Meaning and concept of corporate governance, evolution of corporate governance in India and other parts of world. Need and essence of corporate governance and role of CAG in this regard

Concept of Corporate Governance
The principles of good governance are as old as good behavior, which needs no formal definition. However, in reference to corporate world, it has been defined by various persons, some of whom is described below just in order to satisfy that the vital details and spirit of the term are not missed.

Sir Adrian Cadbury Committee, which looked into corporate governance issues in U.K. defines Corporate Governance “as the system by which the companies are directed and controlled. The basic objective of corporate governance is to enhance and maximize shareholder value and protect the interest of other stake holders”. According to World Bank, Corporate Governance is Blend of law, regulation and appropriate voluntary private sector practices,

- Which enables the corporation to attract financial and human capital to perform efficiently, and
- Prepare itself by generating long term economic value for its shareholders,
- While respecting the interests of stakeholders and society as a whole

The Kumar Mangalam Birla Committee constituted by SEBI has observed that "Strong corporate governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure"

N.R. Narayana Murthy Committee on Corporate Governance constituted by SEBI has observed "Corporate Governance is the acceptance by management, of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company."

The Institute of Company Secretaries of India has also defined the term Corporate Governance as under:
"Corporate Governance is the application of best management practices, compliance or jaw in true letter and spirit and adherence to ethical standards for effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders."

Another comprehensive definition given in the report on corporate governance that was accepted for implementation by the Singapore Government is that the term refers to the “process and structure by which the business and affairs of the company are directed and managed in order to enhance long term shareholder value through enhancing corporate performance and accountability, whilst taking into account the interests of other stakeholders".
Thus in order to get a fair view on the subject we may summarize the Corporate Governance in a narrow and broad definition. In the narrow sense, corporate governance involves a set of relationship amongst the company’s management, its board of directors, its shareholders, its auditors and other stakeholders. These relationships, which involve various rules and incentives, provide the structure through which the objectives of the company are set, and the means of attaining these objectives as well as monitoring performance are determined. Thus, the key aspects of good corporate governance include transparency of corporate structures and operations; the accountability of managers and the boards to shareholders; and corporate responsibility towards stakeholders. While corporate governance essentially lays down the framework for creating long-term trust between companies and the external providers of capital, it would be wrong to think that the importance of corporate governance lies solely in better access of finance.

Companies around the world are realizing that better corporate governance adds considerable value to their operational performance in the following ways:

- It improves strategic thinking at the top by inducting independent directors who bring a wealth of experience, and a host of new ideas
- It rationalizes the management and monitoring of risk that a firm faces globally
- It limits the liability of top management and directors, by carefully articulating the decision making process
- It assures the integrity of financial reports
- It has long term reputational effects among key stakeholders, both internally and externally

In a broader sense, however, good corporate governance- the extent to which companies are run in an open and honest manner- is important for overall market confidence, the efficiency of capital allocation, the growth and development of countries’ industrial bases, and ultimately the nations’ overall wealth and welfare. It is important to note that in both the narrow as well as in the broad definitions, the concepts of disclosure and transparency occupy center-stage. In the first instance, they create trust at the firm level among the suppliers of finance. In the second instance, they create overall confidence at the aggregate economy level. In both cases, they result in efficient allocation of capital.

Having committed to the above definitions, it is important to note that ever since the first writings on the subject appeared in the academic domain, there have been many debates on the true scope and nature of corporate governance mechanisms around the world. More specifically on the question ‘Who should corporate governance really represent?’ This issue of whether a company should be run solely in the interest of the shareholders or whether it should take account the interest of all constituents1 has been widely discussed and debated for a long time now. Two definitions of Corporate Governance highlight the variation in the points of view:

‘Corporate governance is concerned with ways of bringing the interests of investors and manager into line and ensuring that firms are run for the benefit of investors’.2

Corporate governance includes ‘the structures, processes, cultures and systems that engender the successful operation of organizations’.3

The issue raised here is whether the recognition of claims of a wider set of stakeholders, than those of shareholders alone, is the legitimate concern of corporate governance. If it can be established that there are groups other than shareholders with legitimate claims on companies, and that their involvement in corporate decision making is both a right and is
also economically beneficial, then the task of policy makers is to consider: ‘How should the company be regulated so as to enhance its effectiveness as a mechanism for enhancing the overall wealth or well-being of all stakeholders?’

The belief that the purpose of the modern corporation is to maximize shareholder value, along with typical capital market and ownership features, has been associated with the ‘Anglo-Saxon’ agency model of the corporation. This contrasts the ‘German (and Japanese) conception of the company as a social institution’. In making this distinction, commentators have mostly focused on the extent and nature of the separation of ownership and control. The Anglo-Saxon model is said to be characterized by a clear separation between management control and shareholder ownership, and hence is described as an ‘outsider’ system of corporate governance. It is contrasted with the ‘insider’ system, thought to be more descriptive of continental European and Japanese corporate forms.

Shareholder primacy is embodied in the finance view of corporate governance, which is a special instance of the principal-agent framework in economic theory.

1 In its broadest sense the ‘constituents’ may be thought of as those stakeholders who have a ‘moral interest’ or ‘stake’ in the existence and activities of a corporation. In a more narrow sense it embraces, at the core, shareholders and employees, but also extends to certain customers, suppliers and lenders. It is this loose definition of ‘stakeholders’, which we adopt here.


Corporation is to maximize shareholder wealth. Since ownership and control are separate (for purposes of liquidity, risk sharing and specialization), the central corporate governance issue from this perspective is aligning the objectives of management with the objective of shareholder wealth maximization. While companies are encouraged to foster long-term relationships with stakeholders by taking their interests into account, there is no concomitant pressure to build into corporate governance, structures and processes that would ensure company accountability towards stakeholder groups. It is frequently argued that attempts to mediate stakeholder claims may obscure performance evaluation and therefore facilitate discretionary behavior by management.

The issue raised in the stakeholder theories is whether the recognition of a wider set of claims than those of shareholders alone is the legitimate concern of corporate governance. It is argued that the new high technology world has significantly reduced the opportunity, ability, and motivation of consumers to engage in rational decision-making. Therefore, the development of loyal, inclusive stakeholder relationships, rather than the production of a better product at a lower price, will be the most important determinant of commercial viability and business success.

The main intention of the stakeholder’s concept as theory is to affirm and show that the company together with its executive board is responsible not only for shareholders but also for individuals or groups that have a stake in the actions and decisions of such
organization. Concerning the concept of company, the theory implies understanding the company as a social institution that conforms a plural project in which distinct groups with rights and demands take part. With reference to company manageability, this theory implies searching for a balance among the distinct company interest groups – shareholders, workers, clients, suppliers, banks, subsidiaries, local communities, pressure groups and the like- on part of the executive board. Furthermore, the executive board should also look for participation of those individuals and groups – either directly or by means of representatives- that are somehow linked to the organization aims.

[In India, we have sought to resolve the “shareholder vs. stakeholder” debate by taking the view that since shareholders are residual claimants, in well performing capital and financial markets, whatever maximises shareholder value should maximise corporate prosperity and best satisfy the claims of creditors, employees, shareholders, and the State. Moreover, there exist well-defined laws to protect the interests of employees, and recently framed legislations have considerably strengthened the rights of the creditors. It is therefore appropriate that corporate governance regulations in India seek to promote the rights of shareholders, while at the same time ensuring that the interests of other stakeholders are not adversely impacted.]

Objectives of Corporate Governance

Good governance is integral to the very existence of a company. It inspires and strengthens investor's confidence by ensuring company's commitment to higher growth and profits. It seeks to achieve following objectives:

(i) A properly structured Board capable of taking independent and objective decisions is in place at the helm of affairs;
(ii) The Board is balanced as regards the representation of adequate number of non-executive and independent directors who will take care of the interests and well-being of all the stakeholders;
(iii) The Board adopts transparent procedures and practices and arrives at decisions on the strength of adequate information;
(iv) The Board has an effective machinery to subserve the concerns of stakeholders;
(v) The Board keeps the shareholders informed of relevant developments impacting the company;
(vi) The Board effectively and regularly monitors the functioning of the management team; and
(vii) The Board remains in effective control of the affairs of the company at all times.

The overall endeavor of the Board should be to take the organization forward, maximize long-term values and shareholders' wealth.

Elements of good Corporate Governance

Good governance is decisively the manifestation of personal beliefs and values, which configure the organizational values, beliefs and actions of its Board. The Board as a main functionary is primary responsible to ensure value creation for its stakeholders. The absence of clearly designated role and powers of Board weakens accountability mechanism and threatens the achievement of organizational goals. Therefore, the
The foremost requirement of good governance is the clear identification of powers, roles, responsibilities and accountability of the Board, CEO, and the Chairman of the Board. The role of the Board should be clearly documented in a Board Charter.

To sub-serve the above discussion, the following are the essential elements of good corporate governance:

- Transparency in Board’s processes and independence in the functioning of Boards. The Board should provide effective leadership to the company and management for achieving sustained prosperity for all stakeholders. It should provide independent judgment for achieving company’s objectives.

- Accountability to stakeholders with a view to serve the stakeholders and account to them at regular intervals for actions taken, through strong and sustained communication processes.

- Fairness to all stakeholders.

- Social, regulatory and environmental concerns

- Clear and unambiguous legislation and regulations are fundamentals to effective corporate governance.

- A healthy management environment that includes setting up of clear objectives and appropriate ethical framework, establishing due processes, clear enunciation of responsibility and accountability, sound business planning, establishing clear boundaries for acceptable behavior, establishing performance evaluation measures.

- Explicitly prescribed norms of ethical practices and code of conduct are communicated to all the stakeholders, which should be clearly understood and followed by each member of the organization.

- The objectives of the company must be clearly documented in a long-term corporate strategy including an annual business plan together with achievable and measurable performance targets and milestones.

- A well composed Audit Committee to work as liaison with the management, internal and statutory auditors, reviewing the adequacy of internal control and compliance with significant policies and procedures, reporting to the Board on the key issues.

- Risk is an important element of corporate functioning and governance, which should be clearly identified, analyzed for taking appropriate remedial measures. For this purpose the Board should formulate a mechanism for periodic reviews of internal and external risks.

- A clear Whistle Blower Policy whereby the employees may without fear report to the management about unethical behaviour, actual or suspected frauds or violation of company’s code of conduct. There should be some mechanism for adequate safeguard to employees against victimization that serves as whistle-blowers.

**Evolution of Corporate Governance**

**Global Scenario - US and UK**

Ever since the concept of corporate entity was recognized, corporate governance in various manifestations has been in existence. The Foreign Corrupt Practices Act, 1977 (USA) made specific provisions regarding establishment, maintenance and
review of systems of internal control. In 1979, US Securities Exchange Commission prescribed mandatory reporting on internal financial controls. Due to high profile failures in the US, the Treadway Commission constituted in 1985 highlighted the need of putting in place a proper control environment, desirability of constituting independent boards and its committees and objective internal audit function. As a consequence, the Committee of Sponsoring Organizations was formed which prescribed a control framework in 1992. After the Enron debacle of 2001, came other scandals involving large US Companies such as WorldCom, Owest, Global Crossing and the auditing lacunae that eventually led to the collapse of Andersen. These developments triggered another phase of reforms in the area of corporate governance, accounting practices and disclosures - this time more comprehensive than ever before. In July 2002, less than a year from the date when Enron filed for bankruptcy, the Sarbanes-Oxley Act popularly called SOX was enacted. The Act made fundamental changes in virtually every aspect of corporate governance in general and auditor independence, conflict of interests, corporate responsibility, enhanced financial disclosures and severe penalties for willful default by managers and auditors, in particular.

A spate of scandals and financial collapses in the UK in the late 1980s and early 1990s made the shareholders and banks worry about their investments. This led the UK Government to recognize insufficiency of existing legislation and role of self-regulation as a measure of controlling scandals and financial collapses. Some of the corporate disasters took place primarily due to insufficiency of implementable governance practices. To prevent the recurrence of such business failures, the Cadbury Committee was set up by the London Stock Exchange in May 1991 to help raise standards of corporate governance. In its report and associated "Code of Best Practices" (1992), it spelt out the methods of governance needed to achieve a balance between the essential powers of the Board of Directors and their proper accountability. Of the 19 recommendations, the most debatable requirement was the one obliging the directors to report on the effectiveness of a company's system of internal control. Subsequently constituted Paul Ruthman Committee, to some extent, watered down the Cadbury committee's proposal. It restricted the reporting requirements to internal financial controls as against the effectiveness of the company's system of Internal control. After about 5 years Ron Hampel Committee on Corporate Governance was appointed to assess the impact of Cadbury committee's recommendations and to develop further guidance. Greenbury Committee, which submitted its report in 1995, addressed the issues pertaining to director's remuneration.

The cumulative effect of above efforts was the formulation of London Stock Exchange's Combined Code appended to the listing rules of the Exchange and its compliance being made mandatory by all listed companies. Listing Rules of the Exchange require a listed company to include in the annual report a disclosure statement that should be in two parts. In the first part the Company has to add a report as to how it applies the principles in the Combined Code while in the second part of the statement the Company has either to confirm that it complies with the Code provisions or alternatively add an explanation where it does not.

Macro review of corporate governance also includes country specific research and
evaluation of corporate governance framework across national borders, which eventually led to the collapse of Andersen. These developments triggered another phase of reforms in the area of corporate governance, accounting practices and disclosures - this time more comprehensive than ever before. In July 2002, less than a year from the date when Enron filed for bankruptcy, the Sarbanes-Oxley Act popularly called SOX was enacted. The Act made fundamental changes in virtually every aspect of corporate governance in general and auditor independence, conflict of interests, corporate responsibility, enhanced financial disclosures and severe penalties for willful default by managers and auditors, in particular.

The evidence is more on the positive side of direct shareholder monitoring. Large shareholders are active monitors in the corporations they control. They have both the incentives and the means to discipline 'management. In Austria’s, Belgium, Germany, and also the USA, the preponderance of studies do find beneficial effects of large shareholders for firm performance. However, there are also many studies that insignificant and/or unclear results, such as in France, Japan, Netherlands, Spain large shareholders may even be detrimental to the performance of companies. Many predominantly Continental European studies assert that there is a level of ownership concentration beyond which owner-managers get entrenched and extract rents from other smaller shareholders. Expropriation of minority shareholders appears to be consistently worse in countries with weaker shareholder protection and illiquid securities markets, such as in Italy, Spain, Turkey, Germany or Austria. There is also the suspicion expressed by many authors that pyramidal groups may, among other things, serve the purpose of extracting rents from small shareholders. Moreover, although investor protection is quite stringent in the USA or UK, some studies find managerial entrenchment in these countries.

While legislative reform has rectified the most evident abuses or share- holder rights in recent years, some countries are lagging behind. In Belgium for instance, minority shareholders or a group or minority shareholders holding at least one per cent of the equity capital or shares with a value of not less than BEF 50m. can initiate a minority claim and ask the court to appoint one or more experts who can scrutinize the company’s accounting and its internal operations since 1991. On the other hand, in Germany a 75 percent majority shareholder may legally make a binding tender offer to minority shareholders below market value. Similar regulations are in place in Austria.

Gugler points out "One reason for inefficient compensation contracts may be that manager dominated boards decide about key elements of the contract between the principals (shareholders) and the agents (managers). The evidence suggests that - in the face of weak boards - shareholders themselves may decide about proposals on compensation packages in general meetings". Gugler prescribes better transparency regarding the level and structure of compensation contracts, especially in Continental Europe.

In the context of Continental Europe, the identity or large and controlling equity owners matters. But Gugler agrees that in the absence of adequate studies so far, any such observations are necessarily preliminary. "While the effects or close bank-
firm relationships and shareholding of institutional investors on firm profitability are ambiguous, the evidence concerning State ownership is on the negative side. Some studies confirm beneficial effects or bank involvement concerning other dimensions or performance, e. g. financial constraints or distress". "Contingent governance" system or Japan is evidence on this point. In Japan banks are particularly dominant. The evidence regarding incentives or institutional investors points out theoretical ambiguities. "In view or the rapidly increasing importance of institutional holdings, the lack or established empirical evidence is particularly worrying".

Institutional investors can provide part or the answer to the policy dilemma, Gugler points out. While the key to more efficient corporate governance is to have private savings channeled to stock exchanges yet, at the same time, it is necessary not to lose control and give rise to managerial discretion. However, prudent regulation must provide efficient control and governance in the institutional investors themselves. As the problem seems to be that institutional investors are not too active but too passive, restrictions or their holdings in individual companies must be questioned". In the UK, the Hampel Committee considered the introduction or compulsory voting for institutional shareholders as is the case in the USA, "Generally, excessively stringent restrictions or holdings in individual firms provide only insufficient incentives to fund managers to participate in active monitoring and to exert the 'Voice' rather than the 'exit' option. Reconsideration or overtly restrictive legislation in this field is warranted. Good corporate governance. Needs the right incentives, concentrated holdings or a residual claim provides them".

"It is commonly held that supervisory boards are less effective monitors than intended by the law. Roe (1998) enumerates attributes it to the large size of the supervisory board, infrequent board meetings, sparse information flow to the board, low incentives to actually monitor management, and code termination, which gives shareholders and management incentives to weaken the board". Roe argues, blockholders would not get a fair price for their stock if a diffusion of ownership left firms either with labour dominated or weak boards".

The US and UK corporate governance debate, Gugler points out, centers around the manager-shareholder conflict. Continental Europe and Japanese corporate governance is more concerned with the large shareholder small shareholder conflict. "The former debate poses questions such as whether the takeover process is a good mechanism to constrain management, or how to efficiently design compensation packages. The latter discussion is more concerned with questions like whether minority shareholders should be better protected against large shareholders and whether the identity of owners matters. Of course all these questions are interrelated contributing to the complexity of the analysis." Gugler, therefore, suggests the following general and abstract policy guide: any corporate governance reform should be gradual, taking into account the endogenous nature of corporate governance and the national specificities of existing corporate governance arrangements.

Continental Europe features tremendous ownership and voting power concentration. Consequently, there is an important conflict of interest between large controlling shareholders and weak minority shareholders. It sometimes becomes necessary to
analyses this conflict to understand corporate governance and sometimes its failures in these countries. "However, it is also equally important to recognize the growing importance of the large public corporation in Europe. Large-scale privatization of former State-owned quasi-monopolies contribute to this development. This privatization process in Europe (France, Germany, Austria, not ignoring the Eastern European countries) makes the role of the State as entrepreneur less important; however, at the same time poses new challenges as to how to design the relationship between ownership and control. The associated conflict between management and owners will, therefore, grow in importance. Institutional investors like pension or mutual funds will play a key role in channeling private savings to productive investment as is already the case in the USA and UK. Regulation of the institutional investors will be the key to successful reform of the European capital markets".

France

Corporate governance in France reflects the country's political, economic and social history. The State, banks and corporate management hold the controlling interests in the French governance structure. In this regard, the French system is different from the Anglo American model as also from the German model. In no other modern industrialized country in the world, except Japan, does the state play so powerful a role as does in France. Since World War II, when the state stepped in to rebuild France's shattered economy, the French intellectual elite class represented by both civil servants and industrial managers has been actively involved in the formation of industry. The bankers who provide the companies with capital and the Government officials who oversee them are all drawn from the same educational background and all share the same goal of keeping French industry under their own control.

The government protects industry in indirect ways. For example, any non-European company desirous to buy more than 20% of the capital of a French company must require prior approval of the government. The government plays a powerful role in non-state owned companies also. The state's control over private companies also extends indirectly through the banking system. The financial institutions like banks, insurance companies are the main providers of capital to French Industry. They account for 5% of the stock market's capitalization. As nationalized companies became increasingly uncompetitive, the Jacques Chirac govt. of 1986-88 started taking privatization drive exactly in line with Margaret Thatcher's govt. in UK. In order to protect fledgling private companies from takeover, these were given in the hand of a 'noyeandur' (hard core) management-friendly shareholders.

The French law provides for various kinds of corporate structure.

(1) **Societes anonymes (SAa)**
These are the large French public companies which are similar to the AG companies in Germany or the plc. in UK. Nearly, 630 of such companies are quoted. A company either quoted or not, with more than 50 shareholders, must be incorporated as a SA. It must have a minimum capital base of FF 250,000.

(2) **Societes a responsibilite Limitee (SARL)**
These are limited liability companies similar to the GmbH in Germany or the ltd. company in UK. A company with less than 1 up to 50 shareholders with a minimum capital base of FF 50,000 may be incorporated as a SARL.
(3) EURL
It is exactly same as a SARI but with one exception that in such a company, the entire capital is held by a single shareholder.

(4) Partnerships
(a) SP:Societeen participation (silent partnership) - It is a traditional type of joint venture company.
(b) Societe nom collectif - It has the characteristics of partnerships but still a company.
(c) Limited (societe en commandite simple and societe en commandite par action).

(5) Civil Company (Societe civile)

(6) Succursale: It is a branch of company with its H.O. abroad. It has no separate legal entity.

Management and Boards of Sas
In France, the SAs have a choice of two quite distinct systems of board governance. They may adopt either a unitary boardroom structure like Anglo-American model or a two-tier structure like German companies.

System 1
It is the traditional French system for SAs and has two main components: a) the PDG and b) the board.

(a) The PDG (President directeur-general).
The PDG is elected by the board and the board is appointed by the shareholders. In reality, the PDG picks the board and the shareholders ratify its appointment. In French law, executive authority rests with PDG only. France is the only western country in the world where one man (PDG) determines the strategy of the company, executes it and controls it. The PDG has virtual control over the board of directors. He dictates the subjects of discussion in the board. He can only delegate his power. His authority is wider and greater than that of the CEO in the UK or USA. He may, on his desire, set up a management board or an executive committee.

Though the PDG has absolute power over the board and its selection, he would definitely pay attention to the wishes of his owners in choosing new board members. In fact, the banks are generally represented on the board of most SAs. The board has the power to dismiss the PDG though exercise of it is very rare. If he is removed, then he is not entitled to receive compensation from the company. He is not protected by the social regulations. He is not even entitled to official holidays. The PDG is responsible not only for day-to-day operations but also for the long-term strategic direction of the company for which he may have to even seek opinion of the government. In principle, a PDG retires on attaining the age of 65 years but there are many exceptions in this regard.

(b) The Board (The Counseil de Administration)
The board must consist of minimum 3 and maximum 12 members. Maximum 1/3rd of the members may be represented by the executives having minimum 2 years’ service with the company. Therefore, at least 2/3rd of the members must be non-executive. Sometimes, the institutions having considerable shareholdings do appoint nominees to the board. Besides, there is a provision of 2 staff representatives on the board (one representing the executives and one from the workers) but they are not considered as full directors.

The members are elected by the shareholders in the assemble generale (the general meeting), though a strong PDG has a considerable role in choosing them. If shareholders are powerful, their support is essential. So they are consulted beforehand. Generally, the
people of substance having considerable experience, reputation & influence in the
commercial and industrial world are chosen as board members. No member can sit for
more than 8 boards. Directors must hold minimum number of qualification shares
prescribed in the articles (actions de garantie) of the company.

System II
In 1966, the French government introduced legislation to provide companies with the
option of an alternative structure i.e. two-tier structure. In this system, there is an executive
committee (directoire) and a supervisory board (counseil de surveillance). The
supervisory board oversees the activities of the executive committee (directoire). This
structure is extremely similar to the German system of Vorstand I Aufsichtsrat. In this
system, management is in the hands of the executive board (directoire). It has 2 to 5
members appointed for 2 to 6 year term by the supervisory board. The supervisory board
(counseil de surveillance) has 3 to 12 members. The members of the executive board
cannot be dismissed by the supervisory board. This can only be done by the shareholders
in general meeting through a simple majority.
The executive board (directoire) is vested with full executive authority and is empowered to
take decision on day-to-day affairs of the company by majority. It's members do not require
to hold shares. But members of the supervisory board must hold qualification shares and
they cannot sit on more than 8 boards. A small company having capital less than FF 1
million, may have oneman directorate called a directeur general unique (DGU). The DGU
or the executive board must submit a quarterly report to the supervisory board.
In state-owned companies, the government, for a period of 3-year term, appoints the PDG.
The government maintains a strong interest in the strategic decision of the company. The
directors are selected by the state from staff representatives, civil servants and qualified
people. The directors generally are not permitted to sit on more than 4 boards.

Japan
Japan rebuilt its economy in the years following World War II. It has developed a unique
corporate governance structure. Some' of its remarkable features are noted hereunder:
1. Powerful government intervention dominated by the Japanese Ministry of Finance (MoF). It maintains strong regulatory control and supervises every aspect of industrial
activity inducting capital flows.
2. Cross-shareholding by affiliated companies to counter hostile takeover and
spreading of corporate growth throughout the group.
3. Close links and relationships between Corporates and government sectors.
4. Focus of Corporate priorities on 'growth' and 'market share', not 'profit' or
'shareholders' returns except through capital appreciation.
5. No market control for corporates and minimal takeover activity
There are three main general features affecting Japanese attitudes towards corporate
governance. They are: (a,) concept of' obligation', (b) concept of, family' and (c) concept
of consensus. All these concepts are interlinked. In fact, the Japanese system is based on
'community logic' unlike the U.S. system, which is based on 'market logic'. When a
company in a group is beyond salvage, then it is dismembered or sold and its staff gets
redeployed: But when a whole basic industry is threatened, the Japanese show their
resilience as the French to protect it.
The importance of the social fabric is generally reflected in the basic attitude towards
business. Though Japan has an important stock market, yet it does, not play much part in
the allocation of resources. This is due to the fact that the objectives of Japanese banks who mainly financed rebuilding industry during post World War II as directed by the Ministry of International Trade & Industry (MITI), are not the maximization of profits but safety & growth.

In Japan, there appears to be a general consensus that although 'profit' is important, the long-term preservation and prosperity of the family (companies) are primarily the objectives and not profit maximization or shareholders immediate gain in terms of dividend. Finally, the emphasis on 'family' and 'continuity' has led the Japanese to adopt a policy of insurance for which they are prepared to pay a substantial premium.

**Shareholders and the General Meetings**

It is a standard practice amongst Japanese companies to exchange small amount of stocks with the lenders and business partners & associates as a gesture of goodwill, sincerity and commitments. Japanese institutional investors e.g. Insurance firms, Trusts and Pension funds, also have stakes in most major Japanese corporations. They represent over 60%-80% of all shares and form a block of friendly and stable shareholders. The balance 20%-30% of all shares are with the individual shareholders. The individuals are by far the largest group of shareholders but they hold a minority of shares. Stable shareholders are not motivated to hold on to their stakes for 'dividends' or 'profit' as it is very small. However, these shareholders seek mainly to increase their business transactions and enhance their standings. They have little interest in selling their stakes for profit. Japan's interlocked stock system also prevents takeover bids. Cross-shareholding among business partners cements good relations, which yield for greater returns. Institutional investors are interested in long-term capital gains. In most cases, the stable shareholders are not interested in participating in the company's management but are interested in its overall health and growth. In case of serious trouble, the bail-outs by the lenders / business associates are conducted with a minimum of disruption to the board. The Japanese AGMs have two major functions to perform viz. the appointment of directors and approval of the dividend. However, there is hardly any case reported till date whereby the shareholders by simply using an AGM have removed a board or taken any other drastic action.

**Corporations-Government Relations:**

The relations between the Japanese 'companies and the government are close and amicable. The Japanese govt. sees itself not so much as an impartial regulator, but as a promoter and protector of domestic industry. The govt. bureaucracy enforces laws mainly by informal administrative guidance. Meetings between the Ministry of Finance (MoF), the institutions and the companies are quite common and regular. It is the common practice of retiring bureaucrats joining in the industry they previously regulated. This is called 'Amakudari' (descent from heaven). The officials of MOF generally get themselves deeply involved in the management of a troubled company.

**The Board of Directors**

The governing structure of Japan's major listed companies (called as Kabushiki Kaisha) is similar to that of US, UK and Indian companies i.e. a board of directors elected by shareholders. The board sets overall corporate policies & direction, appoints and monitors the performance of company executives for implementation of policies. In practice, the boards of the major Japanese corporations represent the interests of the company and its employees collectively rather than the interests of the shareholders. Almost all directors
are composed of 'insiders' i.e. full time employees, senior managers or former company employees.

As per 1992 survey, around 76% of the directors of listed companies were 'internal' appointees and 24% external appointees. The outside directors in the large companies represent major lenders and in small companies they come from the business partners & associates. The directors need not be the shareholders and cannot be incompetent or bankrupt. There shall be at least 3 directors and they cannot be appointed for more than 2 years at a time. They shall be appointed at a general meeting of shareholders. They need the support of 1/3rd of the shareholders to be elected. The board of directors shall decide administration of affairs of the company and supervise execution of duties of directors. Boards are required to meet every quarter. In small Japanese corporations the board may well be the decision taking body. In a large company, apart from the board a top management committee (called Jomukai) consisting of the president and the top-level directors i.e. a hard core of -proper people- control the affairs of the company.

The president, in practice, chooses directors by nomination or consultation with the other superior board members and chairman. They are first nominated by the board and then elected by the shareholders in general meetings. Promotion of the senior officers to the board level is predominantly performance oriented. The directors can be appointed for a maximum period of 2 years. The first and foremost priority of a Japanese corporate board is the health and growth of the company as a whole. Growth is the most important goal because it maximizes the welfare of the shareholders through capital gains.

In Japanese concept, the Statutory Auditors (Kausayaku) are not the external auditors as they are appointed by the shareholders. The kausayaku's function is to audit the directors' activities to ensure that the business is conducted as per applicable laws and the company's regulations and in the best interest of the shareholders. These auditors must report at the shareholders' meeting. They are obliged to attend board meetings and other meetings, obtain business reports and financial documents from the company executives and check the operations of subsidiaries. These auditors also get the audit reports from the independent auditors as also the internal auditors. If they find any illegal or improper activities causing substantial damage to the company, they must advise and recommend the directors to stop such activities and take appropriate actions as deemed fit.

Some Japanese companies take the role of kausayaku very seriously and even bring outside experts to perform it. Normally a retired employee or director is chosen for this job. The Japan Statutory Auditors Association (JSAA) has appealed to the Justice Ministry to strengthen the kausayaku's position by making them more independent of management and extending their period of office beyond the present two year term.

In Japan, the banks take the stakes and become the shareholders of their customer companies to cement their relationship with the customers. It is also useful to strengthen their position in case the company encounters serious problems when they have to exercise their influence. At present, the banks can invest in the stock of a company only up to 5% of its stock. In order to strengthen the relationship with the client companies as also to avoid the hostile takeover the banks buy the shares of these companies and in return, the companies also buy the banks' shares. This cross-holding of shares plays an important role in active equity financing. Japanese banks are the largest owners of equity shares as compared to other countries e.g. in 1990 Japanese banks held 25.2% of the total outstanding shares whereas Germany held 8.1%, France 3.5% and USA 0.5%. The banks
often nominate a senior banker in the board of a client company as their representative. One of the most important fundamental changes in Japan in recent years has been the shift in the public attitudes towards their political, economic and corporate governance system. The prosecution of prominent politicians for corruption charges has cut a vital link between companies and the bureaucracy. Several amendments to the Japanese Commercial Code, involving shareholder lawsuits, shareholder access to the company books and records, the audit system, were put into effect in October 1993. The change to the audit system has a long-term substantial implication on the corporations in Japan. The law requires large companies to appoint a three member audit committee within 6 months of enactment i.e. October 1, 1993, composed of internal auditor, statutory auditor and one independent full time member. “Independent” has been defined as a person having no relationship or affiliation with the company for at least 5 years (including suppliers, creditors, etc.). This new auditor (Kausayaku) will be appointed by shareholders at the AGM for a period of 3 years.

The role of the companies in Japanese society is changing. Now several cases of diseases caused by industrial pollution have enlarged the corporate responsibilities to the community. A pledge not to damage the immediate environment is now increasingly common. Companies are under pressure to extend this pro environmental attitude to domestic and international operations. Health care, particularly for the retired citizens, is another area of growing concern to the community and the companies are now compelled to respond.

India

The concept of good governance is very old in India dating back to third century B.C. where Chanakya (Vazir of Parliputra) elaborated fourfold duties of a king viz. Raksha, Vriddhi, Palana and Yogakshema. Substituting the king of the State with the Company CEO or Board of Directors the principles of Corporate Governance refers to protecting shareholders wealth (Raksha), enhancing the wealth by proper utilization of assets (Vriddhi), maintenance of wealth through profitable ventures (Palana) and above all safeguarding the interests of the shareholders (Yogakshema or safeguard).

Corporate Governance was not in agenda of Indian Companies until early 1990s and no one would find much reference to this subject in book of law till then. In India, weakness in the system such as undesirable stock market practices, boards of directors without adequate fiduciary responsibilities, poor disclosure practices, lack of transparency and chronic capitalism were all crying for reforms and improved governance. The fiscal crisis of 1991 and resulting need to approach the IMF induced the Government to adopt reformative actions for economic stabilization through liberalization. The momentum gathered albeit slowly once the economy was pushed open and the liberalization process got initiated in early 1990s. As a part of liberalization process, in 1999 the Government amended the Companies Act, 1956. Further amendments have followed subsequently in the year 2000, 2002 and 2003. A variety of measures have been adopted including the strengthening of certain shareholder rights (e.g. postal balloting on key issues), the empowering of SEBI (e.g. to prosecute the defaulting companies, increased sanctions for directors who do not fulfill their responsibilities, limits on the number of directorships, changes in reporting and the requirement that a ‘small shareholders nominee’ be appointed on the Board of companies with a paid up capital of Rs. 5 crore or more)
The major corporate governance initiatives launched in India since the mid 1990s are discussed below:

**The CII Code**

On account of the interest generated by Cadbury Committee Report of UK, the Confederation of Indian Industry (CII) took special initiative with the objective to develop and promote a code of Corporate Governance to be adopted and followed by Indian Companies both in private & public sector, Banks and Financial Institutions. The final draft of the code was circulated in 1997 and the final code called ‘Desirable Corporate Governance Code’ was released in April 1998. The Committee was driven by the conviction that good corporate governance was essential for Indian Companies to access domestic as well as global capital at competitive rates. The code was voluntary, contained detailed provisions with focus on listed companies.

**Kumar Mangalam Birla Committee Report**

While the CII code was well received by corporate sector and some progressive companies also adopted it, it was felt that under Indian conditions a statutory rather than a voluntary code would be more meaningful. Consequently the second major initiative was undertaken by the Securities and Exchange Board of India (SEBI) which set up a committee under the chairmanship of Kumar Mangalam Birla in 1999 with the objective of promoting and raising of standards of good corporate governance. The Committee in its Report observed “the strong Corporate Governance is indispensable to resilient and vibrant capital market and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure”. In early 2000 the SEBI Board accepted and ratified the key recommendations of this committee and these were incorporated into Clause – 49 of the Listing Agreement of the Stock Exchanges. (Discussed in detail in Session XI & XII) These recommendations, aimed at providing the standards of corporate governance, are divided into mandatory and non-mandatory recommendations. The recommendations have been made applicable to all listed companies with the paid-up capital of Rs. 3 crore and above or net worth of Rs.25 crore or more at any time in the history of the company. The ultimate responsibility of putting the recommendations into practice rests directly with the Board of Directors and the management of the company.

**Report of Task Force**

In May 2000, the Department of Corporate Affairs (DCA) formed a broad based study group under the chairmanship of Dr. P.L. Sanjeev Reddy, Secretary of DCA. The group was given the ambitious task of examining ways to “operationalise the concept of corporate excellence on a sustained basis” so as to “sharpen India’s global competitive edge and to further develop corporate culture in the country”. In November 2000 the Task Force on Corporate Excellence set up by the group produced a report containing a range of recommendations for raising governance standards among all companies in India. It also recommended setting up of a Centre for Corporate Excellence.

**Naresh Chandra Committee Report**

The Enron debacle of 2001 involving the hand-in-glove relationship between the auditor and the corporate client, the scams involving the fall of the corporate giants in the U.S. like the WorldCom, Owest, Global Crossing, Xerox and the consequent enactment of the
stringent Sarbanes Oxley Act in the U.S. led the Indian Government to wake up. A committee was appointed by Ministry of Finance and Company Affairs in August 2002 under the chairmanship of Naresh Chandra to examine and recommend inter alia amendments to the law involving the auditor-client relationships and the role of independent directors. The committee made recommendations in two key aspects of corporate governance: financial and non-financial disclosures: and independent auditing and board oversight of management. The recommendations are discussed in detail in Session XIII & XIV

**Narayana Murthy Committee Report**
The SEBI also analysed the statistics of compliance with the clause-49 by listed companies and felt that there was a need to look beyond the mere systems and procedures if corporate governance was to be made effective in protecting the interest of investors. The SEBI therefore constituted a committee under the chairmanship of Narayana Murthy for reviewing implementation of the corporate governance code by listed companies and issue of revised clause 49. Some of the major recommendations of the committee primarily related to audit committees, audit reports, independent directors, related party transactions, risk management, directorships and director compensation, codes of conduct and financial disclosures. Details of the major recommendations are given in *Session – XIII & XIV*

**J.J. Irani Committee Report**
The Companies Act 1956 was enacted on the recommendations of the Bhaba Committee set up in 1950 with the object to consolidate the existing corporate laws and to provide a new basis for corporate operation in independent India. With enactment of this legislation in 1956 the Companies Act 1913 was repealed.

The need for streamlining this Act was felt from time to time as the corporate sector grew in pace with the Indian economy and as many as 24 amendments have taken place since 1956. The major amendments to the Act were made through Companies (Amendment) Act 1998 after considering the recommendations of Sachar Committee followed by further amendments in 1999, 2000, 2002 and finally in 2003 through the Companies (Amendment) Bill 2003 pursuant to the report of R.D. Joshi Committee.

After a hesitant beginning in 1980, India took up its economic reforms programme in 1990s and a need was felt for a comprehensive review of the Companies Act 1956. Unsuccessful attempts were made in 1993 and 1997 to replace the present Act with a new law. In the current national and international context the need for simplifying corporate laws has long been felt by the government and corporate sector so as to make it amenable to clear interpretation and provide a framework that would facilitate faster economic growth. The Government therefore took a fresh initiative in this regard and constituted a committee in December 2004 under the chairmanship of Dr. J.J. Irani with the task of advising the government on the proposed revisions to the Companies Act 1956. The recommendations of the Committee submitted in May 2005 mainly relate to management and board governance, related party transactions, minority interest, investors education and protection, access to capital, accounts and audit, mergers and amalgamations, offences and penalties, restructuring and liquidation, etc. The summary of recommendations are given in *Session – XIII & XIV*

**Central Coordination and Monitoring Committee**
A high powered Central Coordination and Monitoring Committee (CCMC) co-chaired by Secretary, Department of Corporate Affairs’ and Chairman, SEBI was set up by the Department of Corporate Affairs to monitor the action taken against the vanishing companies and unscrupulous promoters who misused the funds raised from the public. It was decided by this committee that seven Task Forces be set up at Mumbai, Delhi, Chennai, Kolkata, Ahmedabad, Bangalore and Hyderabad with Regional Directors/Registrar of Companies of respective regions as convener, and Regional Offices of SEBI and Stock Exchanges as Members. The main task of these Task Forces was to identify the companies, which have disappeared, or which have misutilised the funds mobilized from the investors and suggest appropriate action in terms of Companies Act or SEBI Act.

National Foundation of Corporate Governance
Recently the Ministry of Company Affairs has set up National Foundation for Corporate Governance (NFCG) in association with Confederation of Indian Industry (CII), Institute of Company Secretaries of India (ICSI) and Institute of Chartered Accountants of India (ICAI). The NFCG would focus on the following areas:

- Creating awareness on the importance of implementing good corporate governance practices both at the level of individual corporations and for the economy as a whole. The foundation would provide a platform for quality discussions and debates amongst academicians, policy makers, professionals and corporate leaders through workshops, conferences, meetings and seminars.
- Encouraging research capability in the area of corporate governance in the country and providing key inputs for developing laws and regulations, which meet the twin objectives of maximizing wealth creation and fair distribution of this wealth.
- Working with the regulatory authorities at multiple levels to improve implementation and enforcement of various laws related to corporate governance.
- Working in close co-ordination with the private sector, work to instill a commitment to corporate governance reforms and facilitate the development of a corporate governance culture.
- Cultivating international linkages and maintaining the evolution towards convergence with international standards and practices for accounting, audit and non-financial disclosure.
- Setting up of ‘National Centers for Corporate Governance’ across the country, which would provide quality training to Directors as well as produce quality research and aim to receive global recognition.

Need and Essence of Corporate Governance
A natural question to ask, given the theory behind corporate governance, is why do we need to impose particular governance regulations through stock exchanges, legislatures, courts or supervisory authorities? If it is in the interest of firms to provide adequate protection to shareholders, why mandate rules, which may be counterproductive? Even with the best intentions regulators may not have all the information available to design efficient rules. Worse still, there is a danger that regulators can be captured by a given constituency and impose rules favoring one group over another. There are at least three reasons for regulatory intervention. The main reason advocated in favour of mandatory rules is that if the founder of the company was allowed to design and implement a
corporate charter he likes, he may not clearly address the issues faced by other shareholders and thus would, in the view of the society, conjure inefficient rules. The functioning of the market for corporate control is an example. In absence of regulations, founders could employ anti-takeover defenses excessively and in the process not allow the capital employed, which is owned by the shareholders, to be used most efficiently. Alternatively, shareholders may favor takeovers that increase the value of their shares even if they involve greater losses for unprotected creditors or employees. Thus, in absence of regulations, the collective bargaining process may not yield socially acceptable solutions and may be at the peril of one or multiple stakeholders.

Another argument for mandating regulations of corporate governance comes from the externality argument. An externality may be defined as a good, generated as the result of an economic activity, whose benefits or costs do not accrue directly to the parties involved in the activity. An externality is created by one person and experienced by other(s) and may be positive (a well-maintained garden) or negative (pollution). Bad corporate governance practice by a firm can in the same vein be seen as a negative externality. One corporate failure or scandal can potentially erode shareholders trust in the whole of the corporate sector and thus negatively affect the businesses of honest firms as well. This theory is reinforced by the recent corporate scandals in the United States. A few instances of fraud, as seen in the case of Enron and later on in WorldCom, destroy the faith of investors in the entire corporate sector and thus hurt the larger interest of the economy. Thus in such cases where private action fails to resolve widespread externals involving large numbers of parties, the state has the responsibility to intervene to provide a level playing field and also to prevent market failure.

In case of dispersed shareholding, due to the (individual) large cost of monitoring the company on a regular basis, there remains a possibility that management may change the rules (to their advantage) ex post. Thus the final argument in support of mandatory rules is to avoid a situation where efficient rules are designed initially but due to lack of active tracking by dispersed shareholders, are altered or broken later.

