agreement. However, there is growing recognition to address stakeholder interests in order to maximize shareholder value over the long run.

The Naresh Chandra Committee recognizes that 'the board responsibilities to shareholders as well as to customers, employees, suppliers and the communities in which the company operates are all founded upon the successful perpetuation of the business.' Thus, it is presumed that shareholders and stakeholders interests are compatible in the success of the company in the long run.

II Legal and Institutional Reforms for corporate Governance Improvement

1. Legal development regarding Corporate Governance in India

In India, the family owned business houses followed their particular way of governance, which suited them. The stakeholders considered them as acronyms of competence and trust. The meager holding of the families in their company's capital, non-transparency at various levels on various matters and superficial professionalism on the board with no public disclosure did not bring any reaction from the stakeholders, in a protected economy, till the seventies in India. Non-separation of ownership from the management generated corruption in business and resulted in denial of the value to the stakeholders.

In India, the fundamental concern of corporate governance is to ensure the means by which a company's managers are held accountable to capital providers for the use of assets. The past five years has witnessed a proliferation of corporate governance guidelines, reports and codes designed to improve the ability of corporate directors to hold management accountable. Although, the board of directors provide an important mechanism for holding management accountable, effective corporate governance is supported by and is dependent on market for corporate control, securities regulation, company law, accounting and auditing standards, bankruptcy laws, stock exchange listing rules and judicial enforcements.

In order to improve the corporate performance, a number of government and industry initiatives have been taken to lay down the necessary laws, bodies and guidelines for corporate governance. The most notable are the voluntary Code of Corporate Governance

of the CII, the Kumar Mangalam Birla Committee Report, the Naresh Chandra Committee Report, the Narayana Murthy Committee Report. The Kumar Mangalam Birla Committee Report led the introduction of clause 49 in the standard listing agreement for implementation by all stock exchanges for all listed companies, within a time frame of three years commencing from the financial year 2000-2001. The Committee's recommendations pertained to the composition of the board, constitution of audit committee in certain sized companies, remuneration of directors, director's report to include management discussion & analysis report, better disclosure norms to the shareholders through annual report, etc.

Based on these reports, the Companies Act was amended, first in 2000 and then in 2002. Based on the recommendations of the Naresh Chandra Committee the Companies (Amendment) Bill, 2003 was introduced in the Parliament to further amend the Companies Act. The Bill has been since withdrawn under the strong pressure of the industry.

Supervisory function and Management Function

The legislative and administrative efforts of the government and the industry have impacted the corporate governance tremendously. Due to these charges, now in India, the board is a combination of executive and non-executive directors (the outsiders) under the chairman who accepts the duties and responsibilities which the post entails. The executive directors are involved in the day-to-day management of companies; the non-executive directors bring external and wider perspectives and independence to the decision-making, but make only supervisory function.

In regard to the composition of the board, Clause 49 of the Listing Agreement provides 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 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 the board should comprise of independent directors".

The expression 'independent director' here means the non-executive director. Thus, the composition of board is one of the tools of corporate governance, and it should comprise

of mixture of directors, i.e., promoter directors, non-executive directors and independent directors and in no case the number of promoters or executive directors should exceed 50% total strength of the board.

Independent director

As per clause 49 of the Listing Agreement the independent director has been defined as a non-executive director who does not have any pecuniary relationship or transactions with the company, or its promoters, or its senior management and its holding or subsidiary company. As per clause 49-I (A) of the Listing Agreement the board should be of seven members, out of which four should be independent directors. The independent directors should not be less than 50% of the board.

There are seven more negative covenants for independent director:

(i) he is not related to promoters or management;

(ii) he has not been an executive of the company in the last three years;

(iii) he is neither a partner nor an executive of the audit, internal audit, legal firm or any consulting firm associated with the company for the last three years;

(iv) he is not a significant supplier, vendor or customer of the company;

(v) he is not a shareholder of the company, owning 2% or more voting shares;

(vi) he has not been any type of director of company for more than nine years; and

(vii) he is not a nominee director.

