud reporting compliances. As is applicable to statutory auditors of the company wherein any fraud detecting against the company has to be brought to the notice of the board and audit committee and to be reported to the Central Government basis materiality; the same shall be expected to be complied with, by the secretarial auditor as well.

Contraventions with the provisions of Section 143(12) that is *mutatis mutandis* applicable to secretarial auditor as well shall result in fine being imposed not less than Rs. 1 lakh which may extend upto Rs. 25 lakhs.

v. What is expected of the secretarial auditor once a fraud is identified in course of audit?

As per section 143(12) read with Rule 13 of Companies (Audit and Auditors) Rules, 2014, fraud reporting is to be done by the secretarial auditor. Where in course of the audit, an auditor has sufficient reason to believe that an offence involving fraud has been committed against the company by the officers or employees of the company, the same shall be forthwith reported to the Board/audit committee for their consideration and appropriate response within 45 days of the identification of the fraud.

Once the response from the board/audit committee is received, the auditor shall within 15 days report the same to the Secretary, Ministry of Corporate Affairs in the form ADT 4. In essence, the auditor is required to report fraud within 60 days of identification to the Central Government.

7.3.3 Penal Provisions

i. What are the penal provisions for contravention of section 204?

Section 204(4) provides that where any company or officer of the company or the company secretary in practice contravenes the provisions of section 204, the officer in default shall be punishable with a fine which shall not be less than Rs. 1 lakh but which may extend upto Rs. 5 lakhs.

Where the audit report makes any fault statement in any material particulars or omits any material facts knowing it to be material, the auditor shall be liable under Section 447 of CA, 2013.

7.4 COST AUDIT

i. What class of companies are required to maintain cost records?

Section 148(1) of CA, 2013 provides that the Central Government shall notify such class of companies to maintain cost records in the prescribed manner.

For the purpose of Section 148(1), the Central Government has by way of Companies (Cost Record and Audit) Amendment Rules, 2014 notified the classes of companies engaged in production of goods or providing of services, as prescribed and having an overall turnover from all its products and services of Rs. 35 crores or more in the immediately preceding financial year to include cost records for such products or services in their books of account.

Rule 3 provides for the classes of companies including foreign companies which are required to maintain cost records. These companies are classified into

A. Regulated Sector

B. Non Regulated Sector

Companies covered under the regulated sector include companies engaged in telecommunication, transmission, distribution and supply of electricity, drugs and pharmaceutical etc. Whereas, the non regulated sectors include arms and ammunitions, steel, road and infrastructure projects corresponding to Schedule VI of CA 2013, rubber and allied products, coffee and tea etc.

Non-regulated sector includes tea and coffee, milk powder, insecticides, plastics and polymers, tyres and tubes, paper, textile, glass, other machinery, electrical or electronic machinery.

Companies falling under regulated sector and satisfying the threshold shall maintain their cost records from financial commencing on or after 1st April, 2014 in Form CRA-1, as provided in Companies (Cost Record and Audit) Amendment Rules, 2014. On the other hand, companies falling under the non-regulated sector, cost records shall be maintained from the financial commencing 1st April, 2015.

ii. What class of companies are required to conduct cost audit?

Section 148(2) provides that the Central Government may prescribe such categories of companies as covered in sub-section (1) of section 148, having the prescribed net worth and turnover to conduct their cost audit in the prescribed manner.

For the purpose of Section 148(2) of CA, 2013, Rule 4 of Companies (Cost Record and Audit) Amendment Rules has prescribed that every company falling under the regulated sector of the classified companies shall get its cost records audited in the prescribed manner, if overall annual turnover from all its products and services during the immediately preceding financial year exceeds Rs. 50 crores and the aggregate turnover for the product or products or service or services for which cost records are required to be maintained as per Rule 3 is Rs. 25 crores or more. For every company falling under the non-regulated sector cost record audit in accordance with these rules shall apply if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is Rs. 100 crores or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under rule 3 is Rs. 35 crore or more.

However, the requirement for cost audit under these rules shall not apply to a company either under the regulated sector or non regulated sector whose revenue from exports, in foreign exchange, exceeds seventy five per cent of its total revenue or which is operating from a special economic zone.

iii. When does the company need to appoint a cost auditor? Who can be a cost auditor?

For the class of companies specified in Rule 3 and Rule 4 based on their area of operations and networth and turnover threshold shall within 180 days from the commencement of every financial year appoint a cost auditor.

This would mean that the threshold limits are to be seen at the beginning of the financial year for the cost auditor appointment to effectuate.

A cost accountant, including a firm holding a certificate of practice as per the provisions of Cost and Works Accountants Act, 1959 can be appointed as a cost auditor.

iv. What is the process of appointment and determination of remuneration of a cost auditor?

Section 148(3) read with Rule 14 of the Companies (Audit and Accounts) Rules, 2014 provides for the appointment and remuneration of a cost auditor

in the following two circumstances, the appointment and determination of remuneration of a cost auditor will be as follows:

(i) Companies which are required to constitute an audit committee:

The audit committee shall recommend to the board a person who is eligible to be appointed as a cost auditor, along with the recommendation of remuneration to be paid to him. Thereafter the board shall appoint the cost auditor based on the recommendation of the audit committee. Further the remuneration recommended by the audit committee shall be considered and approved by the board of directors and ratified subsequently by the shareholders.

(ii) Companies which are not required to constitute an audit committee

The board shall appoint a cost auditor and the remuneration of such cost auditor shall be ratified by shareholders subsequently.

Once appointed the company shall inform the cost auditor of his appointment and file a notice of such appointment with Central Government within 30 days of the board meeting in which such appointment happened or with 180 days within 180 days from the commencement of the financial year whichever is earlier in Form CRA - 2.

This would mean that latest by 180 days from the commencement of the financial year the appointment must be done **and** the form for his appointment must be filed.

The cost auditor shall hold office till the expiry of 180 from the end of the financial year or till he submits the cost audit report for the year for which he was appointed.

v. Once the cost auditor is appointed, what are the compliances a company needs to carry out?

Once the cost auditor is appointed at the board meeting, the shareholders will ratify the appointment. The company will file the Form CRA 2 with regard to the appoint of cost auditor within 30 days from the board meeting or 180 days from the beginning of the financial year whichever is earlier.

vi. What are the regulatory compliances for the cost auditor?

The cost auditor shall:

- a. Comply with the cost auditing standards;
- b. Report any offences involving fraud, under section 143(12) of CA, 2013 and the rules thereof, committed against the company, in course of the performance of the duties as an auditor;

- c. Ensure that the provisions with regard to qualifications/disqualifications, duties and obligations as applicable to statutory auditor have been complied by the cost auditor as well;
- d. Submit his report along with reservations, qualifications and observations to the board of directors within 180 days from the close of the financial year in Form CRA – 3.

vii. Whether due to non-availability of revised Form CRA-4 on MCA portal penalty will be levied on account of delayed filing?

MCA has vide circular dated 12th June 2015 clarified that due to delay in notification of revised Form CRA-4, additional fee on delayed filing of Form CRA-4 for cost auditor's report for the FY starting 1st April 2014 shall be waived for all such filings up to 31st August 2015.

viii. Can the statutory auditor of the company be appointed as a cost auditor of the same company?

No. The statutory auditor of the company cannot be appointed as its cost auditor as well. This is clearly laid down in the first proviso to Section 148 (3) of the CA, 2013.

ix. Whether the appointment of cost auditor shall be for a period of 5/ 10 years like that of the statutory auditor as prescribed under Section 139?

The provisions of Section 139 apply to the appointment of statutory auditors only and the same cannot be extended to cost auditors as well. If the intent of the law maker was to include cost auditors, the law would have expressly said so.

Further a reading of Rule 6 of the Companies (Cost Records and Audit) Rules, 2014 makes it clear that a cost auditor so appointed in a financial year to conduct cost audit shall hold office only upto a maximum period of 180 days from the end of such financial year or till he submits the cost audit report, for the financial year for which he has been appointed.

x. Once the company receives the cost auditor's report, what compliances are the company required to carry out?

Once the company receives the cost auditor's report, the company is required to file the report along with the explanations on the qualifications and remarks in the report, with the Central Government, within 30 days from the date of receipt of the report in Form CRA 4.

xi. Who is the cost audit report addressed to?

The cost audit report is addressed to the board of directors.

xii. What if the company falls within the regulated or non-regulated sector list but has not commenced operations; will it still be required to carry out the cost audits?

The need for cost audit arises where the company falls under the listed category in Rule 3 and breaches the thresholds provided in Rule 4 for the trigger of requirement of cost audits. The trigger requirements specified in Rule 4 are turnover based, considering the company has not commenced operations, the company certainly does not have any turnover, hence the question of applicability of cost audit does not arise.

xiii. What shall be the term of the cost auditor?

The term of a cost auditor shall continue till the expiry of one hundred and eighty days from the closure of the financial year or till he submits the cost audit report, for the financial year for which he has been appointed, whichever is later.

xiv. Within what time shall casual vacancy in the office of a cost auditor be filled?

Any casual vacancy in the office of a cost auditor, whether due to resignation, death or removal, shall be filled by the board of directors within thirty days of occurrence of such vacancy and the company shall inform the Central Government in Form CRA-2 within thirty days of such appointment of cost auditor.

xv. What is the punishment for contravention of the provisions?

The penal provisions for non-compliance with the provisions of the section will be the same as provided under section 147, both for the company and the cost auditor, wherein:

- a. The company contravening the provisions shall be punishable with fine not less than Rs. 25000 and may extend to Rs. 5 lacs
- b. Every officer of the company who is in default shall be punishable with imprisonment for a term which may extent upto one year or with fine not less than Rs. 10000 which may extend to Rs. 1 lakh or both.
- c. The non-compliance cost auditor shall be punishable with a fee not less than Rs. 25000 which may extend to Rs. 5 lakhs

- d.* In case the auditor has knowingly or wilfully defaulted he shall be punishable with imprisonment of 1 year **and** with fine which shall not be less than Rs. 1 lac and may extend to Rs. 25 lakhs. Further, in such a case the auditor will be liable to refund the remuneration and shall be paying for damages suffered by any person on account of incorrect or misleading statements provided in the report.

BOARD'S POWERS

CHAPTER

8

8.1 PROHIBITION ON LENDING TO DIRECTORS AND ITS RELATED ENTITIES

i. What is the legislative intent of Section 185 of CA, 2013?

The intent of Section 185 of the CA, 2013 is to ensure that directors, who are sitting in the position of trustees for the shareholders, do not use their powers to benefit themselves by lending the money of the company to themselves or to such persons in whom the director is interested. The purpose of the section is evidently to avoid a conflict of interest.

ii. In context of Section 185 of CA, 2013, if any group private limited company gives/provides corporate guarantee and equitable mortgage of its property in favour of its group public limited company, is it possible to give the same. What if both the companies are private limited companies?

Section 185 of the CA, 2013 specifies that Company shall not either directly or indirectly advance any loan including any loan represented by a book debt, to any of its directors or to any other person in whom the director is interested.

Explanation to Section 185(1) lays down the meaning of the expression “to any other person in whom director is interested” to mean:

“.....

(c) any private company of which any such director is a director or member;

(d) any body corporate at a general meeting of which not less than twenty-five per cent of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together;”

Before we delve into the applicability of Section 185, it is important to study if the case under review is exempt from the provisions of Section 185. Pursuant to proviso (b) to Section 185(1) of CA, 2013, if the guarantee is provided by a company which is into the business of providing guarantee and charged commission as per applicable rates, then provisions of Section 185 will not be applicable.

If the exemption provision is not applicable, then the applicability of Section 185(1) can be studied as follows:

- (a) Private company providing guarantee on behalf of a public company:
This would fall under clause (d) above. Hence if a director of the private company, either individually or together with two or more directors controls or exercises 25% or more of the total voting capital of the public company, such a guarantee cannot be given.
- (b) Private company providing guarantee on behalf of a private company:
This would fall under clause (c) above. Hence, if a director of the private company is a director of the other private company or is a member of the other private company, such a guarantee cannot be given.

However, if in both scenarios the public/private company is the *wholly owned* subsidiary of the private company, the provisions of section 185 would not apply and the guarantee can be extended. In case the public/private company is a subsidiary (and not a wholly owned subsidiary) of the private company, and the private company is extending the guarantee in respect of a loan made by any bank or financial institution to such subsidiary company, the giving of guarantee would be exempted from the provisions of Section 185 provided that the loans are utilised by the wholly owned subsidiary or subsidiary in its principal business activities only. This is derived from Rule 10 of the Companies (Meetings of Board and its Powers) Rules, 2014. Further, the exemption clause was also made a part of section 185 by Companies (Amendment) Act, 2015 which was notified by MCA w.e.f. May 29, 2015

iii. The definition of loan is not provided under the CA, 2013. Therefore in layman language, can it be said that all transactions where a sum of money is given to a person to be returned with or without interest can be termed as loan?

It would be wrong to merely state that any financial transaction is a loan. One needs to study the meaning of the term 'loan' to conclude the applicability of Section 185 to any financial transaction.

If one were to see the definition of 'loan' in the 6th edition of Black laws dictionary, the same is defined as:

Delivery by one party to and receipt by another party of sum of money upon agreement, express or implied, to **repay it** with or without interest. *Boerner v. Colwell Co.*, 21 Cal. 3d 37, 145 Cal.Rptr. 380, 384, 577 P.2d 200 (emphasis supplied)

Further, in the case of *CIT v. Bajpur Co. Rerative Sugar Factory Ltd.*¹²⁴, the Hon'ble Supreme Court stated that for the purpose of loan, there must be a relationship of borrower and lender in the given transaction and if there is no relationship of borrower or lender, then the amount received cannot be considered as loan. There are also number of case laws which have analysed the meaning of the term 'loan' in the context of Section 2(22)(e) of IT Act, 1961. Looking at such case laws, the key elements of loan can be summarised as follows:

- (a) approach by the borrower to the lender for lending such amount as loan,
- (b) a relationship of lender and borrower,
- (c) an amount or a sum which may be in the shape of money or kind,
- (d) a recognition of liability on the part of the borrower to return it with or without interest.

Hence only when a financial transaction fulfils all of the conditions specified above, will the same be taken to be a loan.

iv. What is the implication of the words "save as otherwise provided in this Act" at the start of the Section 185 the CA, 2013?

Section 185 starts with the lines '*Save as otherwise provided in this Act.....*' The words means that where any other section in the Act contains provisions with regard to loans to directors then such section shall have overriding effect over the provisions of Section 185. In essence, if there is any other section that provides for loans to directors or permits loans to directors then the specific provisions of that section will prevail over Section 185 of CA, 2013. In all other matters provisions of Section 185 shall prevail.

Incidentally there is no other section in CA, 2013 which contains provisions on loans to directors or to such other persons in whom the director is interested. Some may argue that section 186 provides for the loans to be provided generically within certain limits, hence the provisions of Section 185 shall

124 Read the entire ruling at :<http://indiankanoon.org/doc/27080649/>

be overridden by the provisions of Section 186. However this view is not appropriate, since Section 185 is the restriction section providing blanket bar on loans to directors and Section 186 provides for quantum of loan that a company may extend. Section 185 is a permissibility section and section 186 is a section laying down magnitude.

Both the sections are mutually exclusive.

v. Whether Section 185 is applicable to a private company also?

MCA by way of its notification dated June 5, 2015¹²⁵ exempted private companies from the applicability of Section 185 subject to fulfilment of following cumulative points:

- (a) There is no body corporate shareholder in the lending/ guaranteeing company;
- (b) The lending company's aggregate borrowings from other bodies corporate or banks or financial institutions is limited to the lower of:
 - (i) 2X net worth of company; or
 - (ii) Rs. 50 crores; and
- (c) There is no pending default in repayment of such borrowings by the lending company.

Except for such private companies meeting each of the criteria mentioned above, Section 185 is applicable to all private companies.

vi. Whether section 185 of CA, 2013 is applicable to a banking company?

No, by virtue of Section 185(1)(b) of the CA, 2013, a banking company will be excluded from the purview of applicability of Section 185 of CA, 2013.

vii. What are the carve outs to the applicability of provisions of Section 185?

Section 185(1) shall not be applicable to the following:

- (a) Any loan given to a managing or whole-time director
 - (i) as a part of the conditions of service extended to all its employees; or

125 http://www.mca.gov.in/Ministry/pdf/Exemptions_to_private_companies_05062015.pdf

- (ii) pursuant to any scheme approved by the members by a special resolution.
- (b) A company which in its ordinary course of business extends loans, guarantees provides securities in respect of a loan and where the interest charged on such loan is not lower than the bank rate declared by RBI.
- (c) Additionally by way of Companies Amendment Act, 2015 the following exemptions were introduced:
 - (i) any loan made by a holding company to its wholly owned subsidiary company or any guarantee given or security provided by a holding company in respect of any loan made to its wholly owned subsidiary company; or
 - (ii) any guarantee given or security provided by a holding company in respect of loan made by any bank or financial institution to its subsidiary company:

Provided that the loans made under the circumstances listed above are utilised by the subsidiary company for its principal business activities.

- (d) Further, by way of Exemption Notification for private companies, Section 185 of CA, 2013 will not be applicable to private companies if the three conditions listed out in Question v above are fulfilled.

viii. Whether Section 185 is applicable to NBFCs?