While regulations are necessary, there are however, a few issues that need to be considered. The first relates to policing and punishment. The SEBI envisages that all these corporate governance norms will be enforced through listing agreements between companies and the stock exchanges. A little reflection suggests that for companies with little floating stock — which account for more than 85% of the listed companies — delisting because of non-compliance is hardly a credible threat. The SEBI can, of course, counter that by stating that the reputation effect of de-listing can induce compliance and, hence better corporate governance.

The second issue is more problematic, and it has to do with form versus substance. There is a fear that by legally mandating several aspects of corporate governance, the regulators might unintentionally encourage the practice of companies ticking checklists, instead of focusing on the spirit of good governance. The fear is not unfounded. Take, for instance, the case of Korea. After the crash of 1998, a part of the IMF bailout package was that a fourth of the board of every listed Korean company must consist of independent directors. They do, but the directors are hardly independent by any stretch of imagination. For most part, they are retired executives of the chaebols, friends of business groups and politicians that have supported the business in the past. And, in any event, they don’t do what was
intended — namely, to speak for shareholders and ensure that management does what is necessary to maximize long-term shareholder value.

The third concern relates to apprehension about excessive interference. There is an apprehension that over-regulation of corporate governance could disrupt the functioning and quality of boards without resulting in any substantial improvement in the standards of corporate governance. It needs to be ensured that we do not go overboard with corporate governance regulations, and that unwittingly micro-management of companies does not take place.

This raises a question of how to trace the line that divides voluntary from mandatory. In an ideal world with efficient capital markets, such a question need not arise — because he markets would recognize which companies are well governed and which are not, and reward and punish accordingly. Unfortunately, ideal capital markets exist only in theory.

The reality is quite different. Markets are often thin and shallow and operate on the basis of ebbs and flows of pivotal stocks; informational requirements are lax; and regulatory and policing devices leave much to be desired.

Thus, what is needed is a small corpus of legally mandated rules, buttressed by a much larger body of self-regulation and voluntary compliance.

Good governance is decisively the manifestation of personal beliefs and values which configure the organizational values, beliefs and actions of its Board. The Board as a main functionary is primarily responsible to ensure value creation for its stakeholders. The absence of clearly designated role and powers of Board weakens accountability mechanism and threatens the achievement of organizational goals. Therefore, the essence of good governance is a clear identification of powers, roles, responsibilities and accountability of the Board, CEO and the Chairman of the Board.

**Role of Comptroller and Auditor General of India**

The external audit in India like ours derives its mandate from (a) the Constitution of India and (b) Comptroller and Auditor General’s (Duties, Power and Conditions of Service) Act 1971. The system of government audit in India has a long history, starting from the days of the East India Company. The Constitution of India has vested this function with the Comptroller and Auditor General of India (CAG). The CAG is the head of the Supreme Audit Institution of India (SAI) and he derives his duties and powers from Article 149 to 151 of the Constitution of India and the Comptroller and Auditor General’s (Duties, Powers and Conditions of Service) Act 1971. Under provisions of the Constitution of India and the Act, the CAG is the sole auditor of accounts of the Central Government and the State Governments. The external audit set up in our democratic set up is a means through which the legislative accountability of the executive is ensured in the matter of finance.

Under provisions of Section 19 (1) of the Act, the duties and powers of the CAG in relation to the audit of the accounts of Government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act 1956. Under sub section (2) of Section 19 of the Act, the duties and powers of CAG in relation to the audit of the accounts of corporations (not being companies) established by or under law made by Parliament shall be performed and exercised by him in accordance with the provisions of the respective legislations.

The sub section (3) of Section 19 of the Act provides that the Governor of a State or the Administrator of a Union Territory having a Legislative Assembly may, where he is of opinion that it is necessary in the public interest so to do, request the CAG to audit the
accounts of a corporation established by law made by the Legislature of the State or of the union territory, as the case may be, and where such request has been made, the CAG shall audit the accounts of such corporation and shall have, for the purposes of such audit, right of access to the books and accounts of such corporation:
Provided that no such request shall be made except after consultation with the CAG and except after giving reasonable opportunity to the corporation to make representations with regard to the proposal for such audit.

Further, under provisions of Section 19-A of the Act, the reports of the CAG in relation to audit of accounts of a Government company or a corporation shall be submitted to the Government or Governments concerned which shall lay it, as soon as may be after it is received, before each House of Parliament or Legislature.

The provisions of Section 619(2) of the Companies Act provide that the auditor of a Government Company shall be appointed or reappointed by the CAG. While appointing auditors of Government Company, CAG has taken steps for ensuring the independence of auditors by adopting the system of rotation of auditors, prohibition of certain services etc. A system of rotation of the auditors of Government companies every four years has been adopted as a good practice.

Sub Section 3 ibid provides that the CAG shall have power
(a) to direct the manner in which the company’s accounts shall be audited by the auditor appointed in pursuance of sub-section (2) and to give such auditor instructions in regard to any matter relating to the performance of his functions as such;
(b) to conduct a supplementary or test audit of the company’s accounts by such person or persons as he may authorize in this behalf; and for the purpose of such audit, to require information or additional information to be furnished to any person or persons so authorized, on such matters, by such person or persons, and in such form, as the CAG may, by general or special order, direct.

Sub section (4) ibid provides that the auditor aforesaid shall submit a copy of his audit report to the CAG who shall have the right to comment upon, or supplement, the audit report in such manner as he may think fit. Any such comment upon or supplement to the audit report shall be place before the Annual General Meeting of the Company in terms of sub section (5) ibid at the same time and in the same manner as the audit report.

Thus the provisions made in the statutes and rules and orders there under are comprehensive and foolproof. Despite such elaborate and strong control and checks, we find that the best results are not forthcoming. True that Finance, Accounts and Audit cannot be held responsible wholly for the failures but at the same time, all these players in the financial sector can play a very significant role in minimizing, if not eliminating, the deficiencies in the system and practices and shortfall in performance.

We are at the threshold of a new age with newer challenges and newer opportunities as a result of increasing global interests of corporate world in our economy and in order to shoulder the increased responsibilities we have to emerge stronger in the days to come.
Session III & IV

Session Title:
Legal and regulatory framework – discussion on salient provisions relating to corporate governance in Companies Act, 1956, Sick Industrial Companies Act 1985, SEBI and Stock Exchanges Act 1992

Companies Act 1956
The Companies Act 1956 is the most focal law of the country governing the corporate sector of India. It is a comprehensive act that covers the functioning and management of the company right from its establishment to winding up. Unlike other countries our Companies Act has also undergone a number of amendments necessitated by liberalization and globalization of our economy and growing interest of global corporate world.

The major amendments to the Act were made through Companies (First Amendment) Act 1999 by implementing some of the provisions of Companies Bill, 1997. Further amendments were made in 2000, 2002 and finally in 2003 through the Companies (Amendment) Bill 2003 pursuant to the report of R.D. Joshi Committee.

The Companies (Amendment) Act 1999 contained important provisions regarding buy-back of securities, nomination facility, sweat equity etc. The Companies (Amendment) Act 2000 is very comprehensive and has implemented a good number of provisions as discussed below:

1. Many new terms have been introduced in the definition clause, like abridged prospectus, depository, derivative, employees stock option, hybrid (securities), listed public company, option in securities, securities, shares with differential rights.

2. Enhancement of the powers of SEBI with respect to listed companies.

3. Regulation of public deposits- protection of small deposit holders.


5. Introduction of equity shares with differential rights.

6. Deletion of the concept of public trustee.


8. Protection of the interest of debenture holders.


10. Amendments in provisions relating to auditors.

11. Introduction of secretarial audit.

12. Issuance of Indian Depository Receipts by foreign companies.

13. Appointment of directors by small shareholders.


This was followed by further amendments as per the Companies (Amendment) Act, 2002 and the Companies (Second Amendment) Act 2002. The Companies (Amendment) Act, 2002 incorporated provisions to strengthen cooperatives by enabling the incorporation of cooperatives as companies and conversion of existing cooperatives into companies. The Companies (Second Amendment) Act 2002 inter-alia deals with the establishment of a National Company Law Tribunal (NCLT) which takes over the authority currently vested with the Company Law Board and Courts. The Sick Industrial Companies (Special Provisions) Act (SICA) to be repealed and corresponding provisions incorporated in the
Companies Act. All matters regarding sickness and rehabilitation of companies will be handled by the NCLT by abolishing the Board for Industrial and Financial Reconstruction (BIFR) and Appellate Authority for Industrial and Financial Reconstruction (AAIFR). Looking at the pending provisions of Companies Bill 1997, the DCA constituted a committee under the chairmanship of Shri R.D. Joshi to examine the remaining provisions of the Companies Bill 1997. The Committee submitted its report and also recommended amendments to some other provisions of the Act in addition to the points relating to the Companies Bill 1997. The recommendations of the Joshi Committee inter alia included appointment of Chief Accounts Officer, prevention of chain of subsidiaries, definition of officer in default, rotation of auditors, falsification of accounts, number of directors, retiring age of directors, appointment of relatives, auditors report on diversion of funds, increase in the powers of the Board etc. The recommendations of Joshi committee were by and large included in the Companies (Amendment) Bill 2003 which was introduced in the Rajya Sabha on 7th May 2003. Pending acceptance of the Bill the Government has revamped the Auditor’s Report by replacing the Manufacturing and Other Companies (Auditor’s Report) Order (MAOCARO) with a new Companies (Auditor’s Report) Order (CARO), 2003 with effect from 1st July 2003. The CARO is applicable to all companies other than banking companies, insurance companies and private companies with a turnover of less than Rs. five crore. As per the new Order, the auditors would be required to specify the reasons for any unfavorable or qualified answer to the points refereed in the CARO. The Auditors are also required to state whether the company has defaulted in repayment of dues to financial institution, bank or debenture holders and whether the company is regularly depositing the dues relating to Investor Education and Protection Fund. The auditor’s report shall also disclose on the end use of money raised by public issues and whether any fraud on or by the company has been noticed or reported during the year. The new Order is a big step in achieving a stringent disclosure necessary for effective corporate governance.

DEEMED Government COMPANIES

Central and State Deemed Government Companies

Section 619-B of the Companies Act, 1956 lays down the criteria for determining whether a company is a Deemed Government Company i.e., whether 51% or more of its paid up share capital is held by Central / State Governments, Central/State Government Companies and Corporations owned or controlled by Government. According to information available, there were 82 Deemed Central Government Companies as on 31 March 1998 and 51 Deemed State Government Companies.

As of 31 March 1998 the equity of Rs. 2180.71 crore in 65 Deemed Government Companies was held by the Government of India (Rs 6.32 crore in 3 companies only), State Governments (Rs.0.66 crore), Central Government Companies / Corporations (Rs.115.10 crore), State Government Companies / Corporations (Rs.1.28 crore), Financial
Institutions / Banks (Rs.2038.19 crore) and others (Rs.19.16 crore). Government of India also guaranteed one company for repayment of cash credit from State Bank of India to the tune of Rs.0.50 crore.

SICK INDUSTRIAL COMPANIES ACT, 1985
In the wake of sickness in the country's industrial climate prevailing in the eighties, the Government of India set up in 1981, a Committee of Experts under the Chairmanship of Shri T. Tiwari to examine the matter and recommend suitable remedies therefor. Based on the recommendations of the Committee, the Government of India enacted a special legislation namely, the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986) commonly known as the SICA. The main objective of SICA is to determine sickness and expedite the revival of potentially viable units or closure of unviable units (unit here in refers to a Sick Industrial Company). It was expected that by revival, idle investments in sick units will become productive and by closure, the locked up investments in unviable units would get released for productive use elsewhere.

The Sick Industrial Companies (Special Provisions) Act, 1985 (hereinafter called the Act) was enacted with a view to securing the timely detection of sick and potentially sick companies. The speedy determination by a body of experts of the preventive, ameliorative, remedial and other measure which need to be taken with respect to such companies and the expeditious enforcement of the measures so determined and for matters connected therewith or incidental thereto.

A Board of experts named the Board for Industrial and Financial Reconstruction (BIFR) was set up in January 1987 and it became functional with effect from 15th May 1987. The Appellate Authority for Industrial and Financial Reconstruction (AAIFR) was constituted in April 1987. Government companies were brought under the purview of SICA in 1991 when extensive changes were made in the Act including, inter-alia, changes in the criteria for determining industrial sickness.

SICA applies to companies both in public and private sectors owning industrial undertakings:-
(a) Industries specified in the First Schedule to the Industries (Development and Regulation) Act, 1951, (IDR Act) except the industries relating to ships and other vessels drawn by power and;
(b) Not being "small scale industrial undertakings or ancillary industrial undertakings" as defined in Section 3(j) of the IDR Act.
(c) The criteria to determine sickness in an industrial company are (i) the accumulated losses of the company to be equal to or more than its net worth (paid up capital plus free reserves), (ii) the company should have completed five years after incorporation under the Companies Act, 1956 (iii) it should have 50 or more workers on any day of the 12 months preceding the end of the financial year with reference to which sickness is claimed, and (iv) it should have a factory license.

The Companies Act 2002 provides for establishment of a National Company Law Tribunal (NCLT) which will replace the authority currently vested by the Companies Act, with the Company Law Board and Courts. The SICA shall be repealed and the BIFR (Board for Industrial and Financial Reconstruction) and AAIFR (Appellate Authority for Industrial and
Financial Reconstruction) as all matters pertaining to sickness and rehabilitation of companies will now be handled by the NCLT. The orders passed by the NCLT can be appealed with an Appellate Tribunal and the decision of Tribunal can also be appealed before the Supreme Court on any matter of law.

**OECD PRINCIPLES AND INDIA**

United States and the United Kingdom comprehend standards for corporate governance which took roots there and stretched to the other countries. The members of Organization for Economic co-operation and Development (OECD) took early initiatives to deal with governance issues. Equity markets in these countries were not especially strong but the investment in equities was on the ascendance. Subsequent to 1990 the changeover from central planning to market forced economies, predominantly the privatization of public sector companies, and the need to make available governance principles for the promising private sector, brought the subject of corporate governance to the center stage. Due to outcome of 1997 economic and financial setback, Asian countries too became intensely involved in the subject of corporate governance. It was understood that despite the fact that corporate management is vital when it comes to investment, somewhat more important is superior corporate governance. This has become all the more significant because globalization means, in economic expressions, that four pillars of the economy i.e. physical capital in terms of plant and machinery, financial capital in terms of foreign direct investment or investment in emerging capital markets, technology and labour move across national borders freely.

The age-old wisdom of vasudev kutambham has become relevant again and the world has turned into truly borderless and a global village. This forced to put into practice internationally acknowledged norms of corporate governance standards initiate atmosphere in private sector, public sector. The focal point of official efforts brought out the OECD 'principles of Corporate Governance, endorsed by OECD ministers in May 1999 and subsequently revised in 2004. The doctrine are based, for all intents and purposes, on the accessible legal and regulatory preparations as well as the best prevailing practices followed by market players in the OECD countries. Support for this OECD principles has been reaffirmed on several occasions by diverse inter-Governmental groups and by international organizations as part of efforts to construct a sound architecture of corporate governance after the 1997 crisis.

The OECD revised its set of guidelines of Corporate Governance in the year 2004 pursuant to corporate governance developments including corporate sandals that further focused the minds of Governments on improving corporate governance practices. The new OECD principles agreed by OECD countries in April 2004 reflects a global harmony vis-à-vis the critical importance of good corporate governance in contributing to economic feasibility and strength. For text of OECD Principles of Corporate Governance 2004,

In this context we can benchmark India’s corporate laws, primarily the Companies Act 1956, and the Clause 49 of the listing agreement of SEBI Act to these principles and highlight the fact that India Inc. conforms to most OECD principles of corporate governance (2004) in terms of governance, transparency and disclosures. The OECD principles are mentioned below in bold (and italics) with an
elaboration of appropriate Indian corporate governance guidelines corresponding to these principles:

**Ensuring the basis for an effective corporate governance framework**

*The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory, and enforcement authorities*

A. The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.

India has a well-established corporate governance framework and it remained unaffected by the Asian financial crisis of the late 1990s. Indeed, the move towards adopting good corporate governance practices; better financial and non-financial disclosures, and the promotion of transparent and efficient markets in India had built up well before the Asian debacle.

The corporate governance framework in India primarily consists of the following legislations and regulations:

**The Companies Act, 1956:** Companies in India, whether listed or unlisted, are governed by the Companies Act. The Act is administered by the Department of Companies Act (DCA). Among other things, the Act deals with rules and procedures regarding incorporation of a company; prospectus and allotment of ordinary and preference shares and debentures; management and administration of a company; annual returns; frequency and conduct of shareholders’ meetings and proceedings; maintenance of accounts; board of directors, prevention of mismanagement and oppression of minority shareholder rights; and the power of investigation by the government, including powers of the CLB.

**The Securities Contracts (Regulation) Act, 1956:** It covers all types of tradable government paper, shares, stocks, bonds, debentures, and other forms of marketable securities issued by companies. The SCRA defines the parameters of conduct of stock exchanges as well as its powers.

**The Securities and Exchange Board of India (SEBI) Act, 1992:** This established the independent capital market regulatory authority, SEBI, with the objective to protect the interests of investors in securities, and promote and regulate the securities market.

**The Depositories Act, 1996:** This established share and securities depositories, and created the legal framework for dematerialization of securities.

**Listing Agreement with stock exchanges:** These define the rules, processes, and disclosures that companies must follow to remain as listed entities. A key element of this is Clause 49, which states the corporate governance practices that listed companies must follow.

B. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.

The regulations listed above are consistent with the rule of law, clearly spelt out, and are enforceable. Both DCA and SEBI have been conferred investigative powers.
C. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served. Listed companies in India fall under the dual jurisdiction of the DCA and SEBI on issue related to corporate governance. While this may not hamper the ability to pursue key corporate governance objective, it results in overlap of jurisdiction on one hand, and additional compliance costs for companies on the other.

D. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfill their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained. Regulatory authorities, particularly SEBI, have done an excellent job. The rules and regulations made by SEBI to regulate and monitor the capital market are at par with international standards. However regulatory authorities do suffer from lack of more effective powers as well as shortage of key qualified personnel.

The rights of shareholders and key ownership functions

The corporate governance framework should protect shareholders’ rights and facilitate the exercise of shareholder rights.

A. Basic shareholder rights include the right to:

1) Secure methods of ownership registration;
The enactment of Depositories Act in August 1996 paved the way establishing the National Securities Depositories Ltd. (NSDL), the first depository in India. This depository established a national infrastructure of international standard that handles most of the trading and settlement in dematerialized form in Indian capital market. Later, a second depository was introduced, the Central Depository Services Ltd. (CDSL), which maintains equally high standards of safety and efficiency. Registration in depository and the unique account number is proof of ownership for the shareholders.

2) Convey or transfer shares;
There are no restrictions on the transferability of shares, except in the case where the Board may, subject to the right of appeal conferred by section 111 of the Companies Act, decline to register the transfer of shares, not being fully paid shares, to a person they do not approve; on which the company has lien. The free transferability of shares cannot be restricted by private contractual agreements.

3) Obtain relevant information on the corporation on a timely and regular basis;
Most of the financial and non-financial information on the companies is available on their websites or other commercial websites free of cost. Apart from this regular filings with Stock Exchanges, SEBI and DCA are also available for shareholders’ scrutiny free of cost or at a nominal cost. Moreover, detailed annual accounts are sent to each shareholder, which contain the chairman’s letter, management discussion and analysis, directors’ report with its annexes, report on corporate governance, additional shareholder information, balance sheet, profit and loss account with all its detailed schedules plus notes on accounts, auditor’s note, cash flow statement, etc.

4) Participate and vote in general shareholder meetings;
Board of directors are entrusted with the duty of convening the Annual General Meeting and Extra Ordinary General Meeting. In addition, shareholders may ask the board of directors to hold an Extra Ordinary General Meeting. This is usually known as Requisition Meeting.
Section 166 of the Companies Act states that every company must hold an Annual General Meeting (AGM) every year. The gap between two AGMs should not exceed 15 months (Registrar of companies can permit an extension of 3 months in certain cases but in no case it shall exceed 18 months). The notice of the AGM is usually sent to all shareholders 21 days prior to the date of the meeting. Notice of the meeting also includes Annual Report which includes audited annual accounts, directors' report, auditors' report, agenda for the meeting with explanatory statement. AGM is generally held at the registered office of the company or in a place within the local limits of the city, town or village in which the registered office of the company is situated.

Apart from the AGM, the company may requisition a general meeting if it is called for by shareholders holding 10% or more of the paid up capital having voting rights. Resolutions that are required to be passed in the general meeting requisitioned by the members have to be circulated in advance by the members.

Once the requisition for the general meeting is received, the board of directors must send the notice of meeting within 21 days to all members. The notice must specify the business proposed to be transacted along with necessary explanatory statement. The general meeting must take place within 45 days from the date of submission of the requisition by the members.

5) Elect and remove members of the board;
Section 257 of the Companies Act, 1956, enables shareholders to elect members of the Board of Directors. Section 284 of the Companies Act enables a company to remove a director through an ordinary resolution.

6) Share in the profits of the corporation.
A company can declare dividends only out of current profits after providing for depreciation; or out of undistributed profits of previous years after providing for depreciation; or out of monies provided by the Central or State Government for the payment of dividend in pursuance to a guarantee given by that Government. Section 205–207A of the Companies Act deals with declaration and distribution of dividends.

Even as the Board of directors are responsible for the declaration of dividend, it has to be approved by the shareholders in annual general meeting must approve such dividends. Shareholders also have the power to reduce the quantum of dividend proposed by the Board of directors though they can never enhance it. Board of directors can authorise interim dividend provided the articles of association permit it. The amount of dividend along with the interim dividend shall be deposited in a separate bank account within five days of the declaration and should be used solely for payment of dividend. A company has to compulsorily transfer a certain percentage of dividends to reserve subject to a maximum of 10 per cent as per Companies (Transfer of Dividend to Reserves) Rules, 1975. A company can also pay dividend by capitalizing its reserves also known as bonus dividend.

Dividend declared by a company has to be paid within a period of thirty days. Any default in payment of dividend may result in imprisonment of directors or officers of the company, if he is knowingly a party to the default. A prison term of three years and a fine of one thousand rupees for every day during which the default continues may be imposed. However, no offence is deemed to have been committed in the following cases
a) Where dividend could not paid by reason of the operation of law,
b) Where a shareholder has given directions to the company regarding the payment and those directions cannot be complied.
c) Where there is a dispute regarding the right to receive the dividend, 
d) Where the dividend has been lawfully adjusted against any sum due from the 
shareholder,  
e) Where, for any other reason, failure was not due to any default on the part of the 
company.

B. Shareholders should have the right to participate in, and to be sufficiently 
informed on, decisions concerning fundamental corporate changes such as: 
1) Amendments to the statutes, or articles of incorporation or similar governing 
documents of the company; 
Shareholders have the right to participate, be sufficiently informed and vote on 
amendments to company articles or statute; appointment and removal of directors; 
appointment and removal of auditors; authorizing share capital; issuing share capital; 
remuneration of board members; major corporate transactions, such as acquisitions, 
disposals, mergers and takeovers; transactions with related parties and changes to 
company business, or objectives among other things. Some of these resolutions require 
simple majority of the shareholders while others require 75 per cent majority.

2) The authorization of additional shares; 
As mentioned earlier, pursuant to the Companies Act, 1956, shareholders have the right to 
participate in the decision to issue new shares. To raise fresh capital a company is 
required to pass a special resolution (requiring approval by over 75% of shareholders, 
present and voting) to this effect.

3) Extraordinary transactions including the transfer of all or substantially all assets, 
that in effect result in the sale of the company 
Section 293 restricts the Board of directors of a company to “sell, lease or otherwise 
dispose of the whole, or substantially the whole, of the undertaking of the company” 
without passing a resolution in a general meeting to this effect.

C. Shareholders should have the opportunity to participate effectively and vote in 
general shareholder meetings and should be informed of the rules, including voting 
procedures that govern general shareholder meetings: 
1. Shareholders should be furnished with sufficient and timely information 
concerning the date, location and agenda of general meetings, as well as full and 
timely information regarding the issues to be decided at the meeting. 
The notice of the AGM (as specified in Section 171) is sent to all shareholders at least 21 
days prior to the date of the meeting. Notice of the meeting also includes Annual Report 
which includes audited annual accounts, directors report, auditors report, agenda for the 
meeting with explanatory statement. AGM is generally held at the registered office of the 
company or in a place within the local limits of the city, town or village in which the 
registered office of the company is situated. 
In case of general meetings, once the board of directors receives the requisition, it must 
send the notice of meeting within 21days to all members. The general meeting must take 
place within 45 days from the date of submission of the requisition by the members. As 
specified in Section 172, the notice must specify the place, date and hour of the meeting 
and contain a statement of the business to be transacted. 
Section 173 states that in case of special businesses, a statement setting out all material 
facts concerning each such item including in particular the nature of the concern or
interest, if any, therein, of any director or a manager has to be attached with the notice of the meeting.

2. **Opportunity should be provided for shareholders to ask questions of the board, including questions related to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions subject to reasonable limitations.**

According to section 188 of the Companies Act, 1956, a company is required to, on the requisition in writing of shareholders holding at least 5% of voting power, circulate amongst all shareholders the notice of any resolution, which is intended to be moved by the requisitionists at the general meeting. The company is also required to circulate to all shareholders, any statement (of not more that one thousand words) with respect to the matter referred to in any proposed resolution. At the meeting, shareholders are allowed, subject to reasonable limitations, to ask questions and speak otherwise.

Clause 49 of the listing agreement of the stock exchanges stipulates that the chairman of the Audit Committee should be present at the general meeting to respond to shareholder queries.

3. **Effective shareholder participation in key corporate governance decisions, such as the nomination of and election of board members, should be facilitated.**

Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.

The right of the shareholders to elect and remove directors has been discussed earlier. Section 309 provides that the remuneration payable to directors should be determined either by the articles of the company, or by a resolution, or if the articles so required, by a special resolution, passed by the company in general meeting.

4. **Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.**

Shareholders, according to Section 176 of the Companies Act, may vote in absentia by appointing a proxy. The proxy so appointed may or may not be shareholders of the company. A proxy can demand a poll and cast his vote, though he cannot speak at the meeting. Notice convening the meeting must state that a member can appoint a proxy.

Also according to the provisions of section 154, the registration of transfers may be suspended at such times and for such periods as the Board may decide from time to time. Section 154 of the Companies Act states that a company may, after giving not less than seven days notice by advertisement, close the register of members or debenture holders for any period or periods exceeding in aggregate 42 days in each year (but not exceeding 30 days at any one time).

**D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.**

According to Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001, public companies have to obtain approval of its shareholders by passing a resolution, in general meeting, to increase its share capital by issuing new shares with differential voting rights;

- The notice of the meeting at which the resolution is to be passed should contain an explanatory statement as under:
• The rate of voting rights, which the equity share capital with differential voting rights shall carry;
• The scale or proportion of variation of voting rights;
• An undertaking that the company shall not convert its equity share capital with voting rights into equity share capital with differential voting rights or vice versa;
• A statement that the shares with differential voting rights shall not exceed 25% of the total issued share capital of the company;
• A statement specifying the entitlement of a member of the company holding equity shares with differential voting right to bonus shares, or right shares of the same class;
• A statement specifying that holders of equity shares with differential voting rights shall enjoy all other rights to which they are entitled, except the right to vote as provided under (1) above

Also, Clause 49 of the listing agreement mandates each listed company to disclose their capital structure extensively.

E. Markets for corporate control should be allowed to function in an efficient and transparent manner.

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

Since the Securities and Exchange Board of India or SEBI framed the takeover code in 1997 the equity side of the market for corporate control has become very transparent. Popularly known as the takeover code, the major provisions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulation, 1997 are:

• **Disclosure.** Any person or body corporate whose shareholding crosses the 5% threshold has to publicly disclose this to the relevant stock exchange and to SEBI.
• **Trigger.** SEBI initially specified a 10% trigger. If an acquirer’s shareholding crossed 10%, he (person or body corporate) had to make an open offer for at least an extra 20% of the shares. In other words, for market purchases, a slow rise in shareholding from 9.9% to say 11.9% is no longer permissible. If the acquirer crosses the 10% threshold, he must purchase at least 30%. Given the structure of share ownership in corporate India, SEBI believes — and rightly so — that 30% generally suffices to give controlling interest. In 2001, the trigger was raised from 10% to 15%.
• **Minimum offer price.** Any such public offer must carry a minimum price which
  is the average of the market price for the last six months.
• **Creeping acquisition.** Existing management is allowed to consolidate its holdings through the secondary market so long as such acquisition does not annually exceed 2% of the shares. This was subsequently raised to 5% in 2001. The creeping acquisition provision is aimed to allow management to gradually consolidate its ownership without detriment to minority shareholders.
• **Escrow.** To ensure that the takeover bids are serious, there has to be an escrow account to which the acquirer has to deposit 25% of the value of his total bid. He
loses this in the event of his winning the bid but reneging on timely payment. The SEBI regulation has had two beneficial effects. First, it has created a transparent market for takeovers. Second, by legislating in favour of open offers, it has ensured that minority shareholders will have the right to obtain a market driven price in any takeover. Moreover, while friendly takeovers are still the norm, hostile takeovers have begun. And the SEBI Takeover Code has been already tested in at least 25 hostile bids, and has come out more robust than before.

For mergers and de-mergers, the companies concerned must go through the following steps:
- First, secure approval of their respective board of directors.
- Second, appoint valuers for doing the valuation and, hence, the share-swap ratio.
- Third, secure approval from shareholders in a shareholders’ meeting.
- Fourth, get approval from the High Court about the arrangement of merger or demerger.

2. Anti-take-over devices should not be used to shield management from accountability.

Defensive tactics such as poison pills are banned by law. Sometimes, however, in the face of a hostile takeover, the target company may get a white knight to make a counter-bid. When that happens, the white knight will also have to follow the SEBI.

F. The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated

1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.

2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts if interest that may affect the exercise of key ownership rights regarding their investments.

This is a new principle that has been incorporated in the revised OECD principles of corporate governance enunciated in 2004. At present, there are no official guidelines mandating these disclosures. In general institutional investors are seen to use their voting rights very judiciously and in the interest of the company and shareholders. In certain cases they can block and amend resolutions, they feel are not in the interest of the company, public or shareholders.

G. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholders rights as defined in the Principles, subject to exception to prevent abuse.

This, too, is a new principle. Institutional investors often consult each other on how to vote on a particular issue and it has been observed that they generally vote together.

4.3 The equitable treatment of shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

A. All shareholders of the same class should be treated equally.

1. Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the rights attached to all series...
and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares, which are negatively affected. The Companies Act specifies only are two types of shares—equity and preference. Ordinary shares are freely transferable and carry voting rights based on one-share-one vote. There are no differential classes of voting shares in India. If a share is entitled to vote, it is an ordinary share, and each such share carries one vote. Preference shares carry no voting rights but are committed to pre-committed, fixed dividends, which are cumulative in nature. In times of redemption or during winding up, preference shareholders get preference over ordinary equity shareholders.

2. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders, acting either directly or indirectly, and should have effective means of redress.

The Companies Act confers fairly strong rights to shareholders in matters dealing with oppression by minority or mismanagement. Section 397 of the Act deals with relief in the case of oppression and section 398 with mismanagement. In either case, 100 or more shareholders, or a number representing at least one-tenth of the total number of shareholders, whichever is less, can apply to the Company Law Board if they believe that the affairs of the company are being conducted in a manner prejudicial to the public interest or to the interest of the company, or in a manner oppressive to any shareholder. Shareholders can also file an application if mismanagement arises due to a change in the board or control of the company, which they believe, can result in affairs of the company being conducted in a manner prejudicial to public interest or to the interest of the company. In such cases, the CLB, can if it sees fit, order to end such oppression/mismanagement by

i) Directing the manner in which affairs of the company would be conducted in the future;

ii) Ordering the majority to purchase the shares held by the oppressed minority;

iii) Terminating, setting aside or modifying any agreement with the management; or

iv) By other means thought equitable.

3. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

Unlike in some OECD countries, the votes of shareholders not present at the meeting are not automatically cast in favour of the management. Also institutional investors do not, by default, vote in favour of the management and may, depending on their judgement, vote differently.

4. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

As mentioned earlier the general shareholder meetings are accessible to all shareholders and their proxies. There are no significant costs involved with voting. Postal voting was introduced in the Companies Act, 1956 in 2001 under section 192A. Though not mandatory, a company may seek postal voting on the following resolutions:

a. Alteration in the Object Clause of Memorandum
b. Alteration of Articles of Associations in relation to deletion or insertion of provisions defining private company
c. Buy-back of own shares by the company
d. Issue of shares with differential voting rights as to voting or dividend
e. Change in place of Registered Office out side local limits of any city, town or village
f. Sale of whole or substantially the whole of undertaking of a company
g. Giving loans or extending guarantee or providing security in excess of the limit prescribed under sub-section (1) of section 372A
h. Election of a director
i. Power to compromise or make arrangements with creditors and members as specified
j. Variation in the rights attached to a class of shares or debentures or other securities

B. Insider trading and abusive self-dealing should be prohibited.

While insider-trading regulations were framed in 1992, it was felt that there was no framework for prevention of insider trading. Consequently, The Insider Trading (Amendment) Regulations were notified on February 20, 2002. The following changes have been made through these amendment regulations:

Several existing provisions were amended to strengthen the regulations. These amendments include changes in the definition of connected person, broadening the meaning of dealing in securities, redefining the term 'deemed to be connected', re-framing the term 'unpublished price sensitive information', and amendments to the procedure of investigations, in addition to other amendments.

2. Incorporation of disclosure requirements by insiders such as directors and large shareholders
A new regulation has been included providing for initial and continual disclosure of shareholding by directors or officers and substantial shareholders (holding more than 5 per cent shares/ voting rights) of listed companies. These disclosures are to be made to the companies, which have to inform the stock exchanges within the prescribed time period. This requirement will further enhance transparency in the market.

3. Creation of preventive framework consisting of code of conduct for listed companies and other entities associated with securities markets
To create a preventive framework to curb insider trading, all listed companies and other entities associated with securities market are now required to adopt a code of conduct on the lines of the model code specified in the regulations. The codes of conduct cover the following aspects: Maintaining confidentiality of “Unpublished Price Sensitive Information”
   - Trading restrictions such as Trading windows, restricted lists of securities and pre clearance of trades
   - Internal reporting Requirements for transactions in securities
   - Provisions for internal enforcement and penalty to be imposed by companies/ other entities for contravention of code of conduct

4. Creation of a code of corporate disclosure practices for listed companies
Listed companies are now required to adopt a code for corporate disclosure to improve transparency in the market and fairness in the dissemination of information by corporate to the market. This code covers the areas of:
   - Prompt disclosure of price sensitive information by listed companies
   - Responding to market rumors
   - Timely Reporting of shareholdings/ ownership and changes in ownership
   - Disclosure of Information with special reference to Analysts, Institutional Investors
   - Dissemination of information by companies including through company websites.

5. Dissemination off price sensitive information to public
To have a proper method for dissemination of price sensitive and other important information relating to companies and market to the public, the stock exchanges have been advised to display such information on their terminals in the quickest possible manner.

6. Dealing with market rumours
Companies are required to designate compliance officers who can be contacted by the stock exchanges whenever such verification is needed. Exchanges are required to take up quick verification of rumours and ensure proper dissemination of the relevant information. Exchanges routinely scan newspapers to verify unconfirmed news reports and disseminate information to the market. In addition, exchanges have also been advised to verify rumours pertaining to specific market entities.

7. Co-ordination and sharing of information
The exchange has to designate a senior level official handling surveillance function to co-ordinate with other exchanges on surveillance matters. Major exchanges have instituted coordination in crucial areas related to market functioning, and also meet periodically to discuss relevant issues.

C. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly, or on behalf of third parties, have a material interest in any transactions or matter directly affecting the corporation.
Section 299 of the Companies Act, 1956, specifies that every director of a company, who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement, should disclose the nature of his concern or interest to the Board. According to section 297 of the Companies Act, the board of directors has to give their consent on any such related party transactions. Further, under the provisions of Section 300, the “interested” director is not allowed to take part in the discussions or vote on any contract entered into in which he is interest
Session V

Session Title
Legal and Regulatory Framework (Continued..)

Session Objective :
At the end of the session, the participants should understand the various legal and regulatory frameworks under corporate governance.

The role of stakeholders in corporate governance
The corporate governance framework should recognize the rights of stakeholders as established by law or through mutual agreements, and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A. The rights of stakeholders that are established by law or through mutual agreements are respected.

The rights of creditors
Secured creditors such as banks, development financial institutions (DFIs) and insurance companies offering long term debt, have the right to be represented on the board through their representatives who, in India, are called ‘nominee directors’. This right arises from the contract executed between the company and the creditor organisation, and is enforced through the covenants of such a contract. Almost all major listed companies belonging to Group A and B1 of the BSE which have sizeable debt from banks, DFIs and insurance companies have nominee directors.

Creditors also have the right to block dividend payments if their dues have not been paid. This involves all debt dues, including payment towards debentures or bonds; this right is enforced by petitioning the civil courts, the Company Law Board or High Courts.

Creditors’ rights are supreme in bankruptcy restructuring or liquidation. Under the Companies Act, 1956, the Sick Industrial Companies Act, 1985, (SICA), and the Debt Recovery Act, 1992, creditors have the right to take a company to bankruptcy court, civil courts, High Courts or Debt Recovery Tribunals for securing their dues either through receivers, or via bankruptcy restructuring or winding up procedures. Under section 19 of 22 SICA, secured creditors have the right to veto any bankruptcy restructuring plan proposed by the debtor company, and this veto right is binding. In winding up under the Companies Act, creditors and workmen (as defined by the Industrial Disputes Act, 1947) have pari passu rights over all other claimants to recover through asset sale their unpaid debt and wages / salaries, respectively.

Recently, the Government of India enacted the Securitzation Act where creditors have the right to foreclose on debt and its mortgaged assets in the event of the account becoming a non-performing loan — defined as one in which payments have not been made for two successive quarters.

The rights of employees
All employees, workmen or otherwise, have the right to form trade unions. The Industrial Disputes Act, the Factories Act and the Contract Labour Act say that workers cannot be fired, retrenched or laid-off without due cause and without following due process. If anything, these processes are biased in favour of workers. In bankruptcy restructuring, representatives of workers have the legal right to participate in the proceedings. As mentioned earlier, in winding up, workers have pari passu rights (along with secured creditors) to their unpaid wages.
B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.

Creditors
Creditors can, and do, petition the Company Law Board, the Board for Industrial and Financial Reconstruction (BIFR, the special bankruptcy court under SICA), civil courts, High Courts and Debt Recovery Tribunals for violation of their rights. This is routinely done in instances of violation. Workers and employees
Workers and employees can petition civil courts and High Courts. This is regularly done in cases of violation. However, workmen of a company are not allowed to file petition for winding up. Workers may be allowed to appear and be heard in support or opposition of the winding up petition.

C. Performance enhancing mechanisms for stakeholder participation should be permitted to develop.
ESOPs are increasingly becoming popular in companies. The Securities and Exchange Board of India (SEBI) has prescribed a detailed guideline on the issue of share options (available under the section on guidelines on www.sebi.gov.in). For unlisted companies, Department of Company Affairs (DCA) has recently come out with a report on ESOP, Sweat Equity and Preferential Allotment, which has made detailed recommendations on the subject. (This report is available on www.dca.nic.in).

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on timely and regular information.
All relevant communication from a listed company must be posted on the company’s website, which includes presentations to analysts. Besides, annual, half-yearly and quarterly financial results have to be published in national newspapers, sent to the stock exchanges and SEBI, and be posted on the website.

E. Stakeholders, including individual companies and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.
The Narayana Murthy committee has proposed that all listed companies adopt a whistle blower policy. According to this proposed policy: “Personnel who observe an unethical or improper practice (not necessarily a violation of law) should be able to approach the audit committee without necessarily informing their supervisors. Companies shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars, etc. The employment and other personnel policies of the company shall contain provisions protecting “whistle blowers” from unfair termination and other unfair prejudicial employment practices.”

F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by enforcement of creditor rights
The Sick Industrial Companies (Special Provisions) Act, 1985, popularly known as SICA, lays down the framework for bankruptcy restructuring of financially distressed companies. The process, which is supervised by the Board for Financial and Industrial Restructuring (BIFR), does have its flaws and there is definite scope for improvement.
By law, creditors have prior claim over shareholders. When their contractual obligations are not met, creditors can demand bankruptcy reorganisation under SICA, file for winding up of the company or apply for receivership. In addition, since 1993, banks and financial
institutions can take recourse to another alternative— that of filing for recovery of dues at the Debt Recovery Tribunals (DRTs). In an important development, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, has been enacted. This Act has three important aspects: to establish asset reconstruction companies for non-performing loans; to allow for securitisation of loans and other securities; and to allow expeditious attachment and foreclosure of NPLs.

Disclosure and transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.
2. Company objectives.
3. Major share ownership and voting rights.
4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships, and whether they are regarded as independent by the board.
5. Related party transactions.
7. Material issues regarding employees and other stakeholders.
8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

Most of this information is routinely disclosed by the company to its shareholders. The details of the disclosures made by listed companies in India is mentioned in the table below:

<table>
<thead>
<tr>
<th>Type of disclosure</th>
<th>Statutory or non-statutory</th>
<th>Disclosure to whom</th>
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<tbody>
<tr>
<td>Annual Report</td>
<td></td>
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</tr>
<tr>
<td>Chairman’s letter</td>
<td>Non-statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, Registrar of Companies (ROC)</td>
</tr>
<tr>
<td>Management discussion and analysis</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
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### Half yearly disclosures

- **Half-yearly audited profit and loss account, with notes**

### Quarterly disclosures

- **Quarterly non-audited profit and loss account, with notes**

**B. Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.**

Auditing standards in India are materially in line with International Standards on Auditing (ISA). These include Ethical requirements (as described in ISA 100) and the IFAC Code of Ethics for Professional Accountants.

**C. An annual audit should be conducted by an independent, competent, and qualified auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.**

Annual audit is mandated by the Companies Act. The auditors are independent, and under Section 226 Clause (3) of the Companies Act (1956) the following are not eligible for appointment as auditors:

- a) Body corporate
- b) Officer or employee of the company
- c) A person who is a partner or in employment of an officer or employee of the company
- d) A person indebted to the company for an amount exceeding Rs. 1000; or which has given any guarantee or provided any security in connection with the indebtedness
- e) A person holding any security carrying voting rights if the company

Apart from the above, according to the Companies Act and Clause 49 of the Listing Agreement with stock exchanges (and the proposed Companies (Amendment) Bill, 2003) all widely held companies with paid-up capital and free reserves in excess of Rs.100 million or turnover in excess of Rs.500 million must have an Audit Committee of the board — consisting of only non-executive directors and having at least three members. Given below are the mandated roles and responsibilities of the Audit Committee under Clause 49 of the Listing Agreement.

