

Agenda



- ❑ Internal Financial Control: Four Themes
- ❑ Related Party
- ❑ CSR Provisions
- ❑ Class action suits
- ❑ Dormant Company

Internal Financial Control



Internal Control reporting

Applicability	Requirement	Implication
Board responsibility Internal Financial Controls (including controls over financial reporting – ICOFR): ▪ All listed companies Internal financial controls only with reference to controls over financial statements • All other companies Auditor responsibility Comment on adequacy of internal financial controls (over financial reporting)	a. Board's assurance on internal financial controls to cover ▪ financial statements ▪ ensuring orderly and efficient conduct of business <i>“ Internal financial controls” mean the policies/procedures adopted for ensuring orderly/efficient conduct of business; adherence to policies; safeguarding of assets; prevention/ detection of frauds/errors; accuracy/completeness of accounting records; and timely preparation of reliable financial information”</i>	▪ Coverage beyond SOX404 to include assurance on operations and business ▪ Extremely onerous requirement to document controls and procedures and testing the operative effectiveness of controls ▪ Definition of internal financial controls rationalized with to refer to controls over financial statements. However, the definition in the Act not changed

Internal Control reporting

- **The Companies Act 2013 requires:**

- the Directors report for listed companies, including public companies with paid up capital of INR 25 Crore or more, and
 - auditor's report for all companies
- to comment on whether the company has adequate internal financial controls (IFC) system in place and the operating effectiveness of such controls.

- Audit Committee is entrusted with evaluating internal financial controls (both operational and financial).
- All Companies will need to lay down IFC covering its operations, reporting (financial and non-financial) and compliance responsibilities; and not just over financial reporting.
- Discussion draft issued by ICAI as guidance to Statutory Auditors has indicated using the COSO framework as the basis on which IFC will be evaluated.
- Organizations would need to shift from **point-in-time testing** to **ongoing-testing embedded** within the business processes.

4 Themes - Plans and responsibilities

As companies raise bar on their own performance to contend with the greater regulatory and stakeholder expectations, it also raises the bar on IFC



Necessary for **management to review their methodology** and include specific procedures to address these changes



1

Mandatory
reporting on
Internal Financial
Controls

2

Strengthening
Enterprise Risk
Assessment
processes

3

Assessing Fraud
Risk
Vulnerabilities

4

Comprehensive
Legal Compliance
Framework

1 IFC - Reporting

1. Assess and Evaluate “Tone at the Top”

- Review management's philosophy and operating style
- Review Board/Audit committee's oversight responsibility over financial reporting & internal control
- Ensure presence of defined policies and procedures

2. Develop an Internal Control Framework

- Ensure holistic coverage of operational, financial and fraud risks
- Design in accordance with the COSO / COBIT Frameworks

3. Develop a combined Assurance Plan

- Develop a combined Assurance Plan for risk management and continuous monitoring
- Evaluate, document and prioritize risks across the organization / business segments

4. Test the operating Effectiveness of Internal Financial Controls

- Assist management's assessment of design of controls over business operations
- Enable evaluation of operating effectiveness and deviation identification



1 Key changes impacting internal control framework

Focus on

3

critical
themes

1. Rigor on 'Internal Control Reporting Framework'

- Coverage beyond SOX404 to include assurance on operations and business
- Extremely onerous requirement to document controls and procedures and testing the operative effectiveness of controls
- Section 134 required listed companies to specifically assert on adequacy and operating effectiveness of internal financial controls

2. Higher 'Auditor Accountability'

- Required to report on the adequacy of internal financial control system and effectiveness
- Report all frauds to the Central Government

3. 'Increased Responsibility' of Board , Independent Directors, Audit Committee & KMP

- Audit Committee responsible for the evaluation of internal financial controls and risk management systems
- Audit Committee responsible for review and pre approvals of Related Party Transactions
- Board responsible for development and implementation of risk management policy

1 IFC - Plans



- Adopt risk based audit plans
- Dynamic audit planning: rapid response to emerging risks
- Build consensus: Assess risks to future growth (value creation)
- Facilitate a “portfolio” view of risk
- Educate audit committees and management on the value of effective risk management
- Build robust risk mitigation process
- Expand risk assessment process: evaluate risks embedded in the core business strategies
- Leverage continuous and anticipatory auditing processes

2 Key changes impacting risk management framework

Section 134:

- The Board of Director's report must include a statement indicating development and implementation of a risk management policy for the company including identification of elements of risk, if any, which in the opinion of the board may threaten the existence of the company

Section 177 :

- The Audit Committee shall act in accordance with the terms of reference specified in writing by the board, which shall, inter alia, include evaluation of risk management systems

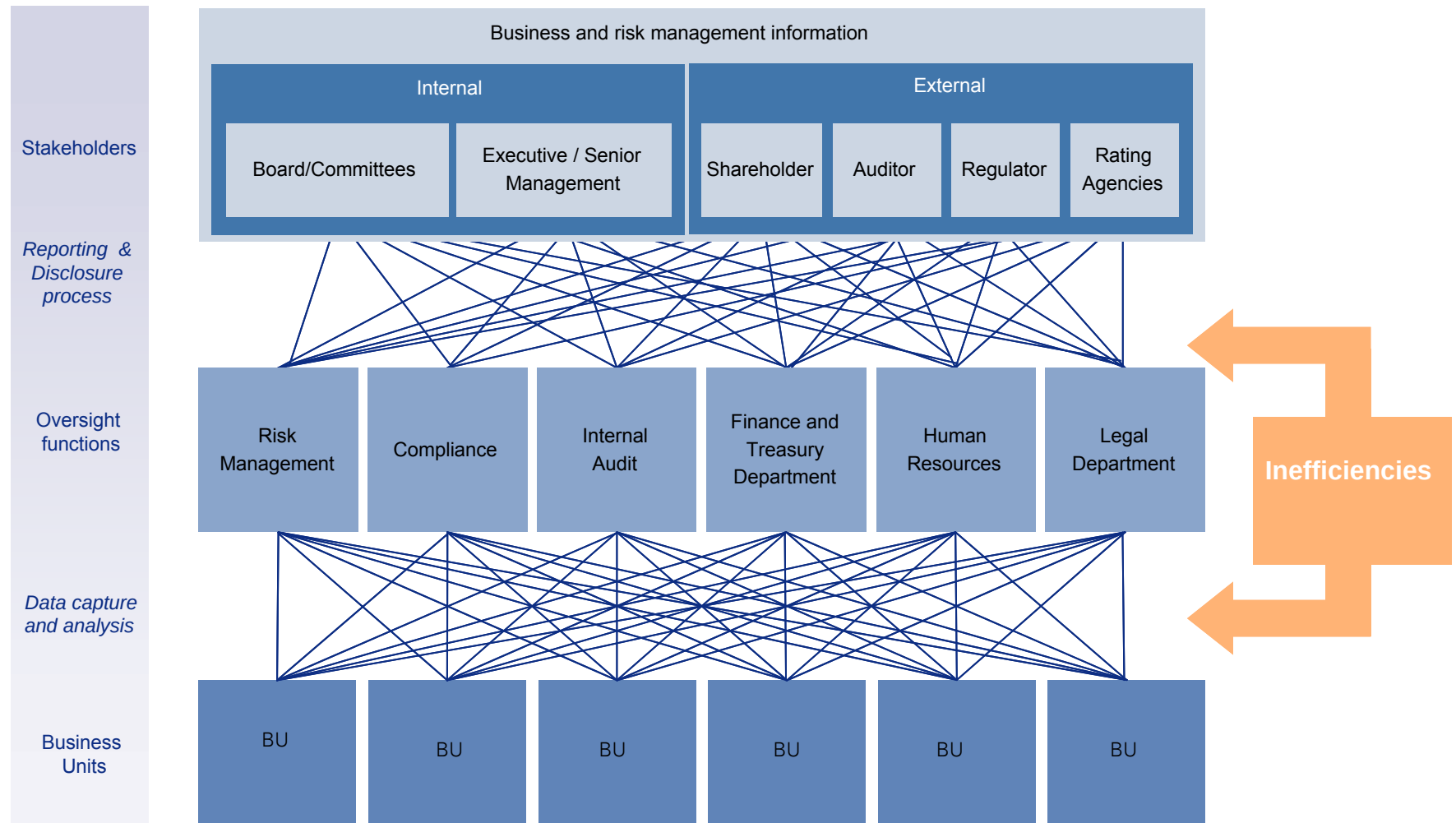
Schedule IV :