The carve-out to the applicability of Section 185 is to such company which in ordinary course of business extends loans or gives guarantees or securities for the due repayment of any loan. An NBFC company registered as a loan company by virtue of its business activities provides loans in ordinary course of business. Hence such company may fall under the exemption category. Point to be noted that the carve-out is for a company which in ordinary course extends loans or provides guarantees. Not every NBFC is engaged in the business of granting loans or giving guarantees in the ordinary course of its business. For example, if the company is an investment company, its business consists of making investments, and not granting loans. In such a case, the exemption in proviso (b) to sub-section (1) of Section 185 may not be available. But if granting of loans is the ordinary business of the NBFC, the section will not be applicable to such company.

ix. Whether provisions of Section 185 apply to deposits?

The distinction between loans and deposits is well understood in law. There is a large body of case laws under Money lending laws, Section 2(22) (e) of the Income Tax Act and Section 370 of the CA, 1956, whereby courts have distinguished 'loans' and 'deposits'. Succinctly, where the *have-not* approaches the *have*, and seeks accommodation, the transaction is called a loan. Where a *have* approaches a *have-not*, and seeks parking of money, it is called a deposit. The distinction is highly circumstantial. However, given the fact that the section does not employ the language given in section 370 of the CA 1956, "loans" under the section cannot include deposits.

x. Whether pursuant to the provision of Section 185, such loan must carry Interest?

According to Black's Law Dictionary '*loan*' means a lending, advance of money with absolute promise to repay, a borrowing with a promise to repay delivery of money by one party and receipt by another on agreement, express or implied, to repay, or a deposit. It is not necessary for a loan to carry interest.

However, Section 185(1)(b) provides that loan on such interest must be charged at a rate not less than bank rate declared by the RBI. Hence in case if exemption is claimed under Section 185(1)(b) interest must be charged at a rate not less than bank rate declared by RBI. Even if a company was not to claim any exemption under section 185(1), it would anyway be bound by section 186(7) to grant loan at a rate not lower than the prevailing yield of 1 year, 3 year, 5 year or 10 year Government security closest to tenor of loan.

xi. Whether the provisions of Section 185 apply to advances?

Loan is a bailment of money. Therefore, the four elements of a loan are:

- (a) an amount, a sum which may be in the shape of money or kind;
- (b) placing of it with another, called borrower;
- (c) an agreement to repay, once again, in form of money; and
- (d) a recognition of liability on the part of the borrower, to return it with or without interest

An advance is given for a specific purpose, on the condition that either the money will be adjusted to offset obligation of the maker of the advance, or otherwise refunded. While a loan is a money-for-money transaction, an advance is intended to be for some specific pre-identified commercial transaction, for instance, advance for purchase of goods, advance for purchase

of services. The goods or the services, for which the advance is given, are usually pre-identified, as it defies commercial reality that one will provide an advance without any purpose.

In *Raja of Venkatagiri vs. Krishnayya Rao Bahadur* (AIR 1948 PC 150), the Privy Council has held that normally an advance is not repayable as an advance usually conveys an idea of a prepayment, that is, paying something in advance before it is actually due. Further in *CIT v. K. Srinivasan*¹²⁶ the expression 'advance' is construed as it means something which is due to a person but which is paid to him ahead of the time when it is due to be paid.

The section is clearly applicable only to loans and not advances. Given the same, one needs to also understand the distinction between loan and advance. If the advance has however been standing in books for a longer period than the usual terms of credit, then the same can be taken to be a loan. If an advance has been given to a director or directors' entity, the transaction may well be covered by Section 188.

xii. Whether the provisions of Section 185 apply to book debt?

The section is applicable only when there is loan in substance. The provisions of Section 296 of the CA, 1956 have been subsumed in Section 185. Hence, if a book debt is prolonged beyond the usual credit period, so as to allow more time to a debtor, such a debt may also amount to a loan. This intent is clear from the phrase 'including any loan represented by a book debt' as appearing in Section 185(1) of the CA, 2013.

xiii. Is a loan to an HUF, in which the director is the karta, any different from giving loan to the director itself?

Under the Hindu Undivided Family (HUF) system, the Karta is vested with the powers of decision making and has control over the HUF. All members of the family of the karta stand as beneficiaries/Co-parceners to the HUF.

A loan to the HUF, where the director of the company is the karta, will not be any different from giving loan to the director himself.

xiv. Whether the provision of Section 185 is applicable to subscription of debenture issued by another company?

Section 185 is applicable only to loans, and not to subscription of debentures. If the director's entity issues debentures, to which the company subscribes, the company is acquiring a 'security', and not making a loan. Hence, the provision of section 185 does not apply in such a case.

126 Read the entire ruling at: <http://indiankanoon.org/doc/526964/>

xv. Whether the Section 185 is applicable to a loan given to a wholly owned subsidiary?

By way of Companies (Amendment) Act, 2015, proviso to Section 185(1) was amended to state that loans, guarantees or security provided to wholly owned subsidiaries are exempt. Similar provisions were previously contained in Rule 10 of Companies (Meetings of Board and its Powers) Rules, 2014.

xvi. What is the true meaning of “accustomed to act in accordance with the directions or instructions” as given in Explanation (e) below Section 185(1)?

Explanation to Section 185(1) brings out the meaning of the expression ‘to any other person in whom director is interested’. Clause (e) of the *Explanation* provides that a company cannot extend loans to a body corporate where the board or managing director or manager of the borrowing company is ‘*accustomed to act*’ in accordance with the instructions of board or directors of lending company.

The meaning of the expression “accustomed to act” here essentially means that the board of the borrowing or beneficiary company does not use its prudence or wisdom while taking any decisions but merely acts according to the whims of the board of the lending company. The said clause (e) is purely circumstantial – in order to attract the section, it has to be made out that:

- (a) instructions were consistently given by the board of company A to the board of company B; and
- (b) the board of company B, without examining the rationale of such instructions or determining whether such instructions are in the best interest of the company; abided by the same.

There is no *prima facie* circumstance to presume the existence of such a situation. If at all there is any assertion that the board of the subsidiary is “accustomed to act” as per provisions of the *Explanation*, the onus of proving the assertion lies on the person making the same.

Moreover, under CA 1956, the MCA vide its circular dated 12th May 2011¹²⁷ clarified that approval of Central Government should be sought only if the provisions of clause (d) or (e) of Section 295(1) of the CA, 1956 are attracted. The intent of the above circular is that sec. 295(1)(e) cannot be taken as applicable merely due to the presence of common directors. There may, of course, be *prima facie* situations where one may contend that the board of

¹²⁷ http://www.mca.gov.in/Ministry/pdf/Circular_24-2011_12may2011.pdf

the borrower company is nothing but a subset of the board of the holding company. But such a *prima facie* contention may be rebutted with circumstantial evidence.

xvii. Whether Section 185 is applicable to a letter of comfort given by the company?

Section 185 is applicable to giving of guarantee. The word guarantee is defined in the Indian Contract Act, 1872 to imply the undertaking of the liability of a principal debtor by the guarantor. It will be a case of a guarantee where the guarantor undertakes to pay the debt of the principal debtor. However, where the commitment of the so-called comforting party is merely to the extent of introducing the principal debtor, or prevailing upon the principal debtor to pay, etc., there may be a moral or reputational obligation, but there is no contractual obligation of the comforting party, and hence, there is no guarantee. The distinction between guarantee and LoC is not merely one of language, it is language and intent put together. If there is a clear contractual liability being assumed by the contracting party, then it is a guarantee irrespective of the nomenclature.

xviii. When a loan is given by a lender in violation of the section, is the borrower also liable?

Section 185 (2) makes it very clear that not only is the lender liable for contravention of any of the provisions of sub-section (1) but also the director or the other person to whom any loan is advanced or guarantee or security is given or provided in connection with any loan taken by him or the other person, shall be punishable with imprisonment which may extend to six months or with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, or with both.

xix. Proviso (c) to section 185(1) read with Section 185 gives an impression that only loans from holding companies to wholly owned subsidiaries are exempted from the requirements of that Section and loans from holding companies to other subsidiaries continue to be governed by the requirements of Section 185. Does that mean loans from holding companies to other subsidiaries are prohibited unless the holding company gives such loans in the ordinary course of business at a rate of interest not less than the bank rate?

Looking at proviso (d) to section 185(1) it is apparent that loans extended to subsidiaries are not outright exempt from section 185 of CA, 2013. One needs

to study the provisions of explanations (c) and (d) to Section 185(1) of CA, 2013 to ascertain the applicability of Section 185(1). Further, the expression “accustomed to act” is purely circumstantial and requires to be proven by the person/party alleging it. Section 185(e) would not be attracted unless the same is proven. Further, Section 166(3) casts a statutory duty on every director to exercise his independent judgment while discharging duties as director. Thus, in view of the above stated, loans to subsidiaries may not get covered by section 185(1) at all.

xx. There is a blanket bar as per Section 185 on extending loans to directors or such persons in whom the director may be interested. What if a company was to extend a loan despite the bar under the Section?

Since there is a blanket bar on the companies to extend loan/security or guarantee under Section 185, if a company extends any of these in contrivance to the section, such contracts may be void and further the company and the director or the other person to whom any loan is advanced would attract the liability of Section 185(2) of the CA, 2013. However, the loans extended prior to 12th September, 2013 shall remain valid.

xxi. Section 185 of CA, 2013 *inter alia* provides that no company shall give loan to director or any other person in whom director is interested. Whether compulsorily convertible loan into equity, which does not carry any interest, given by a private NBFC to another private company wherein directors are common in both company are also barred in terms of the section?

Section 185 of the Act, 2013 clearly prohibits granting of loans by a company to another private company which has common directors or in which a director is a member.

In the present case a private NBFC company intends to grant interest free, compulsorily convertible loan to another private company which has common directors.

Compulsorily convertible loan is a debt until its conversion; and it becomes equity only on conversion. However *proviso* to Section 185 provides that the provision of this section shall not apply to a company which in its ordinary course of business provides loan and in respect of such loan interest has been charged at a rate not less than bank rate declared by Reserve Bank of India. Hence in this case an NBFC in its ordinary course of business is

proposing to grant loan to such private company and such loan does not carry any interest.

Having said this granting of interest free loan would hit the restrictions under Section 185 and thus private NBFC cannot grant 'interest free loan' to another private company in which the director is interested pursuant to the provision of Section 185 of CA, 2013 unless it is not covered by *Explanation (c)* to Section 185(1).

8.2 RESTRICTIONS ON LOANS AND ADVANCES

i. What types of specified transactions are covered under the Section 186(2)?

Section 186(2) of CA, 2013 provides three types of transactions to which the provisions of Section 186 would apply:

- (a) Loan to any person or body corporate;
- (b) Guarantee or providing any security in connection with loan to any other body corporate or person;
- (c) Acquiring by way of subscription, purchase or otherwise the securities of any other body corporate.

ii. What is the ceiling on the specified transactions that Board of Directors of a company can enter into?

Transactions entered into by the Board under Section 186(2) should not exceed the aggregate of:

- (a) 60% of its paid-up share capital, free reserves and securities premium account; or
- (b) 100% of its free reserves and securities premium account.

iii. A company intends to give loan to another company. What are the potential sections that may get attracted from the lender company's perspective?

The lender company needs to see whether the following sections get attracted:

- (a) Section 179 – Whether the Board has the power to grant a loan?
- (b) Section 185 – Whether the loan tantamounts to be a loan given to any of the directors or to any other person in whom director is interested?
- (c) Section 186 – Whether the loan give falls within the threshold limits provided in the section?

In case the company is a listed company, then requisite compliances with regard to related party transactions under Clause 49 of the listing agreement will also have to be carried out as any transaction involving a transfer of resources, obligations or services to a related party will be regarded as a related party transaction.

iv. If a company receives a loan from any other company exceeding 60% of the paid up capital and free reserves of the company, would the provisions of Section 186(2) apply?

The provisions of Section 186(2) is applicable only when the company is extending loans to persons exceeding the limits as specified in Question ii above. In the present case the provisions of section 186 will be applicable to the lending company and not the company receiving the loan, irrespective of the fact that the loan received by the company exceeds 60% of its paid up capital and free reserves.

v. What if the ceiling of the specified transactions mentioned in Section 186(2) exceeds above limit?

As per Section 186(3) of the CA, 2013 where ceiling on specified transactions exceeds the limit provided in section 186 (2) of the CA, 2013, a prior approval by means of a special resolution would be necessary.

Rule 11(1) of the Companies (Meetings of Board and its powers) Rules 2014, provides that loan or guarantee is given or where a security has been provided by a company to its wholly owned subsidiary company or a joint venture company, or acquisition is made by a holding company, by way of subscription, purchase or otherwise of the securities of its wholly owned subsidiary company, the requirement of sub-section (3) of section 186 shall not be applicable.

vi. What is the meaning of free reserves for the purpose of Section 186?

Free Reserves is defined in section 2(43) of the CA, 2013 as –

(43) “free reserves” as means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:

Provided that:

- i. *any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or*

- ii. *any change in carrying amount of an asset or of a liability recognized in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves.*

vii. Is there any limit upto which shareholders can give approval if the transaction limit under Section 186(2) is exceeded?

No. By way of a special resolution, shareholders may approve any limit upto which the company may extend loans or give guarantee or provide security or acquire securities in any body corporate.

viii. Is there any exemption from the requirement of Section 186?

Section 186(11) prescribes the classes of companies to which Section 186, except sub-section (1), will not be applicable.

Further Rule 11 of the Companies (Meeting of Board and its Powers) Rules, 2014 also exempts loan or guarantee given or a security provided by a company to its wholly owned subsidiary company or a joint venture company, or acquisition made by a holding company, by way of subscription, purchase or otherwise of, the securities of wholly owned subsidiary company, from the requirements of section 186(3) of the CA, 2013 *i.e.* special resolution will not be required by the holding company if the transaction limits under Section 186(2) are exceeded.

ix. What is the meaning of 'body corporate' in the context of Section 186 of the CA, 2013?

Body Corporate is defined in Section 2(11) of the CA, 2013 as -

(11) *"body corporate" as "body corporate" or "corporation" includes a company incorporated outside India, but does not include –*

- i. *a co-operative society registered under any law relating to co-operative societies; and*
- ii. *other body corporate (not being a company as defined in this Act), which the Central Government may, by notification, specify in this behalf.*

x. Whether loans to employees are also covered under Section 186(1) of CA, 2013?

A plain reading of section 186 of CA, 2013 gives an impression that employee loans will be covered by the sweep of the stated section. This created problems for companies since companies had the practice of providing loans to

its employees. MCA by way of its General Circular dated March 10, 2015¹²⁸, clarified that employee loans will not be covered by Section 185 provided that the same were provided in accordance with the remuneration policy of the company and in accordance with the conditions of service.

xi. What are ‘investment companies’ as per Section 186(1) of the CA, 2013?

Explanation to Section 186 defines the term ‘Investment Companies’ to mean any company whose ‘principal business’ is the acquisition of shares, debentures or other securities. An investment company typically makes investments in other entities. Section 186(2)(c) provides the following to be counted as *investments*:

- (a) Subscription or purchase of shares;
- (b) Subscription or purchase of share warrants;
- (c) Subscription or purchase of debentures, bonds or similar debt securities.

An investment company may or may not be a group investment company, or so-called “core investment company”. So, Section 186(1) is attracted only when the investment is through investment companies.

While defining ‘investment companies’ the term ‘principal business’ has been used, which is nowhere defined. However, the term can be construed to mean the line of business in which the company is largely into and carries on such a business with regularity. Merely having a clause in the main objects clause of memorandum of association of the company stating that investment in securities as a probable line of business shall also suffice. For the purposes of this section, the investment company should carry on the business of acquiring securities as a main line of business.

xii. What is meant by ‘layers of investment companies’ under section 186(1) of the CA, 2013?

Section 186(1) of the CA, 2013 puts down restriction on companies to make investments through more than 2 layers of investment companies. The word “layer” has not been defined in Section 186 of the CA, 2013. However, this would cover only vertical layers of investments through such investment companies. Let us understand this by way of the following examples:

For instance if a company A has investment in company B and B has investment in company C and C has investment in company D, one would say,

A has invested in D, through B and C. B and C merely acted as layers, as the flow of investment was clear. In such a scenario there will be a bar on D making an investment in the securities of company E. This is assuming that companies B, C and D are investment companies.

On the contrary, if A makes investment in B, and A makes investment in C as well, and B and C make an investment in D, then obviously there will be one layer only. Thus, the restriction is not on horizontal propagation.

xiii. Can the entity making the investment as also the target entity be a foreign entity?

The entity making the investment has to be a company as the section applies only in case of investments made through investment companies. However, Section 186(2)(c) talks about investment in a body corporate; hence the target company can be a body corporate.

xiv. Are there any exceptions to the provisions of Section 186(1)?

Yes. The proviso exempts the applicability of this section to:

- (a) A company acquiring from any other company incorporated outside India if that company has investment subsidiaries beyond two layers as per the laws of that country.
- (b) A subsidiary company from having an investment subsidiary to fulfil any regulatory requirement.

xv. In case a company makes an investment in violation of the provisions of Section 186(1), who would be liable - the investing company or the target company?

The restraint is clearly on the making of the investment. Hence, it is maker of the investment who violates the section. Unlike Section 185, there is no implication on the recipient company.

xvi. Is the section applicable to Core Investment Companies ('CIC') which are formed to make investments in group companies?