**Key information that must be reported to, and placed before, the Audit Committee of the board as well, must contain:**

- Annual operating plans and budgets, together with up-dated long term plans.
- Capital budgets, manpower and overhead budgets.
Quarterly results for the company as a whole and its operating divisions or business segments.

Internal audit reports, including cases of theft and dishonesty of a material nature.

Show cause, demand and prosecution notices received from revenue authorities which are considered to be materially important.

Fatal or serious accidents, dangerous occurrences, and any effluent or pollution problems.

Default in payment of interest or non-payment of the principal on any public deposit, and/or to any secured creditor or financial institution.

Defaults such as non-payment of inter-corporate deposits by or to the company, or materially substantial non-payment for goods sold by the company.

Any issue which involves possible public or product liability claims of a substantial nature, including any judgment or order which may have either passed strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company.

Details of any joint venture or collaboration agreement.

Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.

Recruitment and remuneration of senior officers just below the board level, including appointment or removal of the Chief Financial Officer and the Company Secretary.

Labour problems and their proposed solutions.

Quarterly details of foreign exchange exposure and the steps taken by management to limit the risks of adverse exchange rate movement, if material.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit

Clause 49 stipulates that the appointment and removal of external auditors is recommended by the audit committee of the board

E. Channels for disseminating information should provide for fair, timely and cost-efficient access to relevant information by users.

As mentioned earlier, the annual report of the company along with its audited accounts are sent to all shareholders, to SEBI, DCA, ROC, the stock exchanges, and posted on the company’s website. In addition, key elements of the balance sheet and profit and loss account, segment accounts and cash flow statement along with notes is reported in national newspapers.

Key elements of the audited half-yearly accounts, as defined by the SEBI, are published in national newspapers, submitted to SEBI, DCA, ROC, the stock exchanges and the company’s website.

Similarly, elements of the non-audited quarterly accounts, as defined by the SEBI, are published in national newspapers, submitted to SEBI, DCA, ROC, the stock exchanges and the company’s website.

Annual accounts have to be prepared within six months of the end of the financial year. The Companies (Amendment) Bill, 2003, proposes to reduce this period to three months.

Half yearly accounts have to be prepared within two months of the end of the six-month period. Quarterly accounts have to be prepared within one month of the end of the quarter.

F. The corporate governance framework should be complemented by an effective approach that addresses and promotes the provisions of analysis or advice by the
analysts, brokers, rating agencies and others that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysts and advice.

The Naryana Murthy Committee has recommended that SEBI should make it mandatory for a security analyst to disclose in his report whether the company that is being written about is a client of the analyst's employer or an associate of the analyst's employer. The analyst should also disclose whether he or his employee or an associate holds, has held, or intends to hold any debt or equity instrument in the company that is the subject matter of the report.

**The responsibilities of the board**

*The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.*

(A) Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.

By law, the Board of the company is accountable to the company i.e. the shareholders. The Fiduciary Duty of the Directors is implicit in the common law system. The fiduciary duty of the directors obligates them not to exceed their authority and powers and to act with honesty and good faith. They should not engage in any activity, which is *ultra vires* the company or illegal. Directors must not use unpublished or confidential information belonging to the company for their own purpose. Any knowledge or information that is generated by the company is its own property, and any gain on information should accrue to the company and not to the individual.

A director has to take reasonable care in performance of his duties. He need not be an expert in any particular field or in the activities of the company and might not have any extraordinary skill or knowledge. However, he is expected to be not negligent in performing his duties.

Individually, the members of the board are subjected to the following liabilities (as described in the Companies Act (1956)):

- Under Section 322 and 323, in a limited company the liability of all or any of the directors or managers is unlimited. Any person being proposed to the office of a director or any other management personnel should be informed in writing, before he accepts the office, that his liability will be unlimited and the proposal shall contain a statement to that effect.

- A director, being in the fiduciary position of a trustee for the company, may incur liability for breach of his fiduciary duty to the company.

- Directors are personally liable for the following Acts:
  - For *ultra vires* acts: The act on the part of the directors *ultra vires* the company may render liable to indemnify the company in respect of any consequent loss or damages sustained. If the directors use the company’s money for purposes, which the company cannot sanction, they become personally liable to replace it, however, honestly they may have acted.
  - For mala fide acts: If the directors act dishonestly and in breach of trust or misfeasance in that capacity, they are liable to account for and surrender profits to their company. Also, they should make good the loss sustained by the company by reason of the mala fide exercise of any of the powers vested in them.
For negligence: If directors are negligent in discharging their duties, they may be liable to their company for loss sustained due to their negligence.

Liability to the third parties: In certain circumstances, directors may incur personal liability to third parties.

Under the Companies Act, criminal proceedings against directors may be also be initiated, for actions such as:

- Filing of prospectus containing untrue statements
- Inviting deposits in contravention of rules or manner or conditions
- Issuing false advertisement inviting deposits

Concealing name of the creditors

- Default in distributing dividends
- Failure to assist the Registrar or any officer authorized by central government in inspection of the books
- Failure to lay balance sheet in the Annual General Meeting (AGM)
- Failure in compliance with regard to matters being stated in the balance sheet
- Failure to attach to balance sheet a report of the board
- Improper issue of shares
- Failure to disclose shareholdings in the company
- False declaration of a company’s solvency
- For such offences, monetary penalties ranging from Rs.1000 to Rs.100,000 and/or imprisonment between six months to five years can be imposed.

B. Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.

As mentioned earlier the fiduciary duty of the directors obligates them to treat all shareholders equally and fairly.

C. The board should apply high ethical standards. It should take into account the interests of stakeholders.

D. The board should fulfill certain key functions, including:

1. Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

2. Monitoring the effectiveness of the company’s governance practices and making changes as needed.

3. Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

4. Aligning key executive and board remuneration with the longer-term interests of the company and its shareholders.

5. Ensuring a formal and transparent board nomination and election process.

6. Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

7. Ensuring the integrity of the corporation’s accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.
8. **Overseeing the process of disclosure and communications.**

9. **Under section 217(2AA) of the companies Act, 1956 the directors are required to issue “Directors Responsibility Statement” and attach with the Board of Directors’ Report. (Also refer Session XI & XII of the STM).**

Among the mandated duties of the board are to review as mentioned in Clause 49 of the listing agreement:

- Fatal or serious accidents, dangerous occurrences, and any effluent or pollution problems.
- Show cause, demand and prosecution notices received from revenue authorities, which are considered to be materially important.
- Default in payment of interest or non-payment of the principal on any public deposit, and/or to any secured creditor or financial institution.
- Defaults such as non-payment of inter-corporate deposits by or to the company, or materially substantial non-payment for goods sold by the company.
- Any issue which involves possible public or product liability claims of a substantial nature, including any judgment or order which may have either passed strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company.
- Labour problems and their proposed solutions.
- Non-payment of statutory dues to employees.

The board has to review, on a quarterly basis, at least the following:

- Annual operating plans and budgets, together with up-dated long term plans. Capital budgets, manpower and overhead budgets.
- Quarterly results for the company as a whole and its operating divisions or business segments.
- Internal audit reports, including cases of theft and dishonesty of a material nature.
- Show cause, demand and prosecution notices received from revenue authorities which are considered to be materially important.
- Fatal or serious accidents, dangerous occurrences, and any effluent or pollution problems.
- Default in payment of interest or non-payment of the principal on any public deposit, and/or to any secured creditor or financial institution.
- Defaults such as non-payment of inter-corporate deposits by or to the company, or materially substantial non-payment for goods sold by the company.
- Any issue which involves possible public or product liability claims of a substantial nature, including any judgment or order which may have either passed strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company.
- Details of any joint venture or collaboration agreement.
- Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
- Recruitment and remuneration of senior officers just below the board level, including appointment or removal of the Chief Financial Officer and the Company Secretary.
- Labor problems and their proposed solutions.
E. The board should be able to exercise objective judgment on corporate affairs independent, in particular, from management.

1. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.

According to the Clause 49 of the listing agreement, at least 50 per cent of the Board of directors of a company should consist of non-executive directors. The number of independent directors depends on whether the Chairman is executive or non-executive. In case of a non-executive Chairman, at least one third of the board should comprise independent directors; if on the other hand the Chairman is executive at least half of the board should comprise independent directors.

Clause 49 has made it mandatory for all Indian listed companies to constitute an audit committee, consisting of non-executive directors, majority of whom are independent. The chairman of this committee has to be an independent director. The duties of the audit committee include oversight of the financial reporting process of the company and review of related party transactions.

In addition, a non-mandatory provision of clause 49 provides for the formation of a remuneration committee to fix the remuneration of executive directors. This committee must constitute of non-executive directors with an independent director being the chairman.

2. When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.

Clause 49 stipulates that all board committees (audit, remuneration, and shareholder committees) disclose their composition, terms of reference, name of members, and attendance record in their annual report.

3. Board members should devote sufficient time to their responsibilities.

The company, as part of the non-financial disclosures, has to mention in its annual report the total number of meetings of the board held in the year and the number of meetings attended by each member of the board.

F. In order to fulfill their responsibilities, board members should have access to accurate, relevant and timely information.

Schedule 1A of Clause 49 of the listing agreement mandates that the board of directors be provided (at least) the following information on a quarterly basis:

1. Annual operating plans and budgets and any updates.
2. Capital budgets and any updates.
3. Quarterly results for the company and its operating divisions or business segments.
4. Minutes of meetings of audit committee and other committees of the board.
5. The information on recruitment and remuneration of senior officers just below the board level, including appointment or removal of Chief Financial Officer and the Company Secretary.
6. Show cause, demand, prosecution notices and penalty notices which are materially important
7. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.
8. Any material default in financial obligations to and by the company, or substantial non-payment for goods sold by the company.
9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgment or order which, may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
10. Details of any joint venture or collaboration agreement.
11. Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
12. Significant labour problems and their proposed solutions. Any significant development in Human Resources/Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme etc.
13. Sale of material nature, of investments, subsidiaries, assets, which is not in normal course of business.
14. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.
15. Non-compliance of any regulatory, statutory nature or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer etc.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)
The SEBI was established under the Securities and Exchange Board of India (SEBI) Act, 1992 as an independent capital market regulatory authority with the objective to protect the interests of investors in securities, promote and regulate the securities market in India. The scams committed by Harshad Mehta in early nineties and subsequently rigging of share prices by Ketan Parikh resulted in heavy losses to public and erosion of faith in the capital market. These circumstances resulted in passing of an ordinance to empower the SEBI which inter-alia hiked the monetary penalties for various offences to either three times the undue gains made by a market player or a maximum of Rs. 25 crore whichever is higher (as against the monetary limit of Rs. 5 lakh earlier).

Besides, the SEBI has also been granted powers to search and seize books of accounts and other documents of the stockbrokers and intermediaries after obtaining the approval of a Magistrate. The strength of the Board has also been increased from six to nine of which three are full time directors, excluding the Chairman. The ordinance was confirmed to make the amendments part of the SEBI (Amendment) Act 2002. The SEBI is playing an important role in promoting good corporate governance as would be evident from the following discussions on the functions and powers of the Board:

Functions
1. Regulating the business in stock exchanges and any other securities markets;
2. Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an
issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner;

3. Registering and regulating the working of the depositories, participants, custodians of securities, foreign in institutional investors, credit rating agencies and other intermediaries as the Board may, by notification, specify in this behalf.

4. Registering and regulating the working of venture capital funds and collective investment schemes including mutual funds;

5. Promoting and regulating self regulatory organisations;

6. Prohibiting fraudulent and unfair trade practices relating to securities markets;

7. Promoting investors’ education and training of intermediaries of security markets;

8. Prohibiting insider trading in securities;

9. Regulating substantial acquisition of shares and take-over of companies;

10. Calling for information from, undertaking inspection, conducting enquiries and audits of the stock exchanges, mutual funds and other persons associated with the securities market and intermediaries and self regulatory organizations in the securities market;

11. Performing such functions and exercising such powers under the provisions of the Securities Contracts (Regulation) Act 1956, as may be delegated to it by the Central Government;

12. Levying fee or other charges;

13. Conducting research;

14. Calling from or furnishing to any such agencies, as may be specified by the Board, such information as may be considered necessary by it for the efficient discharge of its functions;

15. Performing such other functions as may be prescribed.

Powers

- The Board is vested with same powers as are vested in a civil court in respect of following matters, namely:
  1. the discovery and production of books of account and other documents at such place and at such time as may be specified by the Board;
  2. Summoning and enforcing the attendance of persons and examining them on oath;
  3. Inspection of any books, registers and other documents of stockbrokers, sub-brokers, share transfer agents etc.
  4. For the protection of investors' interests, the Board may issue regulations for (Section 11A):
    The matters relating to issue of capital, transfer of securities and other matters incidental there to; and
    - The manner, in which such matters, shall be disclosed by the companies.
  5. The Board may issue directions under section 11B to:
- Stock-brokers, sub-brokers, share transfer agents, bankers to an issue, trustee of trust deed, registrar to; an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may, be associated with securities market.
- Depository, depository participant, custodian of securities, foreign institutional investor, credit rating agency or any intermediary associated with the securities market
- Sponsors of venture capital funds, or collective investment schemes including mutual funds
- And to any company with regard to matters to be disclosed by the companies as specified in section 11A.

1. Different intermediaries mentioned above can commence functioning in their respective activities only after registration with the SEBI and complying with requirements as stated under specific regulations mentioned for each
2. Stock-brokers, sub-brokers, share transfer agents, bankers to an issue, trustee of trust deed, registrar to; an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may, be associated with securities market can not buy, sell or deal in securities except under, and in accordance with, the conditions of a certificate of registration obtained from the Board in accordance with the regulations made under this Act.
3. No Depository, depository participant, custodian of securities, foreign institutional investor, credit rating agency or any intermediary associated with the securities market, as the Board may notify by notification, shall buy or sell or deal in securities except under and in accordance with the conditions of a certificate of registration obtained from the Board in accordance with the regulations made under this Act.
4. No person shall sponsor or cause to be sponsored or carry on or cause to be carried on any venture capital funds or collective investment schemes including mutual funds, unless he obtains a certificate of registration from the Board in accordance with the regulations.
5. No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which an adjudicating officer appointed under this Act or a Securities Appellate Tribunal constituted under this Act is empowered by or under this Act to determine and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act. However, appeals against the decision of the Securities Appellate Tribunal can be preferred before a High Court.

Safeguard for investors
The SEBI has taken several steps for ensuring the interests of investors and helping them to exercise their choice and decisions in their financial dealings:
- The Electronic Data Filing and Retrieval System (EDIFAR) was commenced from July 2002. It is an automated web based system for filing, retrieval and dissemination of information pertaining to corporate.
• Benchmarking has been made compulsory for debt oriented and balanced funds for providing objective analysis of performance of the mutual fund schemes.
• A code of conduct for mutual fund intermediaries has been prescribed.
• Guidelines for risk management system issued and implemented for the mutual funds in order to eliminate/minimize the risks in operations of mutual funds.
• Guidelines have been issued for valuation of unlisted equity shares by mutual funds with a view to bringing about uniformity in the calculation of NAV.
• A provision of nominations for the unit holders has been made.
• Mutual funds have been advised to follow a uniform method to calculate the sale and repurchase price. This would avoid creation of confusion in the minds of the investors.
• Rebating and discounting by the mutual funds has been prohibited for ensuring a fair treatment to all the investors.
• Guidelines have been issued to mutual funds for exercising due diligence while making investments in unlisted equity shares. The Mutual funds cannot buy unlisted equity shares at high prices arbitrarily.
• With a view to improving corporate governance standards, the trustees who act as first line regulators are now required to meet on bi-monthly basis instead of earlier requirement of meeting on quarterly basis. They are required to review the performance and compliance of regulations on bi-monthly basis.
• Quarterly secretarial audit has been made mandatory for listed entities to reconcile the issued, capital and electronic shares.

**Enforcement of Regulatory Obligations**
The SEBI has initiated several measures for regulating the market players for better service to the investors.

• The Prof. Verma Committee, which reviewed the SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines 1999, inter-alia recommended for mandatory disclosure of the fair value of the ESOPs, the impact on profits and on EPS of the company, had the company expensed the ESOPs on fair value basis and also relaxations from lock-in requirement subject to certain disclosures in the offer document in case the company is going for IPO after the grant of options.
• The Accounting Standards Committee has recommended additional disclosures for investment in associates and subsidiaries. It also recommended introduction of half yearly audited consolidated results and quarterly audit review.
• Credit Rating Agencies have been asked to develop model for rating corporate governance on the principles of wealth creation, wealth management and wealth sharing.
• Code of conduct has been specified for listed entities and regulated firms under the Insider Trading Regulations.
• SEBI has brought a scheme to enable individuals and companies to disclose the irregularities in reporting of acquisition of shares under the SEBI (SAST) Regulations, 1997.

**Insider Trading Regulations**
The Insider Trading Regulations issued by SEBI in 1992 have been amended and the new regulations were notified in February 2002 viz. the SEBI (Insider Trading) (Amendment) (Regulations) 2002 to remove the shortcomings found in the earlier regulations and also to make them mover effective. This will protect investors’ interest and ensure transparency in
dealings of securities of companies by employees, directors, officers and other market intermediaries. SEBI has further amended these regulations in November 2002 with the introduction of SEBI (Prohibition of Insider Trading) (Second Amendment) Regulations 2002.

The Insider Trading Regulations are applicable to those persons who have temporary or permanent relationship with the company including its directors, officers, designated employees, professionals, businessmen and their dependent relatives, who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company. The term ‘Designated Employees’ include all employees comprising of the top two tiers of the company management and those specifically designated by the company and who may be able to have access to any Price Sensitive Information as defined in the regulations.

As per the regulation 3, no insider shall:

- Either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange when in possession of any unpublished price sensitive information; or
- Communicate, counsel or procure, directly or indirectly any unpublished price sensitive information to any person, who, while in possession of such unpublished price sensitive information, shall not deal in securities.
- Provided that nothing contained above, shall be applicable in any communication required in the ordinary course of business or profession or employment or under any law.
- No company shall deal in the securities of another company or associate of that other company while in possession of any unpublished price sensitive information. The regulation 3A shall not apply in certain cases discusses below:

1. In a proceeding against a company in respect of regulation 3A, it shall be a defence to prove that it entered into a transaction in the securities of a listed company when the unpublished price sensitive information was in the possession of an officer or employee of the company if-
   - The decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than that officer or employee; and
   - Such company has put in place such systems and procedures which demarcate the activities of the company in such a way that the person who enters into transaction in securities on behalf of the company cannot have access to information which is in possession of another officer or employee of the company; and
   - It had in operation at that time, arrangements that could reasonably be expected to ensure that the information was not communicated to the persons or persons who made the decision and that no advice with respect to the transactions or agreement was given to that person or any of those persons by that officer or employee, and
   - The information was not so communicated and no such advice was so given.

2. In a proceeding against a company in respect of regulation 3A which is in possession of unpublished price sensitive information, it shall be defence to prove that acquisition of shares of a listed company was as per the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1992.

**Price Sensitive Information**
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 is referred to as Price Sensitive Information. The following shall be deemed to be price sensitive information:

- Periodical financial results of the company,
- Intended declaration of dividends (both interim and final).
- Issue of securities or buy-back of securities.
- Any major expansion plans or execution of new projects.
- Amalgamation or mergers or takeovers.
- Disposal of the whole or substantial part of the undertaking.
- Any significant changes in policies, plans or operations of the company.

All directors/officer/designated employees are required to maintain the confidentiality of all price sensitive information. They must not pass on such information directly or indirectly by way of making the recommendation for the purchase or sale of any security of the company/client company.

Price sensitive information is to be handled on a “need to know” basis. It should be disclosed only to those within the company who may need the same to discharge their duty and whose possession of such information will not give rise to a conflict of interest or appearance of mis-use of the information.

All directors / officers / designated employees of the company shall be subject to following trading restrictions:

- They shall trade in the company’s securities only when the trading window is open. Trading window means a trading period for trading in company’s securities as specified by the company from time to time.
- When the trading window is closed, during that period, the employees and directors shall not trade in the company’s securities.
- The trading window shall be, inter alia, closed at the time of
  a) Declaration of financial results (quarterly, half yearly and annual).
  b) Issue of securities by way of public rights/bonus etc.
  c) Declaration of dividends (interim and final).
  d) Any major expansion plan or execution of new project.
  e) Amalgamation, mergers, takeovers and buy-back.
  f) Disposal of the whole or substantially whole of the undertaking.
  g) Any changes in policies, plans or operations of the company.
- The time for commencement of closing of trading window shall be decided by the company.
- All directors, officers and designated employees of the company shall conduct all their dealings in the securities of the company only in a valid trading window and shall not deal in any transactions involving the purchase or sale of the Company’s securities during the period when trading window is closed.

Threshold limit to transactions in securities

Any transactions in securities of the company exceeding 25000 shares or Rs. 5 lakh in value or 1 percent of the total holding of the company whichever is lower shall be carried out by the designated persons only after receiving pre-clearance of trades from the company and the execution of the order will have to be completed within one week of approval of pre-clearance. Further, the investment in securities will have to be held for a minimum period of 30 days from the date of purchase/actual allotment.
Disclosure of interest or holding by directors and officers and substantial shareholder in a listed company

A. Initial disclosure

(1) Any person who holds more than five percent of shares or voting rights, in any listed company, shall disclose to the company, the number of shares or voting rights held by such person, or becoming such holder, within four working days of

a) The receipt of intimation of allotment of shares or
b) The acquisition of shares or voting rights.

(2) Any person who is a director or officer of a listed company shall disclose to the company, the number of shares or voting rights held by such person, within four working days of becoming a director or officer of the company.

B. Continual disclosure

1. Any person who holds more than five percent shares or voting rights in any listed company shall disclose to the company the number of shares or voting rights held and change in shareholding or voting rights, even if such change results in shareholding falling below five percent, if there has been change in such holdings from the last disclosure made and such change exceeds two percent of total shareholding or voting right in the company.

3. Any person who is a director or officer of a listed company, shall disclose to the company, the total number of shares or voting rights held and change in shareholding or voting rights, if there has been a change in such holdings from the last disclosure made and the change exceeds rupees five lakh in value or 25000 shares or one percent of total shareholding or voting rights, whichever is lower.

4. The disclosure shall be made within four working days of

a. The receipt of intimation of allotment of shares, or
b. The acquisition or sale of shares or voting rights, as the case may be.

A. Disclosure by company to stock exchanges

Every listed company within five days of receipt shall disclose to all stock exchanges on which the company is listed, the information received as above. All designated persons will have to forward details of their securities transactions including the statement of their dependent family members to the compliance officer in the following manner:

- All holdings of securities of that company by directors /officers/designated employees at the time of joining of the company.
- Periodic statement of any transactions in securities (the periodicity of reporting may be defined by the company). The company may also be free to decide whether reporting is required for trades where pre-clearance is also required and
- Annual statement of all holdings in securities.
- The compliance officer shall maintain records of all the declarations in the appropriate forms given by the designated persons for a minimum period of three years.
- The compliance officer shall place before the Managing Director/Chief Executive Officer or a committee specified by the company, on a monthly basis, all the details of the dealings in the securities by employees/director/officer of the company and the accompanying documents that such persons had executed under the pre-dealing procedure as envisaged in the Model Code.
Session VI

Session Title: 
AUDITOR’S CONCERN IN CORPORATE GOVERNANCE. COMPLIANCE CERTIFICATE BY STATUTORY AUDITORS.

In India, whilst management processes were widely explored, till recently relatively little attention has been paid to the processes by which companies were governed. The various aspects of this issue crept into India relatively later after the report of the Cadbury Committee in the U.K. Since the publication by the Confederation of Indian Industries of a Desirable Code of Corporate Governance, it has come into prominence with the report of the Shri Kumar Mangalam Birla Committee set up by SEBI to suggest changes in the listing agreement to promote corporate governance, followed by Naresh Chandra and Narayana Murty Reports of 2002-03.

Corporate Governance has an important role to play as an instrument of investor protection. The development of the capital market is dependent on good corporate governance, without which investors do not repose confidence in the companies. Companies with basic corporate governance principles are more likely to attract investors. Many companies have voluntarily established high standards of corporate governance; however, there are many others who do not pay adequate attention to the interest of the shareholders.

They do not attend to investor grievances such as delay in transfer of shares, dispatch of share certificate and dividend warrants, non-receipt of dividend warrants. Besides, investors have also suffered in the past on account of unscrupulous companies, which have raised capital from the market at very high premium. SEBI initiated several steps for strengthening corporate governance through the amendment of the listing agreement like:

✓ Strengthening of disclosure norms for Initial Public Offerings (IPOs) following the recommendations of the Malegam Committee and other reports;
✓ Providing information in director’s report for utilization and end use of funds and variation between projected and actual use of funds.
✓ Inclusion of cash flow statement in annual reports;
✓ Declaration of unaudited quarterly results;
✓ Filing of ‘Limited Review Report’ with stock exchanges;
✓ Mandatory appointment of compliance officer for monitoring the share transfer process and ensuring compliance with various rules, regulations;
✓ Dispatch of one copy of complete balance sheet to every household and abridged balance sheet to all shareholders.
✓ Timely disclosure of material and price sensitive information including details of all material events having a bearing on the performance of the company.
✓ Issue of guidelines for preferential allotment at market related prices;
✓ Issue of regulations providing for a fair and transparent frame work for takeovers and substantial acquisitions
✓ Clause 49 requirements of corporate governance

To further improve the level of corporate governance, it was felt that a more comprehensive approach was needed at this stage of development of the capital market. This prompted SEBI to
constitute a Committee under the Chairmanship of Shri Kumar Mangalam Birla, member, SEBI Board to suggest changes in the Listing Agreement to promote Corporate Governance. The terms of reference of the Committee were as follows:

1. To suggest suitable amendments to the listing agreement executed by the stock exchanges with the companies and other measures to improve standards of corporate governance in listed companies, in areas such as

   ✓ continuous disclosure of both financial and non financial material information
   ✓ accounting information
   ✓ manner and frequency of such disclosure
   ✓ responsibilities of independent and outside directors

2. To draft a code of corporate best practices; and

3. To suggest safeguards to be instituted within companies to deal with insider information and against insider trading.

Based on the recommendations of the Kumar Mangalam Birla Committee the Securities and Exchange Board of India has made certain provisions, with regard to corporate governance mandatory for listed companies by adding clause 49 to the listing agreement. Broadly, eight points on which provisions have been included are:

1. Board of Directors and its composition
2. Audit Committee
3. Remuneration of Directors
4. Board Procedure
5. Management Discussion and Analysis Report
6. Shareholders/Investors Grievance Committee and other shareholder’s issues
7. Report on Corporate Governance
8. Certificate of Compliance

Good corporate Governance is a must not only in order to gain credibility and trust but also as a part of strategic management for survival consolidation and growth. A good Corporate Governance will improve market capitalization of Indian companies thereby reducing cost of capital. A large number of small or retail investors with limited knowledge require stringent investor protection. Public holdings are widely dispersed such that shareholders have little power on their own. Information is asymmetry between institutional and retail investors. Foreign portfolio investors demand for more transparency and great disclosure.

Negligence in adhering to effective Corporate Governance standards have sounded a death knell for powerful entities. The collapse of BCCI Bank and the epidemic of securities scams in India are full fledged examples of disasters resulting from defiance and negligence of the principles of Corporate Governance.

It should not be concluded that adherence to Corporate Governance could prevent corporate failure. It would definitely act as a spirited move towards achievement of excellence by a corporate
not only in terms of increased profits and revenue but also in terms of respectability for the laws of
the land, protection of interest of shareholders, creditors and employees of the company.

**Constitution of Board of Directors – Independent Directors**

One of the canons of Corporate Governance is that Corporate Boards should include
significant proportion of independent non-executive directors in establishing that ‘control’ is a
separated from ‘ownership’, such that the affairs of a corporation are conducted in the interest of
shareowners. The SEBI prescription that has now been incorporated in the listing agreement of
Stock Exchanges defines ‘independence’ as excluding any material pecuniary relationship or
transactions with the company, its promoters, its management of its subsidiaries that in the opinion
of the Board may affect director’s independence of judgment. However, the monetary remuneration
received for being a director of the company itself is not construed as vitiating independence.

While SEBI has clarified that nominees appointed by financial institutions as directors in a
non-government company should be considered as independent directors, what will be the status of
bureaucrats who by virtue of their official position sit on the Boards of listed public sector
companies. Similarly, when as often is the case, paid executives of overseas corporations are
appointed as directors of their Indian subsidiary or affiliate, would they be deemed independent?
Further, when a relative of the promoter sits on the board of a company as a non-executive director,
would he be considered independent?

The thorny issue is when corporate bodies are shareholders and they have to be represented
by some individuals while asking board positions. Will representative(s) of major shareholders
nominated as non-executive directors on the board of directors of a company be considered
independent directors. While one cannot take a legalistic view on these matters the spirit behind
constituting maximum number of independent directors on the board should be well appreciated. It
may be useful for SEBI and Stock Exchanges to issue some interpretative guidelines on these
matters.

**Role and Independence of Audit Committee**

Audit Committee on Indian Corporate scenes will soon become a common phenomenon. As
per Kumar Mangalam Birla Committee’s recommendations on Corporate Governance a listed
company should set up a qualified and independent audit committee. The audit committee should
have minimum three members, all being non-executive directors, with the majority of them being
independent and such as least one director having financial and accounting knowledge. The Audit
Committee should invite such of the executives, as it considers appropriate (and particularly the
head of the finance function) to be present at the meetings of the committee. The Committee on
occasions may also meet without presence of any executives of the company. The finance director,
head of internal audit as and when required, a representative of the external auditor shall be present
as invitees for the meetings of the Audit Committee.

**Audit Function as a Governance Tool**

The Audit committee’s role is clearly one of ‘monitoring and oversight’ and not
‘operational or managerial’. This is the accepted position around the world. In its oversight
capacity, the audit committee is neither intended nor equipped to quarantine with certainty to the
full board and shareholders the accuracy and quality of a company’s financial statements and accounting practices. The audit committee, as the first among equals, oversees the work of the other actors in the financial reporting process-management, including internal auditors, and the outside auditors- to endorse the processes and safeguards employed by each. In particular, the audit committee should encourage procedures that promote accountability among these players, ensuring that management properly develops and adheres to a sound system of internal control, that the internal auditor objectively assesses management’s accounting practices and internal controls, and that the outside auditors, through their own review, assess management and the internal auditor’s practices. Thus, in the discharge of oversight responsibilities relating to the credibility and reliability of a company’s financial reporting systems, Audit committee will have to depend upon these three sets of professionals, viz. (a) External/Statutory Auditors; (b) Internal Auditors, and (c) Chief Financial Officers (CFO) and his team. Companies (Amendment) Bill, 2003 proposes the appointment of CFO to be mandatory under section 215(A) of the Companies Act, 1956.

It may become virtually impossible for sub-ordinate officers to be open in their contribution to the Audit committee as an invitee since the finance director shall be present in the meeting of the Audit committee. The result will be that the Audit Committee will be denied of valuable inputs that may help them in discharge of their responsibilities.

Section 292 A of Companies Act, 1956 also provides for setting up of Audit Committees by certain companies w.e.f 13-12-2000. Every public Company having a paid up capital of Rs. 5 crores or more is required to have an audit committee. The Audit Committee should have a minimum of three Directors and two thirds of the total number of members of Audit Committee shall be Directors other than Managing or whole time Directors. The terms of reference of the Audit Committee include all matters related to financial reporting and the audit thereof including efficacy of the internal control system. The statutory requirement of the Audit Committees brings into sharp focus the primacy of the independent directors in corporate governance and the critical role of the financial reporting in satisfying the expectations of shareholders. (Also refer session VII & VIII of the STM)  

**Role and Independence of Internal Auditor**

While management is responsible for internal controls, the internal auditors are in a position to evaluate and report on the adequacy and effectiveness of those controls. The internal auditor occupies a unique position – though he is employed by management he is also expected to review the conduct of management.

It may become necessary that an internal auditor has formal mechanism in place to facilitate confidential exchanges between him and audit committee. These mechanisms may take the form of regular meetings independent of regular confidential memos or reports circulated only to the audit committee.

Not withstanding the above idealistic position, let us realize the challenges of professionals in the finance and internal audit functions employed by a relationship with the company hierarchy, and their promotion of progress is determined by the seniors who are in the hierarchy. Such professionals when functioning diligently may be transferred on promotion to another position in the company in the garb of career progression or broadening of their business exposure. In fact, it
has been accepted in certain countries that Audit Committee should assess the performance of professionals in the finance and internal audit functions employed by a company. Hence, any proposal concerning promotion, increase in remuneration removal, etc. of internal auditors should be closely scrutinized by the Audit Committee.

Thus the internal auditor occupies a unique position – though he is employed by management, he is also expected to review the conduct of management.

**Role and Independence of Statutory Auditors**

The external auditors of a company (at least a listed company) should discuss with the Audit Committee, the auditor’s judgments about the quality not just the acceptability, of the company’s accounting principles as applied in its financial reporting; the discussion should include issues such as the clarity of the company’s financial disclosures and reviewed by the outside Auditors. These requirements should be written in a way to encourage open, frank discussion and to avoid boilerplate.

The external auditors in the discharge of their duties are expected to communicate certain information to the Audit Committee, including matters such as disagreements with management, consultation with other accountants, and difficulties encountered in performing the audit such as unreasonable delays by management or unavailability of client personnel. Further, the external auditors would be required to report illegal acts detected during the audit in management and the Audit Committee.

The statutory auditors should, thus, be independent of operating management to ensure their own credibility and performance. There are several practical issues concerning what constitutes independence.

The Independence Standards Board (ISB) in the United States has issued its first standard titled ‘independence discussions with Audit Committee.’ In terms of this standard an auditor of a company is expected to do the following:

(a) Disclosure in writing to the Board of directors/audit committee of a company as to all relationships between:
   (i) the auditor and his/its related entries; and
   (ii) the company and its related entries that in the auditor’s professional judgment may reasonably be thought to bear on independence.

(b) Confirm in the letter, that in the auditor’s professional judgment, its independent of the company, and

(c) Discuss the auditor’s independence with board of directors / the audit committee.

It may be pertinent to note that inadvertent violations do not constitute any impediment to the independence status so long they are in compliance with the aforesaid standard.

In India, we do not have a duly constituted Board equivalent of the ISB as in the U.S. The SEBI, Stock Exchanges and the Institutes of Chartered Accountants of India can get together and evolve similar standard.

With a view to ensuring better Corporate Governance, amongst various proposals, the Companies (Amendment) Act 2000, introduced provisions to the effect that an auditor of a company holding any security which carries voting rights of that company will not be eligible for appointment as auditor. On the same principles a relative of a director or manager of the company, though not provided in law, should not be appointed as auditor of a company. Thus, independence of auditors need to be judged either by themselves or by regulations on the basis of absence of relationships that may impact their ability to perform their duties in a fair and unbiased manner.
Apart from this, the Companies (Amendment) Act, 2000 further states that the auditor’s report should state in thick types or in italics the observations or comments of the Auditors, which have any adverse effect on the functioning of the Company. The report should further state whether any director of a company is disqualified from being appointed as director. These proposals will have salutary effects in ensuring good Corporate Governance. Auditor’s independence is also sought in Companies (Amendment) Bill, 2003.

**Facilitating Audit Independence**

What can be done to facilitate audit independence, both in perception and practice? Legal provisions exist for voicing his rights when an external or statutory auditor is removed. Rotation of Auditors is yet another concept with a view to distancing an auditor from corporate management as it could demonstrate their independence. Certain companies secure approvals of shareholders only for appointment of auditors but their remuneration being left to the board for negotiation and decision. It is suggested that this practice should be stopped with a view to fostering audit independence.

In several countries, the selection and recommendation of remuneration of independent auditors is the responsibility of the audit committee for approval by the board of directors and shareholders. The Corporate Governance code in India also stipulates that the appointment and removal of external auditor, fixation of audit fee and also approval for payment for any other services should be within the purview of the audit committee.

Since the audit committee comprises of independent directors its recommendation for the appointment and removal of statutory auditor and fixation of audit fee would be perceived as unbiased and therefore this should be clearly followed.

**Independence of Statutory Auditors of Government companies and deemed Government companies:**

The statutory Auditor has a fiduciary duty to provide independent, professional opinion on the financial statements of the company he audits. In order to ensure independence of the auditors and to obviate any chances of conflict of interest, Section 226 of the Companies Act, 1956 prohibits the appointment of (i) an officer or employee of the company or their partner or employee, (ii) a person who is indebted to the company and (iii) a person who is the holder of any securities having voting rights etc. as the auditor of the company. Similarly, the Chartered Accountants Act, 1949 also contains provisions to ensure independence of the auditors.

In order to further ensure the independence of the auditors of the Government companies, the following further safeguards have been provided by the CAG:

(i) **Acceptance of non-audit assignment by the auditors** – In order to maintain the independence of the Auditor as well as the quality of audit, partners or relatives (husband, wife, brother, or sister or nay lineal ascendant or descendant) or associates of the auditors of the Government company, are prohibited from undertaking any assignment for internal audit or consultancy or other services to the government company during the year of the audit and for one year after the firm ceases to be the Auditor. Acceptance of non-audit assignments that involve performing management functions or making management decisions are also prohibited during the year of audit and for one year after the firm ceases to be the Auditor.

(ii) **Rotation of audit:** A system of rotation of auditors of Government companies every four years has been adopted as a good practice.
Compliance Certificate by Statutory Auditors

A listed company is obligated to obtain a certificate from its statutory auditors regarding compliance of conditions of Corporate Governance as stipulated in Clause 49 of the listing agreement and attach the certificate with the director’s report. What an auditor needs to ensure is that whether compliance of conditions of Corporate Governance has been followed by a listed company? He need not make a detailed checklist for examining the system followed by a listed company for compliance of conditions of Corporate Governance. Normally, it should suffice if the statutory auditor focuses his attention to the following:

(a) Whether the board of directors has been properly constituted – comprising executive and non-executive directors and requirement as to ‘independent directors.’
(b) Whether the Audit Committee has been properly constituted with the majority being independent and at least one director having financial and accounting knowledge.
(c) Whether Board meetings / Audit committee meetings were held and the Board / Audit Committee discussed in their respective meetings the various matters / information set out in Clause 49 of the listing agreement.
(d) Whether the Audit Committee has recommended the appointment and removal of external auditors and fixation of audit fees and also has approved payment of any other fees.
(e) Whether disclosures have been made by the management to the board relating to all material financial and commercial transactions where they have personal interest that may have a potential conflict with the interest of the company at large.
(f) Whether disclosures received from directors as to membership / chairmanship as the case may be, in various board constituted committee are in compliance with limits prescribed in the Corporate Governance code.

Work on Audit Committee and Corporate Governance in India:

India has formulated codes or corporate governance thorough various committees, more important ones being –

✓ CII Code of desirable Corporate Governance (1998)
✓ UTI Code of Governance (1999)
✓ SEBI norms based on Kumar Mangalam Birla Committee on Corporate Governance (2000) (under revision)
✓ Naresh Chandra Committee on Corporate Audit and Governance (2002)
✓ R D Joshi Committee to review Company Bill, 1997 (2002)
✓ N.R Narayana Murthy Committee appointed by SEBI (2003)

Besides, companies like ICICI, BSES, Infosys etc. have created their own benchmarks. The recommendations relating to Audit Committee are as under:

CII Code recommended that –
✓ Key information to be reported
✓ Listed companies to have audit committees
✓ Corporate to give a statement on value addition
✓ Consolidation of accounts to be optional
✓ Audit Committee to have clearly defined terms of reference
✓ Audit Committee to have at least three non-executive members
Birla Committee recommended that –
Board to set up qualified and independent audit committee to enhance the credibility of financial disclosures and to promote transparency.
Audit Committee should have at least three directors with one being finance literate.
Companies to provide consolidated statements in respect of all its subsidiaries in which they hold 51% or more of the share capital.
Shareholders to show greater degree of interest and involvement in the appointment of directors and the auditors.
Audit Committee should meet at least thrice in a year.
Chairman of Audit Committee should be present in AGM

Naresh Chandra Committee recommended that –
- Audit firm’s rotation is required
- Every five years, audit partner should rotate
- Audit Committee to be set up all independent directors
- Companies to have at least 50 percent independent directors
- Certain professional assignment should not be undertaken by auditors
- Audit Committee should have a audit charter.

R D Joshi Committee recommended that –
- If Chairman is unable to attend AGM, Audit Committee can nominate any other member of committee to attend AGM.

N.R. Narayana Murthy Committee recommended that –
- Audit Committee of listed companies should review financial statements, draft audit reports and quarterly information, management discussion and analysis; management letters, letters of internal and statutory auditors, records of related party transactions etc.
- All audit committee members should be financially literate and at least one member should have accounting and financial management expertise
- Personnel who observe unethical or improper practice should be able to approach the audit committee freely.
- Appointment, removal and terms of remuneration of chief internal auditor should be reviewed by audit committee.
- Provisions relating to the composition of the board of directors of holding company should be made applicable to subsidiary companies also.

Global Recommendations on Accounts and Audit
Various global Committees/Codes recommended the following in relation to accounts, reporting and audit:

Cadbury Committee on Financial Aspects of Corporate Governance (1992)
- Audit Committee to have minimum three members, written terms of reference and authority to investigate.
- Listed companies to publish full financial statements annually and half-yearly reports interim

Code of Best Practice
- Board to present a balanced and understandable assessment of company’s position
- Directors to report on effectiveness of internal control systems.

King’s Committee on Corporate Governance (1994)
- Effective Internal Audit function
- Establishment of Audit Committee
- Observance of highest level of business and professional ethics
- Accounting standards in line with international standards.

**Blue Ribbon Committee on improving the Effectiveness of Corporate Audit Committees (1999)**
- Members of Audit Committee to be independent
- Audit Committee to have minimum of three directors – each to be financially literate
- Audit committee to have formal written charter, approved by the full board, specifying
  - Responsibilities
  - Structure, process and membership
- Charter to specify outside auditors responsibility towards Board and Committee
- Companies to attach with Annual Report a letter from Audit Committee as to whether or not -
  - Management reviewed the audited financial statements with the committee
  - Outside auditors discussed with the Committee, their judgements
  - Committee believes that company’s financial statements are fairly presented in conformity with Generally Accepted Accounting Practices (GAAP)

**Bosh Report (Australia)**
- East listed company board or more than four members should appoint an audit Committee with at least a majority of non-executive directors, preferably independent, with written terms of reference.
- The Audit committee must have unrestricted access to CFO, CEO and internal and external auditors.
- The committee may recommend an audit firm for shareholder endorsement and it serves as liaison with external auditors for purposes of audit quality, effectiveness, interaction with internal auditors, risk assessment, communication with management and external auditors resignation situations

**Day Report (Canada)**
- Audit Committees should be composed only of outside directors and should enjoy direct communication with both internal and external auditors.