- Independent Directors should satisfy themselves that systems of risk management are robust and defensible

Clause 49 of the Listing Agreement from SEBI:

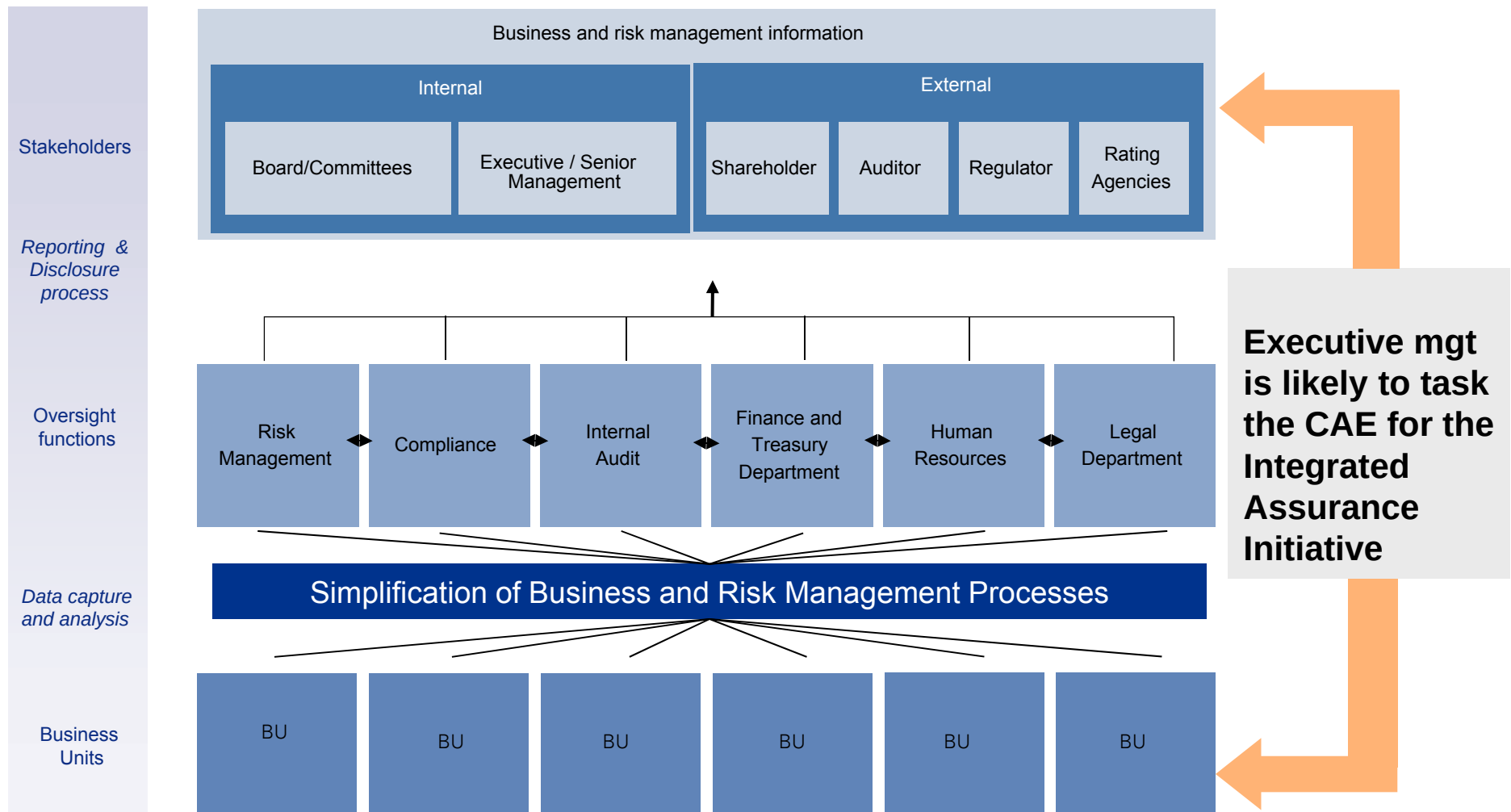
- It widens the requirements for risk management. It requires the Board to be responsible for framing, implementing and monitoring the risk management plan for the company

2 Increasing regulatory – Complex business and risk mgt process



2 Case for integrated assurance: Aggregate, align, formulate a complete and consistent message for stakeholders

Benefits include common risk vocabulary, consistent reporting, cost savings



Fraud provisions: New Act introduces vital changes for the first time

As per Section 447: Fraud now includes:

- any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive,
 - to gain undue advantage from, or
 - to injure the interests of, the company or its shareholders or its creditors
- Liability and punishment extended to **every individual** who has been a party to it deliberately, including the auditors
 - Establish a **vigil mechanism** for directors/employees to report genuine concerns
 - **Adequate safeguards** against victimization of persons who use such mechanism.
 - Details of such mechanism required to be disclosed on company website and Board's report
 - **Directors Responsibility Statement** required to include a confirmation regarding *proper and sufficient care for the maintenance of adequate accounting records for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities*

3 Six actions to be taken by the BoD for fraud risk mitigation

Creation of **'tone at the top'**

which communicates that fraud will not be accepted in any form

Implement policies/code of

conduct that encourage ethical behavior by employees, board members and external business partners

Establish an independent **vigil**

mechanism for directors and employees to report concerns, even violation of policies

6

Monitor the organization's fraud risk management process that ensures action/ resolution on all reported fraud/ violations

Create effective governance model for deterrence of fraud; consider all aspect of board governance including processes controlling board information, agenda, access to management etc

Oversight of executive management's compliance with appropriate financial reporting and preventing override of controls or other inappropriate influence

4 Three elements of a comprehensive legal compliance framework

Comprehensive Legal Framework

Compliance with 'Provisions of All Applicable Laws'

Governance level

- Compliance organization structure, policies and procedures documents, well defined roles and responsibilities, **a well-defined reporting structure**