CIC are such NBFCs which invest 90% of net assets in the securities issued by its group companies and hold at least 60% of the equity shares in group companies. By virtue of Section 186(11) the entire section except section 186(1) of CA, 2013 is exempted for such companies whose principal business is acquisition of securities. Thus, the limit of investing through more than 2 layers of investment companies shall be applicable on CICs also.

xvii. Is the provision relating to having a limit on the number of investment companies under Section 186(1) different from the provision of Section 2 (87) of the CA, 2013 which provides for having a limit on the number of subsidiary companies a company can have?

Yes. Section 186(1) is attracted only when the investment is made through more than 2 layers of through ‘investment companies’. Here, investment companies are different from subsidiary companies. Investment companies are companies whose primary business is the acquisition of securities.

The provision of Section 2(87) limits the number of subsidiaries that specified companies may have, which has not yet been notified by the Government. Section 2(87) does not specify the use of investment companies as a conduit to make investments. Thus, even if investments are made through an operating company, the limits as and when prescribed under Section 2(87) of Act, 2013 shall also apply. By operating company we mean such a company which uses resources to carry on a substantive operation, such as manufacture, trading or provision of services.

A tabular presentation of the difference between the Sections 2(87) and 186(1) of the CA, 2013 is presented below:

Criteria	Section 2(87)	Section 186(1)
Applicability	Presently on all companies	Presently on all companies
Restriction on	Holding company having layers of subsidiaries as may be prescribed.	Investing through more than 2 layers of investment subsidiaries
Entity at the end of the loop of the layer	Can be a body corporate	Has to be a company
Investment through	Can be through bodies corporate	Has to be necessarily through investment companies
Onus of complying with the section	Holding company	Holding company
Criteria of establishing relationship	Subsidiary can be either by way of control of composition of board of directors or by way of investment in total share capital of company	Holding company has to invest through investment subsidiaries. Investment can be in any security.

Table 24: Difference between the sections 2(87) and 186(1) of the CA, 2013

xviii. Whether various advances and deposits will also be covered under Section 186 of the CA, 2013?

Section 372A of the CA, 1956 specifically provided that loans include deposits. However the corresponding Section 186 of the CA, 2013 does not have such

inclusion. Hence advances and deposits will not be covered under Section 186 of CA, 2013 subject to the reply to the question below.

xix. Whether book debts will also be considered as loans for the provisions of section 186 of the CA, 2013?

Loan is not defined in CA, 2013. Where a book debt is prolonged beyond the usual credit period provided to the debtor, such book debts would be considered nothing but a loan in disguise.

xx. Whether investments in mutual funds are also covered under Section 186 of the CA, 2013?

Yes. Investment in units of mutual funds is included in the definition of securities and would, therefore, be covered under section 186 of the CA, 2013.

xxi. What is the procedure for entering into specified transactions under Section 186(2)?

In case the transaction limits do not exceed the specified limit of 60% of its paid-up share capital, free reserves and securities premium account or 100% of its free reserves and securities premium account, whichever is more, then the same may be entered into with Board's/delegated authority's sanction. In case the same is being approved at a meeting of the Board, Form MGT-14 would be required to be filed with the RoC. However, the same would not require filing in case such powers of the Board has been delegated to a Committee or other persons, as provided under section 179(3).

In case the transaction being entered into exceeds the 60% or 100% limit, prior approval of members by means of special resolution would be required. The special resolution is passed would also require filing of Form MGT-14 with the RoC. Pursuant to Rule 22(16)(i) of Companies (Management and Administration) Rules, 2015 approval of shareholders is required to be obtained by way of postal ballot in case of companies having more than 200 members

xxii. Section 372A explicitly provided that the 60%/100% limit was to be seen in the aggregate of such transactions. However Section 186 does not provide whether the 60% limit is for individual transactions or in the aggregate of such transactions. Please clarify.

Though the same is not explicitly laid down in the section, the most logical interpretation would be that such transaction limits should be exceeded in aggregate of all such transactions to attract the provisions of the section.

For instance if the company wants to extend a loan which together with all other loans extended would exceed the limits under Section 186(2), then prior shareholder approval would be required before extending the loan. An individual loan which alone exceeds the limits would any which way be covered by the prior special resolution requirement.

xxiii. MCA vide its clarification dated 9th April, 2015 clarified that where the effective yield on tax free bonds is greater than the yield on government securities as prescribed under section 186 of CA, 2013, there is no non-compliance of the section. Is this in conformity with Section 372A of CA, 1956?

Section 186(7) says, *“No loan shall be given under this section at a rate of interest lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan.”*

Section 186 talks about loans and bonds are not loans.

Erstwhile Section 372A of CA, 1956 had a similar clarification provided on the tax free bonds, however the distinction being that the explanation to section 327A, clarified that for the purpose of the section loans also included debentures. Such a clarification was not provided in case of Section 186. Therefore the clarification rendered by MCA, may not have much relevance for the present Section 186(7) of CA, 2013.

xxiv. What is the penalty prescribed in case of contravention of provisions of Section 186 under CA, 2013?

Section 186(13) of the CA, 2013 is the penalizing section for contravening the provisions of Section 186. In case the Company contravenes the provisions of Section 186, the company shall be punishable with fine which shall not be less than Rs. 25,000/- but which may extend to Rs. 5,00,000/- and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to 2 years and with fine which shall not be less than Rs. 25,000 but which may extend to Rs. 1,00,000.

xxv. Whether offence under Section 186 can be compounded?

Section 441 of the CA, 2013 provides for compounding of certain offences. This section provides for compounding of offences punishable with ‘fine’ only or ‘fine or imprisonment’.

Section 441(1) any offences with fine only will be compounded by –

- (a) the Tribunal; or
- (b) where the maximum amount of fine which may be imposed for such offence does not exceed five lakh rupees, by the Regional Director or any officer authorized by the Central Government

Further, Section 441(6) provides that offences with ‘imprisonment or fine’ or with ‘imprisonment or fine or with both’ shall be compoundable with the permission of the special court.

Any offence which is punishable with ‘imprisonment’ only or with ‘imprisonment and fine’ cannot be compounded.

In light of the above in case there is non-compliance of the provisions of section 186, the fine levied on the company is compoundable. However officers in default would be liable to ‘imprisonment and fine’ and hence cannot be compounded.

xxvi. Can a company give interest-free loan?

Section 186(7) of the CA, 2013 provides that no loan shall be given under this section at a rate of interest lower than the prevailing yield of one year, three year, five year or ten year Government Security closest to the tenor of the loan. If the Company is exempt by section 186(11) of CA, 2013, then interest-free loan can be provided.

xxvii. Can a company give interest-free guarantee to its wholly owned subsidiary company?

Section 186(7) restricts granting of a loan at a rate lower than G-sec yield. Rule 11 of the Companies (Meetings of Board and its Powers) Rules, 2014 provides exemption from the applicability of sub-section (3) of Section 186 and not the provisions of the entire section. Hence, even in case of loan given to wholly owned subsidiary the rate of interest cannot be lower than G-sec yield. Since the provisions of Section 186(7) are applicable only to providing guarantee, interest free guarantee can be provided under Section 186 of CA, 2013.

xxviii. Whether there is any other restriction on entering into specified transactions by a company under Section 186?

Section 186(8) of the CA, 2013 prohibits a company which is in default in the repayment of any deposits accepted before or after the commencement of this Act or in payment of interest thereon from giving any loan or guar-

antee or providing any security or making an acquisition till such default is subsisting.

In case the company obtains term loans from any public financial institution (PFI), prior approval of such PFIs are required before providing loan or guarantee or security by the company.

Further every company entering into transactions under Section 186(2) is required to disclose details such transactions in their financial statements along with the purpose for which the loan/guarantee/security is proposed to be utilised.

xxix. Whether there are any special provisions for various intermediaries associated with securities market?

Companies registered under section 12 of the Securities and Exchange Board of India Act, 1992, and also covered under such class or classes of companies which may be notified by the Central Government in consultation with SEBI, shall not take any inter-corporate loan or deposits, in excess of the limits specified under the regulations applicable to such company, pursuant to which it has obtained certificate of registration from SEBI. Further such companies to disclose details of loans and deposits in their financial statements. These provisions are provided in Section 186(6) of the CA, 2013 read with Rule 11(3) of the Companies (Meeting of Board and its Powers) Rules, 2014.

xxx. What if the investment company qualifies as an NBFC?

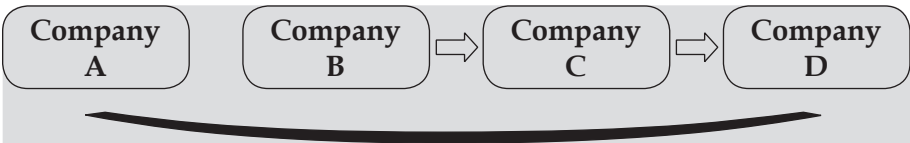
Section 186 talks about investment companies being used as conduits for investments. Here the process involves the flow of the investor's funds and not that of the investment companies. In any event the investment companies will have to comply with the RBI directions for onward investments.

xxxi. C holds investments in D; A makes an investment in B; and B makes investment in C. Will the restrictions on making investments through layers of investments, as per Section 186 of the CA, 2013, be applicable to A?

In the present case, C is merely an investment company. If we take a look from A's perspective, investment is being made in B, which in turn is investing in C, actually not to buy C, but to indirectly buy D. C is merely an investment company. An investment company is merely a shareholding device. A could not have intended to make an investment in C as the actual target investment is D. In the instant case, A might well have made investment in C directly instead of using B as a conduit for its investment. But ultimately,

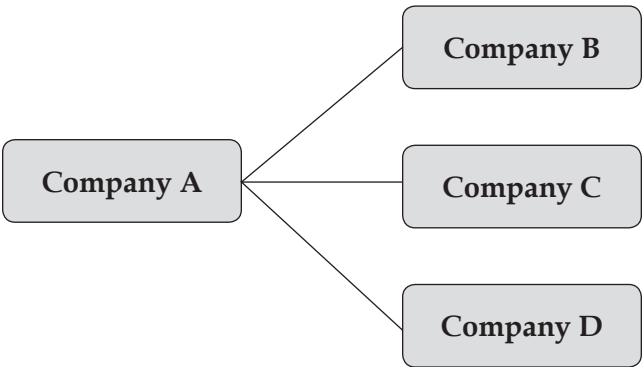
A is investing in D through not more than 2 layers of investment companies, thus, A will not be hit by the restrictions of section 186.

xxxii. D is an operating company, which is held by C, and C is an investment company held by B; A wants to buy D. Will the restrictions on making investments through layers of investments, as per Section 186 of the CA, 2013, be applicable to A? The proposed transaction structure is illustrated as below:



Section 186 prohibits routing of investment through more than 2 layers of companies, but in the present case, A could not have had the choice of making direct investment into Company D as the shares of Company D are held two layers up by Company B. In case B is a company incorporated outside India and if it has investment subsidiaries beyond 2 layers, then investment by A will not be hit by the restrictions of section 186.

xxxiii. Company A, a company incorporated in India, invests in B, C, and D (all companies incorporated outside India), does the provision of Section 186 are applicable to such cases as well? The transaction structure illustrated below:



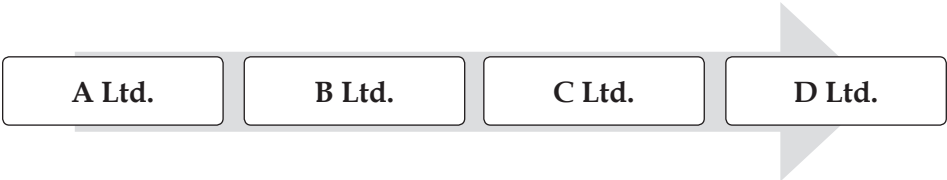
Section 186 of the CA, 2013 is applicable only to the investments done through more than 2 layers of investment *companies*. ‘Company’ under the provision of this Section would denote company incorporated in India. Company which has been incorporated outside India will thus not be covered by the scope of this section and thus, any investment made by A given the facts of the case above, will not be covered by section 186.

xxxiv. A is making an investment in B, which in turn has already made investment in C and D? Will A get hit by the restrictions of section 186? Transaction structure is illustrated as below:



Section 186(1) of the CA, 2013 puts a restriction on investments made through more than 2 layers of investment companies. In the instant case, funds of A are not flowing through more than 2 layers of investment company, and thus the same is not restricted under section 186 of the CA, 2013. As expressed earlier, horizontal propagation is taken to be a single layer of investment.

xxxv. Assume a case where A Ltd. makes an investment in B Ltd. B Ltd makes an investment in C LLP. C LLP now holds shares in D Ltd. Is A Ltd. is under violation of Section 186(1) of CA, 2013? Transaction structure illustrated as below:



Section 186 would not be violated under the said situation, since an investment is not made through two investment companies. This is because C LLP is a body corporate and not a company.

xxxvi. Whether in case of violation of Section 186 of the CA, 2013 the investment made will be termed as void?

Section 374 of the CA, 1956 prescribed penalty for contravention of Sections 372 and 373 if the CA, 1956. For the purpose of the section, government had clarified that where any investment is in violation of public interest, simply payment of fine shall not suffice. The investment shall also be taken as void. Although, CA, 2013 does not have a corresponding section as Section 374 of CA, 1956, yet the principle laid down by the government’s clarification for the erstwhile CA, 1956 can be borrowed for the purpose of section 186(1) too and consequently, any investment in violation of the Section 186(1) should be considered as void.

xxxvii. Whether it is necessary for the investee company to seek declaration from the investor company that such investor company has not violated the provisions of Section 186 of CA, 2013?

It is the investor company which shall be held liable in case of any violation of Section 186 of the CA, 2013. However in light of the Government's clarification under the erstwhile CA, 1956, as discussed above, the investment itself shall also be considered as void in case of violation of the said section. The investee company, thus, may seek for a declaration from the investor company whether the investment made by the investor is coming from more than two layers of investment companies.

xxxviii. Will the provisions of Section 186, be applicable for the investments made prior to the effective date of the section?

The answer to the question would be negative. Since nothing in Section 186 suggests that the section is applicable retroactively, it does not affect investments made prior to the effective date.

xxxix. Whether the section limits the right of infrastructure companies to form Special Purpose Vehicles (SPV)?

SPV signifies a horizontal propagation, whereas the object of Section 186 is to restrict vertical propagation. Thus, a company can have as number of SPVs as required and still will not be hit by the provisions of section 186(1) of CA, 2013.

xl. Section 2(87) postulates that a relationship of subsidiary can be established if one controls the Board of the other company. Whether such category of subsidiary falls within the purview of Section 186(1)?

Section 186(1) of CA, 2013 nowhere talks about investment through subsidiary. Hence for the purpose of section 186(1) control over the board of company will not be the reason enough for attracting the provision of section 186(1).

However, if apart from control, such subsidiaries are also investment companies, Section 186(1) shall be attracted.

xli. Does investing in preference shares by a company needs compliance of Section 186(2)/(3) of the CA, 2013?

Investment in any securities of any other body corporate will require compliance of Section 186(2)/(3) unless the same falls under exemption provided in Section 186(11). Hence investments made in preference shares by a company will attract the liabilities of the section.

xlii. The reading of provision of Section 186(7) of the CA, 2013 indicates that interest free loan is not permitted under CA, 2013. The Act however is silent on the fact, whether a moratorium on loan so granted can be provided. Can a company provide for a loan with a moratorium period?

The purpose of Section 186(7) of CA, 2013 is that companies do not engage in lending at rates of return below risk-free rates. The focus of Section 186 (7) is on the rate of interest that a company charges, and not on timing of payment of such interest. Hence, if interest accrues during a certain moratorium period, but the interest becomes payable only after the moratorium, there is no offence of Section 186(7) at all.

xliii. Whether a resolution passed under Section 372A of CA, 1956 will still be valid?

Yes, the resolutions passed under Section 372A of the erstwhile CA, 1956 would still be valid since as per Section 465 of the CA, 2013 anything legally done under the provisions of a previous act would hold good, unless the same is contrary to the present act.

Further, if the intention of the law maker was to require a fresh resolution to be passed under section 186(2), it would have indicated the same as in case of section 180 of the CA, 2013.

xliv. Whether specified transactions with parties covered under Section 185 of the CA, 2013 will also be governed by Section 186 of the CA, 2013?

Sections 185 and 186 of CA, 2013 are mutually exclusive sections. Section 185 puts a bar on certain kinds of loan, guarantee or security provided, whereas, Section 186 talks about the quantum of loan, guarantee or security that a company can provide for.

In essence Section 185 is a barring section whereas Section 186 provides the quantum of loans and investments. Hence if there is an explicit bar on a transaction as per the provisions of Section 185 then the question of quantum as under Section 186 does not arise.

xl. Two companies (One private limited and One public limited) has granted loan and taken loan respectively, in excess of the limits specified in Section 186(2) of the CA, 2013 and Section 180(1)(c) of the CA, 2013 as on 31st March 2014. Further the company has done transactions in the current year as well. Earlier Section 293 of

the CA, 2013 and Section 372A of the CA, 1956 was applicable to public limited companies only. What are the applicable procedural compliances under the CA, 2013?