**Malaysian Code on Corporate Governance (Malaysia)**
- The audit committee should consist of at least three non-executive directors, a majority of whom are independent. There should be an independent, non-executive Chairman and the finance directors; head of internal audit and a representative of external auditors should normally attend meetings.
- The audit committee should have explicit authority to investigate any matter under its terms of reference, the resources it needs to do so and full access to information. The committee should be able to obtain external professional advice and to invite outsiders with relevant experience to attend meetings when necessary.

**Singapore Stock Exchange Recommendations (Singapore)**
- The listing Manual requires each listed issuer to set up an audit committee, which reports to the board of directors.
- A majority of members of the audit committee, including its Chairman should be independent of management.
- The audit committee should have full access to and co-operation by the management, including internal auditors and have full discretion to invite any director and executive officers to attend its meetings.
The audit committee should be given reasonable resources to enable it to discharge its functions properly.

The audit committee serves as a useful channel of communication between the board and the external auditors on matters related to and arising out of the external audit.

**The Code of Corporate Practices and Conduct (King Report) (South Africa)**

The board should establish an audit committee with the majority of its members (including the chair) being non-executive director with written terms of reference confirmed by the board. The head of internal audit, the external auditor or audit partner and the financial directors should be invited to attend audit committee meetings.

**London Stock Exchanges: The Combined Code (United Kingdom)**

The audit committee should comprise at least three non-executive directors. A majority of whom should be independent, with written terms of reference that identify their authority and who should be named in the annual report.

**Business Round Table (United States of America)**

Membership should be limited to outside directors. The primary functions of an audit committee are to –

- Recommend the appointment of the public accountants and review with them their report on the financial reports of the corporation
- Review the adequacy of the system of internal controls and of compliance with material policies and laws, including the corporation’s code of ethics;
- Provide direct channel of communication to the board for the public accountants and internal auditors and, when needed, finance officers, compliance officers and the general counsel.

**New York Stock Exchange (NYSE)**

New York Stock Exchange standard for its listed companies require audit committee’s to broader their oversight of external auditors and assume responsibility for its fiduciary obligations.

**Listed Companies/Audit Committees of listed companies should –**

- Increase authority of audit committee and responsibility over external auditors
- Adopt Audit Committee charter
- Have a majority of independent directors on board and apply independence standards to members of Audit Committee.
- Audit Committee should have sole authority to retain and terminate company’s independent auditors.
- Audit Committee should approve audit engagement fees and other terms
- Adopt corporate governance guidelines and code of business conduct and ethics.

**CACG Guidelines – Principles for Corporate Governance in the Commonwealth (1999)**

- to ensure that the corporation complies with all relevant laws, regulations and codes of best business practice;
- To ensure that the corporation communicates with shareholder and other stakeholders effectively;
- To server the legitimate interests of the shareholders of the corporation and account to them fully;
- To regularly review processes and procedures to ensure the effectiveness of its internal systems of control, so that its decision making capability and the accuracy of its reporting and financial results are maintained at a high level at all times;
To ensure annually that the corporation will continue as a going concern for its next fiscal year.

**Rotation of Auditors:**

The idea of rotation is governed by the principle of independence only as it is felt that over a period of time (say 5 years or more), auditors tend to develop generally, a sort of relationship wherein management starts confiding its weaknesses and other fragile acts with a view to seek advise on how to overcome those weaknesses or to shield those acts. It is here that auditor’s independence is attached and compromise with audit duty prevents the auditors to express the true view, as he starts playing a dual role of advisor and auditor.

Rotation may be viewed as a deterrent for auditors in their allowing companies to indulge in accounting malfeasance by providing a new of fresh insight by new auditors. Rotation of auditors may result in disassociation of auditors with companies and more equitable distribution of audit work among professional but it needs to be vigiled whether it would bring in the desired results. The international practice is also tilted against the rotation of auditors. Even if it is allowed, there may be situations of tie up arrangements, which are reciprocal in nature. This would also result in reorganization of audit firms with the objective of retaining the client. Auditor’s independence is governed by law and personal ethics. A true auditor will never allow his independence to be diluted at the cost of integrity or greed thus putting his professional career at stake. Rotation of auditor will also result in time and cost inefficiencies resulting in dilution of quality of audit work. It would also deprive the corporate managements to have auditors who are specialized in certain specific industries like power, insurance, banking etc. leading to loss of expertise. Rotation will also not provide any incentive for the retiring auditors to give their best performance. Above all, peer review, recently introduced would suffice as an alternative to rotation. If such a review is adverse, it shall certainly call for rotation or change in auditor. Even if rotation is allowed, there exists no guarantee of a good corporate governance on the part of company because governance is an issue of attitude and mindset, not the auditor’s appointment. The independence of an auditor is well taken care of by audit committee and peer review. Pressures from peer review will also force auditors to adhere to rules for the fear of losing credibility.

The policy of retiring auditors on the basis of rotation may look ideal and appealing but it will certainly affect quality of audit and ultimately stakeholders will not get the high quality accounts emerging from objectivity and knowledge of the auditor. The quality of audit is not solely dependent on rotation of auditor but mainly on other factors such as auditor’s experience, training, integrity and the involvement of auditor in the assignment. Independence and objectivity of auditors; knowledge base, understanding of accounting, auditing and professional standards, understanding and knowledge of auditee’s business- all are relevant. In India, there are already several safeguards in place to decide against rotation of auditors, at least for the time being.

While rotation of auditors could be a possible experimental solution to the issue of independence and freedom of auditor, the following remedial measures should also be considered:

- Appointment of joint statutory auditors.
- Mandatory appointment of internal auditor.
- Mandatory requirement for audit committee irrespective of size, nature, capital or turnover
- Strengthening the procedure for appointment of auditors and fixing their remuneration.
- Making auditors more responsible and accountable.
- Restriction on acceptance of other assignments of auditee company
**Non Audit Services by Auditors**

The Naresh Chandra Committee has provided an explicit list of prohibited non-audit services. One of the recommendation states that the following services should not be provided by an audit firm to any client (auditee)

- Accounting and book keeping services relating to accounting records or financial statements of the auditee
- Internal audit services
- Financial information system design and implementation
- Services related to IT Systems for preparing financial or management accounts and information flows by company.
- Actuarial services.
- Broker, dealer, investment adviser or investment banking services.
- Outsourced financial services.
- Management functions including provision of temporary staff to auditee.
- Any form of staff recruitment including hiring of senior management staff for auditee
- Valuation services and fairness opinion.

It also suggests that in case the audit firm undertakes any such service or other services, it should be done only with the approval of audit committee of the company. It is only hoped that recommendation would not result in any conflict between professional engagements and independence. What is required is a reasonable degree of self restraint and an arms length distance between the functional relationship between the both auditor and auditee and between the audit task and other function.

**Independence of Directors**

Independent directors are non-executive external directors independent of the management and are free of any interest, monetary or otherwise, and who can be easily perceived to be independent by outsiders, insiders and stakeholders.

Clause 49 of Listing agreement of SEBI stipulates that independent directors are directors who apart from receiving directors remuneration, do not have any other pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the board may affect independence of judgment of the director. Except in the case of government companies, institutional directors on the boards of companies should be considered as independent directors whether the institution is an investing or a lending institution.

The Sarbanes Oxley Act, 2002 of USA states that a director is independent if he does not accept any consulting, advisory or other compensatory fee from the public company and is not affiliated to the company or any of its subsidiaries. According to NASDAQ stock exchange’s view, an independent director is a person who is not a officer or employee of the company or its subsidiaries or any other individual having a relationship which is the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities as a director of a company.

The Naresh Chandra Committee has also examined the issue of independent directors and recommended that independent directors must comprise a majority on the board or at least form 50 percent of the total board strength. It has defined the term ‘independent director’ clearly

It has come out with a precise definition of independent director who essentially is a non executive director who –
1. Apart from receiving director’s remuneration, does not have any material pecuniary relationships of transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;

2. Is not related to promoters or management at the board level, or one level below the board (spouse and dependent, parents, children or siblings);

3. Has not been an executive of the company in the last three years;

4. Is not a partner or an executive of the statutory auditing firm, the internal audit firm that are associated with the company, has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity.

5. Is not a significant supplier, vendor or customer of the company;

6. Is not a substantial shareholder of the company, i.e. owning 2 percent or more of the block of voting shares?

7. Has not been a director, independent or otherwise, of the company for more than three terms of three years each (not exceeding nine years in any case);
   - An employee, executive director or nominee of any bank, financial institution, corporations or trustee of debenture and bond holders, who is normally called a ‘nominee director’ will be excluded from the pool of directors in the determination of the number of independent directors. In other words, such a director will not feature either in the numerator or the denominator.
   - Moreover, if an executive in, say, Company X becomes an non-executive director in another Company Y, while another executive of Company Y becomes a non-executive director in Company X, then neither will be treated as an independent director.

It is suggested that an independent agency should maintain a panel of independent directors to be nominated to corporate boards. The panel may have people from various quarters such as professionals, management consultants, technocrats, administrators, educationists, and scientists etc who are well versed in their respective fields and are capable of providing value addition to the quality of board decisions. This independent agency could be one of the regulatory bodies like SEBI or DCA or an Oversight Board, which could also oversee the functioning of directors. These directors may be asked to attend a minimum number of board and committee meetings to justify their contribution and be subjected to training an enhancement of skills. The so-called independence of board members should become a reality so that India can achieve a real good governance environment.

The independence of directors would enhance the quality of composition of board, improve corporate decisions and bring in desired governance principles. Independent directors will also play fearless, selfless and proactive role in crucial committees like audit committee.

The committee also recommends that non-executive directors should also be absolved from certain civil and criminal liabilities such as under the Companies Act, Negotiable Instruments Act etc. This emanates from the concern that people of eminence are reluctant to join corporate boards because of the fear of possible prosecution and its adverse consequences. To attract good people on board, only executive and whole time directors should be penalized. In fact, India needs to frame a separate code for independent and non-executive directors in respect of their responsibilities and accountability in contrast to the prevailing ones, which applies uniformly to all directors, in order to achieve, the
desired results. It does not call for total immunity to such directors but we also do not want silent spectators to violations of law and promoter’s enrichment at the cost of small stakeholders. Those independent directors who do not discharge their functions diligently may also have to suffer some penalties, besides removal. Today, prominent people and experts are shying away from accepting board positions because Indian laws are stringent and which allow their prosecution even for minor offence. It has truly considered this aspect of governance as such directors only attend 4.5 board meetings in a year and they should not be arrested or prosecuted for offences like bouncing of cheque etc. or other violations of which they do not have an knowledge in routine functioning of the company.

Whether independent directors should also be subjected to rotation to maintain independence remains an unanswered question. Many feel that the sitting fee, stock options and commissions etc paid to such directors make such positions attractive where independence is impaired. There are issues and concerns for and against this and rotation of independent directors is a question, which needs to be publicly debated.

To conclude, it can be said that auditors need to serve the entrepreneurs, captains of industry and corporate as agents and help in wealth creation and achieving corporate excellence. The message is loud and clear. One can not ill afford to be silent, overlooking and laid back. Doing nothing is not an option.

Shareholders require auditors to work with and not against management while always remaining professionally objective – that is to say applying their professional skills impartially and retaining a critical detachment and a consciousness of their accountability to those who formally appoint them.

Compliance Certificate by Statutory Auditors’

As per paragraph VIII of Clause 49 (paragraph IX of revised clause 49) of the Listing Agreement, the entity is required to obtain a certificate from the auditors of the entity as regards compliance of conditions of corporate governance as stipulated in that clause. This certificate is required to be annexed with the Directors’ Report, which is sent to the stock exchange (s) along with the Annual Returns filed by the entity. The expression “auditors of the company” would mean the auditors appointed to audit the financial statements of the entity under the relevant statutes.

The auditor should also ascertain whether minimum information was made available to the board as given in Annexure- I to clause 49 of the Listing Agreement. Non-Compliance of any mandatory requirement, i.e. which is part of the listing agreement with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in Enclosure-I and List of non-mandatory requirements is given in Enclosure-II.

Enclosure-I

Enclosure referred to in report on Corporate Governance

1. A brief statement on Company’s philosophy on code of governance.
2. Board of Directors:
   - Composition and category of directors, for example, promoter, executive, non-executive, independent non-executive, nominee director, which institution represented as Lender or as equity investor.
   - Attendance of each director at the Board of Directors meetings and the last AGM.
   - Number of other Board of Directors or Board Committees he/she is a member or Chairperson of
3. **Audit Committee**
   - Number of Board of Directors meetings held, dates on which held.
   - Brief description of terms of reference
   - Composition, name of members and Chairperson.
   - Meetings and attendance during the year.

4. **Remuneration Committee**
   - Brief description of terms of reference.
   - Composition, name of members and Chairperson.
   - Attendance during the year.
   - Remuneration policy.
   - Details of remuneration to all the directors, as per format in main report.

5. **Shareholders Committee**
   - Name of non-executive director heading the committee.
   - Name and designation of compliance officer.
   - Number of shareholders complaints received so far.
   - Number not solved to the satisfaction of shareholders.
   - Number of pending share transfers

6. **General Body Meetings**
   - Location and time where last three AGMs held.
   - Whether special resolutions were put through postal ballot last, details of voting pattern.
   - Person who conducted the postal ballot exercise.
   - Procedure for postal ballot.

7. **Disclosures**
   - Disclosures on materially significant related party transactions, i.e. transaction of the company of material nature, with its promoters, the directors or the management, their subsidiaries or relatives, etc. that may have potential conflict with the interest of company at large.
   - Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets during the last three years.

8. **Means of communication**
   - Half-yearly report sent to each household of shareholders.
   - Quarterly results.
   - Which newspapers normally published in
   - Any website where displayed official news releases; and
   - The presentations made to institutional investors or to the analysts.
   - Whether MD & A is a part of annual report or not.

9. **General Shareholders information**
   - AGM: Date, time and venue.
   - Financial calendar.
   - Date of book closure.
   - Dividend payment date.
   - Listing on Stock Exchanges.
• Stock Code
• *Market Price Data:* High, Low during each month in last financial year.
• Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index, etc.
• Registrar and Transfer agents.
• Share Transfer Systems.
• Distribution of shareholding.
• Dematerialization of shares and liquidity.
• Outstanding GDRs/ ADRs/ Warrants or any convertible instruments, conversion dates and likely impact on equity.
• Plant Locations.
• Address for correspondence.

**Enclosure –II - Non-mandatory requirements**

:A- *Chairman of the Board:*

A non-executive Chairman should be entitled to maintain a Chairman’s Office at the company’s expense and also allowed reimbursement of expenses incurred in performance of his duties.

*B- Remuneration Committee:*

I. The board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company’s policy on specific remuneration packages for executive directors including pension rights and any compensation payment.

II. To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors should comprise of at least three directors, all of whom should be non-executive directors, the Chairman of Committee being an independent director.

III. All the members of the remuneration committee should be present at the meeting.

The Chairman of the remuneration committee should be present at the Annual General Meeting to answer the shareholders queries. However, it would be up to the Chairman to decide who should answer the queries.
Session VII & VIII

Session Title:
Audit Committee - Need and Constitution, Functions, Audit Committee as a tool of Corporate Governance.

Audit Committee

Sub-clause II (A) of clause 49 specifies that the Board shall arrange a competent and independent Audit Committee and give its stipulations. While the requirement of clause 49 pertain to all listed companies, provisions of section 292A of the Companies Act, 1956 relate to every public limited company having a paid-up share capital of rupees five crore or more, such companies shall comprise a Committee of the Board christening the same as Audit Committee. Audit Committee can be comprised both under the provisions of section 292A of the Companies Act, 1956 and in terms of the references of sub-clause II of clause 49 of Listing Agreement

Structure

The Audit Committee shall operate in conformity with the terms of reference under SEBI clause 49 of listing agreement, such further provisions as may be predetermined under Listing Agreement with Stock Exchanges where companies shares are traded, the Companies Act 1956 and other laws in force and any amendment or re-enactment, and the requirements as defined by the Board as and when required.

Qualified and Independent Audit Committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:

(i) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

(ii) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

Explanation 1:- The term "financially literate" means the ability to read and understand basic financial statements, i.e., balance sheet, profit and loss account, and statement of cash flows.

Explanation 2:- A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(iii) The Chairman of the Audit Committee shall be an independent director;

(iv) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;

(v) The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;

(vi) The Company Secretary shall act as the secretary to the committee.

Meeting of Audit Committee

The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.
**Powers of Audit Committee**

The audit committee shall have powers, which should include the following:

1. To investigate any activity within its terms of reference.
2. To seek information from any employee.
3. To obtain outside legal or other professional advice.
4. To secure attendance of outsiders with relevant expertise, if it considers necessary.

**Role of Audit Committee**

The role of the audit committee shall include the following:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
2. Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.
3. Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
4. Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:
   (a) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2 AA) of section 217 of the Companies Act, 1956
   (b) Changes, if any, in accounting policies and practices and reasons for the same
   (c) Major accounting entries involving estimates based on the exercise of judgment by management.
   (d) Significant adjustments made in the financial statements arising out of audit findings
   (e) Compliance with listing and other legal requirements relating to financial statements
   (f) Disclosure of any related party transactions
   (g) Qualifications in the draft audit report.
5. Reviewing, with the management, the quarterly financial statements before submission to the board for approval.
6. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.
7. Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.
8. Discussion with internal auditors any significant findings and follow up there on.
9. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
10. Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
11. To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividends) and creditors.
12. To review the functioning of the Whistle Blower mechanism, in case the same is existing.
13. Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

Explanation (i): The term "related party transactions" shall have the same meaning as contained in the Accounting Standard 18, Related Party Transactions, issued by , the Institute of Chartered Accountants of India.

Explanation (ii): If the company has set up an audit committee pursuant to provisions of the Companies Act, the said audit committee shall have such additional functions/features as is contained in this clause.

Review of information by Audit Committee

The Audit Committee shall mandatorily review the following information:
1. Management discussion and analysis of financial condition and results of operations;
2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;
3. Management letters/letters of internal control weaknesses issued by the statutory auditors;
4. Internal audit reports relating to internal control weaknesses;
5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.
6. The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company

Responsibilities of the Audit Committee

The Audit Committee will help the Board with its duty for supervising the reliability and truthfulness of the accounting, auditing, and reporting procedure of the Company and its observance with the statutory and regulatory provisions. The Committee’s rationale is to administer the overall accounting, costing and financial reporting practices of the Company, the audits of the Company's financial statements, the qualifications, independence and performance of the statutory auditors, the cost auditors the performance of internal auditors and companies policies thereto.

Arrangement of Members:

The Committee shall comprise such number of members as the Board is able to decide as and when required, but whatever the case may be not less than three. Two-third of the members of the Audit Committee must be Independent Directors as stipulated in the Listing Agreement clause 49. Every members of the Committee shall be ‘financially literate’ and the Committee will have at least one member who shall have financial and accounting proficiency. The Company Secretary shall act as the Secretary to the Committee. The Annual Report of the Company shall disclose the composition of the Audit Committee.

Composition of Audit Committee Constituted in terms of Section 292A of Companies Act

The Committee shall be made up of no less than three directors and such number of other directors as the Board may decide on. Two-thirds of the total, number of members of the committee shall be directors other than managing or whole time directors. Members of the committee shall elect a chairman from amongst themselves. The Annual Report of the Company shall disclose the composition of the Audit Committee.

The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and take part in meetings of the Audit Committee however they shall not have the authority to vote.
Chairman:
The Chairman of the Audit Committee can be chosen by the Board at the instant of establishment / reestablishment of the Audit Committee. The members of the Committee can also elect the Chairman among themselves as per section 292A of the Companies Act, 1956. The Chairman of the Audit Committee shall be an independent director. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries.

Nature of Recommendations of the Audit Committee
The suggestions of the Audit Committee, comprises under section 292A of the Companies Act, on every subject with respect to financial management together with the Audit Report, shall be de rigueur on the Board. In case the Board does not agree to the suggestions of the Audit Committee, it shall record the basis for that. These reasons should be communicated to the shareholders.

Default
If a default is made in complying with the provisions of section 292A of the Companies Act, 1956, the company and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees or with both.

Powers of the Audit Committee
As per Clause 49-II(C), the powers of the Audit Committee shall include the following:
(a) To investigate any activity within its terms of reference
(b) To seek information from any employee
(c) To obtain outside legal or other professional advice
(d) To secure attendance of outsiders with relevant expertise, if it considers necessary.

Reconstitution:
There is no bar in listing agreement on reconstitution of Audit committee so The Board may at its discretion reconstitute the Audit Committee at any time.

Business of Meetings:
The Chairman of the Committee, in discussion with the Committee members, confirm the program and regularity of the audit Committee meetings.
The Committee shall meet at least four times every financial year. The program shall indicate the broad list of items to be converse and deliberated at every meeting to make certain that the Committee’s obligations are completely met. Generally, the Audit Committee meetings took place prior to Board meetings. If the Committee consider necessary additional meetings can be called. The Committee can call Head of Finance, representatives of the Internal Auditors, Statutory Auditors and Cost Auditors, or any other personnel to attend the Audit Committee meetings.

Agenda
The Chairman of the Committee shall approve the Agenda for every meeting, with the advice of the management. Prior communication of the agenda item and workings, concerning the business to be conducted at each meeting, shall be, to the extent that is convenient, communicated to the members well in advance before each meeting, to facilitate meaningful overview.

Meeting proceedings:
As per Clause 49-II (B), Audit Committee constituted in terms of Clause 49 of the Listing Agreement, shall meet at least four times in a year and not more than four months shall elapse between two meetings. The Committee shall make sure to facilitate, minutes of all its proceedings

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are protected and reports on its proceedings and activities are put up at the subsequent meeting of the Board. As a general rule, the Secretary of the Committee put in writing the minutes of the Committee meeting which is then considered and permitted by the Chairman of the meeting for distribution to the other members of the Committee for their comments. In most cases, the final minutes are noted at the subsequent meeting of the Committee and signed by the Chairman of the meeting. On the whole, the Committee is regulated by the similar rules with reference to meetings, notice and voting requirements as are applicable to the Board.

Quorum
The quorum for the function of the Committee meetings shall be any two members or one third of the members of the Committee, there in person, whichever is higher but there should be a minimum of two independent directors present.

Authority
The Audit Committee, constituted in reference to section 292A of the Companies Act, shall have power to:

- To examine any proposal covered under this section;
- To inquire about any particular information, as necessary, from any employee of the Company and the said employee(s) shall assist with the command of the Committee;
- To get legal or other independent professional opinion and secure attendance of outsider(s) with relevant experience if the same is suppose to be essential;
- The Company shall bear all expenses of the Committee.

Role of Audit Committee as per Clause 49-II (D), role of Audit Committee shall include the following Responsibilities

The Audit Committee’s exact duties in execution of its role are given in the revised Clause 49 of the Listing Agreement. In a few words, the Committee’s duties are classified under following broad categories:

Financial Statements and Related Disclosures
- Appraisal and discussion with management and external auditor(s), the financial results together with Management Discussion and scrutiny of Financial Condition and operating results.
- Evaluation of significant accounting policies, financial reporting and accounting standards and principles and their applicability to the company, their updating and significant accounting conclusions and results influencing the Company’s financial statements and disclosures. This shall incorporate validation for alternative choices and feasible decisions.
- Appraisal of the risk management policies periodically and make recommendations to the Board
- Review with the external auditors any audit problems or difficulties and management’s response to the same.

Statutory Auditors’ Qualifications, Independence, Remuneration and Performance
- The Committee’s recommendation for appointment and reappointment of statutory auditors is annually submitted to the Board for placing before the shareholders for approval. If required, the replacement or removal of the statutory auditor and the fixation of audit fees.
- Give consent to the audit and also decide any non-audit services to be provided by the statutory auditors.
- Oversight / overview of the statutory auditor including resolution of disagreements between management and the statutory auditor.
- Review with the management and the statutory auditor, the scope, planning and staffing of the proposed audit on an annual basis.
Follow and review all relationships between the Statutory Auditor and the Company. The Committee shall annually confirm the independence of the Statutory Auditors on the basis of the submission regarding his independence and its review by the committee.

Internal Audit

Reviewing, with the management, performance of internal auditors and the adequacy of the internal control systems.

Reviewing the sufficiency of internal audit function, if any, on its size, experience and ability to function as Internal Auditors including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.

Discussion with the internal auditors of the scope of audit, on the performance of the internal audit and on any significant consequence and follow up there on.

Appraisal of the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.

Observance with Regulatory Requirements

In general, the Committee shall observe compliance with listing and other legal requirements relating to financial statements. The Committee shall obtain information from the management on any legal issue, as may be statutorily necessary and inquiries from regulatory or governmental agencies on the financial matters of the Company. On the whole, the Committee shall assess all such matters with the management, and take any internal or external advice, as the Committee deems fit.

Other Duties

1. In Disclosure of any related party transactions, The Committee may perform such functions in this regard, as may be required and suitable for the performance of its oversight function in this matter.

2. Discuss all the qualifications in the draft audit report. It is the responsibility of the Company’s management to prepare the financial statements in accordance with applicable laws and regulations.

3. Reviewing, with the management, the quarterly financial statements before submission to the board for approval.

4. The members of the Audit Committee and all other persons attending the meetings of the Audit Committee should not reveal confidential matters.

Statutory Requirements on authority and responsibilities of the Audit Committee

According to the revised Clause 49 of the Listing Agreement, the Audit Committee shall have the following powers/role:

- To investigate any matter in its terms of reference.
- To ask for information from any employee.
- To take outside legal or other professional advice.
- To call outsiders with relevant expertise, if it considers necessary.
- Supervision of the Company's financial reporting process and the disclosure of its financial information to confirm that the financial statement is correct, satisfactory and trustworthy.

- Suggesting to the Board, the appointment, re-appointment and, if necessary, the replacement / removal of Statutory auditor and fixation of audit fees.
- Sanction of fee to Statutory Auditors for any other services rendered by the Statutory Auditors.
Appraisal with the management, the annual financial statements before submission to the Board for approval, with particular reference to:

- Matters required to be included in the Directors’ Responsibility Statement to be included in the Board’s report in terms of clause (2AA) of Section 217 of the Companies Act, 1956.
- Changes, if any, in accounting policies and practices and reasons for the same.
- Major accounting entries involving estimates based on the exercise of judgment by management.
- Significant adjustments made in the financial statements arising out of audit findings.
- Compliance with listing and other legal requirements relating to financial statements.
- Disclosure of related party transactions.
- Qualifications in draft audit report.
- Reviewing, with the management, the quarterly financial statements before submission to the Board for approval.
- Reviewing, with the management, the performance of statutory and internal auditors, adequacy of internal control systems.
- Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure, coverage and frequency of internal audit.
- Discussion with internal auditors any significant findings and follow up there on. Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of material nature and reporting the matter to the Board.
- Discussion should be held with statutory auditors, before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern. The Audit Committee should look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividends) and creditors.
- To review the functioning of the Whistleblower Mechanism.
- To carry out such other function as may be specifically referred to the Committee by the Board of Directors and/or other Committees of Directors of the Company.
- To review the following information:
  - The Management deliberation and evaluation of financial condition and operating results.
  - Declaration of significant related party transactions, put forward by management.
  - Management letters / Notes of internal control weaknesses issued by statutory auditors;
  - Internal audit reports relating to internal control weaknesses; and
  - The appointment, removal and terms of remuneration of the Internal Auditor if an outside agency carries it out.
  - Reviewing the financial statements and in particular the investments made by the Unlisted Subsidiaries of the Company.

RECOMMENDATIONS OF NARESH CHANDRA COMMITTEE

The Committee has suggested that the role and operations that an Audit Committee is believed to fulfill in a company should be plainly written in an Audit Committee Charter. Speaking
about the Audit Committee, the Committee recommended that besides disclosing the names of members of the Audit Committee and the dates and timings of meetings, the Chairman of the Audit Committee should annually certify whether and to the extent every function scheduled in the Audit Committee was executed in that financial year.

This disclosure shall also give a concise and precise report of the work carried out by the Audit Committee, which would comprise the Audit Committee's views on the adequacy of internal control mechanism, risks, qualifications in audit reports, reasons for the Audit Committee for accepting and recommending the financial statements with qualifications. The statement should also certify whether the Audit Committee met with the statutory and internal auditors of the company without the management being there, and whether such meetings exposed materially important issues or risk.

Naresh Chandra Committee has defined further few more roles for the Audit Committee. In the context of disqualifications for audit assignments the Committee has recommended (recommendation 2.1) as under:

**Prohibition of personal relationships**, which would exclude any partner of the audit firm or member of the engagement team being a 'relative of any of the key officers of the client company, i.e. any whole-time director, CEO, CFO, Company Secretary, senior manager belonging to the top two managerial levels of the company, and the officer in default (as defined by section 5 of the Companies Act). In case of any doubt, it would be the task of the Audit Committee to determine whether the individual concerned is a key officer.

**List of prohibited non-audit services**: The Committee has further recommended (recommendation 2.2) that an audit firm should not provide the following services to any audit client:

- Accounting and book keeping services related to the accounting records or financial statements of the audit client.
- Internal audit services
- Financial information systems design and implementation, including services related to IT systems for preparing financial or management accounts and information flow.
- Actuarial services.
- Broker, dealer, investment adviser or investment banking services.
- Outsourced financial services.
- Management functions, including the provision of temporary staff to audit clients.
- Any form of staff recruitment, and particularly hiring of senior management staff.
- Valuation services and fairness opinion.

The Committee has further recommended that in case the audit firm undertakes any service other than audit, or the prohibited services listed above, it should be done with the approval of the Audit Committee.

**MANAGEMENT'S CERTIFICATION IN THE EVENT OF AUDITOR'S REPLACEMENT**

The Naresh Chandra Committee pointed out the provisions of section 225 of the Companies Act and recommended its amendment so as to require a special resolution of shareholders, if in case an auditor, while being eligible for re-appointment, is sought to be replaced (recommendation 2.7).

The Committee further suggested that the descriptive statement attached to such a special resolution must divulge the management's explanations for such a replacement, on which the outgoing auditor shall have the right to comment. Pointing to the role of Audit Committee in this
matter, the Committee recommended that the Audit Committee would have to verify that this explanatory statement is 'true and fair'.

**AUDITOR’S ANNUAL CERTIFICATION OF INDEPENDENCE**

The Committee suggested that it would be a sound policy for the audit firm to annually furnish a certificate of independence to the Audit Committee of the Client Company. This will support in confirming that the auditors are independent during the audit tenure.

In these circumstances, Naresh Chandra Committee recommended (recommendation 2.8) that a certificate of independence must be submitted to the Audit Committee or to the Board of Directors of the client company, by the audit firm before agreeing to be appointed the auditor, certifying that the firm, together with its consulting and specialized services affiliates, subsidiaries and associated companies:

1. Are independent and have arm’s length relationship with the client company;
2. Have not engaged in any non-audit services listed and prohibited as mentioned in recommendation 2.2 above,
3. Are not disqualified from audit assignments by virtue of breaching any of the limits, restrictions and prohibitions as mentioned in recommendation 2.1 above.

In the event of any inadvertent violation relating to recommendations 2.1 and 2.2, the audit firm will immediately bring these to the notice of the Audit Committee or the Board of Directors of the client company, which is expected to take prompt action to address the cause so as to restore independence at the earliest, and minimize any potential risk that might have been caused.

The Committee felt that the Audit Committee should be allowed to be true to their name by ensuring that they have a larger role with regard to audit. In fact this should be the starting point in empowering Audit Committees. Therefore the Committee recommended as follows:

**APPOINTMENT OF AUDITORS**

Recommendation 2.9 of the Committee suggested that the Audit Committee of the Board of Directors shall be the first point of reference regarding the appointment of auditors. To discharge this responsibility, the Audit Committee shall:

- Discuss the annual work programme with the auditor;
- Review the independence of the audit firm in line with recommendations 2.1 and 2.2 above; and
- Recommend to the board, with reasons, either the appointment/reappointment or removal of the external auditor, along with the annual audit remuneration

Exception to this rule cover, Government Companies (which follow section 619 of the Companies Act) and scheduled commercial banks (where the RBI has a role to play)

**CEO AND CFO CERTIFICATION OF ANNUAL AUDITED ACCOUNTS**

Referring to section 302 of the SOX Act, the Committee deliberate that this Act indicates that the CEO and CFO of all listed companies must confirm to the SEC concerning the authenticity of every annual and quarterly financial report. The committee considered the management certification issue and furnish that it represent a good corporate governance practice. Naresh Chandra Committee has recommended that for all listed companies as well as public limited companies whose paid-up capital and free reserves exceed Rs. 10 crore, or turnover exceeds Rs. 50 crore, there should be a certification by the CEO (either the Chairman or the Managing Director) and the CFO (whole-time Finance Director or otherwise) which should state that, to the best of their knowledge and belief:
They, the signing officers, have reviewed the balance sheet and profit and loss account and all its schedules and notes on accounts, as well as the cash flow statements and the Directors' Report.

These statements do not contain any material untrue statement or omit any material fact nor do they contain statements that might be misleading.

These statements together represent a true and fair picture of the financial and operational state of the company, and are in compliance with the existing accounting standards and/or applicable laws/regulations.

They, the signing officers, are responsible for establishing and maintaining internal controls which have been designed to ensure that all material information is periodically made known to them; and have evaluated the effectiveness of internal control systems of the company.

They, the signing officers, have disclosed to the auditors as well as the Audit Committee deficiencies in the design or operation of internal controls, if any, and what they have done or propose to do to rectify these deficiencies.

They, the signing officers, have also disclosed to the auditors as well as the Audit Committee instances of significant fraud, if any, that involves management or employees having a significant role in the company's internal control systems.

That, the signing officers, have indicated to the auditors, the Audit Committee and in the notes on accounts, whether or not there were significant changes in internal control and/or of accounting policies during the year under review.

In the event of any materially significant misstatements or omissions, the signing officers will return to the company that part of any bonus or incentive or equity based compensation, which was inflated on account of such errors, as decided by the Audit Committee.
Session IX & X

Session Title:
Role of board of directors in good corporate governance.

It is one of the prime responsibilities of the Board of Directors (the “Board of the Company”) to keep an eye on the CEO and other senior management in the proficient and ethical conduct of the company on a regular basis. To accomplish this task the Directors have to assume a practical and focused approach to their position, and place standards to confirm that the company is committed to its success through maintenance of the maximum standards of accountability and ethics.

Directors carry to the company a broad variety of skill, information and judgment, and bring these skills to stand for the company. These diverse proficiency imply that good governance depends on far above a routine approach to principles and procedures. The governance organization in the company is considered to be an operational arrangement for ethical actions, useful administration and suitable adherence of both observance and performance.

Successful Directors recognize that their job calls for them to ask inquiring questions from management and to take the action required to get correct and straightforward answers. Good Directors also trust in the recommendation, reports and view of management, counsel and expert advisers. In performance of their duty, the Board continuously weighs up the qualifications of those it depends upon for information and suggestion, and also examines the process used by managers and advisers in achieving their suggestion.

In the middle of the general governance responsibilities, the Board is accountable for confirming that management uphold a system and culture of internal controls which facilitate clear, truthful reporting and communications, moral conduct, and observance of the law. The Board should evaluate the major risks factors for the company, appraise the operational performance of the company, and watch over assessment and authorization of significant corporate transactions.

Finally high-quality Board satisfies itself on keeping the latest and the best governance practices. Board, working jointly with executive and advisers, share the knowledge and information of others functioning in the domain of corporate governance for supplementary information on how to manage company’s affairs. Board should especially note down the continuing regulation of the various stock exchanges as well as the Securities and Exchange Board and other company laws, to uphold better governance. Board should continually monitor the way they govern themselves, including assessing whether there are substitutes or new ideas which would reinforce their governance structures.

With experience over the years, the corporate governance practices have developed to enable the Directors to effectively and efficiently discharge their responsibilities individually and collectively to the shareholders of the Company in the areas of fiduciary duties, oversight of the management, evaluation of the management and performance support and guidance in shaping company’s policies and business strategies.

DIRECTOR’S RESPONSIBILITIES:

The operations of the Companies are managed under the direction of the Board within the outline laid down in the Companies Act, 1956, the Listing Agreement with Stock
Exchanges and the Articles of Association of the Company. The Board is also governed by
Internal codes / measures agreed inside the Company from time to time.

The Board stands for and is responsible to the shareholders of the Companies. The
Boards primarily required giving and evaluating the strategic direction of the Company,
management policies and their helpfulness. The Board’s tasks in additionally include
overseeing the functioning of the Company’s top management and monitoring legal
observance and the management of risks related to the Company’s function. Board
members are supposed to act in good confidence and with proper concern so as to take
their judgments on an informed basis in what they reasonably and sincerely consider to be
in the best interests of the Company and its shareholders.

**Non Statuary (Fiduciary) Duties**

Directorships are regarded as ‘positions of trust’ not firmly classified by any law. The
Board all together and the Directors as individuals have some fiduciary duties to the
Company as a unit and to its shareholders. Directors are supposed to act for the benefit of
all shareholders / stakeholders of the Company in conformity with the Memorandum and
Articles of Association of the Company. The Directors must follow the following principles
in fulfilling their fiduciary responsibilities the fiduciary duties of Directors within the
framework of law are as under:

- Directors must remain themselves conversant of all matters associated with the
  Company and its transactions;
- The fundamental role of the Directors is to exercise their business judgment to act in
  what they reasonably believe to be the best interests of the Company and its
  shareholders
- Directors always have to act together as a Board, for this they are particularly endorsed
  by the Board and its Committees;
- Directors are expected to rigorously prepare for, attend and participate in all Board and
  applicable committee meetings, and to spend the time needed and meet as often as
  necessary to properly discharge their obligations;
- Directors have to put up queries or tell their apprehensions, if at all;
- Directors are accountable for their decisions on specified subject;
- Directors must not reveal classified information except specifically allowed to do so by
  the Board itself or its Working group or as may be necessary in business on behalf of the
  Companies;
- Directors are supposed to make known their individual and business interest on any
  issue put up before the Board and go without voting on such matters;
- Board’s decision must be reverberated by its minutes and the Directors should ensure it.

**Duty of faithfulness to act in agreement and consistently put the goals of the
Company ahead of the individual Director**

Directors ought to be unbiased on any pecuniary or self-interest during their
dealings for/ or with the Company. If shirking is unavoidable in a specific circumstances
then such business must be permitted by non- interested Directors in a approach that
confirm arms length transactions with the right of the non-interested Directors to reject the
transaction as such. Independent Directors should positively evaluate conflict-of-interest
transactions.

**Responsibility to take well-informed decisions**
Responsibility of directors includes individual responsibility and is towards the Company. Directors must apply due diligence in supervising the management of the affair of the Company. Directors should jointly and personally, act carefully in performing their duties. Directors are supposed to be present at all Board and Committee meetings. Due diligence requires that a Director himself pay attention to all relevant information practically obtainable prior to a business decision. This duty also necessitates Directors to update themselves of options to a proposed business decision. The Directors may require whichever information they deem fit before taking decisions.

**Responsibility to perform in trust as per company’s codes and guidelines and the good governance practices**

The responsibility of good faith necessitate that the Directors make sure that all the required practices are pursued to achieve decisions which are in the best interests of the Company.

**Responsibility of the Board and Management**

The Board of Directors is at the top of organization representing the shareholders for administering the overall performance of the actions and performance of the Company. The Board functions under the overall direction of the Chairman and Managing Director (CMD) to assure that the long-term interests of the shareholders are being served. The CMD is assisted by the Executive Directors / senior managerial personnel in overseeing the functional matters of the Company.

**Functions of the Board**

The Board of Directors shall meet periodically to consider matters as required under law and to consider, review and discuss reports by management on the performance of the Company, its plans and prospects as well as immediate issues facing the company. In addition to its general oversight of management, the Board, through itself or through its Committees shall perform a number of specific functions, including:

- Selecting, advising, evaluating and compensating the CMD and overseeing Oversight of Selection and Performance of Other Executive Officers and top management succession planning;
- Providing advice and supervision on the selection, appraisal, improvement and reimbursement of senior management;
- Appraisal, observing and wherever proper, endorsing financial and business plan and main corporate events;
- Observing corporate performance vis-à-vis business strategy, including supervising operating results on a continues basis to assess whether the business is being acceptably managed;
- Evaluating major hazards to the Company and assessment of options for their reduction / prevention;
- Analyzing and approving material transactions not in the regular course of business;
- Confirming procedure are prepared for supporting the reliability of the Company as per truthfulness of the financial statements, observance of regulation and ethics, and substances of relationships with customers, suppliers and other stakeholders;
• Observing that the Company is in conformity with all related legal and lawful requirements;
• Safeguard and enrichment of Shareholders’ value.

Role of the Independent Directors

The CII’s Task Force and the Kumar Mangalam Birla Committee at length discussed the matter of independent directors. The Task Force made-up in its report that "the identities of members of Board crucial to excellence is of course obvious. Equally vital, however are their individual competencies, experience and track record, which must match the business that the company is in. And a mix of operational managers, who have the insider’s perspective and external professionals, who bring in the outsider's cool detachment, will provide the collective capability that a Board needs. In its report, the Task Force emphasized that the key to good corporate governance is a well functioning of Board of Directors. The Board should have a core group of excellent, professionally acclaimed non-executive Directors who understand their dual role of appreciating the issues put forward by the Management and of honestly discharging their fiduciary responsibility towards company's shareholders as well as creditors". The Kumar Mangalam Committee was of the view that the term 'independence' be suitably, correctly and reasonably defined, so that the definition itself does not develop into a constraint in the selection of independent directors on the Boards of companies, The benchmark of the independence is the material pecuniary relationships or transactions of the non-executive directors with the company. this type of relationships or transactions may at times influence the independence of a director, In this perception Birla Committee approved the following definition of independence:

"Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the Board may affect their independence of judgment",

The Kumar Mangalam Birla Committee opined that the non-executive directors i.e. those who are independent and those who are not, help bring an independent judgment to bear on Board's deliberations especially on issues of strategy, performance, management of conflicts and standards of conduct. The Committee, therefore, laid emphasis on the caliber of the non-executive directors, especially of the independent directors,

The subject involving explanation of independent director was also considered by the Naresh Chandra Committee. This committee gave a suitable reflection to the existing circumstances in the Indian and international description of independence. The definition suggested by the Committee is not exact in nature but it is more of a policy that consists of seven points as under:

An independent director of a company is a non-executive director who:

1. Apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;
2. Is not related to promoters or management at the Board level, or one level below the Board (spouse and dependent, parents, children or siblings);
3. Has not been an executive of the company in the last three years;
4. Is not a partner or an executive of the statutory auditing firm, the internal audit firm that is associated with the company, and has not been a partner or an executive of
any such firm for the last three years? This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity;

5. Is not a significant supplier, vendor or customer of the company;

6. Is not a substantial shareholder of the company, i.e. owing two percent or more of the block of voting shares;

7. Has not been a director, independent or otherwise, of the company for more than three terms of three years each (not exceeding nine years in any case);

An employee, executive director or nominee of any bank, financial institution, corporations or trustees of debenture and bond holders, who is normally called a “nominee director”, will be excluded from the pool of directors in the determination of the number of independent directors. In other words, such a director will not feature either in the numerator or the denominator. Moreover, if an executive in say, Company X becomes a non-executive director in another Company Y, while another executive of Company Y becomes a non-executive director in Company X, then neither will be treated as an independent director.