Operating level

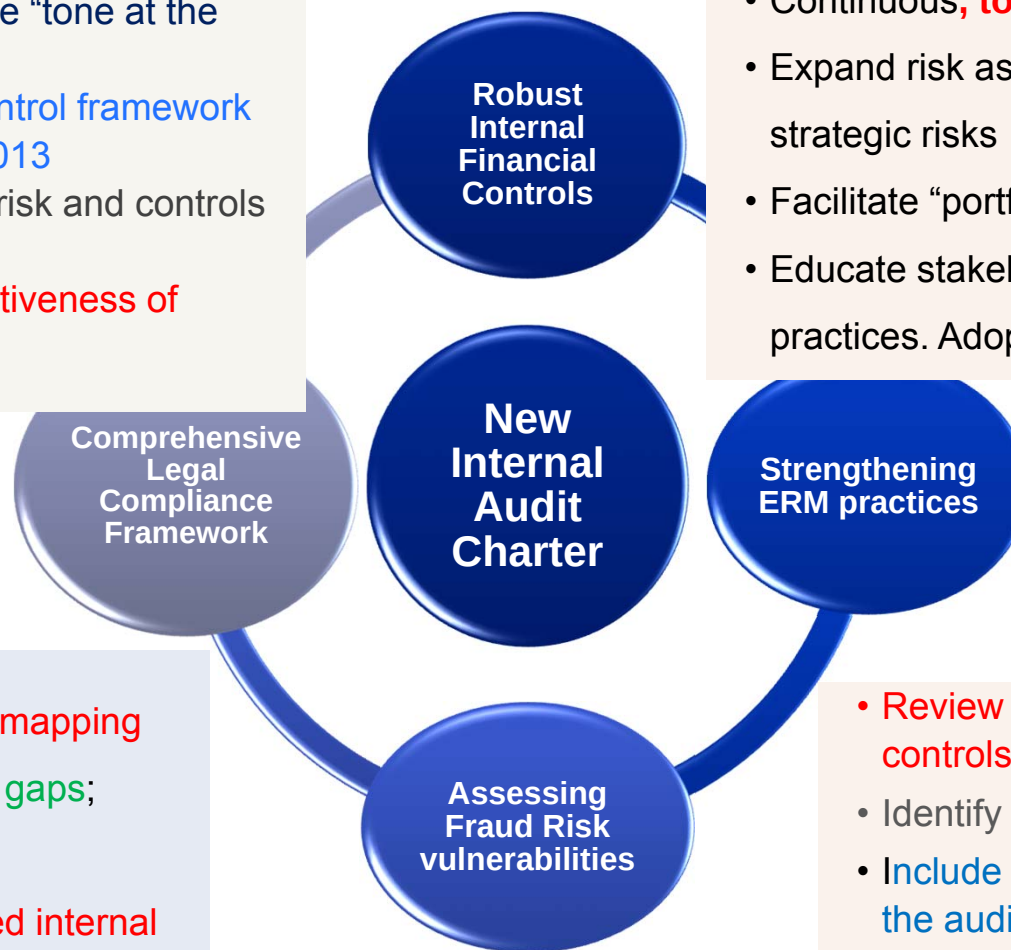
- Business practices aligned with all applicable laws
- **An automated tool** to ensure compliance monitoring is effective
- Document retention and training will be key to ensuring proper compliance

Monitoring level

- Ensure proper **monitoring systems** in place, which include
 - MIS & reporting, Audits, Inspections and Site visits if required, Self-Certification, Third party compliance programs and remediation plans and processes for non-compliances

IFC Charter: To be launched anchored on 4 themes

- Assess and evaluate “tone at the top”
- Develop internal control framework aligned to COSO 2013
- Develop combined risk and controls assurance plan
- Test operating effectiveness of internal controls

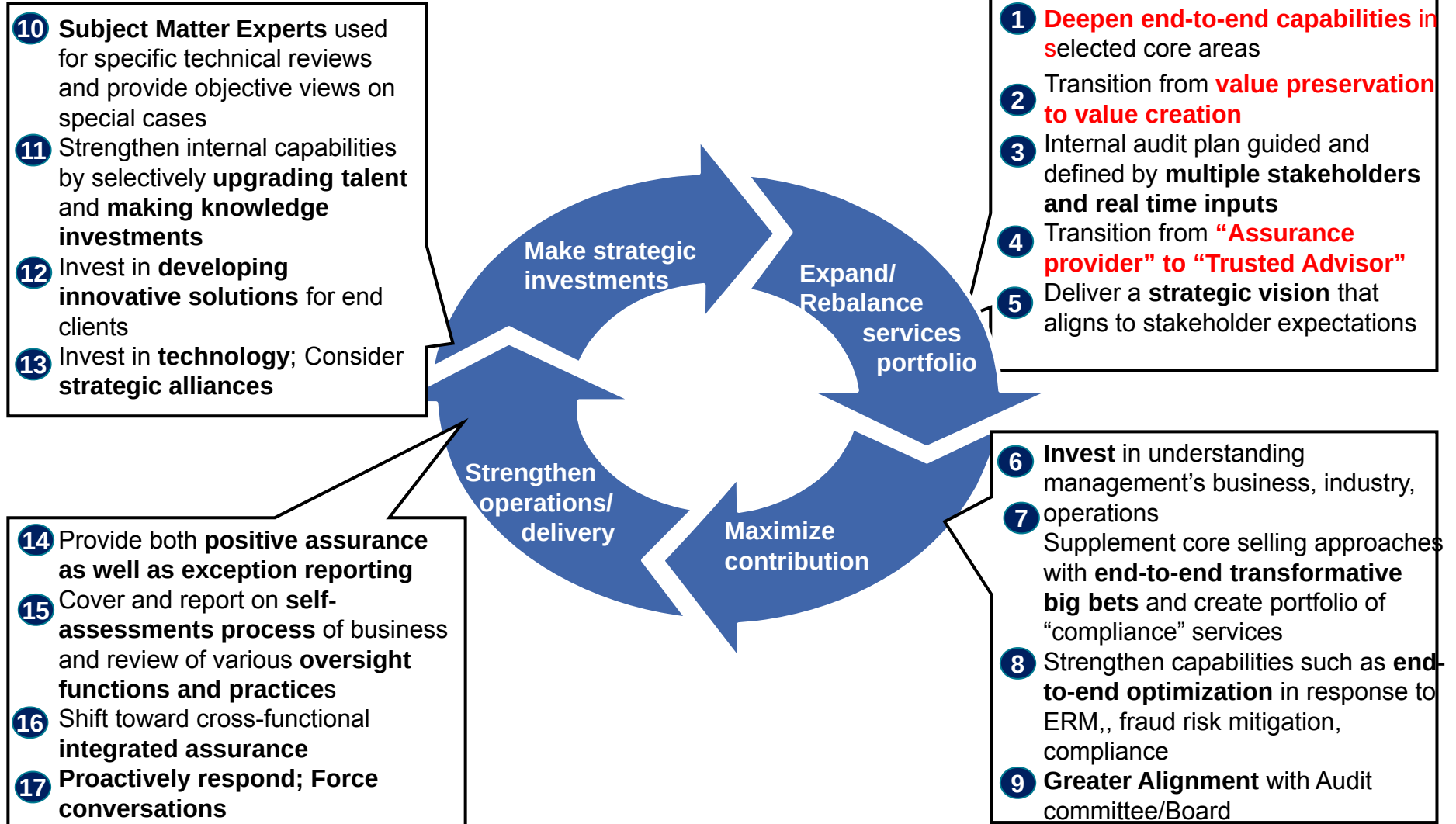


- Continuous, **top down risk assessment**
- Expand risk assessment to include strategic risks
- Facilitate “portfolio” view of risks
- Educate stakeholders on risk mgt practices. Adopt dynamic audit plans

- Detailed **legislation mapping**
- Identify **compliance gaps**; additional controls
- Implement **integrated internal audit and compliance model**

- **Review entity level anti-fraud controls**
- Identify relevant fraud risk factors
- **Include Potential Fraud Indicators in the audit plan**
- Leverage data **analytics** to look through unusual transactions

New expectation: 4 key actions



To strategize and Reengineer IA Function

CAEs

Does the internal audit charter clearly define its roles within the overall governance processes?