Any inter-corporate loans and investments made by a private company were earlier exempt from the provisions of Section 372A of CA, 1956. However Section 186 of CA, 2013 does not provide for any such carve out. The transactions that were undertaken in compliance with the provisions of CA, 1956 will not have to be re-visited as per the provisions of CA, 2013. However any new loans given or investments made or security provided by the private company will have to be compliant with the provisions of CA, 2013. This would mean if the loan/investment to be made exceeds the limits provided in Section 186(2) then shareholders' approval by way of special resolution will be required. The company will have to file MGT 14 for the resolution passed at the meeting. Further in case of the limits in Section 180(1)(c) of CA, 2013, the same will not be applicable to the private company by virtue of the exemption notificated dated June 5, 2016 issued by MCA.

xlvi. In context of Section 186 of CA 2013, if any group private limited company gives/provides corporate guarantee and equitable mortgage of its property in favour of its group public limited company, is it possible to give the same. What if both the companies are private limited companies?

Section 186 does not provide a bar on providing guarantee by a company to any other person. It merely requires a special resolution to be passed in case the providing of guarantee by a company exceeds 60% of its paid-up share capital, free reserves and securities premium account or 100% of its free reserves and securities premium account, whichever is more. Rule 11 (1) of the Companies (Meetings of Board and its Powers) Rules, 2014 further provides that guarantees provided by a company to its wholly owned subsidiary company or a joint venture company is exempted from the requirement of passing the special resolution as discussed in the above para.

Hence if the private/public company is a wholly owned company it will not be required to pass a special resolution if the guarantee extended by it exceeds the 60% or 100% limits. Also the exemptions provided under Section 186(11) to a non-banking financial company may be referred to.

However, the provision of Section 185 need to be kept in mind before granting of loans, providing any guarantee or securities by the private company. Section 185 will however be not applicable to a private company if it fulfils each of the below mentioned criteria:-

- a. There is no body corporate shareholder in the lending/guaranteeing/security providing company;
- b. The lending company's aggregate borrowings from other bodies corporate or banks or financial institutions is limited to the lower of -
 - (i) 2x paid-up share capital of company; or
 - (ii) Rs. 50 crores; and
- c. There is no pending default in repayment of such borrowings by the lending company.

xlvi. Whether advances by the companies to its employees for religious occasions, emergencies etc. will have to be recorded in the registers maintained under Section 186 of CA, 2013.

Section 186 covers only loan transactions and not advances. An advance is given for a specific purpose, on the condition that either the money will be adjusted to offset obligation of the maker of the advance, or otherwise refunded. While a loan is a money-for-money transaction, an advance is intended to be for some specific pre-identified commercial transaction, for instance, advance for purchase of goods, advance for purchase of services. So an advance against salary is an advance and not a loan and therefore outside the purview of Section 186. Similar view can also be taken for trade advances. However any advance is for a short span of time. The time period for providing an advance against salary is a subjective view and thus an advance against 6 months salary, repayable within 24 months thereafter would be appropriate. The same may be incorporated in case a policy to this effect is framed. Similarly for trade advances, if the advance exceeds the normal credit period granted by the Company, the same shall be a loan in disguise. Anything not complying with the Company's policy shall be taken to be a loan in disguise. Thus, Section 186 of CA, 2013 does not apply to advance to employees, provided that these advances retain their nature.

xlvi. As per Section 186 read with Rule 12 of the Companies (Meetings of Board and its Powers) Rules, 2013, companies are required to maintain register to record giving of loans or guarantees or providing securities or making acquisitions from the date of incorporation. How will the companies deal with this, whose details from the time of incorporation are not available as on date?

Since the section was enforced w.e.f. April 1, 2014, therefore transactions which have occurred before April 1, 2014 may be maintained in the old

format. Since, all transactions entered into since incorporation may not be readily available, information as readily available till 31st March, 2014 may be maintained in the old format. Transactions entered into on or after April 1, 2014 shall be maintained in the new format. The Rule requires the register to be maintained in the new format since the incorporation of the company. Such a requirement is only for companies which have been incorporated under CA, 2013.

xlix. Can the entries in the register maintained under Section 186 of CA 2013 be made party-wise instead of chronologically?

Rule 12(2) of Companies (Meetings of Board and its Powers) Rules, 2014 requires the entries to be made chronologically. Where entries are not made chronologically but party wise, the very purpose of this Rule will stand defeated.

1. What is the meaning of 'investment' under Section 187? Is it different from its definition under Section 186 of the CA, 2013?

Section 187 of the CA, 2013 requires companies to hold 'investments' in its own name. In this regard Section 187(1) of the CA, 2013 reads as below:

'All investments made or held by a company in any property, security or other asset shall be made and held by it in its own name.'

The meaning of the word "investment" as occurring in Section 187 is quite different from what it means in Section 186. The meaning of investment under Section 186 is most definitely related to investments in securities of any body corporate. However as is evident from the language of Section 187, investment made or held by a company not only in securities, but also in 'any property or other assets' would define the purview of the section. The same was the stance under the corresponding Section 49 of the Companies CA, 1956, where the term 'all investments' was used, whose interpretation cannot be limited to merely securities of the company.

Moving on, an 'investment' can obviously arise from an investment activity. As for the meaning of the expression "investment activity", we may refer to Accounting Standard-3 which defines 'investing activities' as:

'Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.'

Further, 'operating activities' are defined as:

'principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.'

Drawing cue from the definition of ‘operating activities’, which does not include investment activities, it is clear that “investment activity” and “operating activity” are mutually exclusive. What the company does as a part of its core business activity cannot be an investment. Investment is that of a surplus or an amount which is not used in the core operations of the company.

li. When should a company maintain the register under Section 187 (3) of the CA, 2013?

Section 187(1) of the CA, 2013 requires every company to make and hold all its ‘investments’ in its own name. Sub-section (2) of the section lays down exemptions in certain situations which allow companies to deviate from the above rule. One such situation is where the company is holding securities in the name of a depository as a beneficial owner.

To this, sub-section (3) to the section read with Rule 14 of the Companies (Meetings of Board and its Powers) Rules, 2014 requires companies *in pursuance of clause (d) of sub-section (2)* to maintain a register in Form MBP 3 and enter therein the particulars of investments in shares or other securities beneficially held by the company but which are not held in its own name.

From the above, it becomes abundantly clear is that the requirement of keeping the Register u/s 187 arises only if the shares are held in demat form. This is clarified by the opening lines of section 187(3) which make a reference to clause (d) of sub-section (2) (pertaining to demat holding of investments). Hence, the register u/s 187(3) will not be required to be maintained in case investments are held in physical form.

lii. Whether any demat holding by a company require maintenance of the register under section 187?

The language of section 187(3) is reproduced below:

‘Where in pursuance of clause (d) of sub-section (2), any shares or securities in which investments have been made by a company are not held by it in its own name, the company shall maintain a register which shall contain such particulars as may be prescribed.....’

This means that the requirement of keeping the register will be attracted only if the demated investments are not held by the company in its own name, even though the company is a beneficial owner of the securities.

In this scenario two interpretations may arise:

- (a) The company is required to enter into the register details of all the investments which it holds as a beneficiary in the records of the depository.

One may have this interpretation because sub-section (3) makes reference to clause (d) of sub-section (2) *i.e.* demat holdings which itself tantamounts to not holding of the shares in its own name but in the name of the beneficiary.

If the intent of the section was to include in the register all demated investments of the company, then in addition to this leading to a humongous work on the part of the company, it would only also lead to duplication of work considering that the depositories itself maintain a Register of Beneficial owners wherein the name of the company would be included and which is deemed to be a Register of Members pursuant to Section 88(3) of the Act.

- (b) The other interpretation is that entry in the register would be required for only those investments in which a company is a beneficial owner, but its name is not entered in the Register of Beneficial Owners maintained by the depository.

In this case, those demated investments in which the name of the company is appearing as a beneficial owner in the Register of Beneficial owners will not have to be included in the register. Only those investments, of which the company is a beneficiary, but someone else's name is appearing in the Register of Beneficial owners will need entry in the register.

Sub-section (3) makes reference to Section 187(2)(d). Sub-section (2) of Section 187 itself provides an exception *i.e.* in those cases the company will not need to hold the securities in its own name and the name in which they have been held would be sufficient compliance of the section. In pursuance of this exception (d), where the investments are not held by the company *i.e.* the company is not holding investments in the name of the depository, but someone else's name is entered in the depository Register of beneficial owners, with the company as the actual beneficial owner will require entry in the register.

This view is further supported by the fact that the company needs to enter in the register the purpose of investment.

If there are two interpretations – one which serves purpose of law, and the other which will leads to redundancy, the more practical and useful interpretation should be accepted. The first interpretation leads to an undesirable and absurd result and will only lead to duplication. The second situation offers a more logical and practical interpretation of the section.

liii. Where the Company holds shares in a subsidiary in the names of its nominees (as stated in the proviso to section 187(1), would the same need to be disclosed in the Register maintained under Section 187 of CA, 2013?

As discussed in Question I above, the register under section 187(3) would be required to be maintained only in case of demat holdings wherein the company is a beneficial owner of the investments made but the same are held in someone else's name.

In the present case, if the shares in the subsidiary are not in demat form, the provisions of section 187(3) will not apply. In case of demat holdings, two situations will arise:

- (a) Shares are jointly held with the nominees: In this case, there is no question of the shares not being held in the name of the company, since it is a joint holder of the shares. Here the register will not be required to be maintained.
- (b) Shares are singly held by the nominees: In this case, since the company is the beneficial holder but not holding the shares in its own name, the same would require entry in the register u/s 187(3) of the CA, 2013 along with the purpose of investment.

liv. There may be certain directors who hold more than 2% of the share capital of another company, as disclosed in the notice under Section 184(1). However no contract is entered/proposed to be entered with such company. In this event would it be necessary to make any entry in the Register u/s 189?

A company needs to maintain a register of contracts or arrangements in which the directors are interested, in Form MBP 4, as per the provisions of section 189 read with Rule 16 of the Companies (Meetings of the Board and its Powers) Rules, 2014.

The format of the register is divided into two parts:

- (a) Part A contains the details of the contract or arrangement with any related party under Section 188 or in which any director is concerned or interested.
- (b) Part B contains details of the names of the bodies corporate, firms or other association of individuals in which the director has concern or is interested.

The contents to be stated in Part A of the Register are provided below:

- (a) Date of contract/arrangement;
- (b) Name of the party with which contract is entered into;
- (c) Name of interested director;
- (d) Relation with director/company/nature of concern or interest;
- (e) Principal terms and conditions;
- (f) Whether the transaction is at arm's length basis;
- (g) Date of approval at the meeting of the Board;
- (h) Details of voting on such resolution (No. of directors present in the meeting, voting in favour, voting against, remaining neutral);
- (i) Date of the next meeting at which register was placed for signature;
- (j) Reference of specific items- (a) to (g) u/s 188(1);
- (k) Amount of contract;
- (l) Date of shareholders approval, if any;
- (m) Signature and Remarks, if any.

The contents to be stated in Part B of the Register are provided below:

- (a) Names of the Companies/bodies corporate/firms/association of individuals.
- (b) Name of the interested director;
- (c) Nature of interest or concern/Change in interest or concern
- (d) Shareholding, if any;
- (e) Date on which interest or concern arose/changed

In essence even if there are no contracts entered into by the company with such parties in who the directors have interest or concern, despite that, the company will have to fill the details atleast in Part B of the register. As and when the company enters into a contract with the other company, entry has to be made in Part A of the register.

lv. Suppose a company provides Advance to workers at its units. The following questions arise in this regard?

- (a) Whether salary given as advance will be construed to be loan. If yes, to what extent and what are the procedures to be followed?**

Section 186 covers only loan transactions and not advances. An advance is given for a specific purpose, on the condition that either the money

will be adjusted to offset obligation of the maker of the advance, or otherwise refunded. While a loan is a money-for-money transaction, an advance is intended to be for some specific pre-identified commercial transaction, for instance, advance for purchase of goods, advance for purchase of services.

So an advance against salary is an advance and not a loan and therefore outside the purview of Section 186. Please also see reply to Question number xlvii.

- (b) Salary advance up to which amount and period of repayment/adjustment of the same can be outside the purview of loan. Can we frame policy as per our grade of employees?**

The time period for providing an advance against salary is a subjective view. See reply to Question xlv.

- (c) Can the Board delegate the power to approve loan to any committee/HR Head, so that the Committee/HR Head can sanction the loan as and when required.**

Proviso to section 179(3) provides that the Board may delegate its power “to grant loans or give guarantee or provide security in respect of loans” (under section 179(3)(f)) ‘to any committee of directors, the managing director, the manager or any other principal officer of the company or in the case of a branch office of the company, the principal officer of the branch office, the powers specified in clauses (d) to (f) on such conditions as it may specify’.

However Section 186(5) provides that “No investment shall be made or loan or guarantee or security given by the company unless the resolution sanctioning it is passed at a meeting of the Board with the consent of all the directors present at the meeting”.

This is in direct conflict with the proviso to Section 179(3). The only way to resolve this is to have a harmonious interpretation of both the sections. This is because one needs to be cautious while interpreting two provisions which are on similar lines. If the interpretation renders any other provision infructuous then the very purpose of that section will get defeated. Thus where the powers of the Board have been delegated as per proviso to section 179(3), the same does not get attracted under Section 186(5). This is possible only if the delegating resolution is passed unanimously by directors present in the board meeting. It is only when the company has not delegated such powers will Section 186(5) be applicable. This is supported by the presence

of the words ‘*the resolution*’ which implies that only those resolutions which come to the Board for approval would require unanimous consent of the directors present.

(d) Whether the interest free loan already given to employees before 1-4-2014 will attract interest now?

As per Section 6 of the General Clauses Act, what was valid under the previous Act remains valid under a new Act unless the new law makes it retrospective. Section 186 of the CA, 2013 does not provide retrospective amendments and therefore interest free loans given before 1st April, 2014 will not attract interest under the new Act. However in case the same is renewed under the new Act, interest rate would become applicable.

8.3 RESTRICTIONS ON RELATED PARTY TRANSACTIONS

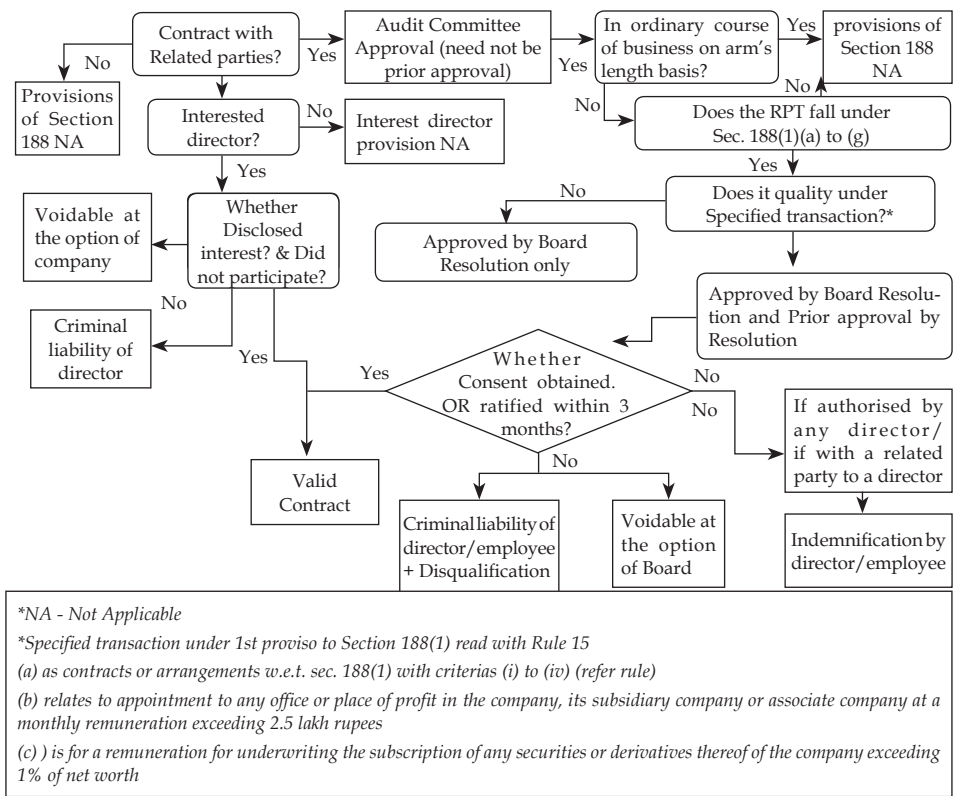


Figure 44: Process flow of Related party transactions under CA, 2013

8.3.1 Meaning and determination of related parties

i. Who are 'Related Parties' under CA, 2013?

Section 2(76) of the CA, 2013 defines the term 'related party' with reference to a company, as under:

- a.* A director/KMP/their relatives;
- b.* A firm, in which a director/manager/their relative is a partner;
- c.* A private company, in which a director/manager [or his relative] is a member or director;
- d.* A public company, in which a director/manager is a director and holds along with his relatives, more than 2% of its paid-up share capital;
- e.* A body corporate, whose Board of Directors/managing director/manager is accustomed to act in accordance with the advice, directions or instructions of a director or manager, other than in professional capacity;
- f.* Any person on whose advice, directions or instructions a director or manager is accustomed to act, other than in professional capacity;
- g.* any company which is a holding/subsidiary/fellow subsidiary/associate company of the other company;
- h.* such other person as may be prescribed.