As per the advice of Narayana Murthy Committee, Independent Director has been identified as non-executive director of the company who:

- Despite receiving director remuneration, does not have any material pecuniary associations or dealings with the company, its promoters, its higher management or its holding company, its subsidiaries and associated companies,
Session XI & XII

Session Title:
CORPORATE GOVERNANCE-COMPLIANCE OF CLAUSE 41 AND 49 OF LISTING AGREEMENTS, REPORT ON CORPORATE GOVERNANCE, DIRECTOR’S RESPONSIBILITY STATEMENT.

Session Structure:
1. Compliance of clause 41 and 49 of Listing Agreements
2. Report on Corporate Governance,
3. Director’s Responsibility Statement,
4. Exercise and Group discussion.

Clause 41 of the Listing Agreement

The un-audited financial results on a quarterly basis in the proforma prescribed by SEBI/Stock Exchanges shall be furnished to the Stock Exchange within one month from the end of the quarter. In addition, a company shall prepare the half-yearly results and the same shall be approved by the board of directors and be subjected to a ‘limited review’ by the auditors of the company and a copy of the review report shall be submitted to the stock exchanges within two months after the close of the half year.

Effective from the quarter ending June 30, 2003, a company will be required to prepare un-audited quarterly financial results and the same shall be approved by the board of directors and be subjected to a limited review by the auditors of the company and a copy of the review report shall be submitted to the stock exchanges within two months after the close of the quarter.

A company shall have an option to publish audited half yearly financial results within two months instead of publishing unaudited results within one month followed by a limited review within two months.

In respect of results for the last quarter of the financial year, if the company intimates in advance to the stock exchanges that it will publish audited results within a period of three months from the end of the last quarter of the financial year, the un-audited results for the last quarter need not be published/given to the stock exchanges. It should be ensured that relevant information as may be required and specifically included in the Listing Agreement is furnished while publishing financial results.

Unaudited financial results should not substantially differ from the audited results of the company. If the sum total of the first, second, third and fourth quarterly unaudited results in respect of any item given in the same pro forma varies by 20% when compared to the audited results for the full year, the company shall explain the reasons to the stock exchanges.

Limited Review of Government Companies:

Clause 41 of the Listing Agreement with the Securities and Exchange Board of India (SEBI) provides that all the entities listed with the Stock Exchanges are required to publish their Quarterly Financial Review (QFR) with effect from quarter ending on or after June 2003, duly approved by the Board of Directors and subjected to a “limited review” by the auditors of the company (or by the Chartered Accountant in case of Public Sector
Undertakings) and a copy of the Review Report to be submitted to the Stock Exchange within two months of the close of the quarter. Public Sector Undertakings (PSUs) also have the option of getting the limited review of QFR done by any Chartered Accountant other than the auditors of the company. In addition, a listed company is required to prepare the half yearly results in the same proforma with effect from half year ending on March 31, 2000 and the same shall be approved by the Board of Directors and subjected to a “limited review” by the auditors of the company (or by the Chartered Accountant in case of Public Sector Undertakings). A copy of the Review Report is required to be submitted to the Stock Exchange within two months of the close of the half-year. In order to facilitate compliance with the provisions mentioned above, Statutory Auditors for listed central Government companies including deemed Government companies are appointed by CAG. The limited review is primarily based on the information and documents obtained from management of the companies concerned.

Clause 49 of the Listing Agreement

I. Board Of Directors

A. The company agrees that the board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors. The number of independent directors would depend whether the Chairman is executive or non-executive. In case of a non-executive chairman, at least one-third of board should comprise of independent directors and in case of an executive chairman, at least half of board should comprise of independent directors.

Explanation: For the purpose of this clause the expression ‘independent directors’ means directors who apart from receiving director’s remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the board may affect independence of judgment of the director.

B. The company agrees that all pecuniary relationship or transactions of the non-executive directors viz-a-viz the company should be disclosed in the Annual Report.

II. Audit Committee

A. The company agrees that a qualified and independent audit committee shall be set up and that:

The audit committee shall have minimum three members, all being non-executive directors, with the majority of them being independent, and with at least one director having financial and accounting knowledge;

- The chairman of the committee shall be an independent director;
- The chairman shall be present at Annual General Meeting to answer shareholder queries;
- The audit committee should invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of the internal audit
and when required, a representative of the external auditor shall be present as invitees for the meeting of the audit committee;

- The Company Secretary shall act as the secretary to the committee.

**B.** The audit committee shall meet at least thrice a year. One meeting shall be held before finalization of annual accounts and one every six months. The quorum shall be either two members or one third of the members of the audit committee, whichever is higher and minimum of two independent directors.

**C.** The audit committee shall have powers which should include the following:

- To investigate any activity within its terms of reference.
- To seek information from any employee.
- To obtain outside legal or other professional advice.
- To secure attendance of outsiders with relevant expertise, if it considers necessary.

**D.** The company agrees that the role of the audit committee shall include the following:

- Oversight of the company’s financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
- Recommending the appointment and removal of the external auditor, fixation of audit fee and also approval for the payment for any other services.
- Reviewing with management the annual financial statements before submission to the board, focusing primarily on;
- Any changes in accounting entries based on exercise of judgment by management.
- Qualifications in draft audit report.
- Significant adjustments arising out of audit.
- The going concern assumption.
- Compliance with accounting standards.
- Compliance with stock exchange and legal requirements concerning financial statements.
- Any related party transactions, i.e. transactions of the company of material nature, with promoters or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of the company at large.
- Reviewing with management, external and internal auditors, the adequacy of internal control systems.
- Reviewing the adequacy of internal audit function, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.
• Discussion with external auditors before the audit commences nature and scope of audit as well as have post-audit discussion to ascertain any area of concern.

• Reviewing the company’s financial and risk management policies.

• To look into the reasons for substantial defaults in payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividends) and creditors.

E. If the company has set up an audit committee pursuant to provision of the Companies Act, the company agrees that the said audit committee shall have such additional functions/features as is contained in the Listing Agreement.

III. Remuneration of Directors

A. The company agrees that the remuneration of non-executive directors shall be decided by the board of directors.

B. The company further agrees that the following disclosures on the remuneration of directors shall be made in section on the corporate governance of the annual report.

• All elements of remuneration package of all the directors i.e. salary, benefits, bonuses, stock options, pension etc.

• Details of fixed component and performance linked incentives, along with the performance criteria.

• Service contracts, notice period, severance fees.

• Stock option details, if any—and whether issued at a discount as well as the period over which accrued and over which exercisable.

IV. Board Procedure

A. The company agrees that the board meeting shall be held at least four times a year, maximum time gap of four months between any two meetings. The minimum information to be made available to the board is given in Annexure-I

B. The company further agrees that a director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

V. Management

A. The company agrees that as part of the director’s report or as an addition thereto, a Management Discussion and Analysis report should form part of the annual report to the shareholders. This Management Discussion & Analysis should include discussions on the following matters within the limits set by the company’s competitive position:

• Industry structure and developments.

• Opportunities and Threats.

• Segment—wise or product-wise performance.
• Outlook
• Risks and concerns.
• Internal control systems and their adequacy.
• Discussion on financial performance with respect to operational performance.
• Material developments in Human Resources/Industrial Relations front, including number of people employed.

B. Disclosures must be made by the management to the board relating to all material financial and commercial transactions, where they have personal interest that may have a potential conflict with the interest of the company at large (e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

VI. Shareholders

A. The company agrees that in case of appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:

• A brief resume of the director.
• Nature of his expertise in specific functional areas; and
• Names of the companies in which the person also holds the directorship and the membership of Committees of the board.

B. The company further agrees that information like quarterly results, presentation made by companies to analyst shall be put on company’s web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.

C. The company further agrees that a board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressing of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This Committee shall be designated as ‘Shareholder/Investors Grievance Committee’.

D. The company further agrees that to expedite the process of share transfers the board of company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

VII. Report on Corporate Governance

The company agrees that there shall be a separate section on Corporate Governance in the annual report of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted.
VIII Compliance
The company agrees that it shall obtain a certificate from the auditors of the company regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the directors’ report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual returns filed by the company.

Schedule of Implementation:
The above amendments to the listing agreement have to be implemented as per schedule of implementation given below:

- By all entities seeking listing for the first time, at the time of listing.
- Within financial year 2000-2001, but not later than March 31, 2001 by all entities, which are included either in Group ‘A’ of the BSE or in S&P CNX Nifty index as on January 1, 2000. However to comply with the recommendations, these companies may have to begin the process of implementation as early possible.
- Within financial year 2001-2002, but not later than March 31, 2002 by all the entities which are presently listed, with paid up share capital of Rs. 100 million and above, or net worth of Rs. 250 million or more any time in the history of the company.
- Within financial year 2002-03, but not later than March 31, 2003 by all the entities which are presently listed, with paid up share capital of Rs. 30 million and above.
- As regards the non-mandatory requirement they shall be implemented as per the discretion of the company. However, the disclosures of the adoption/non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

Annexure I
Information to be placed before board of directors

- Annual operating plans and budgets and any updates.
- Capital budgets and any updates.
- Quarterly results for the company and its operating divisions or business segments.
- Minutes of the meeting of audit committee and other committees of the board.
- The information on recruitment and remuneration of Senior Officers just below the board level, including appointment or removal of Chief Financial Officer and the Company Secretary.
- Show cause, demand, prosecution notices and penalty notices which are materially important.
- Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.
• Any material default in financial obligations to and by the company, or substantial non-payment for goods sold by the company.
• Any issue, which involves possible public or product liability claims of substantial nature, including any judgment or order which, may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
• Details of any joint venture or collaboration agreement.
• Transactions that involve substantial payments towards goodwill, brand, equity, or intellectual property.
• Significant labor problems and their proposed solutions. Any significant development in Human Resources/ Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme etc.
• Sale of material nature, of investments, subsidiaries, assets, which is not in normal course of business.
• Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.
• Non-compliance of any regulatory, statutory nature or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer etc.

Report on Corporate Governance:

As per paragraph VIII of Clause 49 (paragraph IX of revised clause 49) of the Listing Agreement, the entity is required to obtain a certificate from the auditors of the entity as regards compliance of the conditions of corporate governance as stipulated in that clause. This certificate is required to be annexed with the Directors’ Report, which is sent annually to all the shareholders of the entity. This certificate is also required to be sent to the Stock Exchange(s) along with the Annual Returns filed by the entity. The expression “auditors of the company” would mean the auditors appointed to audit the financial statements of the entity under the relevant statutes.

ICAI’s Guidance Note is intended to provide guidance for auditors in certification of the compliance of conditions of Corporate Governance as stipulated in clause 49 of the Listing Agreement between the Stock Exchange and the auditee entity.

The verification procedure to ensure compliance of conditions with reference to committee of directors stipulated in clause 49-IVB is given below:

The auditor should also ascertain whether the director is a member in more than ten committees or act as chairman of more than five committees across all entities in which he is a director. This information should be verified from the mandatory annual requirements for every director to inform the entity about committee positions he occupies in other companies as well as from the changes notified by every director when they take place. The Explanation to sub paragraph B of paragraph IV clarifies that the limit of the committee on which a director can serve would comprise of all public limited companies, whether listed or not and excluding private limited companies, foreign companies and companies
which are granted license under section 25 of the Companies Act, 1956. Further it also clarifies that only three committees namely Audit Committee, Shareholders/Investors Grievance Committee, Remuneration Committee shall be considered for the purpose of limit (Para 7.33).

Institute of Companies Secretaries of India (ICSI) has come out with a Note for the benefit of its members for effectively implementing the provision of corporate governance contained in the Listing Agreement.

Note on Committee of directors

- Check the number of committee of which each director is a member or Chairman across all companies in which he is a director.
- Ensure that a director is not a member in more than 10 Committees or Chairman of more than 5 Committees across all companies in which he is a director.
- If a director is holding committee positions exceeding the above limits, he should be advised to vacate positions on such number of committees so as to comply with this clause.
- Ensure that every director has informed the company about the committee positions he occupies in other companies and notify changes as and when they take place. (Explanation: For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies i.e., private limited companies, foreign companies and companies of section 25 of the Companies Act, etc shall be excluded.)

Directors' Responsibility Statement:

The Companies (Amendment) Act, 2000, has introduced section 217(2AA) by which the directors have to sign a statement which will form part of the report of the board of directors and the statement should include the following:

I. Annual Accounts have been prepared in accordance with applicable accounting standards.

II. Accounting policies—selection and application by directors are consistent, prudent so as to give a true and fair view of the accounts of the company.

III. Proper and sufficient care has been taken by them for maintenance of proper accounting records in accordance with the provisions of the Companies Act for safeguarding the assets of the company and for detecting frauds and irregularities.

IV. Accounts have been prepared on a going concern basis.

V. The penalty for non-compliance—imprisonment up to 6 months or penalty of Rs. 20000 or with both.

Disqualification of a director:

The Companies (Amendment) Act, 2000, has prescribed additional disqualification of director under section 274(1) (g) of the Act. A person is disqualified from being appointed as a director in a company when that person is already a director in a public company
which has failed to file annual accounts and annual returns for a continuous period of three financial years or has failed to repay its deposits or interest thereon or redeem its debentures and such failure continues for one year and more. It has been clarified by the DCA by a notification dated 14.01.2003, that default of privately placed bonds/debentures/debt instruments by public financial institutions will not be considered as default to disqualify directors under section 274(1)(g) of the Companies Act, 1956. The auditors are required to report in their audit report whether any director is disqualified from being appointed as a director under this section.

Important provisions are:

1. Financial statements filed with the SEC must be certified by the CEO and CFO. The certification must state that the financial statements and disclosures fully comply with provisions of the Securities Exchange Act and that they fairly present in all material respects the operations and financial condition of the issuer.

2. Each financial report that is required to be prepared in accordance with GAAP, shall reflect all material correcting adjustments.... That have been identified by a registered accounting firm.

3. Each issuer to disclose whether it has adopted a code of ethics for its senior financial officers and the contents of the code.

4. Disclosure of transactions by Directors, Officers and 10% share-holders to be done immediately.

5. To ensure that auditors of the company are not providing any other prohibited non-audit services to the company.

6. To ensure that CEO, CFO, CAO or any other equivalent person was not employed with the audit firm and not participated in any capacity in the audit of the issuer during one year period preceding the audit.

7. The financial report to disclose all material off balance sheet transactions and other relationships with unconsolidated entities.

8. To ensure that there are no personal loans/credits extended by the company to its directors or executives which are prohibited.

9. A report on management assessment of internal control to be included in annual report.

There are certain compliance requirements in connection with Foreign Corrupt Practices Act (FCPA). A compliance programme has to be made out. A compliance officer has to be designated. The employee should be advised to seek guidance from the compliance officer to avoid violations. The company’s management has to make it known throughout the organisation that there is zero tolerance for violation of the Act. A monitoring mechanism has to be established in the company. All the foreign consultancy and agency agreements should be reviewed properly to avoid violations through intermediaries. Special care has to be taken in dealing with high-risk countries. It should be ensured that violations do not take place through subsidiaries or Joint Venture Partners.
Session XIII & XIV

Session Title:
REPORTS OF IMPORTANT COMMITTEES ON CORPORATE GOVERNANCE – K.M. BIRLA COMMITTEE, NARESH CHANDRA COMMITTEE, N.R. NARAYAN MURTHY COMMITTEE, J.J. IRANI COMMITTEE

Kumar Mangalam Birla Committee Report

Securities and Exchange Board of India (SEBI) appointed a committee on corporate governance on May 7, 1999 with eighteen members under the chairmanship of Shri Kumar Mangalam Birla to promote and raise the standards of corporate governance. In early 2000, the SEBI Board accepted and drafted key recommendations of this committee and these were incorporated into Clause 49 of the Listing Agreement of the Stock Exchanges.

Mandatory recommendations

1. **Applicability**: Applicable to all listed companies with paid up share capital of Rs. 03 Crore and above.

2. **Board of Directors**: The Board of Directors of a company must have an optimum combination of executive and non-executive Directors with not less than 50 percent of the Board comprising of non-executive Directors. The number of independent Directors should be at least one third in case the company has a non-executive Chairman and at least half of the Board in case the company has an executive Chairman.

Shri Kumar Mangalam Birla Committee defines independent directors as directors who apart from receiving directors’ remuneration do not have any material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the Board may affect independence of judgment of the director.

3. **Audit Committee**:
   - A qualified and independent Audit Committee should be set up to enhance the credibility of the financial disclosures and to promote transparency.
   - The Audit Committee should have minimum 3 members, all being non-executive directors, with majority being independent, and at least one Director having Financial and Accounting knowledge.
   - The Chairman should be an independent Director and must be present at the Annual General Meetings to answer shareholders queries.
   - The Audit Committee to invite such of the executives, as it considers appropriate (and particularly the head of the finance function). In addition to head of internal audit, representative of the external auditor for the meetings.
   - Audit Committee to meet at least thrice a year with a gap of not more than six months, with one meeting necessarily before the finalization of annual accounts.
● The quorum should be either two members or one third, whichever is higher with minimum of two independent directors.

● Audit Committee specifically function as the bridge between the Board, the Statutory Auditors and the Internal Auditors.

4. **Remuneration Committee of the Board**:

● The Board of Directors to decide the remuneration of non-executive directors.

● Full disclosure of the Remuneration package of all the directors covering salary, benefits, bonuses, stock options, pension, fixed component, performance linked incentives along with the performance criteria, service contracts, notice period, severance fees etc. to be made in the section on corporate governance of the annual report.

5. **Board procedures**:

The Board meetings to be held at least four times a year with a maximum time gap of four months between any two meetings. Minimum information on annual operating plans and Capital Budgets, Quarterly Results, Minutes of Meetings of Audit Committee and other Committees, information on recruitment and remuneration of senior officers, significant Labour problems, material default in financial obligations, statutory compliance etc. should be place before the Board.

In order to ensure total commitment to the Board Meetings, a Director should not be a member in more than 10 Committees and act as Chairman of more than 3 Committees across all companies in which he is a Director.

5. **Management**: Management Discussions and Analysis (MDA) report covering industry structure, opportunities and threats, segment wise or product wise performance, outlook, risks, internal control system etc. are to form part of Directors’ Report or as an addition thereeto. In addition, disclosure must be made by the Management to the Board relating to all material financial and commercial transactions, where they have personal interest that may have a potential conflict with the interest of the company.

6. **Shareholders**: In case of appointment of a new Director or re-appointment of existing Director, information containing a brief resume, nature of expertise in specific functional areas and Companies in which the person holds Directorship/Committee Membership must be provided.

There is also specific recommendation of sharing of information like quarterly results, presentation made by the companies to analysts through company’s website.

In addition, a Board committee under the chairmanship of a non executive director is to be formed to specifically look into the redressing of shareholder complaints like transfer of shares, non-receipt of accounts, non receipt of declared dividends etc.

7. **Manner of implementation**: A separate section on Corporate Governance in the Annual Reports to be introduced covering brief statement on Company’s philosophy on code of governance, Board of Director, Audit Committee, Remuneration Committee, Shareholders’
Committee, General Body Meetings, Disclosures etc. Non compliance of any of the mandatory recommendations with reasons thereof and the extent of adoption on non-mandatory recommendations highlighted to enable the Shareholders and securities market to assess for themselves the standards of Corporate Governance followed by the company.

**Non-Mandatory recommendations**

1. **Chairman of the Board**: The chairman’s role should in principle be different from that of the chief executive, though the same executive can perform both the roles. In view of the importance of chairman’s role, a non-executive chairman should be entitled to a chairman’s office at the Company’s expense and also allowed reimbursement of expenses incurred in the performance of his duties, to enable him to discharge his responsibilities effectively.

2. **Remuneration Committee of the Board**: The company must have a credible and transparent policy in determining and accounting for the remuneration of the directors. The remuneration package should be good enough to attract, retain and motivate the executive directors of the quality required. The Board of Directors should set up a remuneration committee, to determine on their behalf and on behalf of the shareholders, with agreed terms of reference, the Company’s policy on specific remuneration packages for executive directors including pension rights and any compensation payment. The committee should comprise of at least three directors, all of whom should be non executive directors, the Chairman being an independent director. All the members must be present at the meetings for the purpose of quorum as it is not necessary for the meeting to be held very often. The Chairman should be present at the annual general meeting, to answer the shareholders queries.

3. **Shareholders’ Rights**: Half yearly declaration of financial performance including summary of the significant events in the six months, should be sent to each household of shareholders.

4. **Postal Ballot**: Currently, although the formality of holding the general meeting is gone through, in actual practice only a small fraction of the shareholders of that company do or can really participate therein. This virtually makes the concept of corporate democracy illusory. It is imperative that this situation which has lasted too long needs an early correction. In this context, for shareholders who are unable to attend the meetings, there should be a requirement, which will enable them to vote by postal ballot on key issues. Some of the critical matters which should be decided by postal ballot are given below:

- Matters relating to alteration in the memorandum of association of the company like changes in name, objects, address of registered office etc.
- Sale of whole or substantially the whole of the undertaking,
- Sale of investments in the companies, where the shareholding or the voting rights of the company exceeds 25 percent,
Making a further issue of shares through preferential allotment or private placement basis,

Corporate re-structuring,

Entering a new business area not germane to the existing business of the company,

Variation in rights attached to class of securities,

Matters relating to change in management.

Shri Naresh Chandra Committee Report

A high powered committee was constituted on August 21, 2002 by the Ministry of Finance and Company Affairs to address issues relating to corporate Governance and to examine the Auditor Company relationship and to regulate the role of auditors. The trigger was the happenings in the US and certain instances in India involving auditors. In fact, the spontaneity with which US responded to the high profile corporate scams by enacting Sarbanes-Oxley Act in a very short time, to take strong measures to deter recurrences of such scams, made the Indian regulators and authorities to come out with almost similar response. It was rightly regarded that the ongoing measures, already implemented or under implementation were far too inadequate to combat the deep-rooted weaknesses in the system.

The terms of reference to the committee were:

1. To examine the issues pertaining to the Auditor company relationship to ensure the professional nature of relationship, consider rotation of auditors/auditing partners, restriction on non-audit fee/work, procedures for appointment of auditors and determination of audit fee etc.

2. to examine measures to ensure that the managements and auditors actually present the true and fair statement of the affairs of companies, to look into the measures such as personal certification by directors, random scrutiny of accounts etc.

3. to examine the issues concerning the regulation of professions of Chartered Accountant, Company Secretaries and Cost Accountants in the context of serving the concerned share-holders, especially the small investors and examine the advantage in setting up an independent regulator along the lines of the regulations contained in Sarbanes-Oxley Act of 2002 passed in US.

4. to examine the role of independent directors and how their independence and effectiveness can be ensured, and

5. Any other issues related to or incidental to the above.

The Committee submitted its report to the Finance Ministry on December 23, 2002. The report is a most comprehensive effort to improve quality of governance and recommendations indeed go for real hard measures. Commenting on the prevailing
In this scenario, the committee has reported on the poor structure and composition of boards of directors of Indian Companies, scant fiduciary responsibility, poor disclosures and transparency, inadequate accounting and auditing standards, the need for experts to go through thoroughly the nitty-gritty of transactions among companies, banks and financial institutions, capital markets etc. The committee held that, in India, companies need to follow very stringent guidelines on Corporate Governance and that there is a wide gap between prescription and practice. The committee pointed out that the defaulters escape the contemplated caught in the web of inefficiency, corruption and the intricate dilatory legal system.

The committee’s recommendations are quite comprehensive. The committee has recognized the independence of audit as one of the key factors of governance and has recommended suitable measures which are briefly stated below:

1. Prohibition of direct financial interest in the audit client by the audit firms, its partners or members of the engagement team as well as their direct relatives.

2. Prohibition of receiving any loan and/or guarantees from or on behalf of the audit client by the audit firm, its partners or any member of the engagement team and their direct relatives.

3. Prohibition of business relationship with the audit client by the audit firm and other associated persons as mentioned above.

4. Prohibition of audit partners and other associated persons from joining an audit client or any key personnel of the audit client wanting to join the audit firm, for a period of two years from the time they were involved in the preparation of accounts and audit of the client.

5. Prohibition of undue dependence on audit client by ensuring that fee received by a firm from any one client and its subsidiaries and affiliates should not exceed 25 percent of the total revenue of the audit firm, providing certain exceptions in case of new or small audit firms.

6. Prohibition, restraining audit firms from performing certain non audit services, as per the list specified for this purpose, in line with similar provisions contained in the Sarbanes-Oxley Act of the US.

7. Rotation of the audit partners and at least 50 percent of the engagement team, responsible for the audit every five years, falling short of the provisions contained in the Companies Bill 1997, suggesting rotation of statutory auditors.

The Committee has recommended that the auditors before agreeing to be appointed should provide certificates of independence to the audit committee or the Board of Directors of the client company. The committee further recommended that the Audit Committee should approve the terms of appointment of auditors.

**Disclosures:** With regard to disclosure requirements, the committee recommended that the auditors should disclose implications of contingent liabilities, so that the investors and shareholders have a clear picture of a company’s contingent liabilities. The management on its part should provide a clear description of each material liability and its risks and the auditors should give their comments on management’s views, in clear terms.
Qualifications in audit report: In addition to the existing provisions in the Companies Act, regarding qualifications in audit reports, the committee has made further recommendations to the effect that the auditor should read out the qualifications with explanations, to the shareholders at the company’s annual general meeting and the audit firm is mandated to send separately a copy of the qualified report to the Registrar of Companies, SEBI and the Principal Stock Exchange, with a copy of the letter to the management of the company.

Replacement of auditors: In the event of an auditor being appointed in the place of the retiring auditor, the committee has recommended that section 225 of the Companies Act be amended to require a special resolution for the purpose and that the explanatory statement to give reasons for such replacement. The outgoing auditor to have the right to comment and the Audit Committee to rectify whether the explanatory statement is true and fair.

Certification of Accounts: A very significant recommendation of the committee is to require a company to furnish a certificate by the CEO and CFO stating that the signing officers have reviewed and that the statements do not contain any materially untrue or misleading statement, not omitted any material fact and the statements present a true and fair picture of the financial/operational state of the company, the signing officers are responsible for establishing and maintaining internal controls. The committee has recommended that in the event of any materially significant misstatement or omissions, the signing officers will return to the company that part of any bonus or incentive or equity based compensation which was inflated on account of such error, as decided by the audit committee.

Independent Director: A new definition has been offered by the committee to include a non-executive director, who further fulfills certain conditions to qualify to be an independent director. Apart from receiving remuneration, the director does not have any material pecuniary relationship with the company and its promoters, the senior management and holding, subsidiary and associate companies, not to be a relative of promoters or management at the Board level or one level below the Board, has not been an executive of the company for the last three years, has not been a partner or executive of the statutory audit firm, Internal audit firm of the company for at least three years. In calculating the number of independent directors, nominee directors are to be excluded.

Number of Independent Directors: The committee recommended that in case of all listed companies, as well as unlisted public limited companies with a paid up capital and free reserves of Rs.10 crore and above, at least 50 percent of the total number of directors shall be independent directors. Nominee directors are to be excluded both from the numerator and denominator, while computing the percentage of independent directors.

Minimum number of Directors: The committee recommended that the minimum number of directors for the categories of companies referred to above shall be seven of which at least four shall be independent directors.

Board proceedings: The committee recommended that proceedings of the Board reflected in minutes should clearly disclose, apart from the members who are in attendance, the duration of each meeting and the details of the proceedings thereof. The committee has also recommended for holding the board meeting through tele/video conferencing.
**Exemption from criminal and civil liabilities:** The recommendations include that non-executive/independent directors be exempted in the definition of chapter of various enactments from criminal and civil liabilities.

**Training for independent directors:** It has been recommended that the independent directors should compulsorily undergo at least one training course before assuming responsibilities or within a year from the date of becoming an independent director. Directors failing to undergo such training would be disqualified under section 274 (1)(g) of the Companies Act after giving reasonable notice.

**Remuneration of non-executive directors:** The committee, in view of the enhanced responsibilities of non-executive/independent directors, recommended reviewing the statutory limit on the sitting fees and it should be resolved between the management and shareholders.

**Audit committees:** As per the report, the audit committee should consist of only independent directors. However, this is not to be mandatory for unlisted companies having 50 percent or less shareholders, companies not having debts from institutions and banks, and unlisted subsidiaries of listed companies.

The chairman of the Audit committee must annually certify whether and to what extent each of the functions listed in audit committees charter was discharged in the course of the year. This will serve as the committee’s action taken report to the shareholders. It should also give a specific report on adequacy of internal control system, perceptions of risks and in the event of any qualifications, why the audit committee accepted and recommended the financial statement with qualifications.

**Accountability and deterrents:** The committee has recommended that consolidated financial statements should be made mandatory for companies having subsidiaries. It further recommended that greater accountability should be provided for, with respect to transfer of money by way of inter-corporate deposits or advances of any kind from listed companies to any other company. Managers/promoters to be held personally liable, when found guilty of offences. Other measures suggested to improve governance include prevention of stripping of assets, random scrutiny of accounts and propagation of an internal code of ethics for companies.

**Setting up of a Corporate Serious Frauds Office:** The committee suggested setting up of a corporate serious frauds office without taking away the powers of investigation and prosecution from existing agencies for detecting the frauds committed by companies.

The Department of Company Affairs has accepted most of the suggestions and many of the recommendations have been included in the Companies (Amendment) Bill 2004.

**Setting up of Quality Review Board (QRB):**

In a bid to make corporate more responsible and accountable, the Committee on Corporate Governance headed by former cabinet secretary Naresh Chandra has recommended setting up of independent QRBs, one each for Institute of Chartered Accountants for India (ICAI), Institute of Company Secretaries of India (ICSI) and Institute of Cost and Works Accountants of India (ICWAI).
Mr Chandra said these QRBs would consist of persons of eminence, apart from council nominees. It shall periodically examine and review the quality of audit, secretarial and cost accounting firms and comment on the quality and sufficiency of systems. The QRB has since been set up by the central government, which is given below:

**COMPANY SECRETARIES ACT, 1980 - NOTIFIED QUALITY REVIEW BOARD**

**NOTIFICATION NO. G.S.R. 490(E), DATED 13-7-2007**

In exercise of the powers conferred by Section 29A of the Company Secretaries Act, 1980 (56 of 1980) read with rules 8, 9 and 10 of the Company Secretaries Procedures of Meetings of Quality Review Board and Terms and Conditions of Service and Allowances of the Chairperson and Members of the Board Rules, 2006, the Central Government hereby constitutes a Quality Review Board consisting of the following persons, namely:—

1. Shri Bhagawat Swarup, Ex-Member, Central Board of Direct Taxes, C-241, Ground Floor, Defence Colony, New Delhi-110024
   Chairperson

2. Shri Ravi (Ravindra) Kastia, Group Executive President and Business Head, Aditya Birla Group, Aditya Birla Centre, Mumbai-400030
   Member

3. Shri Rakesh Chandra, Director, Inspection and Investigation, M/o Corporate Affairs
   Member

4. Shri Keyoor Bakshi, Vice-President, Institute of Company Secretaries of India
   Member

5. Shri Harish K. Vaid, Council Member, Institute of Company Secretaries of India
   Member

**Nominees of the Council**

4. Shri Keyoor Bakshi, Vice-President, Institute of Company Secretaries of India
   Member

5. Shri Harish K. Vaid, Council Member, Institute of Company Secretaries of India
   Member

2. The terms and condition of service and allowances of the Chairperson and Members of the Quality Review Board shall be governed by the Company Secretaries Procedures of Meetings of Quality Review Board, and Terms and Conditions of Service and allowances of the Chairperson and Members of the Board, Rules, 2006.

**Shri Narayana Murthy Committee’s report**

The SEBI, while analyzing the financial statements of companies and the reports on corporate governance, observed that their quality was not uniform. It therefore felt a need to review the existing code on corporate governance as to the adequacy of the present practices and to improve such practices. The committee on corporate governance was, thus, set up by SEBI under the chairmanship of Shri N.R. Narayana Murthy.

The terms of reference were:

1. to review the performance of corporate governance and

2. to determine the role of companies in responding to rumour and other price sensitive information circulating in the market, in order to enhance the transparency and integrity of the market.
The important mandatory and non-mandatory recommendations of the committee are discussed below:

**Mandatory recommendations**

**Audit committee:** The committee recommended that the audit committee of public listed companies would be required to review the following information mandatory:

- Financial statements and draft audit reports, including quarterly/half yearly information.
- Management discussion and analysis of financial condition and the results of operations.
- Report relating to compliance with laws and risk management.
- Management letter/s of internal control weaknesses issued by statutory/internal auditors and
- Records of related party transactions.

**Related party transactions:** A statement of all transactions with related parties including their bases should be placed before the audit committee for formal approval/ratification and that if any transaction is not on an arm's length basis, management should provide explanation to the audit committee justifying the same.

**Proceeds from initial public offerings:** The companies raising money through initial public offering, should disclose to the audit committee the uses/application of funds under major heads on a quarterly basis. Each year the company shall prepare a statement of funds utilised for the purposes other than those stated in offer document/prospectus. This statement shall be certified by the independent auditors of the company. The audit committee should make appropriate recommendations to the Board to take steps in the matter. The suggestion enlarges the existing requirement in this regard and is a response to manipulations perpetrated by some corporate in this area.

**Risk Management:** The committee has deemed it necessary for the boards of the companies to be fully aware of the risks involved in the business and that it is also important for the shareholders to know about the process by which companies manage their business risks. The mandatory recommendations in this regard are:

“procedures should be in place to inform board members about the risk assessment and minimization procedures. These procedures should be periodically reviewed to ensure that executive management controls risks through means of a properly defined framework”

Management should place a report before the entire board of directors, every quarter, documenting the business risks faced by the company, measures to address and minimise such risks, and any limitations to the risk taking capacity of the Corporation. This document should be formally approved; by the board.

At present, in clause-49 of the Listing Agreement, there is a stipulation that the management discussion and analysis report forming part of the board’s annual report should include discussion on “risks and concerns”. The suggestion contained in the
Narayana Murthy Committee’s report is more elaborate and this would encourage a meaningful discussion at the board level periodically and the company will have the benefit of advice from board members who are not in day-to-day management.

**Code of conduct:** The committee has recommended making it obligatory for the board of a company to lay down a code of conduct for all board members and senior management of the company and that this code should be posted on the company’s website and all board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect, signed off by the CEO. This suggestion is in line with the best practices adopted by corporate in developed countries.

**Nominee directors:** The committee recommended doing away with nominee directors. If an institution wishes to appoint a director on the board, such appointment should be made by the shareholders. Nominee of the Government on public sector companies shall be similarly elected and shall be subject to the same responsibilities and liabilities as other directors.

**Other mandatory recommendations:**

- Compensation to non executive directors to be approved by the shareholders in general meeting; restrictions placed on grant of stock option, requirement of proper disclosures of details of compensation.

- Whistle blower policy to be in place in a company (freedom to company’s personnel to approach the audit committee without necessarily informing the superiors if they observe an unethical or improper practice, protection for the complainant from retaliation etc.

The directors of the holding company are to be in the picture; audit committee of the holding company to review financial statements of subsidiaries etc.

**Non-mandatory recommendations**

The non-mandatory recommendations pertain to moving to a regime providing for unqualified corporate financial statements, training of board members and evaluation of non-executive director’s performance by a peer group comprising the entire board of directors, excluding the director being evaluated.

The SEBI has approved modifications in clause-49 of Listing Agreement to give effect to the recommendations of Shri N.R. Narayana Murthy Committee’s report on corporate governance. SEBI issued a circular dated August 26, 2003 to all the stock exchanges in this regard. The revised clause-49 contains the sub-clause as per the existing clause-49m as well as new sub-clauses. All listed entities having a paid up capital of Rs. 3 Crore and above or net worth of Rs. 25 crore or more at any time in the history of the entity, are required to comply with the provisions of revised clause-49, effective from April 1, 2004.

**Shri J.J. Irani Committee’s report**

The committee consisting of 13 members and 6 special invitees drawn from various disciplines and fields was constituted on 2nd December 2004 under the chairmanship of Dr. J.J. Irani, Director, Tata Sons with the task of advising the Government on the proposed
revisions to the Companies Act 1956. The objective of this exercise was to have a simplified compact law that will be able to address the changes taking place in the national and international scenario, enable adoption of internationally accepted best practices as well as providing adequate flexibility for timely evolution of new arrangements in response to the requirements of ever-changing business models. The Committee presented its report to Government in May 2005.

A summary of recommendations made by the committee is as under

1. Background

1.1 Legal framework for corporate entities is essential to enable sustainable economic reform. Such framework has to be in tune with emerging economic scenario, encourage good corporate governance and enable protection of the interests of the stakeholders, including investors.

1.2 It is appropriate that comprehensive reviews of the Companies Act 1956 has been taken up through a consultative process initiated by Ministry of Company Affairs by exposing a Concept Paper on Company Law through electronic media. Such broad based consultation would enable working out an appropriate legislative proposal to meet the requirements of India’s growing economy and should form an integral part of the law making exercise.

2. Approach towards new Company Law

2.1 Company Law should comprise of the basic principles guiding the operation and governance of different kinds of corporate entities in India and be available in a single, comprehensive, centrally administered framework. Such legal framework should provide a smooth and seamless transition from one form of business entity to another and be amenable to adaptation to new business models as they emerge.

2.2 Company law should be compact. While essential principles should be retained in the substantive Law, procedural and quantitative aspects should be addressed in the Rules.

2.3 Law should enable self-regulation but impose greater accountability through disclosures and speedy administration of reasonable legal sanctions.

2.4 The new Company Law should enable harmonious operation of all Government and regulatory agencies and dovetailing of various governance codes and standards complementary with the principles laid down in the law.

2.5 The law should enable development of institutional structures to address new requirements dictated by changes in the economic environment.

3. Classification and Registration of Companies

3.1 The law should take into account the requirements of different kinds of companies prescribing the essential requirements of their corporate governance structure.

3.2 Small and Private Companies should be provided greater flexibility and freedom of operation while enabling compliance at low cost. To unleash the entrepreneurial talent of the people in the information and technology driven environment, law should recognize One Person Company (OPC). Such companies should be provided with a simpler legal regime through exemptions.

3.3 Government Companies should be treated at par with other companies and be subject to a similar compliance standards.

3.4 There may not be any restriction to a company having any number of subsidiaries or to such subsidiaries having further subsidiaries. However, the Act should provide for a more elaborate regime of corporate governance alongwith disclosures that reveal the nature of the transaction truthfully. Transactions between holding and subsidiary companies may be treated as related party transactions and consolidation of financial statements should be mandatory for such companies.
3.5 Special dispensations for Producer Companies and Public Financial Institutions (PFIs) need not be provided through the Companies Act. If need be a separate legislation may be considered for such entities.

3.6 Law should recognize that joint ventures enable access to capital, technology and markets and should provide legal recognition to joint ventures ensuring that such arrangements do not become a window for circumventing the essential provisions of the Law.

3.7 The e-Governance Project (MCA-21) taken up by the Government promises significant efficiency and gains to companies in compliance processes. All registration process and statutory filings should be made compatible to the electronic medium. Such filings should be kept secure and should be identifiable through digital signatures.

3.8 Process of registration should be speedy, optimally priced and compatible with e-Governance initiatives. Companies should be required to make necessary declarations and disclosures about promoters and directors at the time of incorporation. Stringent consequences should follow if incorporation is done under false or misleading information.

3.9 Strong action should be taken under law against companies that vanished with the investors’ funds. Preventive action in respect of such “vanishing companies” should begin with registration itself and should be sustained through a regime that requires regular and mandatory filing of statutory documents. This should be followed up with clearly provided legal process for tracking and causing disgorgement of ill-gotten gains. Corporate veil should be lifted to enable access to the individuals responsible.

3.10 Regular filing should be made easy efficient and cost effective. Non-filing of documents or incorrect disclosures should be dealt with seriously. Delays in filing should be penalized through non-discretionary late fee relatable to the period of default. There should be a system of random scrutiny of filings of corporate to be carried out by the registration authorities.

3.11 Limited liability partnerships should be facilitated through a separate enactment. Companies Act need not prescribe limitations on the number of members of other kinds of organisations.

3.12 Law should require transparency in functioning of charitable and licensed companies.

3.13 Procedures applicable for statutory compliance should be made simpler and declaration based. The requirement of obtaining the certificate of Commencement of Business to be dispensed with. The procedure for a company seeking exit from the Companies Act should be made equitable and fair to the stakeholders enabling easy exit to companies that cease to transact business. The procedure for shifting of registered office from one State to another State should also be made simpler, faster and easier.

4. Management and Board Governance

4.1 Law should provide an appropriate framework of governance that should be complied with by all companies without sacrificing the basic requirement of exercise of discretion and business judgment in the interests of company and its stakeholders.

4.2 There should be an obligation on the part of a company to maintain a Board of Directors as per the provisions of the Law and to disclose particulars of the directors through statutory filings of information.

4.3 Law should provide for only the minimum number of directors necessary for various classes of companies. There need not be any limit to maximum number of directors. Government should not intervene in the process of appointment and removal of directors in non-Government companies. No age limit for directors need be specified in the Act other than procedures for appointments to be followed by prescribed companies for appointment of directors above a particular age.
4.4 Every company to have at least one director resident in India. Requirement of obtaining approval of Central Govt under Companies Act for appointment of non-resident managerial persons should be done away with. Duty to inform the Registrar of particulars regarding appointment/resignation/death etc. of directors should be that of the company.

4.5 Presence of independent director on the boards of companies having significant public interest would improve corporate governance. Law should recognize the principle of independent directors and spell out their attributes, role, qualifications, liability and manner of appointment along with the criteria of independence. However, prescription of the number and proportion of such directors in the Board may vary depending on size and type of company and may be prescribed through Rules.

4.6 Decision on remuneration of directors should not be based on a “Government approval based system” but should be left to the company. However, this should be transparent, based on principles that ensure fairness, reasonableness and accountability and should be properly disclosed. No limits need be prescribed. In case of inadequacy of profits also the company to be allowed to pay remuneration recommended by remuneration committee (wherever applicable) and with the approval of shareholders.

4.7 Certain committees to be constituted with participation of independent directors should be mandated for certain categories of companies where the requirement of independent directors is mandated. In other cases constitution of such committees should be at the option of the company. Law should specify the manner and composition of various committees of the Board like (i) Audit Committee (ii) Stake-holder’s Relationship Committee and (iii) Remuneration Committee along with obligation on the part of the company to consult them in certain matters.