Does support for internal audit come directly from the CEO and chairman of the audit committee?

Do IA have direct access to the board, the audit committee, top management, and heads of business operations?

What is an appropriate IA strategy to deliver against the new requirements?

C-suite Executives

Is the CAE strategically positioned to help the board discharge its governance role?

Do I regularly seek internal audit's perspective on trends in risk and control issues?

Is the Management and board aligned on the perception of internal audit's value and performance?

Board and Audit Committee members

Does the CAE focus on key risks; adequacy of ERM processes?

How do we get 'real time' overarching view of the control environment rather than individual information?

Do we contribute to setting the tone at the top by having its chair meet one-on-one at least quarterly with the CAE?

Is there a need to redefine the CAE role; making it increasingly valuable?

The background features two overlapping geometric shapes in shades of blue. The top-left shape is a parallelogram with a dark blue base and a lighter blue top. The bottom-right shape is a larger parallelogram, also with a dark blue base and a lighter blue top, overlapping the first shape.

Related party transactions

Key changes in the framework for related party transactions

Upto 31 March 2014, the reporting framework of related parties was primarily driven by **AS 18 which mandated** only 'disclosure' of certain related party transactions.

The universe of related parties and transactions covered under the Companies Act, 2013/the SEBI clause 49 expanded; clarifications on the definition of related party was issued by the MCA.

Approval process has been made more stringent: audit committee approval, board approval, and shareholders' approval are required in certain cases. **Upto 31 March 2014**, the only requirement under the erstwhile Equity Listing Agreement was for the audit committee to 'review' related party transactions.

Requirements for 'ordinary course of business' and arm's length pricing have come into place for all related party transactions. Earlier, requirement for arm's length pricing was prescribed under the Income Tax Act, 1961 for international transactions and specified domestic transactions.

Increased reporting requirements for related party transactions to the Board, and on quarterly basis to the SEBI.

Draft notification providing relief to private companies from the requirements of Section 188 has been issued. Accordingly, Boards' and shareholders' approvals may not be required.

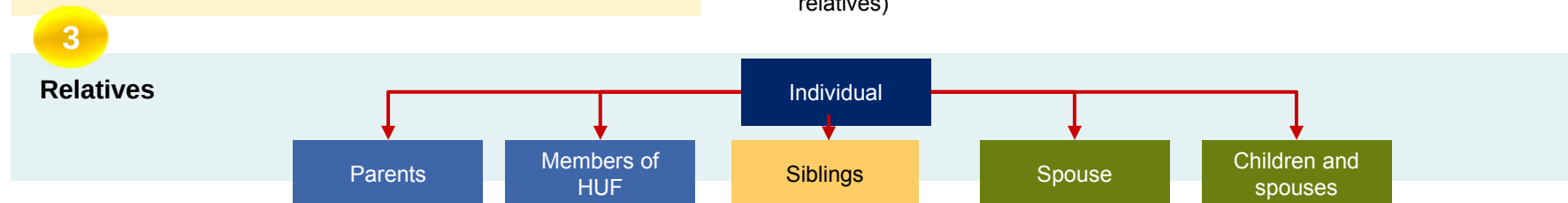
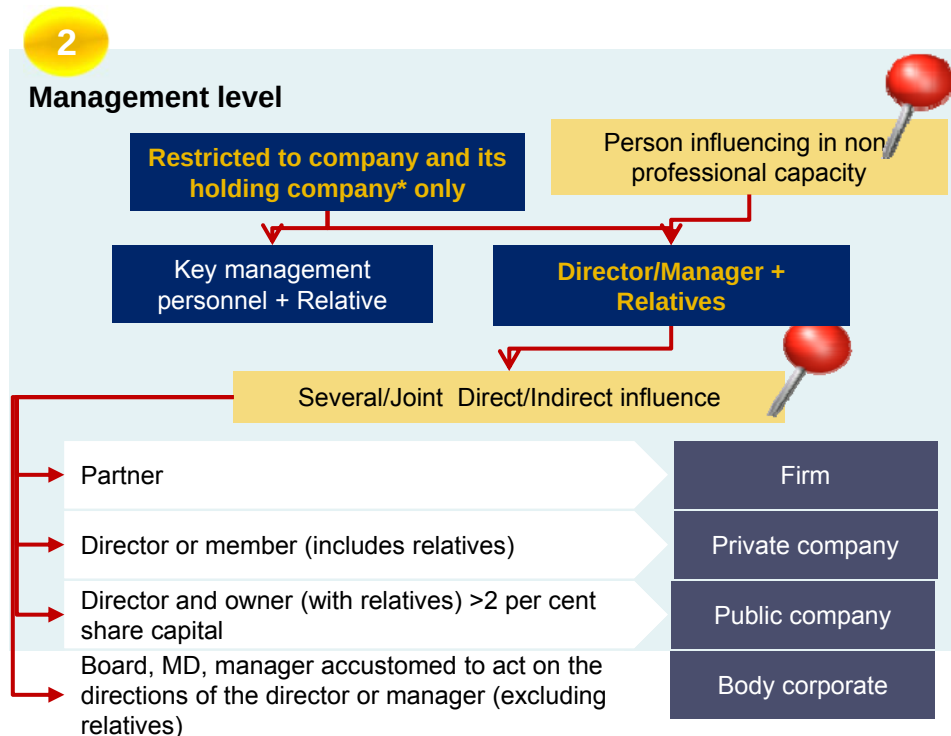
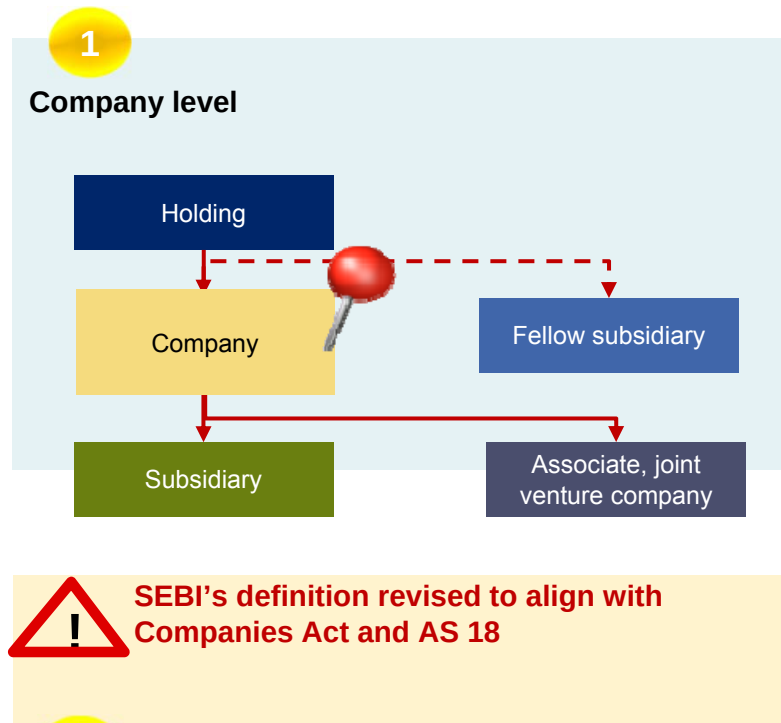
Shift from requiring the Central Government's approval to an emphasis on the **shareholders' approval**