The Companies (Specification of Definitions Details) Rules, 2014 provide that 'a director [other than an independent director] or key managerial personnel of the holding company or his relative with reference to a company, shall be deemed to be a related party'.

For the definitions of 'key managerial personnel' and 'relative', Sections 2(51) and 2(77) of the CA, 2013 has to be referred to along with the Rules on the same.

The definition of Related Party was much broader in Clause 49 of the revised listing agreement issued on 17th April, 2014 than the CA, 2013. It included all parties as under CA, 2013 definition and additionally also covered fellow associates, fellow joint ventures, and all entities under common control of a related party who is an individual.

However the definition of related party for Clause 49 of the listing agreement was later amended on 15th September, 2014 to include:

- a.* such entity is a related party under Section 2(76) of the CA, 2013; or
- b.* such entity is a related party under the applicable accounting standards.

ii. What happens when a party is a related party to the other?

Sections 177 and 188 of the CA, 2013 impose certain restrictions on transactions between related parties. Thus if the other party is a related party, as defined under Section 2(76) of the CA, 2013, these restrictions/compliances will apply on such related party transactions. Further, if the company is question is an equity listed company, the provisions of Clause 49 of the Equity Listing Agreement will also have to be complied with.

iii. Whether definition of Related Party under CA, 2013 is in sync with that of Accounting Standards (AS)?

No. Parties would be considered as related under AS 18 if one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Thus, the two essential ingredients for determining related party status under AS 18 is control and significant influence. However, under the CA, 2013 a director/KMP/their relatives shall be considered as ‘related party’ to the company, merely by virtue of them being a director/KMP.

To illustrate the above view, let us have a look at the following table:

Particulars	Whether related party under CA, 2013	Whether related party under AS-18
Director or relative	Yes	If the director is KMP.
KMP or relative	Yes. KMP defined to mean MD/CEO/manager, WTD, CS, CFO.	Yes. KMP defined to include persons with authority and responsibility for planning, directing and controlling activities.
Firm in which director, manager or his relative is a partner	Yes	No
Private company in which director or manager or his relative is a member or director	Yes	No. If the director can affect policies of both companies in their mutual dealings, then yes. Unless the director is able to affect the policies of both companies in their mutual dealings
Public company with common director <i>and</i> director and relatives hold 2% of its paid-up share capital	Yes	No. If only common director, then no. If the director can affect policies of both companies in their mutual dealings, then yes.

Particulars	Whether related party under CA, 2013	Whether related party under AS-18
BoD of a body corporate who is accustomed to act in accordance with directions of a director or manager which acts on or person on	Yes	Yes
A person on whose advice a director or manager is accustomed to act.	Yes	Yes. In case of individual, there must be an interest in the voting power that gives them control or significant influence. Relatives of such individuals shall also be related party
Holding company, subsidiary or associate	Yes	Yes
Fellow subsidiary	Yes	Yes
Joint venture	Yes	Yes
Fellow associate	No	Yes – if an individual ‘controls’ or exercises ‘significant influence’ over both the enterprises
Investor in the joint venture or associate	No	Yes.
Enterprise over which individuals holding controlling or significant influence in the company, exercise significant influence.	No	Yes
Enterprise over which key management personnel of the company or their relative, exercise significant influence.	No	Yes

Table 25: Comparison of meaning of related party under CA, 2013 and AS-18

The Rules on Definitions to the CA, 2013 also provides that a director (other than independent director) or KMP of the holding or their relatives shall also be deemed to be related to the company.

iv. In case if A is related to B, does this means B is related A?

Considering the provisions of CA, 2013, the answer is No. If A is related to B, this does not essentially mean that B is also related to A. One has to refer to the definition of ‘related party’ under the CA, 2013 to establish the relationship of related party.

For instance, Company A is one the investors in its joint venture/ associate being Company B. In this case, though B is a related party to A, A is not a related party to B under CA, 2013.

v. When there is one common director in two private companies, do such companies become related party?

Yes. Section 2(76)(iv) of the CA, 2013 provides that if a director or manager of any company (private or public) or their relative is a director or member in private company, then the private company would be a related party to the other company. Therefore two private companies will be treated as related parties in case of common directorship.

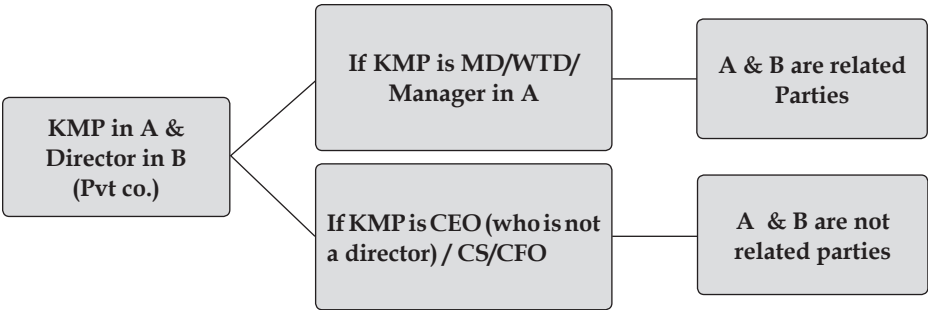
vi. Whether there is one common director in two public companies, do such public companies become related party?

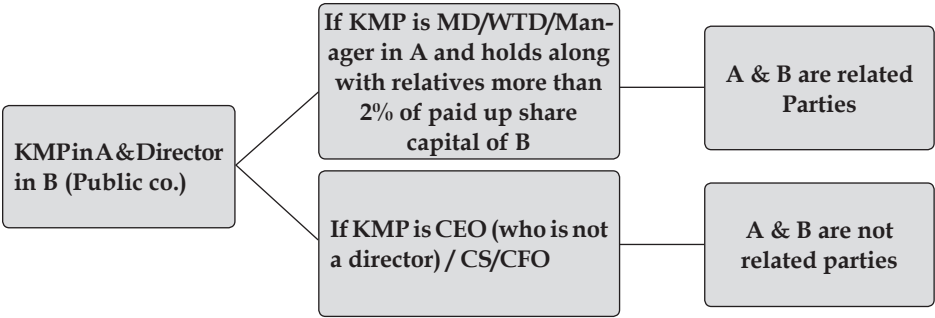
The answer would be No. Section 2(76) (v) of the CA, 2013 previously provided that if a director or manager of any company is a director or holds along with his relatives more than 2% of the paid up share capital of a public company, then such public company would be treated as a related party to the other company.

However the MCA has come out with a clarification vide Companies (Removal of Difficulties) Fifth Order, 2014 dated 28th March, 2014 wherein it has been clarified that a public company would be a related part to another company (in this case a public company) only if the common director is a director and holds along with his relatives 2% or more of the paid-up share capital of that company. This means that both the conditions would have to be complied with for the two public companies to be related parties.

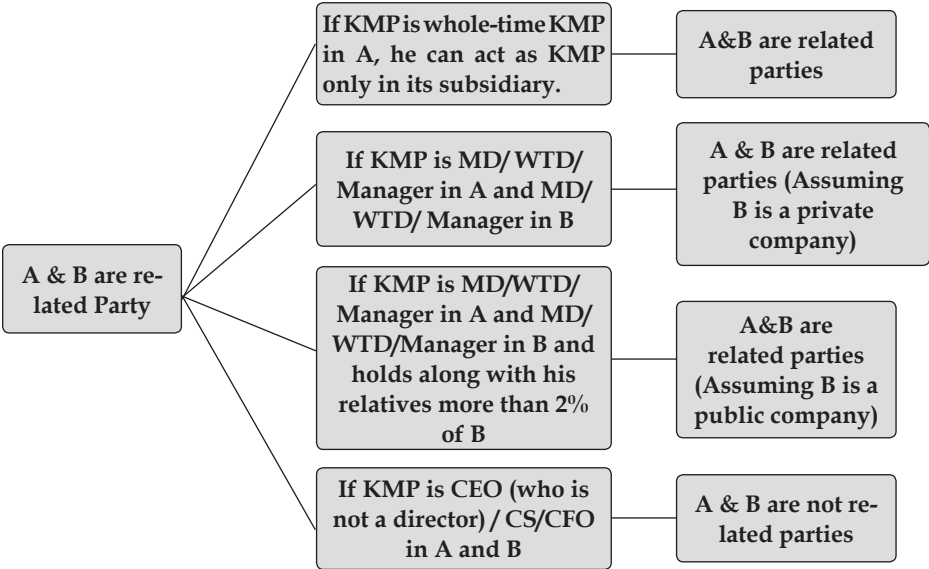
vii. Will two companies be related party if:

- a. If a KMP of one company is a director in another company;**





b. If a KMP of one company is KMP of another company?



viii. A director in company A does not hold any shares in public company B. However his ‘relatives’ hold more than 2% of the paid up share capital in B. Will A and B still be related?

Section 2(76) (v) of the CA, 2013 provides that if a director in one company holds along with his relatives, more than 2% of the paid up share capital in a public company, the two companies would be related.

In this case, the director of A is not holding any shares in B; however his relatives are holding more than 2% of the paid up share capital in B. Here, though the director is not holding any shares in B, however, he along with his relatives is still holding more than 2% of the paid up share capital in B. Here the expression along with will have to be seen in an expansive sense and not in a restrictive sense. The words “along with” syntactically is sim-

ilar to “together with”. In the context of the meaning of “related parties”, the holding of relatives is clubbed with that of the directors, to ascertain relationship, on the premise that the economic interest of the director and his relatives is unified. There is no reason why the shares of the relatives should not be counted, if the director in question does not hold any shares. It will not serve the purpose of the definition if a director could get away with the impact of the section merely by parking his interest in the public company in the name of his relatives. Thus, it will not serve the purpose of the definition if a director could get away with the impact of the section merely by parking his interest in B in the name of his relatives.

Therefore, A and B will be related parties under the CA, 2013.

ix. Which types of contracts between related parties are prohibited under the CA, 2013, except with the consent of the Board of Directors?

Section 188 of the CA, 2013 provides that a company will not enter into any contract or arrangement with a related party with respect to the following, except by passing a resolution at a meeting of the Board of Directors, if the transactions are not in ordinary course and on arms-length basis:

- a. sale, purchase or supply of any goods or materials;
- b. selling or otherwise disposing of, or buying, property of any kind;
- c. leasing of property of any kind;
- d. availing or rendering of any services;
- e. appointment of any agent for purchase or sale of goods, materials, services or property;
- f. such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and
- g. underwriting the subscription of any securities or derivatives thereof, of the company.

Also, as per the Companies (Meetings of Board and its Powers) Rules, 2014, where any director is interested in any of the aforesaid RPTs, he shall not be present in the meeting in which such discussions takes place. This restriction should not apply to private companies in view of the exemption provided under Section 184(2) and second proviso to Section 188(1). The intent of law is to ensure that in case of private companies the directors disclose their interest and participate.

Notably, financial transactions are not covered under the sweep of CA, 2013. However Clause 49(II)(VII) of the revised Listing Agreement covers any

transfer of resources, obligations or services as a related party transaction. Therefore, loan transactions and guarantee transactions, which are not covered by Section 188 of the CA, 2013, are covered by the Listing Agreement.

x. Will the provisions of the CA, 2013 be applicable on RPTs other than the abovementioned list of RPTs?

The CA, 2013 seeks to regulate only the RPTs mentioned under Section 188 (1) and as provided above. Therefore it can be said that RPTs outside that list will fall outside the purview of Section 188.

8.3.2 Approval for Related Party Transactions

i. Whether all of the above transactions can be entered into by any company with a related party passing a Board resolution only?

Section 188(1) of the Act provides that a company can enter into the above contracts/arrangements by passing a board resolution at a meeting of the Board of Directors.

However the first proviso to Section 188(1) to the CA, 2013 read with Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014 provides that companies shall not enter into any of the related party contracts/arrangements u/s 188(1) of the CA, 2013, except by passing of a special resolution at a meeting of the members of the company under the following circumstances:

- (a) as contracts or arrangements with respect to clauses (a) to (e) of sub-section (1) of section 188 with criteria, as mentioned below -
 - i. sale, purchase or supply of any goods or materials directly or through appointment of agents exceeding 10% of the turnover or Rs. 100 crore, whichever is lower, as mentioned in clauses (a) and (e) of section 188(1);
 - ii. selling or otherwise disposing of, or buying, property of any kind directly or through appointment of agents exceeding 10% of net worth or Rs. 100 crore, whichever is lower, as mentioned in clause (b) and clause (e) section 188(1);
 - iii. leasing of property of any kind exceeding 10% of the net worth or 10% of turnover or Rs. 100 crore, whichever is lower, as mentioned in clause (c) of section 188(1);
 - iv. availing or rendering of any services directly or through appointment of agents exceeding 10% of the turnover or

Rs. 50 crore, whichever is lower, as mentioned in clause (d) and clause (e) of section 188(1);

Explanation: The limits specified in sub-clauses (i) to (iv) above shall apply for transaction(s) to be entered into either individually or taken together with the previous transactions during a financial year.

- (b) appointment of related parties to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding Rs. 2.5 lakh as mentioned in clause (f) of section 188(1); or
- (c) remuneration for underwriting the subscription of any securities or derivatives thereof of the company exceeding 1% of the net worth as mentioned in clause (g) of section 188(1).

Further, it has also been clarified that turnover or net worth, as referred to above shall be computed on the basis of Audited Financial statements of the preceding financial year.

Further, in case of a transaction entered into between a company and its wholly owned subsidiary, the special resolution passed by the holding company would be sufficient compliance for the purposes of the CA, 2013.

However, the requirement of passing the resolution shall not be applicable for transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.

ii. Is Central Government approval required for entering into a RPT, as was required under CA, 1956?

No. The requirement of taking prior Central Government approval by companies with paid up share capital of Rs. 1 crore or more under the CA, 1956 has been done away with. The special resolution passed by the members approving such transactions will suffice.

iii. A is a member of company B, and is also a related party to B. In this scenario, can A vote on the resolution to be passed by B for entering into a RPT to which A is not a party?

The answer would be yes.

The second proviso to Section 188(1) of the CA, 2013 provides that no member, who is also a related party, can vote on a special resolution, to approve

any contract or arrangement which may be entered into by the company. This had created confusion.

Subsequently, MCA vide its circular dated 17th July, 2014 clarified that the term 'related party' refers to only such related party as may be a related party in the context of the contract or arrangement for which the said special resolution is being passed. Thus only the related party with whom the company is entering into the contract would abstain from voting on the special resolution, in case he is also a member of the company.

However, the Clause 49 of the Listing Agreement provides no such relief. It states that all entities falling under the definition of related parties shall abstain from voting irrespective of whether the entity is a party to the particular transaction or not. Accordingly, the exemption provided under Section 188 ceases to have an impact for equity listed companies who will still require approval for majority of the minority shareholders for passing of 'material' related party transaction. Further, this requirement under Clause 49 will not be applicable in case of related party transactions between two government companies or between holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.

iv. What kind of shareholder approval will be required in case of a transaction between two related parties?

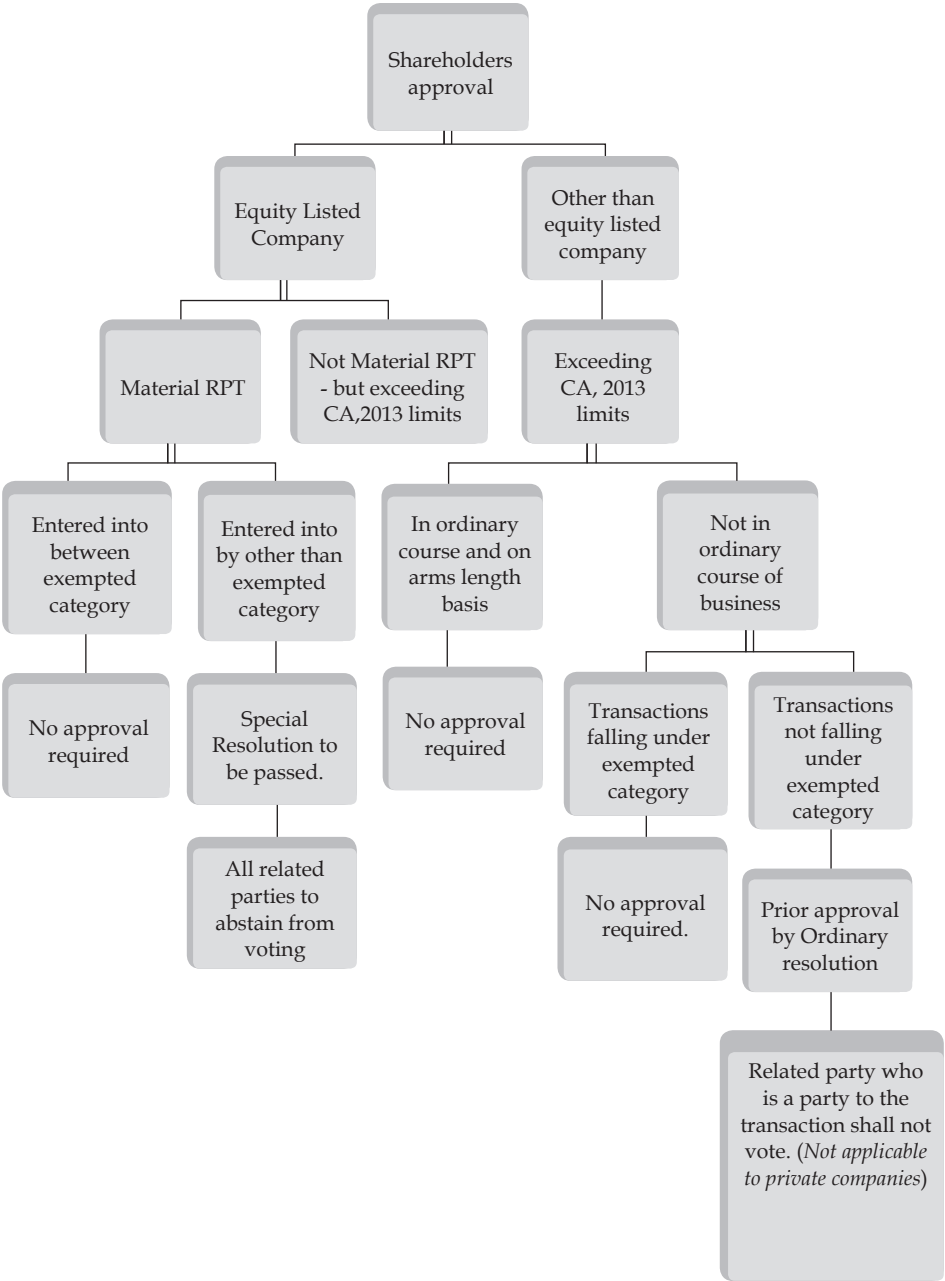


FIGURE 45: NATURE OF SHAREHOLDER APPROVAL REQUIRED FOR RPTs

v. Whether the exempted categories under CA, 2013 are same as those under Listed Agreement?

