The Companies Bill 2008 – The Road to Global Relevance

Since 2004, the Ministry of Corporate Affairs has undertaken a comprehensive exercise to revise the Companies Act of 1956 in order to align Indian corporate laws and regulations to the needs of increasingly gobalised Indian economy and corporates. The number of companies increased from 30,000 in 1956 to over 700,000 in 2008 which includes a number of companies which are either dormant or effectively inoperative. The sheer task of the regulators to effectively perform their duty of oversight is very daunting and was one of the drivers for change.

Ease of operations is one of the pillars the new Bill rests on and there are a number of far reaching changes that address this. The areas include appointment and fixing of the remuneration of directors by the company without the approval of the Central Government or the limits on the number of subsidiaries are being done away with which unlocks diverse structuring options for Indian companies.

The Bill also envisages one person companies for small entrepreneurs to enable them to have a corporate structure and faster processes for dealing with such companies. The new Companies Bill has provisions for dealing with inactive and dormant companies and the Registrar of Companies has the power to deal with such companies including striking them off in cases of default. The ease of compliance regime reiterates the focus on this flavour of change.

The other two pillars on which the Companies Bill stands is on providing for norms which will be codified by law on governance, protection of rights of public, responsibility and accountability based on self regulation. The law leans towards the government moving out of the realms of controlling the internal corporate process and have those processes now be governed by decisions of shareholders.

The new sections which reinforce this transformation includes articulation of rights of minority stakeholders, transition of companies operating under the Act of 1956 to the new Act and also the ability to change from one type of company to another, relaxation of maximum number of persons in a partnership to facilitate functioning of large non-corporate bodies etc.

The third leg is of oversight by the regulators. The bill brings in criminal liability for insider trading for key management personnel, provides for shareholder groups to take part in ‘class action suits’ for fraud perpetrated by the company or its management and provides for guidelines for an effective regime of inspections and investigations of companies while laying down maximum and minimum penalties for non-compliance by the company, its directors, CEO, CFO etc. including provisions for recovery and disgorgement for fraudulent acts. The Bill provides for the number of independent directors in a listed company to be one third, though SEBI requires 50% and states that norms of independent directors for public companies will be released later.

The Bill recognises changes that have happened in technology area by providing for electronic filings to be done for compliance and even includes board meetings which now need to be physically done over video conferencing or other electronic modes as may be prescribed. The Bill also provides for voting in a shareholders’ meeting through e-mail.

There are a number of critical changes in accounting and audit for which the National Advisory Committee will advise the Central Government on the manner of laying down accounting and auditing standards that companies or their auditors would need to follow. Consolidation of subsidiaries is expected to be mandatory even for unlisted companies and roles, rights and duties of auditors are defined for maintaining integrity and independence of auditors.
In countries like the USA, a distinction is made on the services an auditor can offer to its clients based on public interest in that client. The independence rules for an auditor of a SEC listed company is significantly more stringent than

compared to a small private company. ICAI and the government may evaluate whether the permitted services an auditor may offer should be on the same level of stringency for a small company and a listed behemoth given the storage of professional skills available today or they be graded for different classes of companies.

The Bill requires an auditor to make observations or comments on matters which will have an adverse effect on the functioning of a company, which is similar to the earlier Act. The brush of this section is wide and the section increases the responsibility of the auditors from reporting on the financial state of affairs and extend it to make comments on the functioning of the company in areas which could include operations and sales and marketing. The legal interpretation of how responsibility is to be discharged along with how ICAI will deal with this will be critical for the profession.

This clause along with some of the existing clauses relating to compliance with internal controls including reservations on maintenance of accounts and adherence to the policies set by the directors of the board casts one of the highest degree of responsibility on auditors globally. Additionally, members of ICAI will be required under this Bill to make judgement on matters of functioning of companies which are outside the realms of their expertise.

The key change which makes this provision onerous is that the Bill provides for criminal and civil liability including liability to any person who may claim to be relying on the report, for auditors who might contravene the provisions of adequate reporting including those on controls and functioning of companies. Similar liabilities also exist for auditors who deliver services which are prohibited like internal audit, management services, investment advisory services, design and implementation of financial reporting systems and book-keeping.

These services are very broad and nebulous and hence need to be clearly defined especially when they have punitive civil damages and imprisonment and third party liability for contravention. In most countries, if the independence of an auditor is impaired for providing prohibited service, the auditor automatically vacates his office. In such a case, criminal sentence or civil punitive damages will be extremely harsh.

India will transition or converge with IFRS in 2011 and to facilitate such convergence, significant changes to the existing Companies Act of 1956 would be needed to be made. Let us take an example of preference shares which are redeemable under IFRS need to be split into equity and debt. This would affect rights of the preference share and equity shareholders if the instruments retain the characteristics of its classification.

The laws for issue of these instruments are also to be adhered to. There are 10 accounting standards under IFRS which needs change in Companies Act. Inclusion of provisions in existing Companies Bill to deal with substantive changes of law and not merely accounting standards would have helped manage the process of convergence better.

Self regulation always comes with a strict penal consequence for non-compliance. However, if the gravity of the offence and its consequence is not clearly articulated for various responsibilities of the directors, CEO, CFO and auditors, we might open ourselves to a number of interpretations and consequent litigations. This would clearly be self defeating.

The Bill is futuristic and will greatly be instrumental in bringing in an era of transparency, self regulation and ease of operation for Indian companies to be relevant as key players in the global economic landscape.

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