Related party transactions



- Related parties
 - Specifically defined
 - Coverage significantly wider than AS 18 e.g.
 - much larger list of relatives compared to AS 18 (members of HUF, spouse and, as per rules 8 other relationships)
 - director or KMP of the holding company or his relative
- Joint ventures to be considered as related parties; specifically covered in definition of 'associate company'
- Coverage of related party transactions increased as compared to the position as per the 1956 Act
- Definition in Act to be used for legal/ regulatory purposes only
 - AS 18 disclosures to still be as per definitions of AS 18

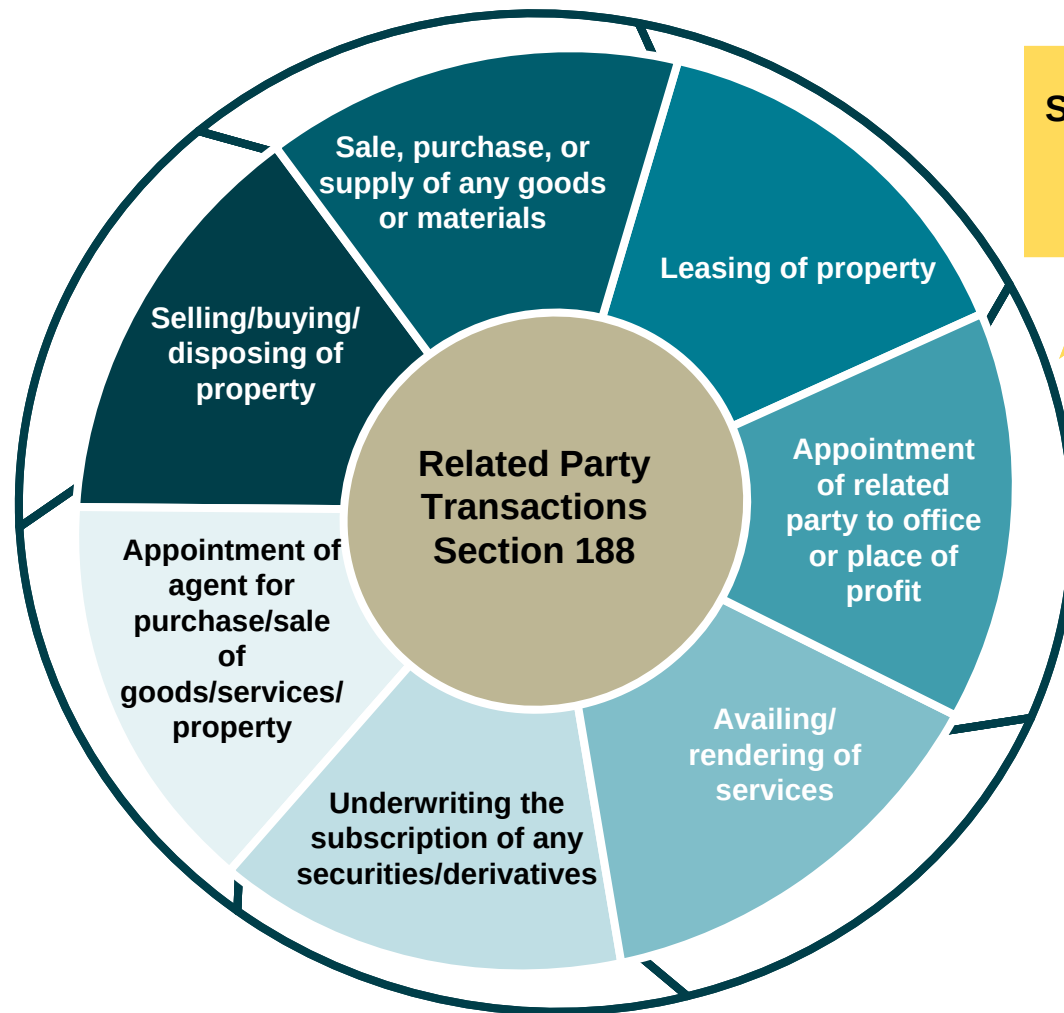
Universe of related parties



*Independent directors of holding company are excluded

**Holding > 50% /20% of 'nominal equity share capital' now replaced with 'total share capital', Total capital includes equity and convertible preference shares

Universe of related party transactions



Section 188 is a subset of all related party transactions

- Section 177 covers all transactions with related parties, whether covered under Section 188 or not
- Clause 49 also covers transactions even if no price is charged

Provisions for related party transactions clarified

- **Related party definition**

- Private company in which relative of a director or manager is a member or director included
- Public company in which a director or manager is a director or holds along with his relatives more than 2% of paid up share capital

The 'OR' condition has been replaced by 'AND' condition

- A director or KMP of the holding company or his relative is a related party

Independent director excluded for this purpose

- **Restriction on voting by a related party to apply only for the contracts it is interested in**

- **Section 188 does not apply to corporate restructuring and amalgamation transactions**

- **Past contracts approved under section 297 of 1956 Act**

- No fresh approval under section 188 till expiry of original term of the contract
- Modifications to be approved as per section 188