Related party transactions	Under Section 188 of CA, 2013?	Under Clause 49 of Equity Listing Agreement
Nature of exemption		
Between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval	Relaxation from obtaining shareholder's approval	Relaxation from obtaining Omnibus approval from Audit committee and shareholder's approval
Between 2 government companies	Relaxation from requirement of obtaining shareholder's approval and disallowance to a related party who is a party to the transaction to vote.	Relaxation from obtaining Omnibus approval from Audit committee and shareholder's approval
Contracts or arrangements entered into by unlisted Government companies, of other than those entered with another government company, in case such Company obtains approval of the Ministry or Department of the Central Government which is administratively in charge of the company, or, as the case may be the State Government before entering into such contract or arrangement.	Relaxation from requirement of obtaining shareholder's approval and disallowance to a related party who is a party to the transaction to vote.	NA
Between holding, subsidiary, associate and fellow subsidiaries in case of a private company.	Exemption from complying with Section 188	NA
Any related party transaction by private companies	Relaxation from disallowance to a related party who is a party to the transaction to vote.	NA

Table 26: Exempted categories under CA, 2013 and Listed Agreement

vi. What will be the position in case of a wholly owned subsidiary company, where the holding company is the only member of the subsidiary and is also a related party?

Formerly, CA, 2013 did not provide any clarity to this aspect. Subsequently, it was inserted by way of Companies (Amendment) Act, 2015 notified by MCA

w.e.f 29th May, 2015 that the requirement of passing the resolution under first proviso shall not be applicable for transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.

Revised Clause 49 of the revised Listing Agreement provides similar exemption to transactions entered into between holding and wholly owned subsidiary companies from the requirement of members' approval, where accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval. i.e. as per the Listing Agreement neither the holding company nor the wholly owned subsidiary need to get members' approval, which is not the case under CA, 2013 which requires holding companies to pass a special resolution.

vii. Will related party transactions entered into in the 'ordinary course of business' exceeding the limits specified under CA, 2013 require to be approved by passing of ordinary resolution?

The third proviso to Section 188(1) of the CA, 2013 provides that the company will not require the approval of the Board and/or shareholders provided the transactions are entered into by the company with the related party:

- a. in the ordinary course of business; and
- b. such transactions are on an arms' length basis

Accordingly, any transaction which takes place in the ordinary course of business, but is not on an arms' length basis will be covered under the provisions of Section 188(1) of the CA, 2013. If the same exceeds the limit specified under CA, 2013 and does not fall under the exempted category, prior approval by passing of a resolution needs to be obtained from the shareholders.

viii. Will RPTs which are on an arms' length basis but does not take place in the ordinary course of business be covered by the provisions of Section 188(1) of the CA, 2013?

Yes. A RPT to be exempted from the provisions of Section 188(1) of the CA, 2013 must necessarily be in the ordinary course of business and the transaction should be on arm's length basis. Both the two prerequisites are required to be fulfilled for availing the exemption.

Accordingly, RPTs on an arms' length basis but not in the ordinary course of business will be covered by the provisions of Section 188(1) of the CA, 2013.

However, under Clause 49 of the listing agreement no exemption is granted to companies entering into transactions in its ordinary course of business on Arm's Length basis. If value of such transactions exceed 10% of annual consolidated turnover, approval of shareholders by way of a special resolution will be required from shareholders, unless the transaction fall under exempted category. The requirement to pass a special resolution under clause 49 has been done away with after enforcement of Regulation 23(4) of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 with effect from September 2, 2015. Thus, prior approval of shareholders for material RPTs are required to be obtained by passing of an ordinary resolution.

ix. What is the remedy available if a shareholder disapproves the resolution while ratifying the same?

In case the shareholders do not pass the resolutions pertaining to existing RPTs and the blanket approval, we must understand that the transactions were taken to the shareholders for their approval pursuant to the threshold limits being crossed; (a) as specified under Clause 49 of the Listing Agreement and/or (b) as specified under section 188(1) of Companies Act, 2013. If the limits were not breached the need for shareholders resolution would not arise in the first place, that is to say, the board has the right to take forth the RPTs within the threshold.

In a scenario where the shareholders do not approve of the transactions (limits), the board and the audit committee can still re-consider the transactions such that the limits are not breached. All RPTs have to be within the thresholds limits provided under Clause 49 and/or Companies Act, 2013 (lower of the two).

c. There are three kind of RPTs:

- i. Those which are neither at arm's length nor in ordinary course of business of the Company – there cannot be RPTs which are not at arm's length, as the board and the audit committee from prudence perspective, cannot be approving any transaction which is not at arm's length. Hence these transactions, irrespective of the threshold limits, cannot be undertaken.
- ii. Those which are at arm's length and in ordinary course of business of the Company – for such transactions, owing to the third proviso under section 188(1), there is no threshold limit prescribed, as these are akin to transactions with unrelated parties.

- iii. Those which are at arm's length but not in ordinary course of business of the Company – For these transactions as long as the threshold limits are not breached, the audit committee and the board has the right to review and carry the transactions out, without shareholders' approval.

In essence, even if the shareholders' resolution gets defeated at the ensuing AGM, the board and the audit committee may re-review the RPTs, to undertake whether to take forth such transactions which are within the prescribed threshold limits as section 188 also states that were transactions have been entered without approval as required, such transactions are voidable at the instance of the Board.

8.3.3 RPTs on arm's length basis

i. Which RPTs will be considered as arms' length basis?

Arms' length basis, as provided under the CA, 2013 means a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.

This, in essence, means that those RPTs which are on terms, including consideration, not biased by the fact of relationship between the parties will be considered as arms' length transaction. Thus, not only the arms' length price, but every aspect of the transaction must be at arms' length, for instance – pricing, credit terms, repayment, interest rates etc. to qualify the RPT to be on arm's length basis.

ii. Whether any criteria have been prescribed for determining which RPTs have been entered into on an arms' length basis?

No. The CA, 2013 does not prescribe any criteria for determining whether the RPT was entered into on an arms' length basis. It would, therefore, be a subjective decision to be decided upon by the Board of Directors and the Audit Committee, if constituted, of every company. The duties of independent directors provided under Schedule IV mandates IDs to pay sufficient attention and ensure that adequate deliberations are held before approving related party transactions and assure themselves that the same are in the interest of the company.

In this regard the Listing Agreement requires companies to prepare a policy on related party transactions. Thus, the criteria for determining whether a transaction is on an arms' length basis and in the ordinary course may be provided therein.

Further, Non-Banking Financial Companies – Corporate Governance (Reserve Bank) Directions, 2015 mandates every non-deposit accepting Non-Banking Financial Company with asset size of Rs. 500 crore and above (NBFCs-ND-SI), as per its last audited balance sheet, and all deposit accepting Non-Banking Financial Companies (NBFCs-D) to formulate a policy on dealing with related party transactions.

iii. Whether any exemption has been given to transactions between holding and subsidiary companies, considering that most of the transactions between them can never be on arms' length basis?

The very concept of a holding-subsidiary relationship is that the subsidiaries mainly thrive on the transactions with their holding companies. As has been discussed above, the requirement to the effect that any transaction under section 188 between a holding company and its wholly owned subsidiary requires a resolution to be passed only by the holding company has been exempted provided the accounts of the wholly owned subsidiary is consolidated in the accounts of holding company and placed before the members for approval at general meeting.

However, no exemption has been given to holding-subsidiary transactions which are not on arms' length. This will make passing of resolutions between them difficult, especially when special resolution is required to be passed by the subsidiary company.

It is only in case of private companies, as provided by MCA Notification No. G.S.R. 464(E) dated 5th June, 2015, that transactions with holding, subsidiary, fellow subsidiary and associate companies will not fall within the purview of related party transactions.

iv. Whether RPTs which are in the ordinary course of business and on an arms' length basis will not require a resolution to be passed by the Board?

The CA, 2013 provides that nothing contained in Section 188(1) shall apply to RPTs which are in the ordinary course of business and on an arms' length basis. Accordingly, it can be derived that RPTs in the ordinary course of business and on an arms' length basis will not require a board resolution.

However, all RPTs entered into by a company along with any modifications to the same will require approval of the Audit Committee of the company, if any (prior approval in case of listed companies) in terms of Section 177 of CA, 2013. Therefore, it seems that while all arms' length transactions in ordinary course of business with related parties are not required to be

approved by the Board or shareholders, they would still require approval of the Audit Committee, if any. However, considering the seriousness surrounding RPTs, it is suggested as a case of abundant precaution, that the company must get the RPT approved at a board meeting.

The concept of ordinary course of business and an arms' length is not there under the Listing Agreement. Hence, the provisions of Listing Agreement need to be referred to for all RPTs entered into by listed companies.

v. Can the calculation of arms length basis under CA, 2013 be taken from the transfer pricing calculation done for income tax purpose?

“Arms' length basis” as provided under the CA, 2013 means a transaction between two related parties that is conducted as if they were unrelated or at arm's length, so that there is no conflict of interest. Accordingly, it is not just the pricing (which is one of the aspects of arm's length basis), but every aspect of the transaction must be at arms' length, which would include pricing, credit terms, repayment, interest rates etc. CA, 2013 does not prescribe any criteria for determining whether the related party transaction was entered into on an arms' length basis and it would, therefore, be a subjective decision to be decided upon by the Audit Committee/ Board of Directors of every company. Some of the indicative criteria for determination of arms length transactions may be as follows (these are only indicative criteria and not exhaustive list):

- i. To determine whether the said transaction(s) have been entered in the company's ordinary course of business;
- ii. To confirm whether the contract(s)/arrangement(s) is continuing in nature. Disclosures to be made to audit committee if it is for on-going transactions, i.e., ones which do not have a written contract;
- iii. In relation to new contracts, the creditworthiness of the parties with whom such contract(s)/arrangement(s) have been entered into needs to be determined and disclosed;
- iv. Whether the credit terms provided in such transaction(s) are at par with the prevalent practice(s) of the company;
- v. To check whether the pricing norms are in accordance with the arm's length pricing norms as per Income-tax Act, 1961. If yes, the certificate obtained be placed at the audit committee meeting;
- vi. To confirm whether the price has been determined through any verifiable transparent market pricing norms i.e. any quotation, tender or open market prices;

- vii. In case of financial transactions, determine the risks associated and returns earned are in tune with the credit policy of the company/ based on principles which are customary in commerce.
- viii. To determine the degree of comparability with uncontrolled transactions.
- ix. To evaluate the flexibility (whether transaction is onerous or not) in the contract with related party and whether expert advice was sought.
- x. A trend analysis from past practices with related parties may also be done and placed at the audit committee. Additionally, an estimation of the expected volume of transactions in the ensuing year may also be done and placed at the audit committee meeting.

8.3.4 Role of Audit Committee

i. Whether Independent Directors are required to exercise additional diligence in respect to RPTs? Are there any duties specified on the part of directors as well?

Schedule IV to the CA, 2013, which spells out the mandatory Code of Conduct for independent directors, casts additional duty upon independent directors to:

- a. pay sufficient attention and ensure that adequate deliberations are held before approving RPTs; and
- b. assure themselves that the same are in the interest of the company.

In any event, the liabilities attached to directors under Section 188 of the CA, 2013 will apply to such independent directors as well. Non-executive and independent directors are entitled to immunity from prosecution under Section 188 only when they can demonstrate evidence of due diligence. Hence an independent director is required to exercise additional diligence in respect to approval of RPTs.

Further, Section 166 (5) of CA, 2013 (5) specifies that a director of a company shall not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates and if such director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company.

ii. What is the role of Audit Committee with regard to RPTs?

The terms of reference of an Audit Committee, as provided under Section 177 of the CA, 2013 has been enhanced to include approval/modification of

any RPT entered into by a company. Therefore the Committee has an added responsibility to oversee transactions with related parties and recommend to the Board accordingly.

Further, the Audit Committee has the authority to investigate into any matter falling under its domain and the power to obtain professional advice from external sources and have full access to information contained in the records of the company.

Under the previous Listing Agreement, the Audit Committee had to merely review RPTs at periodic intervals, which left little scope for effective preventive intervention.

Although the CA, 2013 does not require prior approval of Audit Committee for entering into a related party transaction Clause 49 of the listed agreement requires prior approval of the Audit Committee.

Further, Clause 49 of the Listing Agreement has allowed Audit Committees to grant omnibus approvals for related party transactions and in this regard, the committee is required to ensure that:

- (a) Such RPTs should be repetitive in nature and the Audit Committee shall lay down the criteria for granting the omnibus approval in line with the Related Party Transactions Policy of the company.
- (b) Such omnibus approval is needed and is in the interest of the company;
- (c) The approval should specify the (i) the name/s of the related party, nature of transaction, period of transaction, maximum amount of transaction that can be entered into, (ii) the indicative base price/current contracted price and the formula for variation in the price if any and (iii) such other conditions as the Audit Committee may deem fit.

In case the need of the RPT and the aforesaid details are not available, an omnibus approval upto the transaction value of Rs. 1 crore may be granted for such RPTs.

- (d) Quarterly review of such omnibus approvals by the Audit Committee
- Audit Committee are also permitted under Section 177, vide Companies (Amendment) Act, 2015 to make omnibus approval for related party transactions proposed to be entered into by the company subject to such conditions as may be prescribed. No conditions have been prescribed yet and the amendment has not been made effective by MCA.

As can be seen from the above, a lot of responsibilities have been laid on Audit Committees, both under the CA, 2013 and the Listing Agreement. The responsibilities laid down under SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 are also similar to that provided under Listing Agreement.

iii. Whether it is mandatory for a company to get its RPTs approved by an Audit Committee?

All companies are not required to form an Audit Committee. Therefore companies not having Audit Committees are not required to get its RPTs approved by the Audit Committee.

However, where a company has an Audit Committee, approval of the RPT by the Audit Committee is necessary since the Committee is required to act in accordance with its terms of reference prescribed under Section 177. Once approved by the Audit Committee, the same may be recommended to the Board for its approval, if required.

Clause 49 of the Listing Agreement requires prior approval of the Audit Committee for entering into a related party transaction. However, an exception has been provided where omnibus resolutions approvals have been passed granted by the Committee.

8.3.5 Procedural compliance

i. Describe the procedure to be followed for entering into RPTs?

Sl.No.	Particulars	Remarks
Mandatory Provisions – For RPTs not entered in ordinary course of business and/or on an arms’ length basis		
1.	The RPT will first need to be approved by the Audit Committee, if any. In case the company does not have any Audit Committee, this provision will not apply.	As per the Rules ¹²⁹ , only: (i) listed companies, (ii) public companies with paid up share capital of Rs. 10 crores or more, (i) public companies with turn-over of Rs. 100 crores or more, and (iii) Public companies having loans and borrowings exceeding Rs. 50 crores or more are mandatorily required to form an Audit Committee.