4.8 Certain basic duties of directors should be specified in the Act in an inclusive manner.

4.9 The conditions for disqualification of directors should also be prescribed in the Act. Directors should be required to disclose to the Board their previous disqualification, if any. Failure to attend board meetings for a continuous period of one year to be made a ground for vacation of office regardless of whether or not leave of absence was granted to such director. Specific provisions to be made in the Law to regulate the process of resignation by a director.

4.10 Board meetings to be held every three months with a minimum of four meetings to be held in a year. The gap between two meetings not to exceed four months. Meetings by electronic means to be allowed. In the case of companies where Independent Directors are prescribed, notice period of 7 days has been recommended for Board Meetings with provisions for holding emergency meetings at a shorter notice. Consent of shareholders by way of special resolution should be mandatory for certain important matters.

4.11 Use of postal ballot during meetings of members should be allowed to be more widely used by companies. Law should provide for voting through electronic mode. AGMs may be held at a place other than place of registered office (in India), provided at least 10% members in number reside at such place. Small Companies to be given an option to dispense with holding of AGM. Demand for poll to be limited with due regard for minority interests.

4.12 Managing Director (MD)/Whole Time Directors (WTD)/ Executive Director (ED) should be in the whole-time employment of only one company at a time. Provisions relating to options for appointment of directors though proportionate representation to be continued. Limit of paid up capital under existing section 269 for mandatory appointment of MD/WTD to be enhanced to Rs. 10 crore.

4.13 Every company should be required to appoint, a Chief Executive Officer, Chief Finance Office and Company Secretary as its Key Managerial Personnel whose appointment and removal
shall be by the Board of Directors. Special exemptions may be provided for small companies, who may obtain such services, as may be required from qualified professionals in practice.

5 Related Party Transactions
5.1 Law should impose a duty on every director to disclose to the company the contracts in which he has any interest or concern. Transactions in which directors are interested should take place subject to approval of Board of directors and beyond a limit subject to approval of shareholders. Details of transactions of company with its holding, subsidiary and associate companies to be placed periodically before the Board through the Audit Committee, if any and those not in the ordinary course or not on an arms length basis to be placed along with management justification thereof. Loans to directors and the facility of holding of office or place of profit by relative of a director should be regulated through shareholders approval. There need not be any requirement of Government approvals for such transactions.

6. Minority Interests
6.1 ‘Minority’ and ‘Minority Interest’ should be defined in the substantive Law. Law must balance the need for effective decision making on corporate matters through consensus without permitting persons in control to stifle action for redressal arising out of their own wrong doing.
6.2 Law should prescribe a regime in which minority rights are fairly protected without enabling any interest group to obstruct corporate processes. There should be recognition of principle of valuation of shares through an independent valuer whenever company causes an exercise of merger/restructuring etc.
6.3 The procedure for enabling/giving an effective hearing in company meetings to minority shareholders should be prescribed. In order to object a scheme of amalgamation by investors, a limit should be determined either according to minimum number of members or according to minimum percentage of shareholding.
6.4 Law should recognize “Class suits’ and “Derivative Actions”.

7. Investor Education and Protection
7.1 Investors should be enabled to exercise their choice in an informed manner while making investment decisions. However, interests of small investors and depositors should be specifically safeguarded.
7.2 A separate enactment for investor protection is not required. Corporate processes should recognize the investors as a stakeholder. There is a need to bring about coordination in the role and actions of various regulatory agencies on the matter relating to protection of interests of small investors.
7.3 Monitoring the end use of funds collected from public should be the responsibility of the shareholders of the company. There should be transparency through disclosures of financial operations of the company. The insurance option should be explored for deposits with the companies. Credit rating need not be mandated except for companies seeking deposits.
7.4 There is a need to enable exit options by investors in a reasonable and equitable environment. No provision of compensation except in cases of fraud. Law should enable ill-gotten gains acquired through cheating of investors to be accessed and disgorged.
7.5 An effective investors grievance redressal mechanism by way of recourse to consumer courts and capital markets ombudsman should be provided for safeguarding interests of investors.
7.6 Rights of investors in respect of unclaimed dividends etc. to be recognized even after 7 years period. IEPF should not be based solely on expropriated unclaimed returns but should be in the form of a corpus in which funds may be parked to be managed and utilize for investors education. Contributions to IEPF not to be deposited in Consolidated fund but directly to IEPF, to
be managed by an Administrator. Schemes initiated by Central Government under IEPF should be made more comprehensive.

8. Access to Capital
8.1 There is a need for flexibility to manage capital dynamically and to enable reallocation of capital between businesses.
8.2 The basic framework for governance issues relating to maintenance and management of capital, the rights flowing from ownerships of such capital and regulation of various stakeholders in a corporate entity with regard to capital should be addressed in the Companies Act.
8.3 Simultaneous to the harmonious regulatory approach providing for space to each regulator to operate effectively in their domain, provisions in the Companies Act allowing multiple jurisdiction may be done away with. There is however, need for different regulatory agencies to interact with each other more comprehensively in operational matters.
8.4 Timeframes prescribed for processes of issue of capital be rationalized to be at par with international practices. Processes should be made time bound with the introduction of concept of Deemed Approval. Corporate issuers of capital should also be allowed to use electronic media for communication of information in the process of issue of capital.
8.5 Concept of Shelf Prospectus may be extended to other class(es) of companies who access capital market more frequently as Well Known Seasoned Issuers (WKSI), in a manner to be prescribed by the capital market regulator. In reckoning numbers of persons to whom offer is made, the offers made to Qualified Institutional Buyers (QIBs) should be excluded.
8.6 Enabling provisions for Tracking Stock and Treasury Stocks could be made in the new Law. Actual introduction of these stocks should however be preceded by certain preparatory actions to be taken. Targeted Buyback need not be introduced at this stage.
8.7 Companies should be permitted to issue perpetual/longer duration preference shares. Regulatory framework for payment of dividend to preference shares, particularly when they are cumulative should be reviewed.
8.8 Institutional mechanism such as Courts/NCLT should decide on issues relating to capital reduction in a time bound manner with due safeguards for interests of creditors.
8.9 The regime of acceptance and invitation of Public Deposits should be made stricter.
8.10 Registration of charges to be enabled by the lender if the borrower does not register the charge within a fixed time.
8.11 Non-cash consideration for allotment of shares should be valued through independent valuers. Provisions relating to inter-corporate loans and investments should be strengthened to ensure that there is no mis-use of these provisions for price rigging or by diversion of funds. Penalties to be increased in case of non-compliance. Detailed disclosures to be given, in case of loan transactions, in the annual reports of the lending company about the end use of loans and advances by recipient.
8.12 In case of unlisted public companies, preferential allotment should be made on the basis of valuation by an independent valuer.
8.13 Penalties for fraudulently inducing any person to invest money should be made more stringent
8.14 Law may allow, subject to adequate disclosures and fulfillment of conditions, to retain subscription received in Public Offer, notwithstanding non receipt of amount of minimum subscription.
8.15 Nidhi Companies to be regulated by RBI. The norms relating to limits of DRR in case of NBFCs should be prescribed by RBI.

9. Accounts and Audit
9.1 Accounting Standards should be notified under the Companies Act early.
9.2 Consolidation of financial statements should be made mandatory. Requirement of attaching financial statements of subsidiary company(ies) with the holding company to be done away with.
9.3 Format of financial statements should be prescribed in the Act/Rules. Cash Flow Statement to be made part of mandatory financial statements. Financial year should be aligned to uniformly end on 31st March. Option to maintain books in electronic form should be given to companies. Books of accounts should be preserved by a company for a period of seven years.
9.4 Companies should have the option to keep records outside the country also along with safeguards providing for access and production of such records if needed.
9.5 Small Companies should be given exemptions/relaxations in respect of disclosures relating to financial statements.
9.6 The financial statements should be signed by MD/CEO/CFO/Company Secretary, wherever applicable, even if they were not present in the meeting, which approved the financial statements. All directors present in relevant meeting to sign financial statements. Dissenting director also to sign with dissent note.
9.7 Listed companies should put full financial statements on their websites. Companies should be allowed to use electronic means for circulation of financial statements. Revision of financial statements should be allowed only in extreme situation such as those dictated by change in law.
9.8 The Companies (Transfer of Profits to Reserves) Rules, 1975 and The Companies (Declaration of Dividend out of Reserves) Rules, 1975 may be done away with. Provisions relating to payment of Interest out of capital [existing section 208] may be deleted.
9.9 When Central Govt approves any basis of depreciation, there need not be any restriction of writing off of 95% of cost of the asset over a specified period. The Act should provide flexibility in respect of rates of depreciation for infrastructure or similar projects.
9.10 Rotation of auditors not be mandated in Law. Auditor to be prohibited from performing certain non-audit functions/services to be specified in Law/rules. Disqualification of auditors to be suitably mentioned in the Law/rules. Basic duties and liability of auditors should be in the Act itself. Quantification of penalty for auditors to be prescribed.
9.11 The committee felt that since statutory audit is conducted by the statutory auditor appointed by the C&AG in the manner directed by him, the test supplementary audit is superfluous, as it would duplicate audit work already done by statutory auditor. Further, where any directions are given by the C&AG to the Statutory Auditor not in accordance with the Accounting Standards, the Statutory Auditor may be required to mention the same in the notes to accounts.
9.12 Investors to be educated to understand financial statements. Shareholders associations to be enabled to take part actively in this regard.
9.13 Enabling provisions for empowering Central Government to order Cost audit in certain cases should be retained. Government approval for appointment of Cost Auditor for carrying out such audit is not necessary. Special Audit need not be continued.

**10. Mergers and Amalgamations**

10.1 A single forum for approval of mergers and acquisition schemes in a time bound manner to be provided. The concept of “Deemed approval” concept to be provided in cases where the different regulators do not intimate their comments timely. In stead of existing requirement of separate reports from Registrar of Companies (ROC) and Official Liquidator (OL) in respect of affairs of the company, provisions should be made for time bound responses from them in response to notices.
10.2 Valuation of shares of companies involved in schemes of mergers and acquisition by independent registered valuers (rather than court appointed valuers) should be made mandatory.
10.3 In view of inconsistency in approach followed by various Courts/State Governments, there is need to clarify issue regarding payment of stamp duty on Court Orders sanctioning schemes of merger/acquisition.

10.4 The concept of Electronic registry should be evolved. Jurisdictional issues vis-à-vis stamp duty should be resolved to enable single registry. Further, the Act should provide for compulsory registration of all property of company above a certain value.

10.5 ‘Contractual mergers’ and ‘Cross Border mergers and acquisition’ may be suitably addressed in the new Act. Specific provisions needed for allowing merger of listed company with an unlisted company and vice versa. Mergers among associated companies, private companies or companies where no public interest is involved, should be allowed through a less stringent framework.

10.6 Subject to safeguards relating to liquidity test/security pool, any Corporate Debt Restructuring (CDR) proposal approved by 75% of secured creditors in value should be sanctioned, notwithstanding the minority dissent.

10.7 The need to file separate scheme for reduction of capital simultaneously with the scheme for mergers and acquisition should be avoided.

10.8 Instead of existing provisions of section 396, provisions should be made to empower Central Government to approach Court/Tribunal for suitable order for amalgamations of two companies in public interest.

10.9 The fees paid by Transferor Company on the authorised capital should be available as a set off to the transferee company upon the sanction of the scheme.

10.10 A Non obstinate provision to be introduced to ensure that the assets and liabilities of transferor company absolutely vest in the transferee company notwithstanding anything to the contrary in any other law.

11 Investigation

11.1 Instead of separate provisions for both inspection and investigation under the Act, a single comprehensive process of investigation, may be provided for, including powers to inspect. Comprehensive framework for carrying out investigation to be specified in Law.

11.2 The liability for compliance of Law should be on the company management. This should be combined with a system of oversight through random scrutiny of documents.

11.3 On the basis of technical scrutiny, the Registrar may have the power to call for any other relevant information, documents or records as required under Law.

11.4 The Govt may appoint an officer of the Govt or any private professional as inspector to carry out investigation.

11.5 The Serious Frauds Investigation Office (SFIO) should be strengthened. A separate statute may be framed for SFIO. SFIO should also assist in capacity building for similar organization that may be set up at state level.

12 Offences and Penalties

12.1 The Law should encourage compliance through self-regulation. It should clearly define the rights of stakeholders and means of redressal of their grievances. State to discharge an important responsibility not only in framing the Law but also in its effective implementation, enforcement and administration.

12.2 There is need for a regime of penalties commensurate with the offences. Penalties regime for corporate should be in the nature of monetary fine since company being an artificial economic person cannot be imprisoned.
12.3 The liability of the Board of directors to be clear and absolute. A clear regime for identification of Officers-in-default also to be necessary. Specific rules for fixing criminal liability in appropriate cases should be framed. The liability of CEOs/CFOs/Company Secretaries as well as other officers of the company who are in default to be specifically provided for. The professionals advising the companies on various matters also to be held liable if found not to be diligent or law compliant.

12.4 The Company Law to provide for an in-house structure for levying non-discretionary monetary penalties only (i.e. in respect of offences not involving imprisonment). Central Government (and its officers) to be vested with powers to levy such monetary penalties. Mechanism to transfer eligible proceedings from courts to in-house structure to be suitably provided for.

12.5 The penalties may be classified in the form of two self-contained schedules—one for monetary penalties and the other for those involving imprisonment, with or without fine. The Law to lay down the maximum as well as minimum quantum of penalty for each offence. The Law to provide for suitable deliverance in respect of repeats offences.

12.6 In case of fraudulent activities/actions, provisions for recovery and disgorgement to be suitably provided for. The issue of “Phoenix problem” to be suitably addressed through a combination of disclosures, insolvency processes and disqualification of delinquent directors. The Law to provide for lifting of the corporate veil to check any fraudulent activity.

12.7 Law to provide for special powers to compel filing of documents, with enhanced penalties for persistent default.

13. Restructuring and Liquidation

13.1 An effective insolvency system is an important element of financial system stability. There is a need for an effective Insolvency framework, which enables resolution of insolvency in a timely and efficient manner. Corporate insolvency may be addressed through Companies Act. A separate Insolvency law is not necessary at present.

13.2 A definitive and predictable time frame is needed for rehabilitation and liquidation process.

13.3 The law should strike a balance between rehabilitation and liquidation process. It should provide an opportunity for genuine efforts towards revival. Only where revival/rehabilitation is not feasible, winding up should be resorted to.

13.4 Both debtors and creditors should have fair access to insolvency system. Rather than net worth erosion principle, test for insolvency should be default in payment of matured debt on demand within a prescribed time [liquidity test]. Debtors seeking rehabilitation should be able to approach Tribunal only with a draft scheme. Creditors being at least 3/4th in value may also file scheme.

13.5 A limited standstill period is essential for genuine business restructuring to be regulated through Tribunal’s Orders during which there is prohibition on unauthorized disposition of debtors’ assets and suspension of actions by creditors to enforce their rights. The law should provide for appropriate prohibitions on certain Debtors’ rights [transfer, sale or disposing of assets etc.] subject to certain exemptions on initiations of insolvency.

13.6 There should be duty on companies to convene creditors and shareholders meeting on default in payments to creditors to consider suitable steps to protect interest of stakeholders, preserve assets and adopt necessary steps to contain Insolvency.

13.7 The debtor assets should be subjected to supervision or management of impartial, independent, and effective Administrator.
13.8 Provisions should be made for setting up of Committee of secured creditors to safeguard their interest and provide a suitable platform for creditors’ participation in the process. The law should also provide for mechanism to recognize and record claims of unsecured creditors.

13.9 A Panel of Administrators and liquidators should be prepared and maintained by an independent body out of experienced and knowledgeable Insolvency Practitioners. Private professionals should play a meaningful role in all aspects of insolvency process. The law should encourage and recognize concept of Insolvency Practitioners.

13.10 The law should prescribe a flexible but transparent system for disposal of assets efficiently and at maximum value. Secured creditors’ claim should rank pari passu with workmen. Public interests, Government claims should not get precedence over private rights. Revival plan should be required to be approved by secured creditors holding 3/4th of total value to be binding on all creditors.

13.11 Establishment of NCLT would provide a major initiative for insolvency system reforms in the country and should be enabled quickly. NCLT should have general, non intrusive and supervisory role. The Tribunal should adopt a commercial approach to dispute resolution observing the established legal principles of fairness in the process. Selection of President and Members of the Tribunal should be such so as to enable a wide mix of expertise for conduct of its work.

13.12 Provisions relating to rehabilitation cess should be replaced by the concept of “Insolvency Fund” [Fund] with optional contributions by companies. Government may make grants for the Fund and provide incentives to encourage contributions by companies to the Fund. Companies which make contributions to the Fund should be entitled to certain drawing rights in the event of insolvency. Administration of the Fund should be by an Independent Administrator. Insolvency Fund should not be linked/credited to Consolidated Fund of India.

13.13 A suitable framework for Cross Border Insolvency, which provides for rules of jurisdiction, recognitions of foreign judgments, co-operation and assistance among courts in different countries and choice of law is required. The Government may consider adoption of UNCITRAL Model Law on Cross Border Insolvency with suitable modifications at an appropriate time.
Session XV & XVI

Session Title:
CORPORATE SOCIAL RESPONSIBILITY, CORPORATE COMMUNICATIONS - ENHANCING SHAREHOLDERS' VALUE AND CORPORATE GOVERNANCE IN FINANCIAL REPORTING,

Corporate Social Responsibility

With the process of initiation of economic reforms in India in early 1990s, the India companies were forced to rethink how to prosper in business by gaining the confidence of various stakeholders. The business houses began contemplating how to restructure their business to make them more competitive both in terms of domestic and international competition which required restructuring radical changes across the full range of functional areas e.g. economic, fiscal, procedural and administrative. It also involved attention to the question of what social responsibility means in the changing circumstances of the emerging global economy and an increasingly interconnected society, both nationally and internationally.

Two basic convictions emerge from these thoughts to address this issue of the changing nature of social responsibility. First, the belief that any process of managing change, whether at national or international level, should put the people first and the second thought is that the corporate social responsibility should be viewed as a service to the nation. The basic understanding of the specific role of the corporate sector in promoting social responsibility that emerged from these two convictions is that corporations should be involved in a conscious and dedicated effort to assist social reforms in building the nation.

With this purpose in mind, at the end of 1994 the Board of Directors of Tata Sons Limited, a leading business house of India, appointed two senior directors to form the Tata Council for Community Initiatives (TCCI). This network was charged with facilitating the development of a common direction for all the Tata Companies on social responsibility. Today, the guidelines for community development formulated by TCCI are being implemented by twenty-eight major Tata companies, which form the critical mass of the Tata group. The commitment of the group is reflected in the level of outlays on community initiatives in recent years which amounted to US $ 36 million in 2000 which was in addition to the donations received from various Tata trusts and contributions rendered in kind by the volunteers.

In attempting to impress upon our self-understanding of social responsibilities and implementation in practices and policies of the group, during the 1990s, the TCCI focused its efforts around six themes as discussed below:

**Developing Long-term programmes with stakeholder:** This referred to a coordinated process of managing multiple stakeholders interest such as those of government, non-governmental organizations and local communities. It is believed that the corporate sector has an important but specific role to play in social betterment in addition to its programmes of corporate giving and charity which primarily involves contributing managerial expertise, skill and talent as well as providing some financial assistance in projects that involve the active participation of local communities.

There is an increasing recognition, both by corporate sector as well as NGOs, that the most effective use of resources involves implementing long-term programmes around the concept of self-help and self-reliance. The programmes may refer to initiatives in the form of pilot projects that show new ways to build a ‘can-do’ confidence. This offers possibilities to the community and the authorities of making attitudinal and procedural changes.
The Tripple Bottom Line: This involves leadership not only in adhering to quality driven business practices and procedural ethical norms but also for adding a lateral dimension to its overall vision by demonstrating a deep concern for the environment and genuine care for the community. Thus, for example, social expenditure is not considered as an allocation out of surplus (as charity), but is budgeted well in advance as a business cost like any other social responsibility is an important part of leadership process.

Community Champions: This assumes that other company employees would participate in community work by default rather than by design. A more passive approach would be the one which involves the designation of ‘community champions’ and ‘key result areas’ to be targeted. The idea is that when the heads of human resources identify specific employees who were to be actively involved with local communities (community champions), their function would no longer be just to get engaged with the communities themselves, but more importantly, to motivate other employees to become involved in community development projects as volunteers.

Corps of volunteers: It is believed that active involvement of employees is the key to effective corporate participation in social activities. Through volunteer activities, individual members are able to make very tangible contributions to local communities and individuals. As a result of this direct contact, the large pool of active volunteers provides not only a reliable and knowledgeable resource base for social activity, but also lays the foundation for building high-trust communities.

Improving quality of life: This involves creation of thrust areas for community development. The designated areas may be vocational training, primary education, computer education and application, health and family welfare, supply of drinking water and irrigation, rehabilitation etc.

Environmental Management and Social Auditing: This may include conserving natural resources and preserving the environment. This will not only increase our national resources but help in healthy living and prevention against the threats of global warming that the world is facing today.

Let us review the fundamental purpose of business today. The contemporary business should become more ‘development oriented’. The non-negotiable affirmation has surfaced from our learning action with the community. Today as new ideas emerge on building contemporary society, enlightened business needs to align with the accepted tenets of development if improving the quality of life is a serious goal. Undertaking such a shift in our understanding of business is a challenging endeavor, which calls for a radical change of mindset. The leadership of the corporation s is required to develop a new understanding of the balance between the top line (purpose) and bottom line (profit or advantage) of all the actions.

Corporate Communications:

Improving Shareholders’ Value

In the wake of series of corporate scandals, where even elite corporate played as financial shenanigans, need for fair and proper disclosures and reporting has grown alarmingly crucial. This can be achieved through resorting to Management Discussion and Analysis (MDA) reports. Through MDA two stories are told, one by the management to the investors and the other for the management. The story for investors will be that management understands its business, is honestly conveying all desired information and is thus trustworthy. For the management the story would be that as a result of disclosing all the information
required by shareholders in a clear and desired manner, the investors will have renewed confidence in the company and thus improve the shareholder value.

In general the management should think more about the market, and less about hypothetical consequences. The focus should be on disclosing information to the market that management thinks is important for shareholders or potential shareholders to know. And that information should be an honest assessment of the direction and risk that companies face. Management should be careful to make the disclosure and the goal should not be to put the investors to sleep, but rather to make the information it is conveying to investors compelling and understandable. The moral of the disclosure for management is that, as a result of disclosing all the information that it thinks important to shareholders, in a clear, compelling way, the investors will have renewed confidence in the company and the company will have improved shareholder value.

Management can disclose effectively through the MDA by using clear financial statements and analysis. The information will be more understandable and compelling if they focus on accounting for the substance of transactions. Let us first turn to the matter of improving financial disclosures. The Sarbanes Oxley Act passed in 2002 in US required to conduct a study on the adoption by the US Financial reporting system of a “principles-based accounting” where the auditors must account for the substance of a transaction, rather than its form. Principles based accounting has many benefits, the first and foremost would emphasize the spirit of the accounting standards not just their letter. They apply more broadly, thereby allowing fewer exceptions and there would be less confusion arising from the numerous exceptions that exist under the Generally Accepted Accounting Principles (GAAP). Principles based accounting emphasizes the professional judgment of managers and the company’s auditors rather than the need for interpretative guidance. So, there would be less confusion stemming from an array of interpretive comments. Of course, management and auditors would need to be aware of their central role in a principles based regime and act with the utmost care and integrity.

In assessing the value of GAAP, it is important to remember that it does have its good point also. The GAAP provides basic uniform accounting standards, as well as consistency of accounting standards across all companies. And, although, the detailed exceptions and rules sometimes hide them, GAAP itself is indeed based upon certain fundamental principles of accounting.

The substance of a transaction should dictate the accounting, not vice versa. It is also important to remember that simply comply with GAAP may leave gaps in disclosure and give investors an incomplete – or even misleading picture of a company’s operations. The counselors, professionals should remind their client to look to the principles underlying GAAP so that companies report accurately their business operations – not to strive to take advantage of the technicalities in GAAP to distort the bottom line. Managers should also correct some of the imperfections in GAAP by better disclosure outside the GAAP framework – by describing their actions more vividly in the company’s MDA.

The company’s MDA must be more than a recitation of its recent history. It must describe known trends, uncertainties or other factors that will or are reasonably likely to result in a material impact on company’s liquidity, capital resources, revenues and results of operations. Beyond just pointing out known trends, managers can use the MDA to help investors interpret and understand what a trend mean for the company going forward. Management should also give its insight into the company’s operations. It is exactly this
insight that helps management communicate its understanding of the business environment to investors, and exactly this insight that investors want to see.

A company must use the MDA to disclose ‘known trends and uncertainties’. Typically, companies simply recite financial information in the MDA without any analysis. Instead, work with management to give a detailed analysis of important, year-to-year changes and trends that are material to operations. The corporate should spend more time talking about liquidity, cash flow and capital resources.

As advisors to management, professionals have a central role to play but not to be forgotten that it should be management who decides what to disclose to investors. As advisers, professionals should focus on identifying the risks for management, point out inaccuracies or what is misleading. Management’s disclosures indicate the benefits that may flow as well as how it would help investors to understand better the company’s financials and operations, which ultimately increase shareholder confidence and improve shareholder value.

CORPORATE GOVERNANCE IN FINANCIAL REPORTING

This section deals with financial and non-financial disclosures mandated by law, and their strengths and weaknesses. All companies have to prepare statutorily audited annual accounts which are first submitted to the board of approval, then sent to all shareholders, and finally lodged with the Registrar of Companies. Listed companies have three other requirements. First, the annual accounts have to submitted to every stock exchange where the companies are listed. Second, they have to prepare abridged unaudited financial summaries for every quarter. Third, in addition to all the disclosure requirements mandated under the Companies Act for public limited companies, listed firms have to submit a cash flow statement.

In theory, the most substantive financial disclosures of companies are to be found in their annual reports — particularly the balance sheet, profit and loss account and their relevant schedules. All these sheets have to give the data for the current and the previous financial year. The gist of such disclosures and their critique is discussed here.

**Balance Sheet**

**SOURCES OF FUNDS**

**Capital**: This gives the share capital of the company, backed up by a schedule that gives details of the number of equity shares authorised, issued and paid-up. Taken together, these are sufficiently transparent.

**Reserves and surplus**: The summarized version is supported by a detailed schedule that classifies the reserves under various heads. The mandated items are (i) capital reserve, (ii) share premium reserve, (iii) debenture redemption reserve (iv) investment allowance reserve, (v) general reserves less the debit balance in the profit and loss account, and (vi) the surplus, i.e. balance in profit and loss account after providing for dividends, bonus or reserves. Again, this is up to international standards.

**Secured loans**: The accompanying schedule gives full line-by-line disclosure of debentures. The data on loans and advances from term lending institutions and banks is also quite detailed, and includes the description and extent of charge on each loan, with separate disclosure on foreign currency loans. In some cases, the problems lie with loans and advances from subsidiaries. Unfortunately, Indian accounting standards do not follow the 22 principles of consolidation. As a result, companies can, and do, under- or overstate such transactions for strategic purposes.
Unsecured loan: All heads of unsecured loans have to be listed.

APPLICATION OF FUNDS

Fixed assets. Although the listing of fixed assets in the schedule is quite exhaustive, it suffers from two types of problems. First, gross block is valued at historical cost. A more realistic approach will be to value all the elements at either market prices or replacement cost. Second, the depreciation schedule used in annual accounts have no bearing with that which is permitted for computing the corporate income tax liability. This is a historical anomaly, which could be rectified by allowing for deferred tax liability.

Investments. These are split between long and short term, with the latter covering a period of a year or less. Investments in quoted securities have to be marked to market, while those in unquoted instruments are evaluated at cost. While the disclosures look tight on paper, this is the area of maximal opaqueness. Again, the reasons have to do with the lack of consolidation. This is what often occurs, especially in companies that care little for corporate governance and shareholder value. Suppose a listed company A has 20 closely held subsidiary investment companies. Quite often the management will siphon off investors’ funds from A to the subsidiaries. Since the latter are private limited entities, it becomes very difficult for investors to track the second round of transactions, leave aside the third and fourth. Within a space of weeks, massive sums of money can be taken out as investments of a listed company — only to be parked in the subsidiaries, and then further muddied through complex inter-corporate transactions. For a few years, these ‘investments’ will be reflected as such in the accounts of A. Thereafter, these will be gradually ‘written down’ on the premise that the investments are souring. In the meanwhile, the funds will have effectively disappeared. The best solution is to mandate consolidation according to US-GAAP or Internationally Accepted Accounting Standards (IAAS), and insist of full disclosure of all related party transactions. Until these two changes are brought about, there will always be unscrupulous management intentionally misallocating investors’ funds. In fact, according to bankers, the single largest reason for corporate financial distress in India is diversion of funds. Investment in subsidiary companies is a great vehicle for such siphoning.

Loans, advances and deposits. In the absence of consolidation, entries on this account can also be used to misallocate corporate funds. It is only a matter of eventually writing down the loans and advances as doubtful or bad.

Inventories are normally well captured, especially for medium and large scale manufacturing companies. Smaller companies tend to play around a bit with work-in-progress, but that is quite minor.

Sundry debtors can occasionally be used to artificially push up sales in the profit and loss account. It works as follows. Companies book extra sales in the last month or two before the end of the financial year, knowing that the revenue is not intended to be received by the year-end. The top line on the profit and loss account gets inflated and, all else being equal, the bottom-line as well. Fully anticipated unpaid dues get booked as receivable under sundry debtors. Sometimes this gets a bit more sinister. Output is siphoned out to a host of subsidiary or ‘front’ dealer companies through dummy sales. No payment is intended to take place. The amount languishes receivable for a few years and is then written down — first as doubtful, and then as bad debt.

Cash and bank balances. Usually reflects the true picture.

Profit and loss account
By and large, the disclosures required in the profit and loss account are quite exhaustive and up to international standards. The Companies Act requires detailed schedules for:

- ‘other income’, i.e. income other than what the company earned from its sale of goods and services,
- expenditure on raw materials and intermediate goods,
- wages and employee costs,
- ‘other expenses’, which includes consumables, energy charges, repairs and maintenance, rents, rates and local taxes, advertising and selling costs, R&D expenses, traveling expenses, directors’ fees and commissions, and other heads,
- inventories, including work-in-progress and finished goods
- interest, which includes interest on fixed term loans and debentures and on other loans, less interest received.

There are two areas for fiddling the books. The first relates to manufacturing expenses, which can be inflated up to a point. Beyond that it requires collusion with the government’s sales tax and excise duty officials. The second has to do with selling, distribution, administration and other expenses. However, the scope for mis-reporting on these two heads is far less than for investments and loans on the balance sheet. And, by and large, most of the records in the profit and loss account tend to reflect the true and fair picture of a company.

Cash flow statement

Listed companies have to submit a three-part cash flow statement consisting of cash flows from (i) operating activities, (ii) investing activities, and (iii) financing activities. This statement is quite detailed and any reasonably well equipped financial analyst should be able to arrive at a company’s free cash flows for a given year.

As far as incorporated companies go, the quality of financial disclosure in the annual accounts is determined by three agencies: (i) The Department of Company Affairs, which administers the Companies Act, (ii) SEBI, which mandates special disclosure requirements for listed companies, and (iii) the Institute of Chartered Accountants of India (ICAI) — the body which lays down the parameters of Indian accounting standards.

While these standards are better than what prevails in most of Asia, including Korea and Japan, they are behind the norms laid down by US-GAAP. The critical differences between Indian accounting standards and US-GAAP are given in table below. Of these, the three most serious lacunae are the absence of consolidation, lack of segment reporting, and low standards of disclosure of related party transactions.

**Accounting Standards Summary:**

The compliance with accounting standards has been made mandatory for companies through Companies amendment 1999 by insertion of sub section 211 (3A to 3C). The objective and gist of the Section 211 sub section (3A), (3B) and (3C) are given below.

**Objectives**

- To standardize accounting methods and procedures.
- To lay down principles for preparation and presentation.
- To establish benchmark for evaluating the quality of financial statements prepared by the enterprise.
- To ensure the users of financial statements get creditable financial information.
- To attain international levels in the related areas

**Accounting Standards and The Companies Act, 1956**
Section 211 sub sections (3 A), (3 B) and (3 C) inserted by the Companies Amendment Act, 1999 w.e.f. 31.10.1998:

(3A) Every P & L Account and Balance Sheet shall comply with accounting standards,
(3 B) deviations, if any, to be disclosed with reasons and financial effect of deviation,
(3 C) "Accounting standards" means standards of accounting recommended by ICAI or as may be prescribed by Central Govt. in consultation with National Advisory Committee on Accounting Standards.

Significant differences among US-GAAP, IAS/IFRS and AS:

(1) Significant difference between IAS/ IFRS and AS-1
a) IFRS/IAS-1 deals with overall considerations including fair presentation, offsetting, and comparative information, whereas AS-1 does not deal with these aspects.
b) IFRS/IAS-1 prescribes minimum structure of financial statements and contains guidance on related issues viz. current liabilities whereas AS-1 does not prescribe any minimum structures.
c) Under IFRS/IAS-1, financial statements include statements showing changes in equity whereas AS-1 does not prescribe any such statement to be prepared.
d) Under IFRS/IAS-1, there is a presumption that application of IFRS would lead to fair presentation. There is not such presumption under AS-1.
e) IFRS/IAS-1 requires disclosure of critical judgments made by the management in applying accounting policies whereas there is no specific disclosure requirement in AS-1.

(2) Significant differences among US-GAAP, IAS/IFRS and AS-2

- As per Accounting standard (AS-2), “Valuation of Inventories” means the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs. The cost of inventories, other than those dealt with in above, should be assigned by using the First-In First-Out (FIFO), or weighted average cost formula.
  a) As per IAS/IFRS-2 “Inventories”, the cost formula used to measure the cost of inventories is similar to the Indian GAAP. However, an entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formula may be justified.
  b) As per US GAAP (ARB-43), the Last-In-First-Out (LIFO) method of stock valuation is widely used. The LIFO method, which is popular in the US as the Internal Revenue Services, officially LIFO as an acceptable financial reporting purposes. However, as per Indian GAAP, LIFO method is not acceptable method of valuation.

(3) Significant differences among AS-3, IFRS/IAS-7 and US-GAAP
a) IFRS/IAS-7 and US GAAP allow interest and dividend paid or received as operating cash flows, but AS-3 does not allow so.
b) US GAAP statement 95 requires that income taxes paid be classified as an operating cash flow whereas AS-3, IFRS/IAS-7 require that cash payments or refunds of income taxes be classified as operating activities unless that can be specifically identified with financing and investing activities.
c) US GAAP does not specifically require disclosure separately of extraordinary items whereas AS-3 requires so. IFRS/IAS-7 also does not require disclosure of extraordinary items.
d) AS-3 and US GAAP do not make explicit distinction between bank borrowing and Bank overdraft, whereas IFRS/IAS-7 makes so.

(4) Significant differences among AS-4, IAS/IFRS and US-GAAP

a) Proposed dividend after balance sheet date but before the date of the financial statements in non-adjusting event under corresponding the financial statements in non-adjusting event under corresponding IFRS/IAS-10 and US GAAP.

b) As per AS-4, the proposed dividend is shown in balance sheet and thus treated as adjusting event.

c) Securities Exchange Commission regulation of US requires the adjustment of declared dividend after the balance sheet date but before the issuance of financial statements.

(5) Significant differences among AS-5, IAS/IFRS and US-GAAP

Prior Period Items- IFRS/IAS-8 prescribes that subject to the practicability, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorized for issue after they are discovered by:

a) Restating the comparative amounts for the prior period(s) presented in which the error occurred; or

b) If the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

c) A prior period error shall be corrected by retrospective restatement except to the extent that it is impracticable to determine either the period specific effects or the cumulative effect of the error.

d) Under US GAAP error in financial statement, which form mathematical mistakes, mistakes in the allocation of accounting principles, or oversight or misuse of facts that existed at the time the financial statements, were prepared should be accounted for as prior period adjustments.

e) Disclosure should be given of the nature of the error and the effect of its correction on income before extraordinary items and net income and related per share effects in the period in which the error was discovered and corrected (APB20.37, APB9.18.26).

f) Where financial statements for more than one period are given, the effect on the net income of prior period should also be disclosed. Such disclosure should include the amount of tax applicable to the prior period adjustments.

g) IFRS/IAS-1 prohibits any items to be disclosed as extraordinary items whereas AS-5 specifically requires disclosure of certain items as extraordinary items.
Change in Accounting Policies-
   a) IFRS/ IAS-8 requires that an entity shall account of a change in accounting policy resulting from the initial application of a standard or an Interpretation in accordance with specific transitional provisions, if any, in that Standard or Interpretation; and when an entity changes an accounting policy upon initial application of a Standard or Interpretation that does not include specific transitional provisions applying to that change or changes on accounting policy voluntarily, it shall apply the change retrospectively.
   b) Subject to the impracticability when a change in accounting policy is applied retrospectively, the entity shall adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.
   c) Under US GAAP, the nature of and justification for a change in accounting principle and its effect on income should be disclosed in the financial statements of the period in which the change is made. Financial statements for prior periods included for comparative purposes should be presented as previously reported. The recognition and disclosure of the cumulative amount of change in the income statement for the period of change is required. The entity discloses pro forma comparatives as if the change had been applied to those periods. Retrospective adjustments are, however, required in certain cases such as changes in the method of accounting for inventory pricing, a change in depreciation method for previously recorded assets, a change in the method of accounting for long-term, construction-type contracts. Unlike, IFRS, US GAAP treats a change in the depreciation method as a change in accounting policy, on lines similar to that of Indian GAAP.

(6) Significant differences among AS-6, IAS/IFRS and US-GAAP
   a) AS-6 allows the depreciation on revalued value of the assets as the AS-10 on fixed assets allows the revaluation of assets but US GAAP prohibits revaluation. IAS-16 allows fair value accounting (Upwards) for fixed assets as an alternative treatment.
   b) A change in depreciation method under AS-6 and US GAAP is treated as a change in an accounting policy; whereas under IAS-16, it is treated as a change in estimate, which affects the results of current and future periods. Under IAS-16, a retrospective application of this change with a cumulative adjustment of the surplus/ deficiency against the current period income statement is not required.

   a) After the issue of AS-7 (revised) in 2002 the only method prescribed is percentage completion method to recognize the contract revenue, which is the same as IAS-11. US GAAP in certain circumstances allows another method i.e. completed contract method the recognition of contract revenue.
   b) US GAAP provides detailed guidance on the use of estimate in accounting for construction contract, but no such guidance is provided under AS-7 and IAS-11.
(8) Significant differences amount AS-9, IAS-18/IFRS and US-GAAP
   a) The definition of “Revenue” is almost same in AS-9 and in IFRS/ IAS-18; but there is no specific standard for recognizing the revenue under US GAAP. There are over 75 sources of accounting guidance for revenue recognition in the United States.
   b) Under IFRS/ IAS-18, the revenue recognition from rendering of services is done on the basis of percentage of completion method whereas in AS-9 revenue from rendering of services can be recognized on proportionate completion method or completed service method.
   c) IFRS/ IAS-18 contains the provisions for revenue swaps; however, no such corresponding provisions are in AS-9.

(9) Significant differences among AS-10, IAS-16/IFRS and US-GAAP
   a) Main difference is regarding revaluation of fixed asset.
   b) AS-10 allows revaluation, IFRS/IAS-16 also allow revaluation but with detailed guidelines. US GAAP does not allow revaluation.
   c) Difference in exchange arising out of payment or translation of foreign exchange liability on account of fixed asset as per AS-11 (Revised), which is in accordance with IFRS/ IAS-21 and US GAAP.

(10) Significant differences among AS-11 (Revised), IAS-21/IFRS and US-GAAP
   After AS-11 (Revised), there is no significant difference among AS-11, IAS-21 and US GAAP.
   a) US GAAP uses different terminology such as “functional currency” which is alike a reporting currency in AS-11 and IAS-21. However basic approach in accounting is almost the same in IAS-21, AS-11 and US GAAP.
   b) AS-11 (Revised) covers the forward contract / hedging whereas IAS-21 does not cover it, which is covered in IAS-39 “financial instrument- Recognition and measurement.” US GAAP also (FASB statement No-133) covers forward contract and hedging which is not covered by statement-52.

(11) Significant differences among AS-12, IAS-20/IFRS and US-GAAP
   a) AS-12 does not state about fair value measurement of non-monetary grants whereas IAS-20 talks about non-monetary grants as fair value at the time of initial recognition.
   b) Grant in the nature of promoter contribution is credited to capital reserve as per AS-12 if, however as per IAS-20, such grant should be treated as deferred income, then it should be allocated over the period under which condition attached to grant is fulfilled on a systematic basis.
   c) Refund of grant is treated as extraordinary items as per AS-12 whereas in IAS-20 it is treated as change in estimate.
   d) Under US GAAP, there is no pronouncement on how to account for these grants. The nature of the grant determines the accounting treatment to be adopted. If the grant is revenue is nature, then it is recognized in the income statement in the period when the qualifying expenditure is expensed. If the grant is of a capital nature, e.g. relates to capital expenditure, then it is accounted for either as a deferred credit in the balance sheet or set-off against the cost of the asset.

(12) Significant differences among AS-13, IAS/IFRS and US-GAAP
a) AS-13 covers all the investments like investment of property investment in subsidiary, investment in associates and investment in financial instruments (share and debentures) whereas there are three International Accounting Standard corresponding to AS-13, these are IFRS/IAS-32, IFRS/IAS-39 and IFRS/IAS-40. The ICAI is revising the AS-13
c) US GAAP too contains detailed provisions in respect of valuation of investment properties. The standards on accounting for derivatives are yet under formulation in India, though these have been established in US GAAP and IFRS / IAS a long time ago.
d) He ICAI has issued exposure draft of the accounting standard on “Financial Instruments- Disclosures and Presentations”

(13) Significant differences among AS-14, IFRS-3 and US-GAAP

a) IFSR-3 allows only Purchase Method. Option of pooling method given under IFRS/IAS-22 has been withdrawn whereas AS-14 allows both pooling of Interest Method and Purchase Method.

b) IFRS-3 requires valuation of assets and liabilities at fair value whereas AS-14 requires valuation at carrying value.

c) IFRS-3 requires Goodwill to be tested for impairment whereas AS-14 requires amortization of Goodwill.

d) IFRS-3 requires recognition of negative goodwill immediately in profit and loss account whereas AS-14 does not deal with reverse acquisition.

e) IFRS-3 requires valuation of financial assets to be dealt with as per IFRS/IFRS/IAS-39 whereas AS-14 contains no such similar provision.


a) IFRS/IAS and US GAAP provide details on the actuarial method to be followed.

b) IFRS/IAS and US GAAP deal with, in much greater detail, accounting in respect of short-term employee benefits, multi-employer plans, long-term employee benefits (long-service or sabbatical leave, jubilee or other long-service benefits) termination liability, etc., which are either not dealt with under AS-15 or not dealt with comprehensively under Indian GAAP.

c) IFRS/IAS-19 does not deal with accounting for equity compensation plans, but contains disclosure requirement for equity compensation plans. Accounting for equity compensation plans in India is guided by the guidance Note on Accounting for Employees Share based Payment which is similar to the requirements under US GAAP.

d) The ICAI has revised AS-15 (Indian GAAP) to make it compatible with IFRS/IAS-19; however, the same is yet to be made applicable.