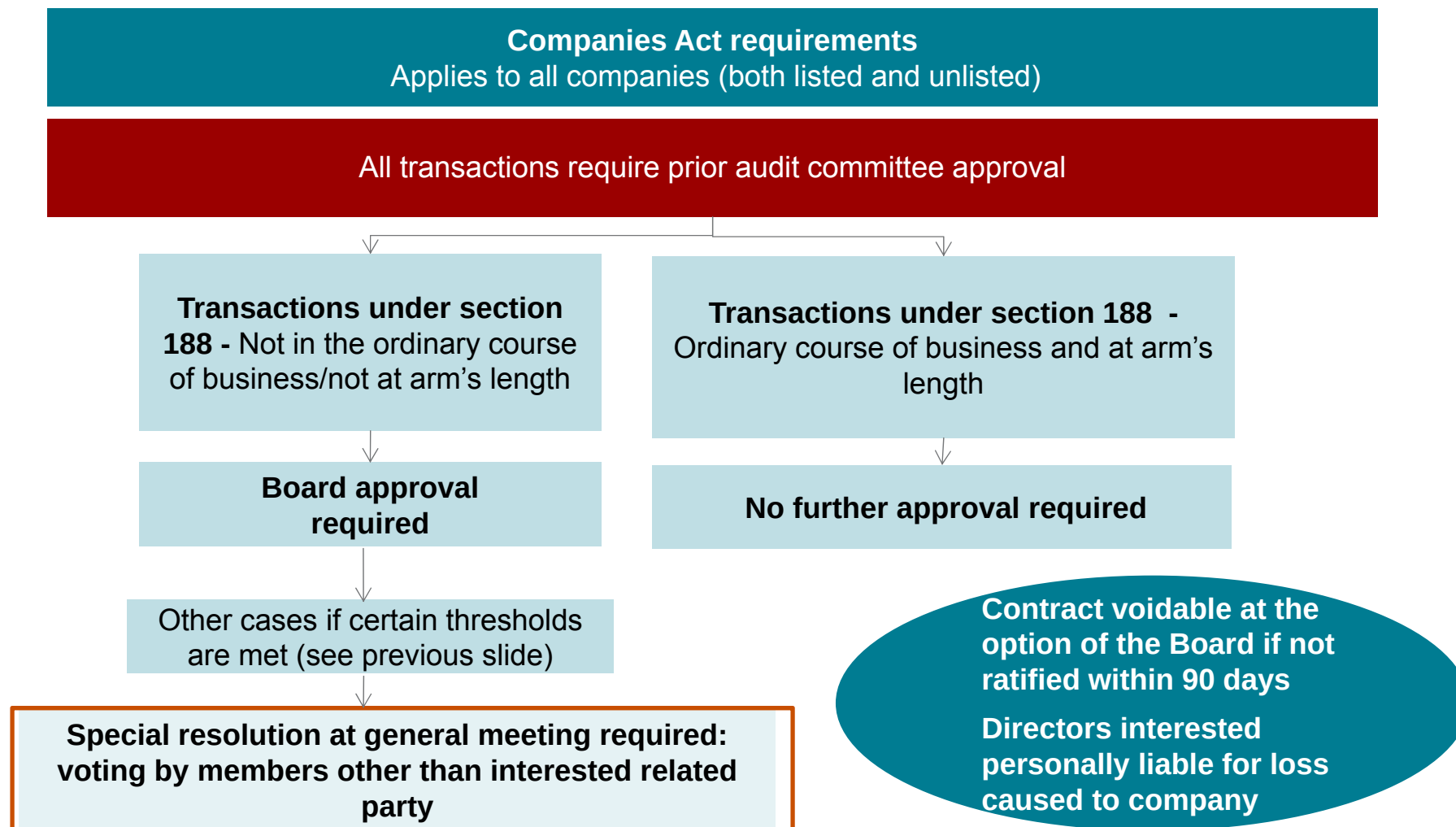
Norms for shareholder approval for related party transactions rationalised

Requirement of prior approval of shareholders if paid-up share capital $\geq$ INR 100 million removed

Transaction level thresholds for approval of shareholders revised

Transaction category	Earlier threshold	Revised threshold
Sale, purchase or supply of goods/material	> 25% of annual turnover	>10% of turnover or INR 1 billion, whichever is lower
Selling or otherwise disposing of, or buying property of any kind	>10% of annual turnover	>10% of net worth or INR 1 billion, whichever is lower
Leasing of property of any kind	>10% of net worth or 10 percent of turnover	>10% of net worth or 10% of turnover or INR 1 billion, whichever is lower
Availing or rendering of any service	>10% of net worth	>10% of turnover or INR 500 million, whichever is lower
Appointment to office or place of profit in company/subsidiary/ associate	Remuneration > INR 0.25 million per month	No change
Underwriting, subscription of securities or derivatives of company	Remuneration >1% of net worth	No change

Related party transactions - Approval process under the Companies Act , 2013



Related party transactions - Approval process under the Companies Act , 2013

1.

Arm's length transaction is a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest.

2.

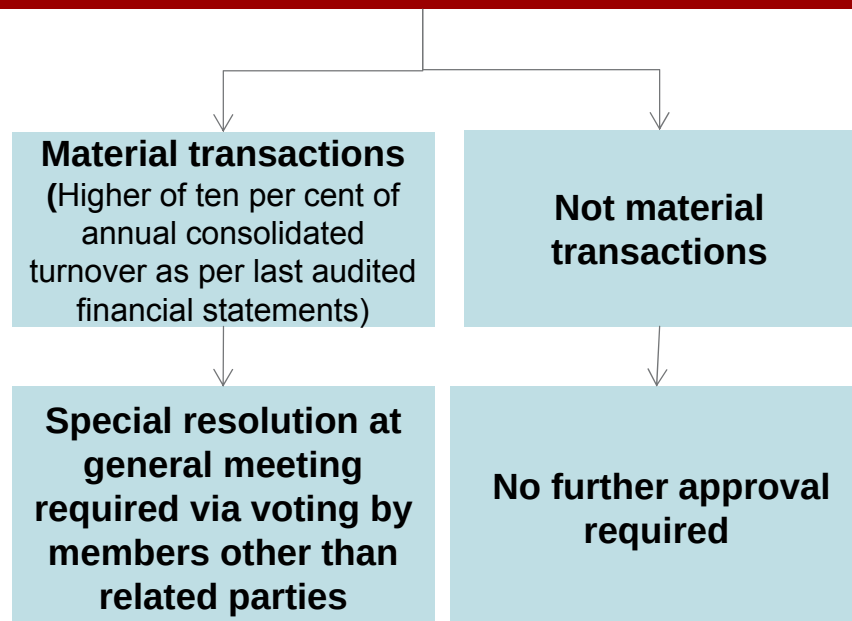
Ordinary course of business is not defined under the Act. However, based on the review of the broad set of parameters on which the phrase has been interpreted by the courts, and other sources both in India and globally, the following instances may classify a particular activity as being treated as being in the ordinary course of business

- Transactions that are reasonable in the context of business
- Transactions that are necessary, normal, and incidental to the business
- Transactions that are customary and happen with certain frequency
- Transactions that are part of the standard industry practice, even though the particular entity in question may not have done it
- Transactions that are not part of the pre-dominant business of the party may be considered in the normal course of business if it is related to such pre-dominant business
- Activities that are infrequent but important to the central mission can arguably be 'in the ordinary course of business'.

Related party transactions - Approval process under SEBI requirements

Clause 49 requirements (incremental)
Listed companies

All transactions (even if no price charged) requires prior audit committee approval



SEBI corporate governance norms

- Audit committee may grant omnibus approval subject to conditions
- Shareholders to approve all material RPTs (special resolution) and related parties to abstain from voting on such resolutions except
 - transactions between two government companies
 - transactions entered into between holding company and its wholly owned subsidiary whose accounts are consolidated and placed at AGM
- All existing material related party contracts or arrangements that would continue beyond 31 March 2015 should be approved by shareholders at the first general meeting after 1 October 2014.