129 Rule 6 of the Companies (Meetings of Board and its Powers) Rules, 2014.

Sl.No.	Particulars	Remarks
2.	Once approved by the Audit Committee, if any, the Board of Directors of the Company will need to pass the resolution at a meeting of the Board.	Such resolutions cannot be passed by a resolution by circulation. Agenda should disclose all details as provided under Rule 15(1).
For transactions exceeding the limits prescribed under Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014.		
3.	The RPT will additionally need to be passed by the shareholders of the company by way of an ordinary resolution. Explanatory statement shall provide details as provided in Rule 15(3). <i>Note: Related parties who are party to the transactions shall abstain from voting. This requirement is not applicable in case of private companies.</i>	Transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval. Further approval will also not be required in case of transactions by government companies and private companies falling under Exempted category as explained in the former part.
4.	Entry to be made in MBP-4 Part A shall be made at once, whenever there is a cause to make entry, in chronological order and shall be authenticated by the company secretary of the company or by any other person authorised by the Board for the purpose.	
5.	Disclosure to be made in Form AOC-2 annexed to the Board report.	AOC-2 mandates disclosing all transactions entered not on arms length basis.
Mandatory Provisions – For RPTs entered in ordinary course of business and on an arms' length basis		
6.	None of the provisions u/s 188 will apply to such transactions. However, approval by Audit Committee, if any would still be applicable.	
7.	Disclosure to be made in Form AOC-2 annexed to the Board report.	AOC-2 mandates disclosing all material transactions entered in ordinary course and on arms length basis. Material means those transactions that exceed the limit specified under Rule 15 of Companies (Meetings of Board and its Powers) Rules, 2014

Table 27: Procedure for entering into RPTs

As per clause 49 of the listing agreement the key requirements are as follows:

1. Company to frame a policy on material related party transactions, and on dealing with related party transactions
2. Every related party transaction to require prior approval of audit committee. Note the CA does not require prior approval of audit committee.
3. If it is a “material related party transaction”, approval by an ordinary resolution of shareholders^{129a}, without the votes of related parties. However, no exemption is granted to companies entering into transactions in its ordinary course of business on Arm’s Length basis.
4. Disclosure as a part of the quarterly corporate governance compliance report.

ii. If a contract is a related party contract as per the CA, 2013, will it require disclosure under AS 18?

No, AS 18 requires disclosures only with regard to transactions which are enumerated under Para 3 to the Standard, which consists of the following;

- a. enterprises that directly, or indirectly through one or more intermediaries, control, or are controlled by, or are under common control with, the reporting enterprise (this includes holding companies, subsidiaries and fellow subsidiaries);
- b. associates and joint ventures of the reporting enterprise and the investing party or venturer in respect of which the reporting enterprise is an associate or a joint venture;
- c. individuals owning, directly or indirectly, an interest in the voting power of the reporting enterprise that gives them control or significant influence over the enterprise, and relatives of any such individual;
- d. KMP/their relatives; and
- e. enterprises over which any person described in (c) or (d) is able to exercise significant influence. This includes enterprises owned by directors or major shareholders of the reporting enterprise and enterprises that have a member of key management in common with the reporting enterprise.

129a. The requirement to pass special resolution under clause 49 has been done away with after enforcement of Regulation 23(4) of SEBI (Listing Obligation and Disclosure Requirement) Regulations, 2015 with effect from September 2, 2015.

iii. What are material related party transactions?

The CA, 2013 provides for different threshold limits for determining materiality for different transactions which have been detailed under Question 12 above.

However Clause 49 of the revised Listing Agreement provides that a related party transaction shall be considered material if the transaction/ transactions to be entered into individually or taken together with previous transactions during a financial year exceeds 10% of annual consolidated turnover of the company as per the last audited financial statements of the company.

iv. What are the provisions contained in the Listing Agreement to attend to the problem of abusive RPTs?

The Listing Agreement prescribes disclosure requirements for RPTs. Presently, Clause 32 of the Listing Agreement requires listed entities to disclose 'Related Party Transactions' in their annual report in compliance with the provisions of AS 18. Clause 49 of the Listing agreement also provides that prior Audit Committee approval is required for every related party transaction. Further 'material' RPTs are required to be approved by majority of the minority shareholders by way of a resolution.

In this regard, SEBI, in its consultative paper on Review of Corporate Governance Norms in India discusses certain provisions to curb abusive RPTs by making amendments to the listing agreement. Some of them are as follows:

- a. Divestment of shares in subsidiaries to require prior shareholder approval, which is presently not required under the CA, 1956.
- b. Immediate reporting of material RPTs to the stock exchanges. Presently, such reporting is done only annually where the information reaches the investors much after the transactions were carried out.
- c. Mandating approval of major RPTs by majority of the minority or disinterested shareholders. Pre-approval of RPTs by Audit Committee and encouraging them to refer major RPTs for third party.
- d. Approval of disinterested/minority shareholders for managerial remuneration beyond a particular limit.

Clause 49 of the Listing Agreement provides for the following disclosures for Related Party Transactions:

- (i) Details of all material transactions with related parties shall be disclosed quarterly along with the compliance report on corporate governance.

- (ii) The company shall disclose the policy on dealing with Related Party Transactions on its website and also in the Annual Report.

8.3.6 Examples of Related parties and RPTs

i. Considering that Section 2(76) of the CA, 2013 refers to the term ‘company’ in the context of related parties, will foreign companies be covered under the definition of related party in reference to a ‘company’?

The word “company” under CA, 2013 has been defined to only mean a company incorporated under the CA, 2013 or CA, 1956 and not under any other act or a body corporate. Hence the phrase ‘with reference to a company’ as appearing in Section 2 (76) of the CA, 2013 does not refer to foreign companies.

Having said this, foreign companies entering into transaction with related entities in India will not be required to comply with the related party provisions under the CA, 2013 and the Listing Agreement. However, the related Indian entity will need to see whether the related party provisions are applicable to it.

However, the related parties as listed in Section 2(76) may or may not be a foreign entity. In this regard, the word “company” when used with holding or subsidiary includes a body corporate by virtue of explanation (c) to section 2(87). Hence while referring to holding or subsidiary companies, foreign companies will be included. However, the definition of “associate company” does not contain provisions similar to explanation (c) to section 2(87) of CA, 2013. Hence, the term “associate company” will not include any overseas body corporate.

ii. C Limited, UK, which is a wholly-owned subsidiary of B Limited, holds 24.97% shares in A Limited as on 31st March, 2014. Accordingly, A is an associate of C. While A is an associate of C, will C also be an associate of A within the meaning of Section 2(6) of the CA, 2013?

Section 2(6) of CA, 2013 covers only such companies on which significant influence has been exercised. Hence, the investee is an associate company and not the investor itself.

Further, Section 2(76) of CA, 2013 covers only downstream entities and not upstream entities in relation to associates. Hence, any investor exercising significant influence will not be a related party u/s 2(76) of CA, 2013.

iii. A Limited is holding 32.58% of shareholding in B Limited ('the Company') but B Limited does not hold any share in A Limited.

Whether A Limited will be treated as a 'related party' to the Company under CA, 2013 and/or revised Clause 49 of Equity Listing Agreement?

In case A Limited does fall under the category of 'related party' as per revised Clause 49 –

- ◆ **whether after October 1, 2014, the Company can execute a new order for supply of goods or services since the value of all transactions will exceed the threshold limit of 'material' related party transactions?**
- ◆ **in this regard, can the Company seek approval of its shareholders at the AGM/EGM to be held after October 1, 2014?**

At the outset and in keeping with the discussions above, it is re-iterated that if A is related to B, that does not necessarily mean that B is also related to A. The related party relationship has to be construed from both the sides.

In the given case, A Limited is holding 32.58% of shareholding in the Company B. Therefore, the Company B is an associate of A Ltd.

However from the Company's B's view, A Ltd. is only an investor and is not a related party u/s 2(76) of CA, 2013. Hence, any transaction with A Ltd. will not attract the provisions of section 188 of CA, 2013.

Reading from Clause 49 (VII) of Equity Listing Agreement perspective, – AS-18 unlike the CA, 2013 also includes investors in the list of related parties. Hence, A Ltd being the investor in the Company B, will be a related party for the purpose of AS-18 solely.

Therefore, A Ltd. will be considered a related party to the Company under revised Clause 49.

As provided above, A is not a related party to the Company B but B is related to A, under CA, 2013. Hence, for entering into contracts with the Company B, A will have to fulfil the requirements of CA, 2013 since A will be entering into transaction with its associate. However, from the Company's B's perspective A Ltd. is not a related party. Therefore the Company B has not fulfil the requirements of CA, 2013. Further, in case A Ltd. and/or the Company B are also listed, compliance with the listing agreement has to be ensured by both the companies need to comply with requirements as specified under Clause 49(vii) for related party transactions.

iv. The Company is in the practice of raising debit notes against resources provided to its subsidiaries. For instance, there is a car

facility provided to directors of subsidiary and later, the Company claims reimbursements for the expenses incurred on behalf of such resource utilization, based on actuals. The situation could be vice-a-versa as well. Whether such transaction(s) will come under the purview of related party transaction under CA, 2013 and/or revised Clause 49 of Equity Listing Agreement?

In the given case, the Company sometimes provide resources to subsidiaries for which it incurs certain expenditure. The situation could be *vice-a-versa* as well. These expenses would have been otherwise incurred by the subsidiary on its own if, the Company would not have accommodated for the same temporarily and these are also later reimbursed on actuals.

On the basis of the above premises, such reimbursements should not be considered 'related party transaction' within the purview of CA, 2013 and revised Clause 49, subject to adherence of the following conditions:

- a. all such reimbursements have been made clearly and explicitly for business purpose;
- b. only genuine expenses incurred for business purposes are being reimbursed, and the expenses are of such nature which, had they been incurred directly by the company, would have been deemed incurred wholly and exclusively for the purpose of business;
- c. the amount paid by the company must be specifically evidenced by proper expense claims, as per standard practices of the Company.

v. While considering material related party transaction under revised clause 49 of Equity Listing Agreement, whether all transactions irrespective of nature of transactions have to be considered for checking whether it exceeds the limit of 10% annual consolidated turnover, i.e the transaction(s) has to be taken together or individually to be checked against the limits?

For determining the materiality of related party transaction under revised Clause 49, the transactions have to be checked for each individual related party and all transactions with that related party during the financial year have to be taken cumulatively.

vi. Are there any indicative tests for assessing what may be in ordinary course of business?

The phrase 'ordinary course of business' has been used in sections 185 and

188 of CA, 2013. In common parlance, whether a transaction is in the ordinary course of business or not, is usually assessed having regard to the following:

- a.* size and incidence of the transaction
- b.* common practice of the industry
- c.* necessary in the normal routine
- d.* incidental to the business

It must also be understood that the expression does not mean “main business”, “principal business” or “main object”. Hence, mere insertion of an object in the objects clause does not make lending business an ordinary business of the company. At the same time, there is nothing to imply that the lending business should be carried on as the principal or main business. Similar phrase has also been used to define ‘deemed dividend’ in section 2(22) of Income-tax Act, 1961.

One may also refer to case laws which provide guidance on what constitutes as ‘ordinary course of business’:

- i.* Whether a business is in the ordinary course can be concluded from the frequency of the activity and whether it is carried on in a normal organised manner.
- ii.* The nature of activity. Where a company provided corporate guarantee and did not charge any guarantee commission, it was held by Income Tax Appellate Tribunal – Delhi in the case of *Malbros Investments Ltd. vs DCIT* that this was not in the ordinary course of business the appellant did not provide such corporate guarantee ordinarily. It is also noteworthy that this ruling was despite the fact that providing corporate guarantee figured in the memorandum of association of the company.
- iii.* Sale of excess inventory or sale of a used vehicle by a car rental company shall also be considered as sale in the ordinary course of business
- iv.* Similar view was also taken in the case of *Raj Kumar Gupta vs CIT* wherein an advance of money was taken to be not in the ordinary course of business since the advance must result in interest income for the company. Where granting of loan or advance was at no interest, it could not be in the ordinary course of business. Similar view was also taken in the case of *All Grow Finance and Investment Pvt. Ltd. vs CIT*.

vii. A Company has provided office space on rental basis and entered into rental agreements about 5/8 years back at the rent which was then prevailing rate and rate is revised every 3 years/4 years as per agreed rate. If we match the prevailing rate of a new property today, the rate charged by the Company is lower. But if rates are matched at the time when the property was let out, the rate is similar. Can it be said that the rates are at arm's length?

The arm's length nature of a contract is determined at the time of entering into the contract. Typically long term contracts such as property rentals provide for escalation clauses. These escalation terms must also be fixed keeping in view arms-length nature and to accommodate the escalation in the property prices over the term of the contract, to bring them at par with the expected property rental rates. If this has been done, the contract does not have to be concurrently proved to be carried on at arm's length.

viii. Suppose in A Ltd. relatives of directors were appointed to office or place of profit in accordance with the provisions of Sec 314 of the CA, 1956. Can the Company continue with the said appointments till expiry of their present term without any compliance Section 188 of the CA, 2013?

Since, section 314 under CA, 1956 was a standalone section and in case, the shareholders have consented to appointment of the relative for a certain term, this resolution shall prevail till the expiry of the approved term.

ix. A Ltd has been selling its products to its overseas subsidiaries for catering to the overseas markets. Is any compliance to be done pursuant to Section 188 of the CA, 2013 regarding such transaction between A Ltd and its subsidiaries?

In case the transaction is at arm's length and in ordinary course of business the A Ltd. may not have to comply with the provisions of Section 188 of CA, 2013. However, the transaction should be placed before the Audit Committee of A Ltd. pursuant to Section 177(4) of CA, 2013. No compliance is required to be done by the subsidiaries since these are foreign companies and the provisions of the CA, 2013 will not be applicable to them.

In case the transaction is not an arm's length basis and/or is not in ordinary course A Ltd. will have to comply with the provisions of the section. If such a transaction was entered into pursuant to a contract prior to the section being enforced (i.e. 1st April, 2014) then only when such a contract comes

for renewal or there is any change made to the terms and conditions of the contract, will the provisions of the section become applicable.

x. A Ltd has taken land/buildings from its group companies on leave and license agreement. The tenure will end in the year 2014. Can the company continue with the said agreements till expiry of the present term without any compliance with Section 188 of the CA, 2013?

Any existing contract continuing post the enforcement of Section 188 may continue without compliance of Section 188 unless they come for renewal or unless any term is altered. The rationale behind this is that the existing contract was done in compliance with the provisions of CA, 1956 and is continuing. Further, the MCA by way of its notification dated 17th July, 2014 also clarified that where RPTs were entered into after ensuring compliance with section 297 of CA, 1956, then fresh approval under section 188 of CA, 2013 is not required. Further, prudence demands that the existing related party contracts must also be placed before the audit committee for their review u/s 177 (4) (iv) of CA, 2013.

xi. A private limited company engaged in the business of finance, has a flat. The Company wants to allot that flat to its director along with the maintenance and other service charges free of cost for director's residential purpose. What are the corporate issues involved in the same?

The situation as described would be covered by related party transaction under Section 188(1)(f) of the CA, 2013 in case providing of rent free accommodation to the director was not included in his remuneration structure.

In case the flat is being leased to the director, it will be covered under section 188(1)(c) of the CA, 2013.

xii. A listed public company had executed a rent agreement with a private company (Related Party) in 2008. The said agreement provides that the monthly rent would be enhanced by 20% after every three years. Also, additional 6 months security deposit for increase of rental needs to be paid. In line with the terms of the agreement, the monthly rental needs to be increased w.e.f. 1st July, 2014.

Whether increase in the monthly rental and security deposit requires any fresh approval/noting from the Board of Directors of the listed Company and the private company?

Since the escalation and the payment of the security deposit was agreed by the parties and was already a part of the rental agreement when the same was executed, the increase in the monthly rental and payment security deposit would not require approval/noting by the Board of either companies.

It is only when the terms of the agreement are being changed or the agreement is being renewed will the provisions of section 188 and other applicable provisions apply.

xiii. A Ltd has a contract with B Ltd for co-sharing of infrastructure. One of the Independent Director of A, say Mr. X, is a Director of B Ltd. and is also a substantial shareholder (say 60% shares) of B Ltd. Whether the said contract will attract provisions of Section 188 of the CA, 2013?

Section 188 of the CA, 2013 is applicable on contracts or arrangements with related parties w.e.f. 1st April, 2014. Since, Mr. X is also the director of B Ltd. and has substantial shareholding, A Ltd. and B Ltd. are related parties. In the case the contract was entered into before 1st April, 2014, the provisions of section 188 of CA, 2013 will not be applicable. However, in case the contract is renewed or terms are amended, the provisions of section 188 will become applicable.

xiv. Whether transactions with a related party already in existence prior to CA, 2013 like granting land on lease needs to be ratified in the ensuing Board Meeting/General Meeting of the Company?

As per Section 6 of the General Clauses Act, what was valid under the previous Act remains valid under a new Act unless the new law makes it retrospective. Section 188 of CA, 2013 is not retrospective in nature and hence the existing related party transactions will not have to comply with the provisions of section 188 unless they come for renewal. Further, the MCA by way of its notification dated 17th July, 2014 also clarified that where RPTs were entered into after ensuing compliance with section 297 of CA, 1956, then fresh approval under section 188 of CA, 2013 is not required. However, it is advisable that the company places such existing related party transactions before the audit committee pursuant to section 177(4) of CA, 2013.

xv. Clause 49 of the Listing Agreement provides all entities falling under the definition of related parties shall abstain from voting irrespective of whether the entity is a party to the particular transaction or not. In view of the above:

- a. Is the promoter of the Company classified as related party? For example - If there is a transaction between Company X and its wholly owned subsidiary Company Y not in ordinary course of business. In that case will the promoters of X be considered as related party as per section 2(76) of the Act and will not be entitled to vote on the resolution?**

The holding and subsidiary companies shall be related parties for the purpose of Section 2(76). Hence, they are related parties under the Listing Agreement as well. Further, assuming that the promoter is not a director or KMP or relative of any director or KMP in X, he will not be related party u/s 2(76) of CA, 2013. The revised Clause 49 effective from 1st October, 2014 as well as fourth proviso to Section 188(1), effective from 29th May, 2015 exempts transactions between a holding company and its wholly owned subsidiary from the requirement shareholder approval.