These requirements are applicable to all public companies that have capital and free reserves of Rs.100 million or turnover of Rs. 500 million. However, it is not applicable to unlisted public companies, which do not have more than 50 shareholders and are without any debt from public, banks and financial institutions. According to current listing norms, institutional directors on the board of companies should be considered as independent directors whether the institution is an investing institution or a lending institution. [Explanation (ii) to clause 49-1(A)]. The institutional directors have same rights, duties,

and responsibilities as other members of the board and as prescribed by Companies Act and listing norms.

Sub-clause II-A of clause 49 stipulates that the Audit Committee should consist exclusively of independent directors. The role and function of audit committee should be clearly laid down in a charter. The chairperson of the audit committee must certify the date and frequency of meetings, to what extent functions listed in the charter were discharged, task performed, committee's views on adequacy of internal control systems, perceptions of risks, why financial statements with qualifications accepted and recommended, whether the committee met with the statutory and internal auditors without the presence of management and whether such meetings revealed materially significant issues or risks. Such directors should be exempted from criminal and civil liabilities relating to company.

In terms of section 309(1) of the Companies Act, 1956, the remuneration payable both to executive as well as non-executive directors is required to be determined by the board in accordance and subject to the provisions of the Act.

Independent directors are required to attend one training course before assuming responsibilities as an independent director. However, during initial years they may undergo training within one year of becoming director. Untrained director should be disqualified.

Protection of Minority Shareholder

Any serious attempt to reform corporate governance in Indian economy is to provide greater legal protection for minority shareholders from transactions involving potential conflicts of interest. In a recent judgment that will have a bearing on the rights of minority shareholders, the Bombay High Court has held that majority shareholders couldn't ease out minority shareholders from the company merely by paying off the value of their shares. The minority shareholders should be offered a scheme by the company under sections 391 and 394 of the Companies Act that provide options to minority shareholders.[29]

In order to protect the rights of the shareholders, clause 49-VII(F) provides that a board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal 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 'Shareholders/ Investors Grievance Committee'. Further, it provides that to expedite the process of share transfers, the board of the 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.

Audit System

It is also required that a half-yearly declaration of financial performance including summary of the significant events in the last six months should be sent to each household of shareholders. The company should disclose in the Report on Corporate Governance whether it has sent to each household of shareholders half-yearly report on financial performance.

Every public company having paid-up capital of rupees 5 crore or more shall constitute a Committee of the Board to be known as Audit Committee.

Audit Committee can be constituted both in terms of requirements of section 292A of the Companies Act, 1956 and in terms of requirements of sub-clause II of clause 49 of Listing Agreement. In case the Audit Committee has been constituted as per requirements of section 292A of the Companies Act, 1956, it would have to additionally meet the requirements of sub-clause II of Clause 49 of Listing Agreement.

Audit Committee has a critical role to play in ensuring the integrity of financial management of the company. This Committee adds assurance to the shareholders that the auditors, who act on their behalf, are in a position to safeguard their interests.

Sub–clause IIA of clause 49 stipulates that the Board shall set-up a qualified and independent Audit Committee. While the requirement of clause 49 applies to all listed companies, provisions of section 292A of the Companies Act, 1956 applies to every public limited company having a paid-up share capital of rupees five crore or more.

The Audit Committee contemplated under Clause 49 of the Listing Agreement shall have at least three members. All members of the Committee should be non-executive directors. However, majority of the directors should be Independent Directors. All members of Audit Committee shall be financially literate and at least one member should have

accounting or related financial management expertise. It is worthwhile to note that since the Audit Committee is a committee of the Board, the provisions of the Companies Act, 1956 and the Articles of Association of the company regarding committees will be applicable to Audit Committee with regard to items such as Notice, Quorum, Minutes, etc.