Related party transactions – approval procedure

Other matters

- Audit committee (where set up) required to approve all transactions with related parties
 - Not restricted to transaction prescribed under section 188
 - Listed companies required to obtain prior approval of audit committee as per Clause 49
 - In case of urgent situations, approval of audit committee to be obtained in the next meeting
- Advisable for the Board to approve all related party transactions if audit committee not required to be set up
- Turnover/net worth (while obtaining shareholders approval) should be determined based on audited financial statements of the preceding financial year
- Wholly owned subsidiary not required to obtain shareholders approval for transaction with holding company
 - if shareholders approval already obtained by holding company

Related party transactions

Determination of transactions at arms length

- Arms length transaction defined to mean
 - a transaction conducted between related parties as if they are unrelated
 - no conflict of interest exists
 - Generally comparable market price is a sound indicator of 'arm's length price' under transfer pricing guidelines
 - Price accepted by tax authorities as arm's length likely to meet the definition under the 2013 Act
 - other terms and conditions of the transaction would need assessment
 - SA 550 on Related Parties interalia suggests
 - comparison of the terms with those of an identical or similar transaction with one or more unrelated parties
 - comparison of the terms to known market terms for identical or similar transactions
- to determine whether the transaction is at arms length



CSR Provisions

CSR Provisions - setting the context

Corporate social responsibility is the commitment of business to contribute to sustainable economic development, working with employees, their families, the local community and society at large to improve their quality of life

World Business Council for Sustainable Development (WBCSD)

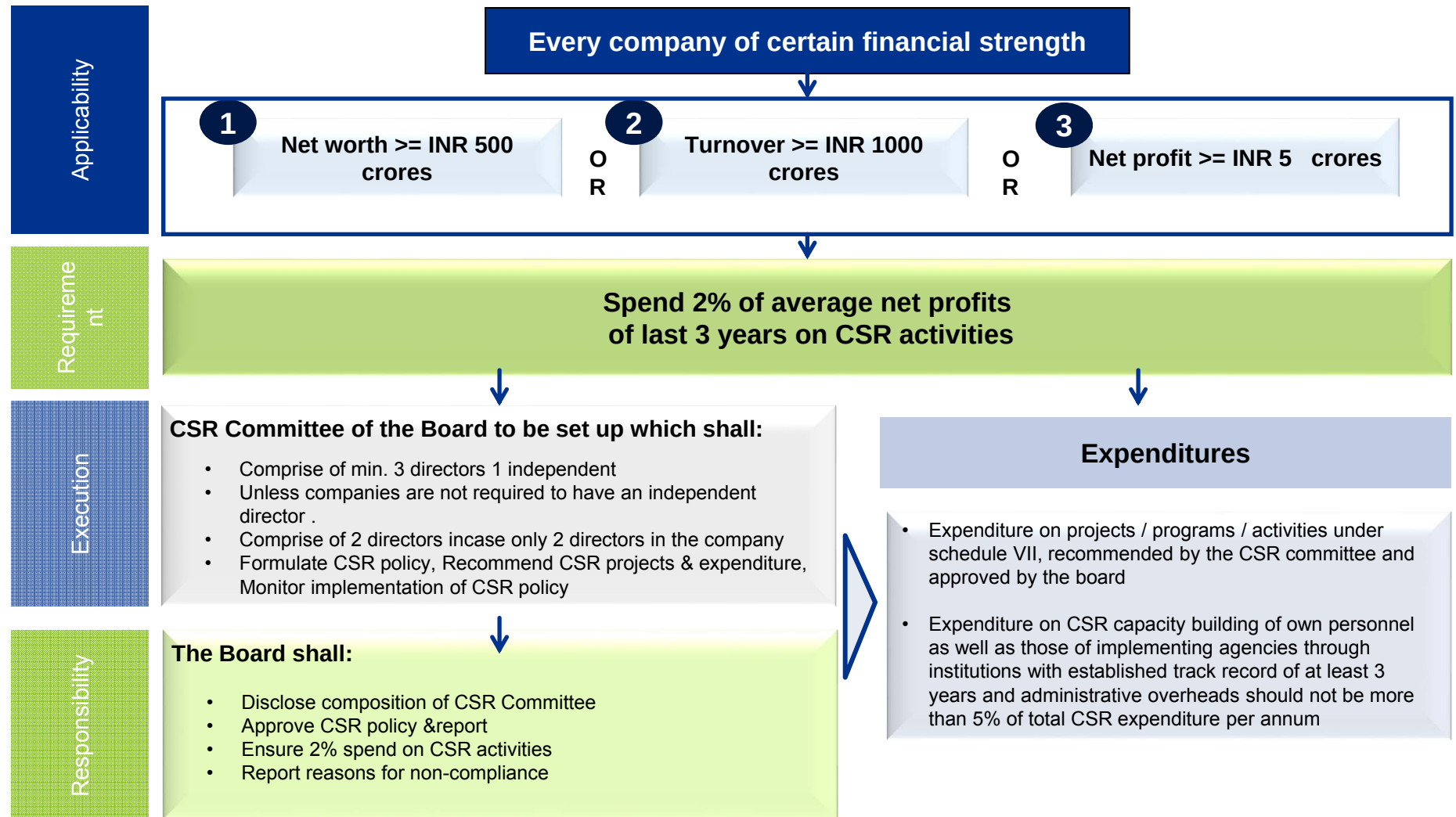


In the context of section 135 and related rules in India, CSR is limited to local community and society at large

Corporate Social Responsibility: PSUs

<u>CATEGORY</u>	<u>EXPENDITURE RANGE (% of PROFITS)</u>	
<u>NET PROFIT (PREVIOUS YEAR)</u>	<u>2010 GUIDELINES</u>	<u>2013 GUIDELINES</u>
<i>Less than Rs.100 crores</i>	<i>3% - 5%</i>	<i>3% - 5%</i>
<i>Rs.100 crores to Rs.500 crores</i>	<i>2% - 3% (Subject to min Rs.3 crores)</i>	<i>2% - 3%</i>
<i>Rs.500 crores</i>	<i>0.5% - 2%</i>	<i>1% - 2%</i>

CSR Provisions of the Companies Act



CSR Provisions - Key Highlights

Definitions

- Net Profit as per section 198 and will not include profits of branches outside India and dividends received from other companies in India which are covered under section 135
- 2% CSR spending will be 2% of *Average Net Profit of the preceding 3 financial years*
- Reporting is to be done annually and shall commence from FY 2014-15

Regulations

- CSR means and includes projects or programs relating to activities as specified under schedule VII
- The CSR Policy should include :
 - list of projects & programmes to be undertaken during the year in line with Schedule VII
 - Specify execution modalities & implementation schedules
 - Specify the monitoring process for the programs and projects
 - Specify that surplus arising out of the CSR activity will not be part of business profits of a company
- Companies must report details of their CSR initiatives in the Board report & on the company website

Permissible Under CSR Act

- Company can execute through the companies own, holding company, subsidiary company - registered Trust, society, Section 8 Company.
- If the entity is not set up by the company then it must be an established entity (at least 3 years old)
- Must specify project and programs & Monitoring system
- Companies may collaborate / pool resources together but companies should be able to report separately
- Companies may spend up to 5% of CSR expenditure on building capacity of own personnel, implementing agencies and on salaries paid to CSR staff

Not Permissible Under CSR Act

- Activities exclusively for benefit of employees and their families shall not be considered
- Activities undertaken in pursuance of normal course of business of the company shall not be considered
- Only CSR activities within India will be taken into consideration
- Contribution directly or indirectly to political parties shall not be considered as CSR spend
- Expenses incurred for fulfillment of any Act / statute of regulations (such as Labour Laws, Land Acquisition Act, etc.)