(a) Recognition of Actuarial Gains and Losses- IAS-19 Provides options to recognize actuarial gains and losses as follows:

- By following a ‘Corridor Approach’, which results in deferred recognition of the actuarial gains and losses, or
- Immediately in the statement of profit and loss, or
Immediately outside the profit or loss in a statement of changes in equity titles ‘Statement of recognized income and expense’.

(b) The revised AS-15 (2005) does not admit options and requires that actuarial gains and losses should be recognized immediately in the statement of profit and loss.

(c) US GAAP also provides options to recognize actuarial gains and losses as per IAS-19 particularly by following the option of ‘Corridor Approach’ (FASB-106).

(d) Recognition of Defined Benefit Assets-

Because of ‘Corridor Approach’ followed in IAS-19 and US GAAP, the recognition of assets under defined benefit plan may be more as compared to AS-15 (2005). In this way the Indian GAAP (AS-15) is more stringent than IAS-19 and US GAAP.

(e) Termination Benefit- Recognition of Liability-

IAS-19 provides that the enterprise should recognize termination benefits as a liability and an expense when, and only when, the enterprise is demonstrably committed to either

I. terminate the employment of an employee or group of employees before the normal retirement date; or

II. provide termination benefits as a result of a offer made in order to encourage voluntary committed to a termination when, and only when, the enterprise has detailed formal plan for the termination and is without realistic possibility of withdrawal.

(f) AS-15 and US GAAP (FASB-88) recognizes termination benefits as a liability and an expense only when-

I. The employer accepts the offer; and

II. The amount can be reasonably estimated.

(g) Because of the above differences in recognition it is possible that under IAS-19, the termination benefits are recognized earlier than AS-15 (2005) and US GAAP.

(h) Transitional Provisions- In respect of transitional liability for defined benefit plan, IAS-19 provides that if the transitional liability is more than the liability that would have been recognized at the same date under the enterprise’s previous accounting policy, the enterprise would make an irrecoverable choice to recognize that increase as part of its defined straight-line basis over up to 5 years from the date of adoption subject to certain conditions.

(i) The revised AS-15 (2005), on the other hand, provides no choice in this regard, and requires that the differences between the transitional liability as per this Statement and the liability that would have been recognized should be adjusted against the opening balance of revenue reserves and transition obligation on straight-line basis over the average remaining service period. If any remaining service period is less than 20 years an optional 20 year period could be used. In substance the Indian GAAP (AS-15) is more stringent than the IAS-19 and US GAAP.

(16) Significant difference amount AS-16 IFRS/ IAS and US GAAP

a) There is no significant difference among Indian GAAP (AS-16), IFRS/ IAS-23 and US GAAP except the slight difference as regards to disclosure requirements.

b) US GAAP (FAS-34) requires disclosure for an accounting period in which no interest cost is capitalized, the amount of interest cost incurred and charged to expense during the period, further for an accounting period in which some interest cost is capitalized, the total amount of interest cost incurred during the period and the amount thereof that has been capitalized.
c) IFRS/ IAS-23 requires the disclosures of the capitalization rate used to determine the amount of borrowing costs eligible for capitalization.

(17) Significant difference amount AS-17, IFRS/ IAS and US GAAP.

a) IAS-14 (Revised) applies to enterprises whose equity or debt securities are publicly trades, including enterprises in the process of issuing equity or debt securities in a public securities market, but not to other economically significant entities. AS-17 applies to listed enterprises as well as unlisted enterprises with an annual turnover exceeding RS.50 crores. US GAAP (FAS 131) applies to publicly traded companies and the companies which are required to file financial statements with Securities and Exchange Commission (SEC).

b) Under AS-17 and IAS, segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as whole. US GAAP does not prescribe the accounting policies to be used and, thus, permits alternative bases of accounting for segments.

c) US GAAP employees a more management approach in defining segments.

(18) Significant difference among AS-18, IFRS/ IAS and US GAAP

By an large, related parties identified under US GAAP, IAS-24 and AS-18 would be similar.

a) AS-18 and IAS-24 require that related party transaction even if at arm’s length prices is to be disclosed. Whereas as per US GAAP, no disclosure is required for such transaction.

b) IFRS /IAS-24 adopts a more ‘substance over form’ approach in defining relatives as close members of the family, i.e they are those who influence and can be influenced by the individual in his/her dealing with the reporting enterprise. IAS-24 does not mention any specific relation. AS-18 includes specific relations.

c) As per IAS-24 State-controlled entities are within the scope of related party disclosure whereas AS-18 excludes State-controlled enterprise from related party.

d) As per AS-18 disclosure depends on the basis of control relationship or influence relationship, whereas such requirements are not prescribed in IAS-24.

e) Pricing policy on related party transaction needs to be disclosed as per IFRS/ IAS-24, whereas there is no such specific requirement under AS-18.

(19) Significant difference among AS-19, IFRS/ IAS-17 and US GAAP

a) Under AS-19 and IAS-17 classification of lease into finance lease or operating lease is a matter of judgment. Under US GAAP classification of operating lease and capital lease is less judgmental, as there are detailed rules to decide the classification.

b) Under US GAAP finance lease is referred as capital lease and further classified as sales types leases or direct financing leases or leveraged leases for the purpose of accounting whereas there is not such further classification of finance lease as per AS-18 or IAS-17.

c) AS-19 is not applicable to lease agreement to use land whereas IAS-17 and US GAAP (FA-13) is applicable to lease agreement to use land.

d) There is difference among US GAAP, AS-19 and IAS-17 regarding accounting treatment of sale and lease back transactions.

e) Onerous leases are not dealt with by Indian GAAP neither in AS-19 nor in AS-29 whereas IAS-37 deals with such onerous leases. Under the US GAAP provisions for
vacant leasehold properties which have become onerous is dealt with by EITF-88-10.

(20) Significant difference among AS-20, IFRS/IAS-33 and US GAAP

a) Share application money pending allotment on the balance sheeting date being utilized in the business of the enterprise is treated as potential equity shares as per AS-20. IAS-33 does not specify anything about it.

b) AS –20 requires disclosure of basic and diluted EPS in the parent separate financial statement as well as in consolidated financial statement, whereas IAS-33 and US GAAP require disclosure in consolidated financial statement.

c) AS-20 and US GAAP (FAS-128) provides guidance on the basis of apportionment of profits over different classes of equity shares whereas IAS-33 is silent about this.

d) If a subsidiary, joint venture or an associate of an enterprise issues potential equity shares. Such shares should be included in the calculation of diluted EPS of the consolidated financial statement as per IAS-33 and US GAAP whereas AS-20 does not specifically mention about this.

e) US GAAP requires that “reverse treasuring stock method” be used for contracts that require the reporting enterprises to re-purchase its own shares whereas AS-20 does not specify anything about buyback of equity shares. IAS-33 requires including forward purchase contract option in calculation of diluted earning per share.

(21) Significant differences among AS-21, IFRS/IAS and US GAAP

(a) Control:-

I. As per AS-21, the definition of “Control” includes indirect control which may exist without majority holding.

II. IAS-27 defines “Control” as the power to govern the financial and operating policies of an enterprise so as to obtain benefits from activities.

III. As per US GAAP (SAFS 94 and ARB 51), only majority owned undertakings are considered as subsidiaries.

(b) Requirements:-

I. As per AS-21, consolidated financial statements are required in addition to, and not in lieu of, separate financial statements if the enterprises are required to prepare the consolidated financial statements under any statute. Presently the listed companies are required to prepare consolidated financial statements.

II. IAS-27 and the US GAAP compulsorily require preparing consolidated financial statements unless it is itself a wholly owned subsidiary.

III. US GAAP (Statement 94) does not permit parent company only financial statements to be issued as general purpose financial statements. This is a significant difference from the practice in any other countries in the world where there is a requirement to publish the parent financial statements separately, as result, American companies provide less information than companies in many other countries.

(c) Goodwill:-

I. As per AS-21, goodwill or capital reserve is determined on historical cost basis; no prescription for amortization of goodwill.

II. As per IAS-27, goodwill or capital reserve is determined on the basis of assets or liabilities considered at their fair value; amortization is also provided.

(d) Differential period:-
I. As per AS-21, differential period between dates of parent and subsidiary, if do not coincide should not exceed six months which is in line with the requirement of section 212 of the companies Act, 1956.

II. As per IAS-27 and US GAAP, differential should not exceed three month.

(e) **Other statutory requirements:-**

I. In India, the Indian Companies Act, 1956, prescribes under section 212 the requirements for disclosure which are in addition to the requirement of the disclosure as per AS-21.

II. There are not corresponding statutory requirements under US GAAP.

(f) **Deferred tax:-**

I. **Both IAS-27 and US GAAP require that if income taxes have been paid on inter-company profits on assets remaining within the group, those taxes are deferred until the related assets are sold in an arm’s length transaction.**

II. **This principle does not apply under Indian GAAP in view of GC-18/2002 issued by ICAI.**

(g) **Investment in subsidiary:-**

I. IAS-27 also proves guidance for accounting for investment in subsidiaries in a parent’s separate financial statements. IAS 27 requires that a parent’s investment in a subsidiary be accounted for in the parent’s separate financial statements (a) at cost, (b) of financial assets as described in IAS-28 or (c) as available for sale of financial assets as described in IAS-39,

II. Under AS-21, in parent’s accounted for in accordance with AS-13. “Accounting for investment” which is cost as adjusted for any permanent diminution in value of those investment.

(h) **Exception of consolidation:-**

I. AS-21 provides that a subsidiary should be excluded from consolidation when it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

II. IAS-27 specifically provides that consolidation is required till control is not lost for such subsidiary.

III. US GAAP does not prescribe such condition for exclusion from consolidation, however, US GAAP (FAS 94) provides that if the subsidiary operates under foreign exchange restrictions, controls or other Government-imposed uncertainties which cast significant doubt on the parent’s ability to control the subsidiary (FA94.13).

(22) **Significant difference among AS-22, IFRS/ IAS-12 and US GAAP (SFAS-109)**

(a) As per AS-22, deferred tax assets to be recognized to the extent there is a reasonable or virtual certainty, whereas as per IAS-12, the enterprise will have sufficient taxable profit. Under US GAAP valuation allowance is made to provide for that portion which is not more likely than no realizable.

(b) AS-22 does not require numerical reconciliation between tax expenses and pre-tax accounting profit, whereas IAS-12 requires numerical reconciliation between tax expenses and pre-tax accounting profit. Under US GAAP, an enterprise shall disclose nature of significant reconciled items, but a numerical reconciliation may be omitted.

(c) As per AS-22, deferred tax assets and liabilities should be measured using tax rates that have been enacted by balance sheet date; the requirement of IAS-12 is the
same. Under US GAAP, deferred tax liabilities and assets be adjusted in the period of enacted change in tax laws or rates.

(d) As per AS-22, deferred tax assets and liabilities should be disclosed separately from current assets and current liability. Whereas in IAS-12, deferred tax assets and liabilities are treated as non-current. Under US GAAP, classification as current or non-current is based on the classification of related non-tax assets or liability.

(23) Significant difference among AS-23, IFRS / IAS-28 and US GAAP (APB-18)

a) AS-23 and US GAAP require that goodwill or capital reserve within the investment amounts are required to be separately identified but IAS-28 does not require so.

b) As per AS-23 equity method is applicable only in the case if the entity prepares consolidated financial statements. Whereas US GAAP (APB-18) requires the use of equity method regardless of whether an entity has subsidiaries. IAS-28 permits investment associates to be measured using equity method, at cost or available for sale in separate financial statements of the investor.

c) As per AS-23 and IAS-28 when financial statements with a different reporting date are used, adjustments are made for the effects of any significant events between the date of the associate’s financial statements and the date of the investor’s consolidated financial statement. US GAAP (APB-18) does not specify so.

d) IAS-28 and US GAAP specifically require that impairment losses be recognized. AS-23 does not specifically state so. However, there is no exclusion of AS-23 in AS-28. Therefore, AS-28 shall apply to investment accounted as per equity method in consolidated financial statement of the investor.

(24) Significant difference among AS-24, IFRS / IAS-5 and US GAAP (FASB-144)

a) AS-24 has been titled as “discontinuing operation” whereas the corresponding IFRS-5 is named as “Non-current assets held for sale and discontinued operation”, corresponding US GAAP (FASB-144) issued in 2001 is titled as “Accounting for the impairment of Disposed of Long-lived Assets”.

b) IAS-35 has been superseded by IFRS-5, AS-24 is based on IAS-35. ICAI shall also revise the AS-24 in line with IFRS-5. Reason for issuing the IFRS-5 was to converge the US GAAP with IFRS to the extent possible.

c) As per AS-24 (Indian GAAP) the disclosure for ‘discontinuing operation’ is to be made after the ‘initial disclosure event’; whereas as per IFRS-5 the disclosure for ‘discontinuing operation’ is done after the classification of non-current asset as ‘held for sale’. The way the ‘held of sale’ is defined under US GAAP (FASB-144), the disclosure for ‘discontinuing operation’ will be earlier as compares IFRS-5 and AS-24.

d) As per IFRS-5 and US GAAP (FASB-144) after the non-current assets are classified ‘held for sale’ these will be carried at lower of carrying amount and fair value, whereas as per AS-24 these assets are to be carried at cost less depreciation less impairment loss.

e) As per IFRS-5, Asset/ Liabilities classified as ‘held for sale’ to be presented separately on the face of the balance sheet similarly income pertaining to discontinuing operation to be separately disclosed on the face of the income statement. However, AS-24 and US GAAP do not prescribe so and, disclosure is made through notes to accounts.

(25) Significant difference among AS-25, IFRS / IAS-34 and US GAAP (APB-28)
a) Under US GAAP, interim period is primarily viewed as an integral part of the annual period whereas under AS-25 and IFRS/IAS-34 primarily discrete approach is followed.
b) Under AS-25 and IFRS/IAS-34, an inventory loss from market price decline is recognized in interim period, whereas under US GAAP such loss is not recognized if decline is expected to be restored before the end of the fiscal year.
c) Accounting policies and practices may need modification at interim reporting dates in US GAAP, whereas AS-25 and IFRS/IAS-34 envisage that same accounting policies and practices as followed for annual reporting should be followed for interim period reporting.

(26) Significant difference among AS-26, IFRS/IAS-38 and US GAAP (FASB-142)

a) There is no difference in charging the research cost to profit and loss statement, however in treatment of development expenditure. US GAAP differs from AS-26 and IFRS/IAS-38. As per US GAAP development expenses also are written off subject to few exceptions e.g. software expenses.
b) Revaluation of intangibles is not permitted in AS-26 and US GAAP, whereas revaluation is permitted under IFRS/IAS-38 as allowed alternative treatment.
c) IFRS/IAS-38 generally requires that an intangibles asset be amortized over its useful life (with a rebuttable presumption that the useful life of an intangible asset will not exceed 20 years). The corresponding period is 10 years under AS-26. No ceiling for useful life of intangibles is specified in US GAAP.
d) AS-26 and IFRS/IAS-38 provide that subsequent expenditure cannot be capitalized unless the test of cost-benefit proves incremental advantage relative to cost incurred; this aspect is not dealt with in US GAAP.

(27) Significant difference among the AS-27, IFRS/IAS-31 and US GAAP (APB-18)

a) Existence of a contract is must between the venturers as per AS-27 and IFRS/IAS-31 to qualify as a joint venture, whereas there is no such requirement under the US GAAP.
b) In a jointly controlled entity, AS-27 requires line-by-line consolidation of jointly controlled entity in venturer’s consolidated financial statements. In the venturer’s separate financial statement, interest in jointly controlled entity is accounted for as an investment in accordance with AS-13. However, IFRS/IAS-31 allows a benchmark treatment and an alternate treatment in the separate financial statement of the investor, US GAAP (APB-18) allows only the equity method of accounting in a separate financial statement of the investor.
c) IFRS/IAS-31 and AS-27 provide guidance for the financial statements of the investors (a party to the joint venture that does not have control). In addition to providing guidance for financial statement of the venture (the party with the joint control over the joint venture), US GAAP (APB-18) only provides guidance for preparing financial statements of a venturer and does not make venture.
d) IFRS/IAS-31 and AS-27 also provide the guidance for the fees charged by the operators or managers of joint ventures and accounting for transactions between a venturer and joint venture should be done in accordance with the respective revenue recognition standard. US GAAP does not include guidance of this type.

(28) Significant difference among AS-28, IFRS/IAS-36 and US GAAP
(a) US GAAP (SFAS 144) is significantly different in recognizing measuring and reversing of impairment loss than AS-28, IFRS/IAS-36, whereas AS-28 and IFRS/ IAS-36 are almost similar.

(b) Recognition of impairment loss:-
I. As per AS-28 and IFRS/IAS-36, impairment loss is recognized if carrying amount is more than the recoverable amount. While calculating recoverable amount, “value is use” is assessed in terms of future discounted cash flow at approximate rate
II. US GAAP estimates “value in use” without discounted cash flow, rather it specifies only aggregate of future cash flows. Other thing remaining equal, impairment losses will be recognized sooner in AS-28 and in IFRS/IAS-36 than under US GAAP.

(c) Measurement of impairment loss:-
I. Under US GAAP impairment loss is excess of carrying amount over fair value
II. Under AS-28 and IFRS/ IAS-36, it is excess of carrying amount over recoverable amount.
III. The recoverable amount over fair value whereas under AS-28 and IFRS/IAS-36, it is excess of carrying amount over recoverable amount. The recoverable amount is higher of net selling price and value in use.
IV. Impairment loss will substantially different in US GAAP and AS-28, IFRS/IAS-36 however if net selling price is more than value is use and cost of disposal is nominal, the impairment loss to be recognized in US GAAP and AS-28, FRS/ IAS-36 may be comparable.

(d) AS-28, IFRS/IAS-36 calculate net selling price by reducing cost of disposal from it fair value irrespective of fact whether asset is to be disposed of or not. Whereas under US GAAP, cost of disposal is reduced only when the asset is to be disposed of.

(e) US GAAP prohibits the reversal of impairment loss whereas the reversal of impairment loss is permitted as per AS-28, IFRS/ IAS-36.

(f) While allocating goodwill or corporate assets under US GAAP only “bottom up” test is followed while under AS-28, IFRS/IAS-36 both the test “bottom up” and “top down” are followed.

(g) AS-28, IFRS/IAS-36 is more detailed as compared to US GAAP; there will be substantial difference in measurement, allocation and subsequent depreciation resulting from impairment loss.

(29) Significant differences among AS-29, IFRS/IAS-37 and US GAAP
   a) AS-29 and IFRS/IAS-37 use words “a reliable estimate” can be made of the amount of the obligation for recognizing the provisions whereas the US GAAP (SFAS-5) states that the amount of loss can be ‘reasonable estimates’. It is possible that under AS-29 and IFRS/IAS-37, the recognition of ‘Provisions’ can be postponed on the pretext of ‘reliable estimate’.
   b) US GAAP interprets the ‘Probable’ as ‘likely to occur’ whereas the IFRS/ IAS-37 and AS-29 interpret it “more likely than not”. Because of different interpretation, it is possible that provision is recognized earlier in AS-29 and IFRS/IAS-37 than in US GAAP.
   c) IFRS/IAS-37 uses the “constructive obligation” for recognizing the provision for restructuring cost whereas AS-29 does, because this IFRS/IAS-37, recognize the ‘provision for restructuring cost’ earlier than AS-29.
d) AS-29 does not require the disclosure of contingent assets whereas IFRS/IAS-37 and US GAAP require the disclosure of contingent assets.

e) IFRS/IAS-37 requires that where the effect of value of money is material, provision may be treated as present value. AS-29 does not allow discounting for present value.

**Punishment for non-compliance of financial disclosures:**

While the Companies Act specifies punishments for non-compliance of financial disclosures, these are light. In most instances, the maximal penalty is either imprisonment for six months, or a fine of no more than Rs.2000 ($48), or both. In practice, there has hardly been any instance of imprisonment. For instance, if a company does not comply with proper audit practices or does not make available the necessary financial documents for audit, the penalty is a fine that does not exceed Rs.500 ($12). If the auditor's signed reports are not in conformity with the law, the maximum penalty is Rs.1000 ($24). In practice, the Indian system is quite lax. Huge judicial delays further diminish the minimal deterrence that such penalties are supposed to inflict. Moreover, some ethically questionable acts are considered par for the course. To give an example, certain auditing firms are known to cast benevolent eyes towards contingent liabilities, and ensure that the notes on account — while on the right side of the law — are sufficiently benign to give comfort to management. Such acts are routinely overlooked. And, while the ICAI prescribes detailed standards for external auditors, rare are the instances when it has taken any serious action against its members.

If anything, stock markets are doing their own enforcement. Increasingly, companies are enjoying premia for good corporate disclosures, and these have increased the demand for hiring the services of internationally respected and independent audit firms. Indian companies are increasingly finding the need for a reputed auditor for seeking foreign capital. This might clean up the system faster than enforcement that is mandated by law.

**Credit rating**

Since the early 1990s, the law prescribes that companies have to be rated by approved credit rating agencies before issuing any commercial paper, bonds and debentures. At present there are five rating agencies, of which four — CRISIL, CARE, ICRA and Duff and Phelps — are well established. Each of these agencies have a set of ratings from very safe to poorer than junk bond status. The rating has to be made public, and must be accompanied by the rating agencies’ perceptions of risk factors that can affect payment of interest and repayment of the principal. Company management also exercises its right to comment on these risk factors.

In the past there has been a tendency to do ‘rating shopping’ — namely, to approach more than one rating agency and then publish the one which is most beneficial to the company. Section 8 highlights the code of best practices suggested by the Confederation of Indian Industry (CII). At this juncture, it is important to note that the CII code has commented on this practice, and recommended that:

“If any company goes to more than one credit rating agency, then it must divulge in the prospectus and issue document the rating of all the agencies that did such an exercise. It is not enough to blandly state the ratings. These must be given in a tabular format that shows where the company stands relative to higher and lower ranking. It makes considerable difference to an investor to know whether the rating agency or agencies placed the company in the top slots, or in the middle, or in the bottom.” [CII, Desirable Corporate Governance: A Code, April 1998, Recommendation 15, pp.9-10]
Historically, three of the credit rating agencies — CRISIL, ICRA and CARE — were set up with shareholdings from the three all-India DFIs, namely ICICI, IDBI and IFCI. Recently, SEBI has insisted that these agencies will not be allowed to rate any of their shareholding companies or their subsidiaries.

**Share ownership**

As mentioned earlier, the Companies Act requires all companies to maintain a register of ‘members’ or shareholders, which has to be updated each time share transfers take place. In any given year, there is are two dates for book closure (typically covering two weeks prior to the date of the AGM) for final updating of the register for payment of dividends. Although the register is legally public domain information, and a list of shareholders has to be sent to the Registrar of Companies, in practice it is not as public as made out to be, especially for closely held, unlisted companies.

It is easier to access shareholding information for listed companies—at least in terms of broad aggregates. Stock exchange listing agreements require shares to be declared in the basis of individual promoters, DFIs, foreign institutional investors, mutual funds, foreign holdings, other corporate bodies, top 50 shareholders, and other shareholders. While better than unlisted companies, this classification often fails to give a fully transparent picture of share control —thanks to the prevalence of fairly complex cross-holdings across most family or group controlled conglomerates.

Traditional family dominated business groups — which constitute a sizeable chunk of listed companies — have tended to protect their interest through complex cross-holdings. Contrary to popular opinion, the main objective of this practice was not so much to thwart takeover bids, but to avoid steep wealth and inheritance taxes that characterized pre-1991 India. Abolition of both these taxes as well as the tax on individuals for dividend income, and a reduction of personal income tax rates to a little over 30%, has led to many business groups slowly unwinding their cross-holdings. Even so, at this point, it would be quite difficult to use the stock exchange ownership classification to construct a share-ownership matrix like the ones required under Form 10-K of the US Securities and Exchange Commission (SEC).

The process of moving towards cleaner and more transparent share ownership is also driven by an increasingly active stock market. Foreign institutional investors, who now account for anywhere between 24% and 30% of the equity of highly traded companies, avoid companies with complex cross-holdings. Desire to raise market capitalisation and access international Capitals are finally doing the right things for the pattern of equity-holdings.

There is another factor that has diminished the importance of cross-holdings: the meteoric rise of new, technologically oriented companies such as information technology and drugs and pharmaceuticals. Today, two internationally recognized IT companies share the pride of place among the top-five in market cap (Wipro and Infosys). Eight drug companies feature in the top-25. These firms are run along highly professional lines; their management is outward oriented and attuned to best principles of disclosures and corporate governance.

Consider the case of Infosys. The company discloses its accounts in keeping with GAAP requirements of India, US and six other countries. It follows the CII code and the Cadbury committee recommendations on corporate governance, has a highly acclaimed and independent board with Audit, Remuneration and Nomination Committees. From 1996 onwards — three years before it issued an ADR and got listed on NASDAQ — Infosys has been making full-fledged disclosures under section 10-K of the SEC. Its annual reports

Regional Training Institute, Allahabad
contain an exhaustive management discussion and analysis as well as other financial disclosures that go beyond best international practices. Other highly acclaimed companies in terms of disclosure include NIIT, Bajaj Auto, Hindalco, Nicholas Piramal, Wipro, BSES, Housing Development Finance Corporation and Dr. Reddy’s Laboratory. All of them have voluntarily gone well beyond the mandated disclosures of the Companies Act, and have done so in their self-interest. They have also been amply rewarded by the market for their transparency.

**Disclosures about directors**

The Companies Act is fairly exhaustive in its requirements about disclosing details of directors, senior management, and selling agents. Registers are required to maintained that disclose material transactions of directors vis-à-vis the company, and whether they are related to each other. Annual reports of companies have to furnish details about the remuneration to the directors as a whole, including salaries, commissions, and directors’ fees. However, many of these disclosure are not detailed enough — for example that of directors’ remuneration is given in the aggregate. Many others are made only at the time of appointment, and are not required on an annual basis. And other still, while technically in the public domain, are not made fully public in the sense of being disclosed in the annual report. The CII code has suggested major changes, and companies that abide by the code now make such disclosures in their annual reports.

**Related party transactions and other disclosures**

As mentioned, perhaps the greatest drawback of financial disclosures in India is the absence of detailed reporting on related party transactions. At the level of the balance sheet, there is no requirement to report which investments and loans made by the corporation are to subsidiaries and associated companies. And while the Companies Act insists upon maintaining registers on sole selling agents and the company’s business relationships with the directors, no such disclosure is separately made in the annual report. In this context, the Working Group on the Companies Act made certain important recommendations, which are listed below.

- Comprehensive report on the relatives of directors — either as employees or board members — should be a part of the Directors’ Report of all public limited companies.
- The fact a company has to maintain a register, which discloses interests of directors in any contract or arrangement, and that it is open for inspection by any shareholder should be explicitly stated in the notice of the AGM of all public limited companies.
- Details of loans to directors should be disclosed as an annex to the Directors’ Report in addition to being a part of the schedules of the financial statements. Moreover, such loans should be available only to executive directors.
- A tabular form containing details of each director’s remuneration and commission should form a part of the Directors’ Report, in addition to the usual practice of having it a note to the profit and loss account.
- All listed public limited company must give segment information as a part of the Directors’ Report in the Annual Report. This should encompass (i) the share in total turnover, (ii) review of operations during the year in question, (iii) market conditions, and (iv) future prospects. In the first instance, the cut-off was recommended at 10% of total turnover. The practice of segment reporting is rare.
- If a company has raised funds from the public by issuing shares, debentures or other securities, it must give a separate statement showing the end-use of such funds, namely: how
much was raised versus the stated and actual project cost; how much has been utilised in the project up to the end of the financial year; and how the residual funds are invested. This disclosure should be in the balance sheet, as a separate note forming a part of accounts.

- In addition to the present level of disclosure on foreign exchange earnings and outflow, there should also be a note containing separate data on of foreign currency transactions that are germane in today’s context: (i) foreign holding in the share capital of the company, and (ii) loans, debentures, or other securities raised by the company in foreign exchange.
- Differences in assets and liabilities between the end of the financial year and the date on which the board approves the balance sheet and profit and loss account must not be limited only to the Directors’ Report. These should be clearly stated under the relevant sub-heads, and presented as a note forming a part of the accounts.

**Insider trading**

Clause (g) of sub-section (2) of section 11 of the SEBI Act, 1992, clearly states that one of the functions of the capital market regulator is “prohibiting insider trading in securities”. The law also defines insider trading quite explicitly:

“Insider trading takes place when insiders or other persons who, by virtue of their position in office or otherwise, have access to unpublished price sensitive information relating to the affairs of a company and deal in the securities of such company or cause the trading of securities while in possession of such information or communicate such information to others who use it in connection with the purchase or sale of securities.”

As in most countries, the problem with insider trading lies in implementation. The example of SEC shows that, even with sophisticated detection devices, it is very difficult to pin-point insider trades. In the US, less than 1% of the trades that are initially identified as potential cases of insider trading are actually investigated; lesser still are charged and convicted. In India there are three sets of problems. The first, despite the BSE and NSE having full-fledged screen based trading, it is still difficult to flag a trade as a possible case of insider trading. Second, given the number of brokers and middle-men who operate in the market, it is possible for a person who has insider information to create enough fire-walls between himself and the traders — which militates against identifying the real insiders. Third, and most important, SEBI does not have judicial powers like courts. It can conduct an investigation, prepare a report and even suggest a penalty; but it cannot inflict that penalty. The act of implementing the punishment vests upon courts. Given the judicial delays in India, such penalties don’t account for much.

**Regulatory requirements for disclosures**

**A.** Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.
2. Company objectives.
3. Major share ownership and voting rights.
4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships, and whether they are regarded as independent by the board.
5. Related party transactions.
7. Material foreseeable risk factors.
8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.
Most of this information is routinely disclosed by the company to its shareholders. The details of the disclosures made by listed companies in India is mentioned in the table below:

<table>
<thead>
<tr>
<th>Type of disclosure</th>
<th>Statutory or non-statutory</th>
<th>Disclosure to whom</th>
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<tbody>
<tr>
<td>Annual Report</td>
<td></td>
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<tr>
<td>Chairman’s letter</td>
<td>Non-statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, Registrar of Companies (ROC)</td>
</tr>
<tr>
<td>Management discussion and analysis</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
<tr>
<td>Directors report and annexes</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
<tr>
<td>Balance sheet with its schedules</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
<tr>
<td>Profit and loss account with its schedules</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
<tr>
<td>Notes on accounts, significant accounting policies, auditor’s certification</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
<tr>
<td>Segment accounts</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
<tr>
<td>Cash flow statement</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
<tr>
<td>Report on corporate governance with certification of the Company Secretary and the auditor</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
<tr>
<td>General shareholder information</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
<tr>
<td>Financial disclosure for the press, SEBI and</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
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<tr>
<td>stock exchanges as per the SEBI format</td>
<td>investors, SEBI, DCA, ROC</td>
<td></td>
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<tr>
<td>Consolidated financial statement as clause 32 of listing agreement and AS-21</td>
<td>Statutory</td>
<td>Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC</td>
</tr>
</tbody>
</table>

**Half yearly disclosures**

| Half-yearly audited profit and loss account, with notes | Statutory | Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC |

**Quarterly disclosures**

| Quarterly non-audited profit and loss account, with notes | Statutory | Shareholders, stock exchanges, analysts, investors, SEBI, DCA, ROC |

**B. Information should be prepared, audited, and disclosed in accordance with high quality standards of accounting, financial and non-financial disclosure, and audit.**

Auditing standards in India are materially in line with International Standards on Auditing (ISA).
Session XVII

Session Title:
IMPROVING CORPORATE GOVERNANCE THROUGH INTERNAL CONTROL MECHANISM

Need of Control Mechanism

‘Corporate Governance’ is the system through which an organisation is controlled at higher echelon, to accomplish its goals and fulfill the prevailing essentials of accountability, integrity, and honesty.

The requirement for improved corporate governance is felt considerably in today’s complex corporate scenario. The NR Narayanmurthy committee inter-alia recommended that the Company’s Internal Control Mechanism, as a part of its Code of Corporate Governance, should comprise laying of guidelines, goals, setting of intentions for acquiring assets, selection of higher personnel adequate to get the goals and monitoring of progress towards those goals all the way through Internal Control Mechanism. Board of directors must be satisfied through Internal Control Mechanism that procedures and measures are in place, adequate, essential and effectual in carrying the operations of the Company. They control and monitor this through Internal Control Mechanism, by inquiring, questioning, penetrating subject and ensuring answers that are sensible, certain and reliable, in preference to doing direct checking themselves.

Organizations are supposed to take care of the following key principles of effective Internal Control Mechanism and risk management as stipulated in SEBI guidelines, Companies’ Act 1956 and other statutes.

- Internal Control Mechanism should cover all risks related to governance, management, and significant to financial standing. Nevertheless it should be focused to the most important key elements.
- Internal Control Mechanism produces an objective approach to risk coverage;
- Internal Control Mechanism is established on a visibly expressed policy and methodology;
- Internal Control Mechanism necessitates regular observance and assessment, for immediate action;
- Internal Control Mechanism should be administered by a known individual and entail the verifiable responsibility of senior officers;
- Internal Control Mechanism should be incorporated even into ordinary business procedures and connected to the strategic issues/goals.
- Organizations are under obligation to appraise annually the effectiveness of their system of internal control as a minimum. In carrying out an assessment of the system, it is suggested that organizations should refer to the latest ICSI, ICAI, ICWAI guidance on Internal Control Mechanism and risk management in their publications.
- Organizations are required to incorporate in their annual financial statements a statement on internal control (Clause 49 of the Listing Agreement - Disclosures (F) Management Internal control systems and their adequacy) in making their disclosure statements on corporate governance.

It is recommended that institutions refer to guidance notes, including from the Institute of Chartered Accountants of India, ICWAI and ICSI and the framework given in the “A guide to companies Audit” published by research committee of ICWAI, where it has been recommended.
that the auditor should ascertain the internal control and their effectiveness while determine the extent of the audit to be exercised.

As a minimum following disclosures pronounced by various accounting bodies should include a description of how the following broad principles of System of internal control have been applied:

- The identification and management of Company’s Internal Control Mechanism should be on continues basis, connected to the attainment of organizational objectives;
- The assessment to internal control should be probabilistic, including an assessment of the possibility and effect of uncontrolled risk.
- Review measures should cover all types of Company’s Internal Control Mechanism related to business, operation and compliance in addition to financial risk;
- Risk assessment and internal control should be well-established in continuing business processes;
- The BOD and Audit committee should review reports on regular basis during the year on internal control functions and risk management;
- The main outcome of Company’s Internal Control Mechanism viz. identification, assessment and management appraisal should be reported to, and evaluated by, the audit committee or BOD;
- The audit committee should acknowledge that it is their responsibility to ensure that a sound system of internal control has been maintained, and that it has assessed the efficacy of the Company’s Internal Control Mechanism;
- Wherever correct, identify fine points of actions taken or planned, to manage important internal control aspects.

In disclosing their policy on corporate governance it is recommended that institutions should use the model disclosure notes included in the revised Clause 49 of the Listing Agreement on 'Corporate Governance' as the starting point for their corporate governance statement. It is recognised that the compliance with the revised Clause 49 of the listing agreement may need to be adapted to further truly reproduce the different internal structures and systems in place in every specific organization.

**Risk Management Process**

The organisations are encouraged to adopt well-managed risk taking practices. The organizations such as public sector as a result require to have in place the proficiency, management preparations, and organizational structures to take advantage of chances to do things better and to reduce the possibility of failure to achieve key objectives. The Company’s Risk Management Policy (set out in Clause 49 - Corporate Governance IV. Disclosures (C) Board Disclosures – Risk management) defines the Company’s response to risk and how risk management should be implanted into management course of action to ensure that the most significant risks are being really managed.

Risk management entail a considered and organized advancement to the classification, appraisal and lessening of the risks which could hold back the success of strategic objectives. It involves the following main steps:

- Recognize the major strategic risks that would thwart the attainment of objectives;
Assigning what you have to do and handing over rights;
Assessing the consequence of every risk;
Taking into account the Company’s risk taking ability;
Identifying appropriate responses to every risk;
Ensuring that the internal control system helps to manage the risk;
Routine appraisal.

Risk classification

Strategic approaches to risk management rely on recognizing risks alongside major organizational objectives. The Companies' Corporate Plan sets out the key objectives on which the risk management process is built up. Working inside this structure helps to ensure a steady approach all over the organization and facilitate a comprehensible structure to be set up.

Responsibility Allocation

Having identified the key strategic risks, it is necessary to allocate responsibility for managing them. The risk identification process for Companies is based on the major corporate strategic risks set out in the Strategic Risk analysis. Usually risks are assigned to named officers; those officers should be expected to formulate acceptable reports on the risks for which they are answerable.

Appraisal of the implication of each risk

The importance of main risks has been evaluated by thinking about their possibility and effect. In view of the fact that if the nature of the Companies business allows, although an activity may possibly be assessed to carry a high prospect and high impact risk, it may perhaps still be pursued. This does not contradict the importance of good risk management practice. The activity under consideration will need a checking and appraisal procedure appropriate with the intensity of risk.

Various risks will be linked to or relied upon additional risks. It is vital to know the associations between various risks in order to effectively prioritize them. This process has led to the generation of the internal control manual, which should be kept under review by the audit committee.

Risk taking ability

The key of private sector risk management is on sustaining and enhancing profitability. Quite on the opposite, the public sector’s concentration is focused mainly on the accomplishment of objectives and release of a beneficial effect in the public interest. It is recognized that risk taking is necessary if the public bodies are to innovate and make progress. The support of Government and other stakeholders to well thought and thorough risk taking decisions and innovation will improve risk-taking ability of public enterprises.

Bearing in mind that the Public enterprises have social objectives too and in receipt of significant public funds, the Government's priorities and intentions have a significant impact on the Public Companies’ risk appetite. The Companies need to balance prospects to innovate and get better with its everyday jobs in terms of responsibility, aptness, promptness, and value for money. It is concerned in a large range of activities with the intention to describe its risk appetite in unqualified terms, which is almost impossible. In a number of areas it has to be risk averse, for example, in matters of finance; in others it would be regarded as a risk taking Companies, for instance in areas of new scientific and ground-breaking social research.

The Companies’ risk appetite is replicated in its strategic objectives. It has to measure its general portfolio of risks to double-check, to the extent possible, that the mix of risk remains reasonable and fair.
Responding to each risk

Subsequent to acknowledging the crucial strategic risks, Audit committee must know how they can manage to decrease their likelihood and impact, should the risk ever take place. It is necessary to appreciate the interface between the well-known risk and mitigation. Two or more risks may be successfully restricted by a single effort. Otherwise, one risk may necessitate a number of improvements to be ready to ensure it is effectively managed.

System of internal control

A control is any action or modus operandi executed by management to amplify the possibility of activities pulling off their objectives. In other terminology, control is an answer to risk, either to restrain the risk to a tolerable level or to enhance the chances of a required result.

The system of internal control offers a structure for all procedure and actions intended to give rational assertion about attainment of objectives. These techniques should be considered to manage to a certain extent rather than stamping out, the risk of failure. Controls can be put down into three categories:

- operational controls: concerning to the effective and efficient use of resources;
- financial controls: relating to the appropriate management and supervision of the organisation's funds, guiding to the groundwork of trustworthy published financial statements;
- compliance controls: relating to compliance with applicable laws, regulations and codes of practices.

Roles and Responsibilities

CFO i.e. the whole-time Finance Director or any other person heading the finance function/discharging that function (set out in Clause 49 - Corporate Governance V. CEO/CFO certification ) As head of Finance/Accounting , the CFO remains ultimately responsible for the organization and its management of risk. He must:

- have a natural awareness and appraisal of the risks that could thwart attainment of objectives;
- take care that the organization has efficient risk management and control process;
- make available with assertion that the development and the main strategic risks are being successfully managed.

Board Of Directors (BOD)

BOD has a primary responsibility in the management of risk which includes:

- receipt of an annual opinion from the CFO / Audit Committee that will include its review of the processes of risk management and internal control;
- contemplation of risk issues as they have an effect on BOD decisions (where suitable all BOD papers will consist of a discussion on the effect on the main strategic risks);
- assessment of important strategic risks that will be examined together with the Corporate Plan;
- from time to time appraising risks as part of the monitoring of the annual operating plans.

Senior Executives who have designated task for managing particular risks should be asked to give regular reports to the Audit Committee and to BOD where appropriate.

As per Clause 49 - Corporate Governance (F) Management, as part of the directors’ report or as an addition thereto, a Management Discussion and Analysis report should form part of the
Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company’s competitive position:

i. Industry structure and developments.
ii. Opportunities and Threats.
iii. Segment-wise or product-wise performance.
iv. Outlook
v. Risks and concerns.
vi. Internal control systems and their adequacy.

vii. Discussion on financial performance with respect to operational performance.
viii. Material developments in Human Resources / Industrial Relations front, including number of people employed.

Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding the Board of Directors. This would also include all members of management one level below the executive directors including all functional heads.

The whole time Finance Director or any other person heading the finance function/discharging that function (set out in Clause 49 - Corporate Governance (V). CEO/CFO certification) acts as the risk and Internal Control Mechanism task coordinator accountable for:

- Helping in classification of key strategic risks and internal control methods;
- Synchronizing BOD’s preparations for internal control methods and risk management;
- Encouraging risk understanding and ability in assessment and reporting.

General employees

All personnel should be tuned into, and identified with, the Internal Control Mechanism framework, the guidelines on Internal Control Mechanism and risk and how these relate to their own task and responsibilities. Particularly, senior personnel need to understand and cope with the risks relating to their activities and the impact on the Companies' crucial strategic risks.

Monitoring and review

Reporting mechanisms

Since risk management is clearly associated to Internal Control Mechanism and the attainment of objectives, coverage will be rooted inside the usual procedure for coverage on the Companies' operating performance. The Internal Control Mechanism should be evaluated by the Audit Committee of BOD on a term basis and reports should be made to BOD by the committee as required.

Other mechanisms for gaining assurance

Internal audit

The CFO, as the Companies' Officer, is in charge for confirming that an effective system of internal control is sustained and run by the Companies. While such a system can only offer reasonable and not absolute guarantee that risks are suitably managed, it should be founded on a structure of regular management information, administrative procedures including separation of duties, and a system of delegation and responsibility.
The role of internal audit is to provide an opinion to the CFO on the effectiveness of corporate governance, risk management and internal control. The work required to provide such an opinion should be abridged by having useful risk management arrangements. The CFO is also finally liable for confirming that the Companies’ internal audit services agree with the objectives and standards summarized in the internal control manual, which particularly comprise an analysis of risk.