- b. In above case, suppose the subsidiary company is not a wholly owned subsidiary of Company Y. In case of resolution to be passed by such subsidiary, whether Company Y (holding Company) can vote on such resolution?**

In case the company is not a wholly owned subsidiary, the exemption, as above, will not apply. In such a situation Company Y, being a related party to the transaction cannot vote on the transaction. However, if the subsidiary is a private company, transaction with the holding company will not be regarded on RPT Pursuant to the exemption notification issued by MCA on 5th June, 2015.

xvi. Can the company enter into a transaction for availing of services with a private company of which a relative of director is a director or member, without obtaining prior Board/Ordinary Resolution as specified under Section 188 of the CA, 2013?

As per Section 2(76)(iv), a private company in which a director or manager is a member or Director will be treated as a related party. However the MCA by way of Companies (Removal of Difficulties) Sixth Order, 2014 on 24th July, 2014 issued an order, providing that a relative of director will also be

covered under Section 2 (76)(iv). Thus the transaction entered into between the Company and such private company will be treated as a related party transaction. Board resolution will be required only if the transaction is not in ordinary course or not on arm's length basis. Further, if the transaction value exceeds the limit specified under Rule 15 of Companies (Meetings of Board and its Powers) Rules, 2014, prior approval of shareholders will be required.

xvii. In a private company which is a subsidiary of a foreign company, under CA, 1956, transactions with foreign companies were exempted. Under the CA, 2013 are these exemptions still available or are they covered under Related Party Transactions?

Pursuant to definition of related party under Section 2(76), transactions with holding company will not be regarded as a related party pursuant to MCA exemption notification No. G.S.R. 464(E) dated 5th June, 2015. The said notification exempts private company from the applicability of Section 2(76)(viii), which regards holding, subsidiary, associate and fellow subsidiaries as related parties, with respect to Section 188. If the transaction is in ordinary course of business and at arms' length, no compliance under Section 188 is required to be made. Where the private company is a wholly owned subsidiary of such foreign company, the special resolution passed by the holding company shall be sufficient for the purpose of entering into the transactions between wholly owned subsidiary and holding company

xviii. Mr P is a director and substantial shareholder in Company X Pvt. Ltd. It proposes to enter into a contract for purchase of goods with Company Y Pvt. Ltd in which Mrs P is a substantial shareholder? The two companies do not have any common director/shareholder. Will it be a case of related party transaction?

Section 2(76) defines related parties and section 188 provides for the list of transactions with such related parties which need certain approvals. Any contract with a private company in which the director (Mr. P) or his relative (Mrs. P) is a member or director will be a related party transaction . In the present case, relative of Mr. P is a member of Company Y. Therefore this will be a related party transaction.

xix. Section 188 is not applicable for transactions in the ordinary course of business and carried out at arm's length basis. Company A sells ordinarily traded goods to Company B at market prices. Both

companies are related with common members, common directors. Is this transaction exempt from [a] registration of resolutions with MCA [b] disclosure of directors' interest [c] approval by members by special resolution?

Considering the transaction is in ordinary course of business and is at arm's length, the provisions of section 188 shall not apply to such transactions even if entered into with related parties. In the light of this:

- a. There is no requirement for registration of resolution with MCA.
- b. If one is to strictly follow the provisions of section 188 of CA, 2013, the transaction will not require sanction of the Board. However, as a matter of prudence and good governance, both the companies should seek the approval of their respective Boards.
- c. There is no need to obtain members approval by way of an ordinary special resolution.

However the transaction has to be placed before the Audit Committee for its approval.

xx. Will there be any change, if the transaction as stated above is not in ordinary course of business but on arm's length basis?

Considering the transaction is not in ordinary course of business but on arm's length, the provisions of section 188 shall apply to such transactions. In the light of this:

- a. There is no requirement for registration of resolution with MCA.
- b. The transaction will require sanction of the Board. Interested director shall not participate in the proceedings pursuant to provisions of Section 184(2). However, in case of private limited companies, as permitted under MCA exemption notification No. G.S.R. 464(E) dated 5th June, 2015, an interested director can participate in the transaction after disclosing his interest.
- c. In case the value of transaction exceeds limit prescribed under the rules, prior approval of members shall be obtained by way of an ordinary resolution.

Further, the transaction has to be placed before the Audit Committee for its approval.

xxi. In case of contracts/agreements which are executed with the related parties prior to commencement of CA, 2013 i.e. 1st April,

2014, is Board approval or Shareholder's approval required to be taken under the CA, 2013?

As per MCA clarification issued vide general circular no. 30/2014 dated 17th July, 2014, contracts entered into by companies after making necessary compliances under Section 297 of Act, 1956 which already came into effect before the commencement of Section 188 of CA, 2013 will not require fresh approval till the expiry of the original term of such contracts. In case any modification is made in contract on or after 1st April, 2014 then requirements of Section 188 will have to be complied with.

However, in terms of revised clause 49, in case of listed companies all existing material related party contracts or arrangements which are likely to continue beyond 31st March, 2015 shall be required to be placed for approval of shareholders in the first general meeting held subsequent to 1st October, 2014. The Companies may opt for obtaining approval at a general meeting held prior to 1st October, 2014 also.

xxii. The Company is in the business of manufacturing and selling of FMCG and also indulges in certain other activities.

Whether following items can be considered as in ordinary course of business :

- a. Giving out on rent a part of the office space to group companies where the Company has already passed resolution u/s 149(2A) of CA, 1956**

It cannot be contended that mere passing of a resolution u/s 149(2A) amounts to the business being ordinary. The term "ordinary course of business" is not about the periphery of business powers of the company, but the ordinary nature of the transaction. Renting of space is not being pursued by the company as a part of its business. In ordinary course of business, the company does not have to part with its properties or provide them on rental or sharing basis to anyone. The purpose of the "ordinary course of business" and "arm length" exemption in the third proviso is whether the transaction is such which should be allowed to go ahead without the scrutiny of the members, or should the board place it before the minority shareholders. In case of related party transactions, focus is specifically on the duties of independent directors – please see item (9) of Part III of Schedule IV, coupled with the fact that interested directors do not participate in board proceeding which discussed related party transactions – Section 184(2).

In view of the specific onus on independent directors, independent directors should tread the line of exemption in third proviso to Section 188(1) cautiously, and not make an ambitious use of it. Wherever there is a shade of doubt, the directors should opt for caution rather than courage.

In taking the sanction of the general meeting, in view of the requirements under rule 15(3) of Companies (Meetings of Board and its Powers) Rules, 2014, the explanatory statement as well as the shareholders' resolution need not state the exact commercial terms, and may provide a broad power for the type of transaction with a particular related party. Thus, the board may be authorized to fix the commercial terms. The explanatory statement can state the estimated value of the commercials involved. This will be to give an idea to the shareholders about the estimated size of the contract.

b. Giving the brand name to group companies for use on payment of royalty

Before we conclude if the same is in the 'ordinary course of business' of the Company, we first opine on whether at all giving the brand name of a company for use to group companies can be classified as a related party transaction.

In this regard, we draw your attention to Para 9 of IAS 24 which defines the words "related party transaction" as a transfer of resources, obligations or services between a reporting entity and a related party, regardless of whether a price is charged. A similar definition appears under Clause 49(VII)(A) of the revised Equity Listing Agreement which has come into effect from October 1, 2014.

In the present case, the brand name is not proposed to be transferred or assigned to the related party. There is no transfer of resources as well. Further, no risks will be assumed by the Company by reason of granting the said permission – hence, there is no transfer of obligations merely by virtue of the grant of approval to use the brand name. Also, the said transaction does not amount to providing any service whatsoever.

The sole intention behind giving the permission to use the brand name of a company to group companies is to establish a relation of flagship. As explained above, this does not tantamount to a 'transaction' at all as provided under para 9 of IAS 24 and Clause (VII)(A) of Clause 49 of the revised Equity Listing Agreement.

Thus, as it is not a transaction in the first place, there is no question of applying Clause 49(VII) of the Listing Agreement or Section 188 or Section 177(4)(iv) of the CA, 2013 to giving the permission to use the brand name of a company to group companies. Hence, when it does not classify as a 'related party transaction', none of the provisions of Section 188 of CA, 2013 will apply.

c. Whether payment of royalty can be made at fixed amount or on the basis of annual turnover?

Given, the discussion above, since it does not classify as related party transaction, it is upto the management of the Company to decide on the method of charging royalty which can be either as a fixed amount or on the basis of annual turnover.

xxiii. The Company has given its brand for use to group companies and is receiving a fixed sum without reference to turnover. Can this be considered to be an arm's length transaction?

'Related party transaction' is defined irrespective of the fact that a price is charged or not and from the discussion above, it is clear that grant of approval for use of a brand name cannot be construed as a 'related party transaction'. The point regarding charging of royalty is not relevant to conclude a 'related party transaction'.

xxiv. "Related party", with reference to a company, means – a public company in which a director or manager is a director and holds along with his relatives, more than two per cent of its paid-up share capital. If the director of the company does not hold any shares in a company, but his relatives hold 2% of paid up share capital in such company, whether such Company would be considered as a Related Party?

Section 2(76)(vi) of CA, 2013 states that any public company in which the director of another company ("Other Company") is a director or holds 2% of the paid-up share capital along with his relatives shall be a related party transaction.

The use of the words "along with" may be interpreted such that the holding of a relative of a director in the Other Company will be counted only if the director also holds some shares. In other words, if the director in question is not a shareholder in the Other Company, then the holding of the relatives in the Other Company will not be countered. The words "along with" syn-

tactically is similar to “together with”. Similar expressions have been dealt with at great length in several rulings – a Division Bench of Allahabad High Court in *Majhola Distillery and Chemical vs State of Uttar Pradesh* ruling dated 4 October, 2007 has cited from several dictionary meanings of the word. In *CIT vs Berger Paints (India) Ltd.* 2002 254 ITR 503 Cal, the Calcutta High court held that the words “along with” is lighter in meaning than “accompanied by”. The Allahabad High court in the ruling referred to above had held that the intent of the words “together with” is to add something to the subject to which these words are appended. In the context of the meaning of “related parties”, the holding of relatives is clubbed with that of the directors, to ascertain relationship, on the premise that the economic interest of the director and his relatives is unified. There is no reason why the shares of the relatives should not be counted, if the director in question does not hold any shares. It will not serve the purpose of the definition if a director could get away with the impact of the section merely by parking his interest in the Other Company in the name of his relatives.

Hence, the conjunctive “along with” has to be read in expansive sense, and not restrictive sense. Therefore, it is possible to disregard the shareholding of the relatives, if the director in question is not holding shares in the Other Company.

8.3.7 Contravention of provisions

i. Whether directors are liable for any loss suffered by the company with respect to RPTs?

The CA, 2013 imposes special liability on directors with regard to RPTs.

- a. Section 188(3) of the Act provides that any RPTs entered into by a director or any other employee, without prior approval of the Board or passing of special resolution by the shareholders, if required, the transaction needs to be ratified by the necessary resolution within 3 months of entering into such RPTs. If the same is not ratified within the said 3 months:
 - i. The RPT shall become voidable at the instance of the Board; and
 - ii. If the RPT is with a related party to any director, or is authorized by any other director, the director(s) concerned shall indemnify the company against any loss incurred by it.

- b.* Section 188(4) further provides that where any RTPT has been entered in contravention of the provisions of Section 188, and any loss has been occurred due to such contract, the company has power to initiate any proceeding against director or employee who has entered into such contract or arrangement.
- c.* Furthering such liability on directors with regard to RTPs, Section 164 provides that a person who has been convicted of an offence relating to RPTs during the preceding 5 years, he shall be disqualified for appointment as a director of any other company.

ii. Whether criminal liability can be imposed on a director who has been convicted for contravention of Section 188?

Section 188(5) of the CA, 2013 provides that any director or employee of the company who had entered into or authorized the contract or arrangement in violation of the provisions of this section shall:

- a.* in case of listed company, be punishable with imprisonment for a term which may extend to 1 year or with fine which shall not be less than Rs. 25,000 but which may extend to Rs. 5,00,000, or with both; and
- b.* in case of any other company, be punishable with fine which shall not be less than Rs. 25,000 but which may extend to Rs. 5,00,000.

Accordingly directors or employees of only listed companies may face criminal liability in case they have been convicted for contravention of provisions of Section 188.

iii. Whether the indemnifying provisions under section 188(3) and prosecution liability under section 188(5) are the same?

No, both are different provisions and effective under different situations.

The indemnifying provision under Section 188(3) will become applicable against a director only if the company has suffered a loss on account of an RPT entered into in violation of the provisions of section 188(1). Accordingly if the company has not suffered a loss or has gained from such RPT, this provision will not be applicable.

However, the prosecution liability under Section 188(5) of the CA, 2013 will become enforceable in the event of a violation of the provisions of the section, irrespective of the fact that the company stands to lose or gain from the RPT.

8.4 PROHIBITION ON INSIDER TRADING

i. Section 195 of CA, 2013 provides provisions with regard to prohibition on insider trading of securities. What is the intent of the section? Is it line with SEBI's regulations on prohibition of insider trading of 2015?

The intent of the section, as the SEBI regulations is to prohibit any trading in securities on the basis of price sensitive information which is not generically available. If the intent of the section was to be made applicable to listed companies, then the SEBI regulations are already in place with regard to prohibiting such trade. However, the provisions of the section as being read are applicable to any company. If by the extended logic the section was to be made applicable to unlisted companies, the very question of trading in the securities basis the price sensitive information gets frustrated.

Para 12.108 of the Standing Parliamentary Committee Report on Companies Bill, 2009 clarifies the intent of the section, as below:

"During preparation of the Bill it was observed that at present the offence of insider trading has not been defined in any statute. Though this term has been referred and prohibited in SEBI Act, 1992, the definition and other detailed requirements for 'insider trading' have been provided in relevant regulations framed by SEBI. Since regulation of insider trading is an important matter for good corporate governance, the provisions in this regard in context of prohibitions for directors and KMPs have been provided in the Bill without referring to any regulatory provisions framed by SEBI. It is not the intention to modify the existing regulatory structure formulated by SEBI on this matter, which may continue as it is.

(b) In view of above, keeping in view the need and appropriateness for enabling provisions on offence relating to insider trading to be provided in the principal legislation for corporate entities, the provisions may not be considered to be deleted from the Bill. However, any suggestion to improve the drafting of this clause to bring more clarity on the matter may be considered."

Further Para 12.113 of the Report, in this regard, provided that:

"The Committee, while appreciating the fact that enabling provisions are required to prohibit forward dealings and insider trading in securities of company by a KMP or a director, would like to point out that the provisions proposed in Clauses 172 and 173 for this purpose should remain in consonance with SEBI regulations on the subject. These clauses may therefore be modified accordingly so as to bring greater clarity to the legislative intent on the issue. It is also necessary in this regard that "insider trading" is also suitably defined in the Bill."

It is thus clear that the section was inserted in the statute book only due to the “appropriateness of enabling provision” on the offence of insider trading in the principal statute dealing with companies.

ii. Is section 195 of CA, 2013 applicable to private companies as well?

The applicability of the section to private companies is not understood given the fact that its shares are not freely transferable. Private companies are closely held companies in which the relevance of insider trading based on UPSI becomes irrelevant.

The term price sensitive information has been defined to mean, *‘any information which relates directly or indirectly, to a company and which if published is likely to materially affect the price of securities of the company.’*

In case of private companies, the circumstances of information having impact on the prices of the securities does not arise considering that the affairs of the company are completely private.

iii. Is the section applicable to unlisted public companies?

The shares of an unlisted public company are freely transferable; therefore in absence of any clarification on the matter, it cannot be assumed that the provisions of the section are not applicable to unlisted public companies. On the face of it, if there is any purchase or sale of the securities of an unlisted company by “insiders”, there is rebuttable presumption that there is non-level information between the trading parties. Also, if there is any transmission of non-public price sensitive information about such companies, other than in normal course of one’s duties, there is an offence of the section.

iv. Is there a need for framing a trading code under CA, 2013?

The listed companies are guided by the SEBI regulations and will create the trading code basis the regulations framed by SEBI in this regard. See the chapter on SEBI’s (Prohibition of Insider Trading) Regulations, 2015 later.

With regard to unlisted public companies there may not be a need for creating a trading code considering that there is no dissemination of information to the public. Further, if there is a trade between two insiders, then it cannot be alleged that the trading was based on price sensitive information. On the other hand, if the trading is based on fair valuation, the question of gaining undue advantage of the price sensitive information does not arise. If only the trading is based on non-level information, the infringement of the provisions of the section arises.

v. What are the penal provisions in case of contravention of the provisions of section 195 of CA, 2013?

Section 195(2) states that in case there is contravention of the provisions of the section, every person shall be punishable with imprisonment for a term which may extend upto 5 years or with fine which shall not be less than Rs. 5 lacs but which may extend upto Rs. 25 crores or three times the amount of profits made by the insider, whichever is higher, or both.