What Qualifies as CSR activity? (Schedule VII)

- **Eradicating hunger, poverty and malnutrition, promoting health care including preventive healthcare and sanitation and making available safe drinking water.**
- **Promoting education, including special education and employment enhancing vocation skills especially among children, women, elderly and the differently abled and livelihood enhancement projects.**
- **Promoting gender equality, empowering women, setting up homes and hostels for women and orphans, setting up old age homes, day care centres and such other facilities for senior citizens and measures for reducing inequalities faced by socially and economically backward groups.**
- **Ensuring environmental sustainability, ecological balance, protection of flora and fauna, animal welfare, agro forestry, conservation of natural resources and maintaining quality of soil, air and water.**

Schedule VII to be interpreted liberally

What Qualifies as CSR activity? (Schedule VII)

- Protection of national heritage, art and culture including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promotion and development of traditional arts and handicrafts.
- Measures for the benefit of armed forces veterans, war widows and their dependents.
- Training to promote rural sports, nationally recognized sports, Paralympic sports and Olympic sports.
- Contribution to the Prime Minister's National Relief Fund or any other fund set up by the central government for socio-economic development and relief and welfare of the scheduled castes, the scheduled tribes, other backward classes, minorities and women.
- Contributions or funds provided to technology incubators located within academic institutions which are approved by the central government.
- Rural development projects.
- Slum area development

Schedule VII to be interpreted liberally

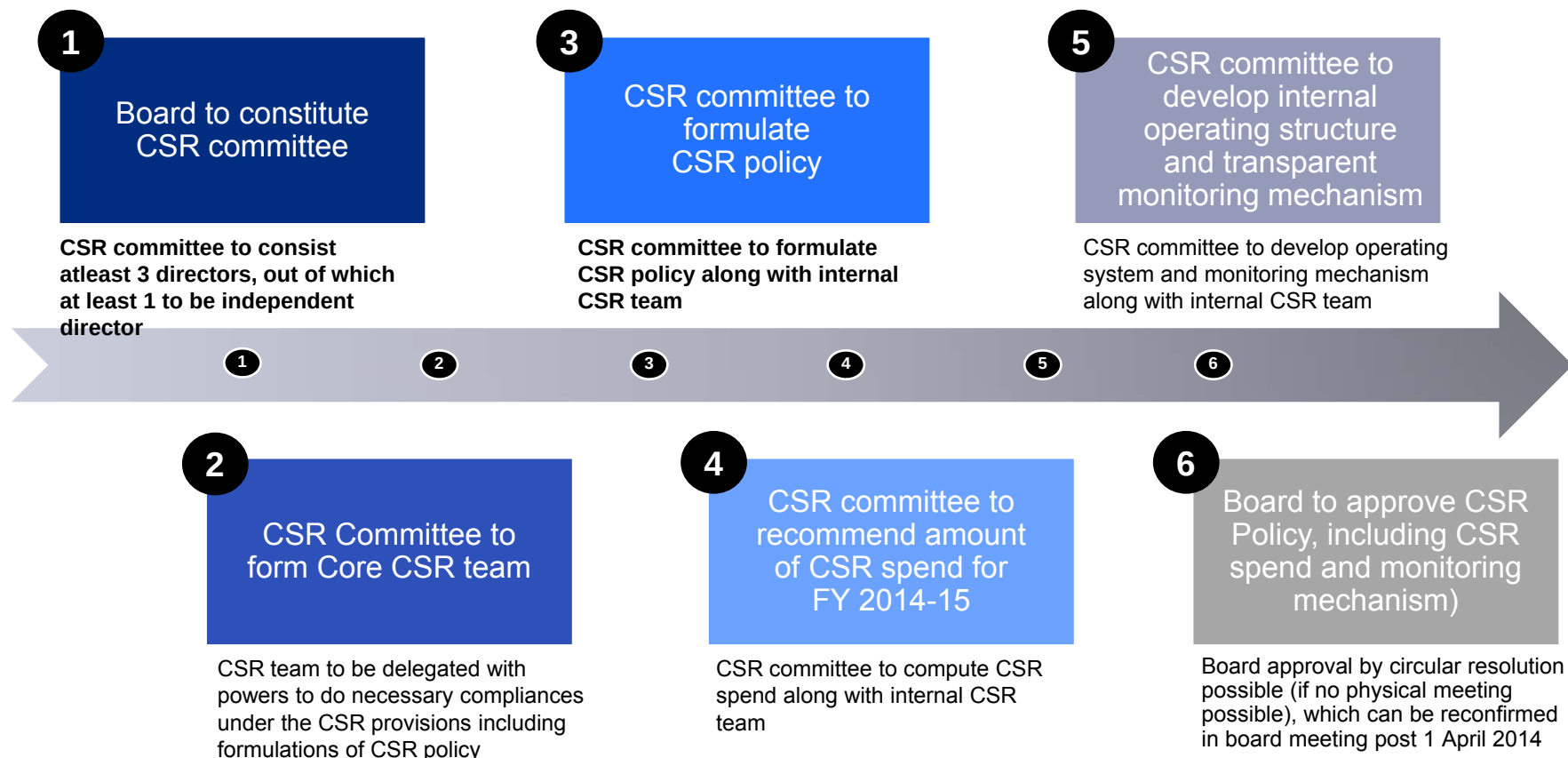
Tax Deductibility of CSR Expenditure

Deductibility of CSR Expenditure under Income-tax Act, 1961

- As per the Finance Bill, 2014 laid down by the Finance Minister, expenditure incurred on CSR activities will not be allowable as a deduction under Section 37(1) of the Act
- If expenditure incurred on CSR activities specifically falls within deductions under Section 30 to 36 of the Act, such expenses will be exempt from the disallowances and can be claimed as a deduction under the specified sections
- Contribution to organisations registered under Section 80G of the Act will continue to provide tax relief at 50% of the amount donated



Way Forward



Class Action Suits and Dormant Company

Insider Trading

- No director/KMP shall be involved in forward dealing or buying options in shares or debentures of company/ holding company/ subsidiary/ associate
- No company person including any Director or KMP with access to non-public price sensitive information indulge in any form of insider trading including counseling.
- **Non compliance would entail:**
 - imprisonment up to five years; or
 - fine up to INR 25CR or three times profits made, whichever is higher; or
 - **both of the above**

Oppression, Mismanagement

- Members/depositors may notify Tribunal if company conduct is prejudicial
- For fraudulent, unlawful or wrongful act; or improper or misleading statements, Class Action Suit can be filed on:
 - Company or its directors; or
 - Auditor/audit firm; or
 - Expert/advisor/consultant
- Who can file Class Action Suit:
 - 100 or 10% of total number of members
 - 100 or 10% of total number of depositors
 - Member(s) holding $\geq 10\%$ of issued share capital
 - Depositor(s) holding $\geq 10\%$ of outstanding value of deposits

Dormant Company

- Company formed and registered for future project or to hold an asset or intellectual property
- Not carrying any business or operation
- Has no significant accounting transactions or FS not filed during last 2 FY