**External Audit**

It is the responsibility of external auditors to provide an annual opinion as to whether the financial statements of the Companies give a true and fair view and are properly prepared in accordance with various applicable laws. This opinion covers the question of whether, in all material respects, the expenditure and income of the Companies have been calculated as per the norms/codes/procedures. This will involve reviewing the Companies’ processes and systems of control. These systems of control will include the effectiveness and efficiency of the internal audit function and the comprehensiveness of the Companies’ risk management framework.

**Review**

The risk surroundings of any organisation is continually varying and changing. As a result the priorities of objectives and the resulting significance of Internal Control Mechanism will also transform. The risk management procedure is self-motivated and continuing and must consequently engage periodic review of Internal Control Mechanism and the consequent adjustment of the control responses.

**Provisions of Auditing & Assurance Standards – 6 of ICAI on “Risk Assessment and Internal Control”**:

The purpose of this AAS is to establish Standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. The standard also extensively deals with aspects such as meaning of audit risk and its three components, meaning and inherent limitations of accounting and internal control systems, control environment, control risk and its assessment, tests of control, assessment of inherent risk and its relationship with control risk, assessment of detection risk, audit risk in small business and communication of weaknesses.

The AAS is effective for all audits related to accounting period beginning on or after April 1, 2002.
1. The purpose of this Statement on Standard Auditing Practices (SAP) is to establish standards on the procedures to be followed to obtain an understanding of the accounting and internal control systems and on audit risk and its components: inherent risk, control risk and detection risk. The principles laid down in the other SAPs, issued by the Institute of Chartered Accountants of India, would be applicable, to the extent practicable, to this SAP also. In this Statement, the term 'financial information' encompasses 'financial statements'. In some circumstances, specific legislations and regulations may require the auditor to undertake procedures additional to those set out in this SAP.

2. The auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach. The auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level.

3. "Audit risk" means the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk has three components: inherent risk, control risk and detection risk.

4. "Inherent risk" is the susceptibility of an account balance or class of transactions to misstatement that could be material, either individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

5. "Control risk" is the risk that a misstatement, that could occur in an account balance or class of transactions and that could be material, either individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems.

6. "Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, either individually or when aggregated in other balances or classes.

7. "Accounting System" means the series of tasks and records of an entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyse, calculate, classify, record, summarise and report transactions and other events.

8. "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal audit function constitutes a separate component of internal control with the objective of determining whether other internal controls are well designed and properly operated.

9. The system of internal control must be under continuing supervision by management to determine that it is functioning as prescribed and is modified, as appropriate, for changes in conditions. The internal control system extends beyond those matters which relate directly to the functions of the accounting system and comprises:

   a. the control environment" which means the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the entity. The control environment has an effect on the effectiveness of the specific control procedures and provides the background against which other controls are operated. A strong control environment, for example, one with tight budgetary controls and an effective
internal audit function, can significantly complement specific control procedures. However, a strong control environment does not, by itself, ensure the effectiveness of the internal control system. Factors reflected in the control environment include:

- The entity's organisational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory functions).
- The function of the board of directors and its committees in the case of a company or the corresponding governing body in case of any other entity.
- Management's philosophy and operating style.
- Management's control system including the internal audit function, personnel policies and procedures.

b. "control procedures“ which means those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives. Specific control procedures include:

- Reporting and reviewing reconciliations.
- Checking the arithmetical accuracy of the records. Controlling applications and environment of computer information environment systems, for example, by establishing controls over:
  - changes to computer programs
  - access to data files.
- Maintaining and reviewing control accounts and related subsidiary ledgers.
- Approving and controlling of documents.
- Comparing internal data with external sources of information.
- Comparing the results of physical verification of cash, fixed assets, investments and inventory with corresponding accounting records.
- Restricting direct access to assets, records and information.
- Comparing and analysing the financial results with corresponding budgeted
In the audit of financial statements, the auditor is concerned only with those policies and procedures within the accounting and internal control systems that are relevant to the assertions made in the financial statements. The understanding of relevant aspects of the accounting and internal control systems, together with the inherent and control risk assessments and other considerations, will enable the auditor to:

- assess the adequacy of the accounting system as a basis for preparing the financial statements;
- identify the types of potential material misstatements that could occur in the financial statements;
- consider factors that affect the risk of material misstatements; and
- develop an appropriate audit plan and determine the nature, timing and extent of his audit procedures.

When developing the audit approach, the auditor considers the preliminary assessment of control risk (in conjunction with the assessment of inherent risk) to determine the appropriate detection risk that may be accepted by the auditor for the assertions made in the financial statements and to determine the nature, timing and extent of substantive procedures for such assertions.

### Inherent Risk

#### 12. In developing the overall audit plan, the auditor should assess inherent risk at the level of financial statements. In developing the audit programme, the auditor should relate such assessment to material account balances and classes of transactions at the level of assertions made in the financial statements, or assume that inherent risk is high for the assertion, taking into account factors relevant both to the financial statements as a whole and to the specific assertions. When the auditor makes an assessment that the inherent risk is not high, he should document the reasons for such assessment.

#### 13. To assess inherent risk, the auditor would use professional judgement to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Examples of such factors are:

**At the Level of Financial Statements**

- The integrity of the management.
- Management's experience and knowledge and changes in management during the period, for example, the inexperience of management may affect the preparation of the financial statements of the entity.

- Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.

- The nature of the entity's business, for example, the potential for technological obsolescence of its products and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.

- Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as indicated by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.

**At the Level of Account Balance and Class of Transactions**

- Quality of the accounting system.

- Financial statements are likely to be susceptible to misstatement, for example, accounts which required adjustment in the prior period or which involve a high degree of estimation.

- The complexity of underlying transactions and other events which might require using the work of an expert.

- The degree of judgement involved in determining account balances.

- Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.

- The completion of unusual and complex transactions, particularly, at or near period end.

- Transactions not subjected to ordinary processing.
### 14.

**Internal controls relating to the accounting system are concerned with achieving the following objectives:**

- Transactions are executed in accordance with management's general or specific authorisation.

- All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with the applicable accounting standards, other recognised accounting policies and practices and relevant statutory requirements, if any, and to maintain accountability for assets.

- Assets and records are safeguarded from unauthorised access, use or disposition.

- Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

### Inherent Limitations of Internal Controls

**Accounting and internal control systems can provide only reasonable, but not absolute, assurance that the objectives stated above are achieved. This is because the internal control systems are subject to some inherent limitations, such as:**

- Management's consideration that the cost of an internal control does not exceed the expected benefits to be derived.

- The fact that most internal controls do not tend to be directed at transactions of unusual nature.

- The potential for human error, such as, due to carelessness, distraction, mistakes of judgement and the misunderstanding of instructions.

- The possibility of circumvention of internal controls through the collusion with employees or with parties outside the entity.

- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.

- The possibility that procedures may become inadequate due to changes in conditions and compliance with procedures may deteriorate.
- Manipulations by management with respect to transactions or estimates and judgements required in the preparation of financial statements.

**Understanding the Accounting and Internal Control Systems**

16. When obtaining an understanding of the accounting and internal control systems to plan the audit, the auditor obtains a knowledge of the design of the accounting and internal control systems, and their operation. For example, an auditor may perform a "walk-through" test, that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control. The nature and extent of walk-through tests performed by the auditor are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment which is less than high.

17. The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things:
   - The size and complexity of the entity and of its information system.
   - Materiality considerations.
   - The type of internal controls involved.
   - The nature of the entity's documentation of specific internal controls.
   - The auditor's assessment of inherent risk.

18. Ordinarily, the auditor's understanding of the accounting and internal control systems significant to the audit is obtained through previous experience with the entity and is supplemented by:
   - inquiries of appropriate management, supervisory and other personnel at various organisational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions, systems descriptions and flow charts;
   - inspection of documents and records produced by the accounting and internal control systems; and
   - observation of the entity's activities and operations, including observation of the organisation of computer operations, personnel performing control procedures and the nature of transaction processing.
### Accounting System

19. **The auditor should obtain an understanding of the accounting system sufficient to identify and understand:**
   
   a. major classes of transactions in the entity’s operations;

   b. how such transactions are initiated;

   c. significant accounting records, supporting documents and specific accounts in the financial statements; and

   d. the accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements.

### Control Environment

20. **The auditor should obtain an understanding of the control environment sufficient to assess management’s attitudes, awareness and actions regarding internal controls and their importance in the entity.** Such an understanding would also help the auditor to make a preliminary assessment of the adequacy of the accounting and internal control systems as a basis for the preparation of the financial statements, and of the likely nature, timing and extent of audit procedures.

21. **The auditor should obtain an understanding of the control procedures sufficient to develop the audit plan.** In obtaining this understanding, the auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether any additional understanding of control procedures is necessary. Because control procedures are integrated with the control environment and the accounting system, some knowledge about control procedures is also likely to be obtained, for example, in obtaining an understanding of the accounting system pertaining to cash, the auditor ordinarily becomes aware of whether bank accounts are reconciled regularly. Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class.

### Control Risk

22. **After obtaining an understanding of the accounting system and internal control system, the auditor should make a preliminary assessment of control risk, at the assertion level, for each material account balance or class of transactions.**

### Preliminary Assessment of Control Risk

23. **The preliminary assessment of control risk is the process of evaluating the likely effectiveness of an entity’s accounting and internal control systems in preventing or**
detecting and correcting material misstatements. The preliminary assessment of control risk is based on the assumption that the controls operate generally as described and that they operate effectively throughout the period of intended reliance. There will always be some control risk because of the inherent limitations of any accounting and internal control system.

24. The auditor ordinarily assesses control risk at a high level for some or all assertions when:
   a. the entity's accounting and internal control systems are not effective; or
   b. evaluating the effectiveness of the entity's accounting and internal control systems would not be efficient.

In the above circumstances, the auditor would obtain sufficient appropriate audit evidence from substantive procedures and from any audit work carried out in the preparation of financial statements.

25. The preliminary assessment of control risk for a financial statement assertion should be high unless the auditor:
   a. is able to identify internal controls relevant to the assertion which are likely to prevent or detect and correct a material misstatement; and
   b. plans to perform tests of control to support the assessment.

**Documentation of Understanding and Assessment of Control Risk**

26. The auditor should document in the audit working papers:
   a. the understanding obtained of the entity’s accounting and internal control systems; and
   b. the assessment of control risk.

When control risk is assessed at less than high, the auditor would also document the basis for the conclusions.

27. Different techniques may be used to document information relating to accounting and internal control systems. Selection of a particular technique is a matter for the auditor's judgement. Common techniques, used alone or in combination, are narrative descriptions, questionnaires, check lists and flow charts. The form and extent of this documentation is influenced by the size and complexity of the entity and the nature of the entity's accounting and internal control systems. Generally, the more complex the entity's accounting and internal control systems and the more extensive the auditor's procedures, the more extensive the auditor's documentation will need to be.
| 28. | Tests of control are performed to obtain audit evidence about the effectiveness of the: |
|     | a. design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and |
|     | b. operation of the internal controls throughout the period. |
|     | Tests of control include tests of elements of the control environment where strengths in the control environment are used by auditors to reduce control risk. |
| 29. | Some of the procedures performed to obtain the understanding of the accounting and internal control systems may not have been specifically planned as tests of control but may provide audit evidence about the effectiveness of the design and operation of internal controls relevant to certain assertions and, consequently, serve as tests of control. For example, in obtaining the understanding of the accounting and internal control systems pertaining to cash, the auditor may have obtained audit evidence about the effectiveness of the bank reconciliation process through inquiry and observation. |
| 30. | When the auditor concludes that procedures performed to obtain the understanding of the accounting and internal control systems also provide audit evidence about the suitability of design and operating effectiveness of policies and procedures relevant to a particular financial statement assertion, the auditor may use that audit evidence, provided it is sufficient to support a control risk assessment at less than a high level. |
| 31. | Tests of control may include: |
|     | Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorised. |
|     | Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it. |
|     | Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity. |
|     | Testing of internal control operating on specific computerised applications or over the overall information technology function, for example, access or program change controls. |
| 32. | The auditor should obtain audit evidence through tests of control to support any assessment of control risk which is less than high. The lower the assessment of control risk, the more evidence the auditor should obtain that accounting and internal control systems are suitably designed and operating effectively. |
| 33. | When obtaining audit evidence about the effective operation of internal controls,
the auditor considers how they were applied, the consistency with which they were applied during the period and by whom they were applied. The concept of effective operation recognises that some deviations may have occurred. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. When deviations are detected the auditor makes specific inquiries regarding these matters, particularly, the timing of staff changes in key internal control functions. The auditor then ensures that the tests of control appropriately cover such a period of change or fluctuation.

34. In a computer information systems environment, the objectives of tests of control do not change from those in a manual environment; however, some audit procedures may change. The auditor may find it necessary, or may prefer, to use computer-assisted audit techniques. The use of such techniques, for example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerised accounting system.

35. Based on the results of the tests of control, the auditor should evaluate whether the internal controls are designed and operating as contemplated in the preliminary assessment of control risk. The evaluation of deviations may result in the auditor concluding that the assessed level of control risk needs to be revised. In such cases, the auditor would modify the nature, timing and extent of planned substantive procedures.

Quality and Timeliness of Audit Evidence

36. Certain types of audit evidence obtained by the auditor are more reliable than others. Ordinarily, the auditor's observation provides more reliable audit evidence than merely making inquiries, for example, the auditor might obtain audit evidence about the proper segregation of duties by observing the individual who applies a control procedure or by making inquiries of appropriate personnel. However, audit evidence obtained by some tests of control, such as observation, pertains only to the point in time at which the procedure was applied. The auditor may decide, therefore, to supplement these procedures with other tests of control capable of providing audit evidence about other periods of time.

37. In determining the appropriate audit evidence to support a conclusion about control risk, the auditor may consider the audit evidence obtained in prior audits. In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control. Before relying on procedures performed in prior audits, the auditor should obtain audit evidence which supports this reliance. The auditor would obtain audit evidence as to the nature, timing and extent of any changes in the entity's accounting and internal control systems since such procedures were performed and assess their impact on the auditor's intended reliance. The longer the time elapsed since the performance of such procedures the less assurance that may result.

38. The auditor should consider whether the internal controls were in use throughout the period. If substantially different controls were used at different times during the period, the auditor would consider each separately. A breakdown in internal controls for a specific portion of the period requires separate consideration of the nature, timing and extent of the audit procedures to be applied.
The auditor may decide to perform some tests of control during an interim visit in advance of the period end. However, the auditor cannot rely on the results of such tests without considering the need to obtain further audit evidence relating to the remainder of the period. Factors to be considered include:

- The results of the interim tests.
- The length of the remaining period.
- Whether any changes have occurred in the accounting and internal control systems during the remaining period.
- The nature and amount of the transactions and other events and the balances involved.
- The control environment, especially supervisory controls.
- The nature, timing and extent of substantive procedures which the auditor plans to carry out.

**Final Assessment of Control Risk**

Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the auditor, the auditor should consider whether the assessment of control risk is confirmed. In case of deviations from the prescribed accounting and internal control systems, the auditor would make specific inquiries to consider their implications. Where, on the basis of such inquiries, the auditor concludes that the deviations are such that the preliminary assessment of control risk is not supported, he would amend the same unless the audit evidence obtained from other tests of control supports that assessment. Where the auditor concludes that the assessed level of control risk needs to be revised, he would modify the nature, timing and extent of his planned substantive procedures.

**Relationship between the Assessments of Inherent and Control Risks**

Management often reacts to inherent risk situations by designing accounting and internal control systems to prevent or detect and correct misstatements and therefore, in many cases, inherent risk and control risk are highly interrelated. In such situations, if the auditor attempts to assess inherent and control risks separately, there is a possibility of inappropriate risk assessment. As a result, audit risk may be more appropriately determined in such situations by making a combined assessment.

**Detection Risk**

The level of detection risk relates directly to the auditor's substantive procedures. The auditor's control risk assessment, together with the inherent risk assessment, influences the nature, timing and extent of substantive procedures to be performed to reduce detection risk, and therefore audit risk, to an acceptably low level. Some detection risk would always be present even if an auditor were to examine 100 percent of the account balances or class of transactions because, for example, most audit evidence is persuasive rather than conclusive.

The auditor should consider the assessed levels of inherent and control risks in determining the nature, timing and extent of substantive procedures.
required to reduce audit risk to an acceptably low level. In this regard the auditor would consider:

a. the nature of substantive procedures, for example, using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity, or using tests of details for a particular audit objective in addition to analytical procedures;

b. the timing of substantive procedures, for example, performing them at period end rather than at an earlier date; and

c. the extent of substantive procedures, for example, using a larger sample size.

44. There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable detection risk needs to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level. Refer to the Appendix to this SAP for an illustration of the interrelationship of the components of audit risk.

45. While tests of control and substantive procedures are distinguishable as to their purpose, the results of either type of procedure may contribute to the purpose of the other. Misstatements discovered in conducting substantive procedures may cause the auditor to modify the previous assessment of control risk. Refer to the Appendix to this SAP for an illustration of the interrelationship of the components of audit risk.

46. The assessed levels of inherent and control risks cannot be sufficiently low to eliminate the need for the auditor to perform any substantive procedures. Regardless of the assessed levels of inherent and control risks, the auditor should perform some substantive procedures for material account balances and classes of transactions.

47. The auditor’s assessment of the components of audit risk may change during the course of an audit, for example, information may come to the auditor’s attention when performing substantive procedures that differs significantly from the information on which the auditor originally assessed inherent and control risks. In such cases, the auditor would modify the planned substantive procedures based on a revision of the assessed levels of inherent and control risks.

48. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. When the auditor determines that detection risk regarding a financial statement assertion for a material account balance or class of transactions cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.
Audit Risk in the Small Business

49. The auditor needs to obtain the same level of assurance in order to express an unqualified opinion on the financial statements of both small and large entities. However, many internal controls which would be relevant to large entities are not practical in the small business. For example, in small businesses, accounting procedures may be performed by a few persons who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong management control system in which owner/manager supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and audit evidence of supervisory controls is lacking, the audit evidence necessary to support the auditor's opinion on the financial statements may have to be obtained entirely through the performance of substantive procedures.

Communication of Weaknesses

50. As a result of obtaining an understanding of the accounting and internal control systems and tests of control, the auditor may become aware of weaknesses in the systems. The auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention. The communication to management of material weaknesses would ordinarily be in writing. However, if the auditor judges that oral communication is appropriate, such communication would be documented in the audit working papers. It is important to indicate in the communication that only weaknesses which have come to the auditor's attention as a result of the audit have been reported and that the examination has not been designed to determine the adequacy of internal control for management purposes.

51. This Statement on Standard Auditing Practices becomes operative for all audits related to accounting periods beginning on or after 1st April, 2002.

Appendix

Illustration of the Interrelationship of the Components of Audit Risk

The following table shows how the acceptable level of detection risk may vary based on assessments of inherent and control risks.

<table>
<thead>
<tr>
<th>Auditor's assessment of inherent risk</th>
<th>Auditor's assessment of control risk is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>High</td>
</tr>
<tr>
<td>Medium</td>
<td>Lowest</td>
</tr>
<tr>
<td>Low</td>
<td>Medium</td>
</tr>
</tbody>
</table>

The shaded areas in this table relate to detection risk.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risk need to
be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.

1. The original Statement on Standard Auditing Practices (SAP) 6 "Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit" issued in May, 1988 would continue to be operative for all audits relating to accounting periods beginning on or before March 31, 2002.

2. With the formation of the Auditing Practices Committee in 1982, the Council of the Institute has been issuing a series of Statements on Standard Auditing Practices (SAPs). Statements on Standard Auditing Practices lay down the principles governing an audit. These principles apply whenever an independent audit is carried out. Statements on Standard Auditing Practices become mandatory on the dates specified in the respective SAPs. Their mandatory status implies that, while discharging their attest function, it will be the duty of the members of the Institute to ensure that the SAPs are followed in the audit of financial information covered by their audit reports. If, for any reason, a member has not been able to perform an audit in accordance with the SAPs, his report should draw attention to the material departures therefrom.

Companies Auditor’s Report Order, 2003 (CARO) on Internal control:

It shall apply to every company including foreign company as defined in Section 591 of the Act, except to a banking company, an insurance company; a company licensed to operate under section 25 of the Act and to private company meeting specified criteria. CARO comes into force on July 1, 2003, and applies for every financial year ending on any day on or after July 1, 2003. Further, under CARO 2003 issued by Government, statutory Auditor is required to report on the adequacy of the internal controls in a company. He will report that is there an adequate internal control procedure commensurate with the size of the company and the nature of its business and an additional reporting on whether ‘there is a continuing failure to correct major weaknesses in internal control.’

CASE STUDY ON FAILURE OF GLOBAL TRUST BANK

Conducted by Prof. A.K. Jain of IIM, Lucknow

On July 26, 2004, the depositors at the Global Trust Bank (GTB) were dumbstruck on reading the following notice pasted on the branches’ locked doors:

“We have been advised by Reserve Bank of India that in exercise of powers conferred by sub section (2) of section 45 of the Banking Regulation Act, 1949, the Government of India have issued an order of moratorium dated 25th July, 2004, in respect of our bank for the period from the close of business on 24th July 2004, up to and inclusive of 23rd October, 2004.

Further, Reserve bank of India in exercise of the powers conferred under Section (1) 36 AB of the Banking Regulation Act, 1949, have appointed Sri RV iyer and Sri G Padmanabhan as RBI nominee directors on the board of our bank.
We have therefore suspected the operations of ATMs in the interim and we regret the inconvenience caused to customers. We also request the customers to contact head of their branch for further guidance.

The closure notice sent ripples across the banking industry, shaking the confidence of depositors and investors. This also signaled the rapid end of one of biggest and quickest success stories in the private banking sector in India.

Eventually the (de) ceased GTB was amalgamated with Oriental Bank of Commerce a public sector bank- with effect from August 14, 2004. At least the depositors' money was now safe. The same could not be said of the small and retail equity investors who got zero compensation from the merger.

**FORMATIVE YEARS OF GTB**

Global Trust Bank was promoted by Ramesh Gelli, Jayanta Madhab and Sridhar Subasri. In addition to the 40% contribution by the core promoters, the bank managed to rope in International Finance Corporation (IFC) and Asian Development Bank (ADB) as the other major shareholders. The banking license from RBI was issued in the name of Jayanta Madhab. Global Trust Bank opened its first branch in Secunderabad on October 30, 1994, and on the first day of operation collect Rs100 crore of deposits- a commendable achievement. This was more than what the promoter Mr. Ramesh Gelli had dreamt of. The Bank’s amazing opening showed that it could stand shoulder to shoulder with its powerful competitors. The new Generation bank, as GTB called itself, was making waves from Day One.

**Windows of Opportunities Post-liberalization**

In the early nineties, the process of liberalization and deregulation were setting the tone for the creation of new private sector banks in India. The Reserve bank of India opened the doors of the banking industry to new players, and the era of the "New Generation banks’ was about to begin. The private banks were vying with the larger and more established banks for the huge market that India offered. GTB, just like ICICI and HDFC banks, was a new force in the banking industry.

Global Trust Bank was probably the only well known private sector bank started in the nineties that did not have a powerful established lineage and a huge deposit base. For instance, HDFC, ICICI and UTI were established and powerful Financial Institutions before entering banking operations and were able to leverage their reputation and cash reserves to establish early credibility and financial stability.

**CORPORATE MISSION**

GTB started with uncomplicated vision-mission statements. It simply said its mission was "to be a modern and model bank".

One of the cornerstones of the mission of Global Trust bank was to improve customer satisfaction & service through reduction in cost of operation and intermediation and spur innovation of specialized, customer-friendly products. Based on this premise, the corporate vision was formulated as a Bank that will:

- Build the Business and the Institution
• Create Shareholder Value
• Grow Profitably
• Develop a Complete Financial Services Organization
• Foster a Caring and Sensitive Organization

RAPID RISE OF GTB

At the time of its inception, Global Trust bank was dreamt of a bank that would rise as a new benchmark in banking. Six years later, Global Trust bank was more than just a bank. It had evolved from an idea to an organization. Some of its landmark achievements were:

• The bank created records of sorts, even before it started operations. The Initial Public Issue of Rs.1040 million received subscriptions of Rs.62.40 billion from over 1 million investors. This meant an over-subscription by a record 60 times

• On day one of its operation, the bank received Rs 1 billion of deposits, which exploded to Rs 10 billion by the end of the first year, and to Rs.27 billion at the end of almost three years. At the end of third year, the total business exceeded Rs 43 billion, making Global trust Bank one of the fastest growing banks in India.

• In just over two years the bank won the Best Export Performance Award from the Gem and Jewelry industry.

• Established more than five hundred thousand client relationships.

• Had a presence in all the major cities and was systematically spreading coverage in smaller cities in a phased manner throughout the country.

• Rated “First” amongst India Best Banks according to the survey done by Financial Express, a leading business daily of India, in February 2001.

The Business Model of GTB

In order to fund its initial growth, a bank needs large depositors and high net worth individuals who can provide large volume of deposits in a short time, since building up of retail customers takes time. At the same time, a new bank has to invest in ATMs and branches network, as well as in technology, in order to attract larger number of customers. Here GTB was at disadvantage—competitors like HDFC Bank and UTI Bank could rely on the brand names of their parents to approach large depositors and access technology.

Therefore in order to remain competitive, GTB adopted the simple expedient of offering high deposit rates to investor. Between 1996 and 1999, GTB’s cost of deposits varied from a minimum of 7.5 percent to as high as 11 percent, with an average of 9.43 percent. In contrast, over the same period the average cost of deposits for ICICI Bank and HDFC Bank was just around 6.76 percent and 6.24 percent. Between the three private banks, GTB was the only bank whose cost of deposits actually rose by a percentage points (though it fluctuated substantially between 1996 and 2001. Both ICICI Bank and HDFC bank managed to reduce their deposit costs over the years “There was tremendous pressure on branch managers to raise deposits in those early years,’ said an executive at GTB. In large number of cases, when potential borrowers approached in GTB branch
manger, the manager asked them to also bring in deposit business. The borrower, in turn, would tap certain brokers who specialized in raising large-scale deposits for a commission. “These brokers are largely found in Mumbai. As long as the borrower brought in these deposits, there was very little rigorous appraisal of the loan”.

In these cases, loans would be given mainly on the basis of a personal guarantee without any collateral security. For GTB such a practice was fairly common.

In order to successfully run its banking operation the GTB had to spread the higher deposit rates over its lending rates. Any established business group was unlikely to borrow at high rates of interest when cheaper loans were available. Therefore since its inception GTB adopted an altogether different strategy. GTB focused its lending to the small and medium companies (SMEs), which could be charged higher rate of interest. Between 1996 and 1999, the average return earned on loans by GTB was HDFC Bank and ICICI Bank was 12.83 per cent and 12.75 per cent respectively. Although GTB earned high average return, advancing loans to SMEs ran the higher risk of default. Within the SMEs, GTB mainly focused on the exporters of garments IT, diamonds and pharmaceuticals etc., where the entrepreneurs were willing to take loans at higher interest rates because of higher profitability but requiring quicker and more efficient service. About 75 percent of the total credit was to the export sector, mainly to companies in the above four industries.

CRITICAL SUCCESS FACTORS

There were a number of factors that led to the rapid growth of GTB in the initial years. Firstly, the Indian market was large enough to accommodate a number of competitors and the environment was conducive enough for the private banks to accumulate a good base of depositors. In a short period, GTB was able to garner a strong customer base.

Secondly, the burgeoning 200 million odd middleclass was looking for new banking options after getting tired of the poor vanilla-type service of the public sector banks. The multinational banks like Citibank and HSBC were not yet able to afford the cost of the superior services provided by them and the higher level of minimum deposits required.

Thirdly, the presence of Mr. Ramesh Gelli probably worked for the bank. Considered a banking genius, Ramesh Gelli evoked an aura that he was the right man for the GTB. Although the banking license was granted to Jayanta Madhab, who was associated with the Asian Development bank (ADB), the public image of the bank was always associated with Ramesh Gelli. He had played a key role in mobilizing funds when the operations started. It is also widely held that diamond traders contributed substantially to the Rs. 100 crore mobilized when the bank had just started operations. Gelli was responsible for building the image of GTB and winning the confidence of customers.

Lastly, GTB was one of the few banks that made excellent use of technology to serve its customers. It entered into technical & financial arrangement with the Hambrecht & Quist Group of USA for technology transfer in capital market related products (underwriting, placement, syndication, research etc.) and with TA Enterprise of Malaysia (TAE) for debt-related products and services like securitization, financial derivatives, etc. The bank installed quick and powerful foolproof systems that gave the front office attendant time to provide the customer with a warm personal touch. The human side of the
bank was friendly and simple. The banking transactions were quick and uncomplicated, thus making the customers happy and satisfied. It was a pioneer effort in computerization and Internet banking. The branches kept open two hours longer than the rest, and customers had the flexibility to do business at any counter and at any branch, and it even forwarded mails that customers sent through it. The bank's communications had talked about ‘redefining banking’ and to a certain extent, this promise was fulfilled and the bank slowly built its brand equity for customer-friendliness.

**FIRST SIGNS OF TROUBLE**

In order to reduce the over centralization and the influence of some prominent persons in the loans disbursement process at GTB, the RBI in 1998, directed the bank to broaden its credit decision process. From then onwards, an executive credit committee and a committee of board members approved all major loans decisions. Gelli was the chairman of both committees, and he continued to call the main shots. Thus although the new structure was put into place, but as banker puts it: ‘the centralization continued’.

GTB’s performance for five continuous years was seemingly stellar. However, in year 2000, the bank fell short of capital and Gelli started looking for inorganic growth through mergers with other banks. Here too, street smartness came in between survival and comfort. As a result there were negotiations with HDFC Bank and then IndusInd Bank, but these did not make much headway. Later in 2001 there were talks with UTI, which progressed to a point where the boards of the two banks approved the merger on a swap ratio of 9 UTI Banks shares to 4 GTB shares. But then allegations of rigging of GTB share price started surfacing and ultimately the proposed merger was called off.

It became evident that in its early years, GTB indulged in reckless lending in pursuit of growth. The initial problems surfaced in 1997-98 when it was revealed that its advances made to small and medium-sized corporates were highly risky. To make matters worse, instead of adopting a more conservative approach, GTB actively fuelled the Ketan Parekh-led bull-run in the stock market between December 2000 and March 2001. It lent heavily to players in the capital market and when the market crashed the bank’s balance sheet suffered a gaping hole. When it was attempting a merger with UTI Bank in 2001, GTB had lent more than Rs.800 crores to suspect and high-risk accounts. Much of the lending proved injudicious Exhibit 3 shows the movement of the share prices of GTB over the period of the existence.

**THE DOWNFALL**

The manner in which the operations at GTB were run could be gauged from the following case in point: GTB’s main stock market business was carried out in the Central Business District (CBD) of south Mumbai. In this part of Mumbai where Bombay Stock Exchange (BSE) is located, almost every single bank in the country—Private, public or foreign-owned—have their branches. A large chunk of the business for these branches comes from funding stockbroker. They transact hundreds of crores of business every day. Most banks post only senior managers with decades of experience in credit appraisal to head these branches because of the risks associated with lending to stockbrokers and because of the high volumes of daily transactions. In the case of GTB, the branch manager who handled this business had previously worked in a Grameen (rural) bank where the biggest loan he had made was for Rs 5000. In other cases, managers who had
never handled or made credit decisions were deputed, and put in charge of making large value loans. Most of such loans later turned sour.

Ketan Parekh, the infamous stockbroker responsible for the stock market crisis of 2001, was considered close to Ramesh Gelli. He lured GTB into the share market in 2001. As a result the bank lent aggressively to brokers and diamond traders, disregarding the prudential norms laid down by the RBI, to which every bank in the country has to abide. These norms state that no bank can lend more than 20 per cent of its money to more than one sector. But Gelli ignored these sacrosanct norms and put GTB into trouble. Moreover good baking practices say that the decision to give a loan should not vest with a single individual. There has to be a credit committee consisting of three or more persons who jointly sanction loans purely on merit. Apparently Gelli violated all these practices and committees must have been set up only to exist on paper.

A special review of disbursals by Global trust Bank in late 2000 and early 2001, carried out by auditors and consultants Ernst & Young in late 2001-02, demonstrated the nexus between the HGCL group, entities related or directly controlled by one-time big bull Ketan Parekh and some top GTB officials, including chairman and managing director Ramesh Gelli. The review, pointed to glaring lapses on the part of the top management of GTB, in connivance with HFCL and KP groups, was never made public. GTB had appointed E&Y to undertake a special review of key accounts, which included accounts belonging to group companies of Himanchal Futuristics Communication Ltd and Ketan Parekh.

**The UTI merger episode**

Apart from lending huge sums of money to Parekh and other brokers, it was accused that Gelli was also busy rigging up the GTB stock to gain advantage of the impending merger with UTI Bank. Following this the Securities and Exchange Board of India (SEB) initiated a detailed enquiry into the allegations. Consequently UTI Bank treated to pull out of the proposed merger. UTI demanded a fresh evaluation to review the share swap ratio. This was raised on the grounds that SBI Capital Markets which did the evaluation did not take into consideration the quality of GTB’s assets and, more particularly, its capital market exposure. UTI Bank appointed Deloitte, Haskins & Sell to conduct the fresh valuation within a week and submit the report to the Reserve Bank of India. Initially GTB resisted this move stating that the two sides should await SEBI’s report on the alleged price rigging in the GTB scrip prior to the merger, before taking a decision in this regard but they gave in to UTI’s demand later on.

Originally UTI did not make an issue about the ratio 9:4, which was entirely loaded in favour of GTB shareholders, since it wanted the merger to go through smoothly. More importantly UTI management treated the unfavorable swap ratio as the price for control over the merged entity. UTI Bank’s concern about the original valuation arose from the fact that the ratio was arrived at on the basis of the average values of the shares of the two entities, which in the case of GTB, as was being alleged, had been manipulated for several months before the merger deal was finalized.

UTI bank was also very unsure about GTB’s exposure to capital market funding. Further, the case for going in for a fresh valuation gained ground, as UTI Bank shareholders felt that the prevailing fall in GTB’s share price will further erode the value of
their holding. It was openly alleged that brokers and non-banking financial companies (NBFCs) borrowed money from the GTB and used it to buy its shares in the market. As a result, there was an upward spiral in the share price of GTB, which helped it achieve a better swap ratio in the merger. However, GTB officials denied that the share price movement had anything to do with the swap ratio, since the swap ratio was not purely based on the market price of GTB and UTI shares. Ultimately the deal did not materialize. Meanwhile Gelli was removed as a director of the bank by the Reserve bank of India.

Regulatory Intervention: The Parliamentary probe and the Reserve Bank

The stock market scam of 2001 led to huge losses for the retail investors. The public furore generated head to an extent that the Parliament set a Joint Parliamentary Committee (JPC) to carry out a probe and fix responsibility. In September 2001, the JPC found that Gelli and other promoters of the bank colluded with Ketan Parekh to push up GTB’s share price. The JPC observed that the bank was guilty of not monitoring the end-use of the funds that it lent. It also opined that the bank ought to have acted because there was a definite evidence of misappropriation of funds. Depositions by bank officials before the JPC confirmed SEBI’s finding of diversion of funds lent by GTB to several companies, among them Ketan Parekh-linked companies, Zee Telefilms and Himanchal Futuristic Communications Ltd. (HFCL).

On March 31, 2000 GTB had allotted 1.48 crore shares of Rs 10 each at a premium of Rs 75 per share to various institutions, mutual funds, and corporate bodies on a private placement basis. Since it also involved some foreign collaborators of the bank, necessary RBI and SEBI clearances were obtained. But the RBI pointed out that the GTB scrip price had risen 34.86 per cent from Rs 68.70 on October 13, 2000 to Rs 92.65 on November 10, 2000 on the Bombay Stock Exchange (BSE).

Independently India’s central bank- the Reserve Bank of India (RBI)- proceeded with its own investigations. On inspection of GTB’s accounts as on March 31, 2002, RBI found that GTB’s management that its net worth was about Rs 400 crores. This meant that the troubled bank had chosen to indulge in window dressing rather than correct its course of action of reckless lending. The central bank removed the bank’s auditors and made a complaint about the auditor to the Institute for Chartered Accountants of India.

In spite of RBI’s actions, the central bank could not remove Gelli’s influence from the bank. The new chief appointed in place of Gelli quit within six months telling the RBI that he was not being allowed to function by Gelli and his supporters. Gelli managed to get his son elected on to the bank’s board and even got himself reelected later in February 2004. But then he had to resign again when several complaints were made to the RBI about his induction.

Ban by SEBI


An investigation in the price movements in the scrip prima-facie revealed irregularities in the trading pattern such as the “synchronization of logging in of trades in a pre meditated fashion, creation of artificial volumes, circular trading, churning of the same stock, market manipulation, amount other”. In an ex-parte order issued on December 31, 2002, SEBI prohibited the promoters and associated entities from dealing in the GTB securities till investigations were completed.

Passing the order, the market regulator said that the investigations “show that the price and volumes of GTB were artificially manipulated. The promoters and entities though not responsible for the price manipulation were certainly responsible for creation of artificial volumes in the scrip. By their commissions and omissions, the regulator said that the entities had directly and indirectly aided and abetted Ketan parekh entities to manipulate the prices and volumes of the scrip”. Further, “the prohibition, which is remedial in nature is not a total prohibition from dealing in securities, it is only a partial prohibition restraining the said entities from dealing in the securities of GTB.

Shri G.N. Bajpai, SEBI chairman further said that ‘Looking into all the facts and circumstances, I am of the considered view that it would be in the interest of investors and orderly development of the securities market that the said partial prohibition continues for some time more”.

Towards an inglorious demise

On September 30, 2003, the auditors of GTB, Price Waterhouse Coopers (PwC) submitted a heavily qualified report. The report pointed out that “accounts are prepared on a going concern basis even though the net worth of the bank has been substantially eroded after considering the loss for the year on account of substantial provision against non-performing assets, taking into account management’s assessment of growth of business, infusion of capital… These accounts don not include adjustments aforesaid in case the management’s business plans do not materialize…”

In case the principle of going concern does not hold or it is not possible to arrive at an opinion, the auditor is supposed to give a disclaimer and not express his opinion. In GTB’s case there were many ifs and buts. For example, the audit report showed that:

- Accounts were prepared on going concern basis even though the net worth had been substantially eroded;
- Advances worth Rs 311.61 crore were considered good although the loans were not fully secured;
- No provision was made for assets valued at Rs 181.75 crore as the bank can hold the property for seven years;
- Accounting method is consistent except in case of the additional provision through statutory reserve permitted by the RBI; and
The accounts give a fair view subject to points (relating to Rs 311.61 crore and Rs 181.75 crore). The impact of which is indeterminate.

Following this audit report, GTB sacked PWC and appointed M Bhaskara Rao & Co as their auditors. It audited the quarterly results for 2003-04 and raised questions on the going concern status of the bank being considerably eroded it was considered a going concern.

Later, RBI asked GTB to curb its activities related to capital market exposure, declaration of dividend, advances and withdrawal of deposits. RBI then decided to monitor the bank on a monthly basis and permitted the bank till September 2003 to publish its revised accounts. But then the new set of accounts raised more issues. GTB reported a marginally positive net worth but RBI found that the net worth was plunging and the capital adequacy ration had turned negative.

In November 2003, RBI gave the opportunity to GTB to inject fresh capital through domestic sources or through a merger so that its capital adequacy ratio could be pumped up to the stipulated 9 per cent. The RBI asked the bank to draw up a schedule to achieve this. In May 2004, Gelli made a last ditch effort to rescue the ailing bank. To this end he submitted a proposal for restructuring to the RBI wherein he showed that he was backed a by a US private equity fund, Newbridge Capital. Gelli’s investment bankers, Lazard, Ambit and Morgan Stanley had tapped at least 12 other invesotsry across the globe. As per the proposal, Newbridge would bring in around Rs 800 crore. Another Rs 700 crore would be infused through domestic institutions. In return, Newbridge asked for numerous exemptions from the RBI- on the amount of capital it needed to set aside for each loan made, on priority-sector (agricultural) lending norms, and on the classification of non-performing assets (NPA). It also wanted to bring in a new management team. The existing one would have no say in GTB under this structure. The other strategic investors in the bank, International Finance Corporation, Washington, and Keppel Bank, Singapore, also met the RBI for an indication on the future of the bank. Nothing concrete materialized from these discussions.

Even as this proposal was being made, the RBI was already considering other options.; RBI was uncomfortable with Newbridge’s conditions. If it gave into such demands for waiver of norms on capital adequacy, provisioning, and accounting for bad loans, it would set a precedent. Future bidders for banks might also ask for the same concessions. RBI also wanted to avoid unnecessary controversy by allowing a Cayman Islands-registered company to take a large stake in a bank already dogged by controversy and corruption charges. Finally, RBI decided to play safe and chose to follow standard practice and merge GTB with a big public sector bank.

In July 2004 RBI rejected the proposal and applied to the central government to place the bank under moratorium for three months with effect from July 25, 2004. RBI announced on July 26 that GTB would be taken over by Oriental Bank of Commerce, a public sector bank. This marked the death of a private bank, which was at one time considered to be one with huge potential to establish itself as a major force in the Indian banking scenario.
Insert Trading Charges

In December 2002, SEBI through its internal investigation found that there was a prima facie evidence against the promoters of GTB because of sudden rise in the price of GTB scrip in 2001. Further the regulatory authority found that GTB had colluded with Mr. Ketan Parekh, a tainted share broker who had spend considerable time in jail for stock market manipulation, to jack up the price of the GTB scrip in order to have a upper hand in the proposed merger talk with the UTI bank. There was unusual trading activity in GTB shares in the stock market before and after announcement of take over of GTB by OCB. This was certainly unusual for an institution that was on its last legs. Meanwhile, reports from the market indicated that large entities including promoters, foreign institutional investors and Overseas Corporate Bodies and Non-Resident Indian, had offloaded their holdings in the GTB scrip in the weeks before the moratorium was declared by the RBI. According to reports, nearly 16 per cent of GTB shares were offloaded by these investors between June 14 and July 24. as a result, the holdings of smaller investors increased from 44 per cent to 51 per cent by the time the bank was declared dead. In fact, there are some reports that these holdings could account for almost 60 per cent of the shares. Clearly the smart people in the know of future events had offloaded their dud investments on the unwary and unsuspecting small retail investors.

In August 2004, SEBI announced that it was examining trade data during the last six months to see whether the activity in the market indicated insider trading. However, speculation is rife because it is now known that OBC gave the RBI its letter of intent in mid-July 2004. The possibility of insider trading is not difficult to fathom. If the promoters and the well connected knew of the impending merger, it would explain their selling the GTB shares. Obviously, those who were in the inside track knew where the bank was heading and quickly dumped their stock. But as happens in the stock market, those outside the information loop were losers.