Authority of Audit Committee

The Audit Committee, constituted in accordance with section 292A of the Companies Act, shall have authority to investigate into any matter in relation to the items specified in the said section 292A or referred to it by the Board. For accomplishing these purposes, the Committee shall have full access to information contained in the records of the company and can seek external professional advice, if necessary. 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.

The Naresh Chandra Committee has recommended that Audit Committees of all listed companies as well as unlisted public limited companies with a paid-up share capital and free reserves of Rs. 10 crore and above, or turnover of Rs. 50 crore and above, should consist exclusively of independent directors. However, this will not apply to:

(1) Unlisted public companies which have no more than 50 shareholders and which are without debt of any kind from the public, banks, or financial institutions, as long as they do not change their character,

(2) Unlisted subsidiaries of listed companies.

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.

The powers of the Audit Committee specified above are illustrative.

Auditor disclosure of contingent liabilities:
Management should provide a clear description of each material liability and its risks followed by the auditors comments on the management view. It should be highlighted in the significant accounting policies and noted on accounts as well as in the auditor's report, if necessary.

Auditor's disclosure of qualifications and consequent action:
It is mandatory for Auditor to send a copy of qualified report to the Registrar of Companies, SEBI and the principal stock exchange along with a copy of letter sent to the management.

CEO and CFO Certification of Annual Audited Accounts:
Chief executive officer and Chief finance officer have to certify that:

(i) they have reviewed the balance sheet and profit and loss account and all its schedules and noted on accounts, the cash flow statement and the Directors' Report;

(ii) these statements do not contain any material untrue statement or omit any material fact nor do they contain statements that might be misleading;

(iii) these statements together represent a true and fair view of the financial and operational state of company and are in compliance with the existing accounting standards and/or applicable laws and regulations;

(iv) they 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;

(v) they have disclosed to the auditors and the audit committee any deficiencies in the design or operation of internal controls; instances of significant fraud involving management or employees; significant changes in internal control and accounting policies during the year; and

(vi) will return to the company that part of any bonus or incentive or equity based compensation that was inflated on account of such errors as decided by the audit committee.

Three independent Quality Review Boards (QRBs) should be established one each for ICAI, ICSI, ICWAI to periodically examine and review the quality of audit, secretarial and cost accounting firms.

Regulation for Listed Companies:
The SEBI and the Stock Exchanges in which the listed companies are registered regulate the listed companies in India. The major Acts are the Securities Contract (Regulation) Act, 1956 and the various guidelines issued by SEBI and enforced through stock exchanges. The listed companies have to follow the Listing Agreement, which has been amended from time to time.

2 The Features and Problems of Law Reform

The movement to articulate standards for corporate governance in India is very much influenced by the international developments, particularly of the U.K. and the U.S. which subsequently spread to other countries.

In UK over the past decade a trilogy of committees has reviewed the issue of corporate governance from a wide range of perspective. *Cadbury Committee* reviewed financial aspects of corporate governance, *Greenbury Committee* reviewed remuneration, while *Hampel Committee* reviewed broader aspects. In addition, three recent reports, the *London Stock Exchange Combined Code*, the *Turnbull Report*, and the *Higgs Report* have added a further dimension to the current corporate governance debate.[30]

The Cadbury Committee was established in 1991 following a series of corporate scandals. The Cadbury report (1992) was acknowledged as a landmark development in corporate

governance both in UK and internationally, and was effective in raising awareness of corporate governance. The committee was to consider the financial aspects of corporate governance only.

The second report, *the Greenbury Report* (1995), focused solely on directors' remuneration. During the 1990s high salaries and share options for company directors appeared to be out of step with company performance and with the accompanying call for workforce cutbacks and employee pay restraints. The Greenbury Report did not answer for top directors pay restraint but instead stressed accountability and full disclosure of directors' remuneration.

The third, *the Hampel Committee* (1998), spoke in terms of principles of good corporate governance rather than rules. Hampel emphasized on good internal control and risk management by the board and the effective communication of information through the company, in order to ensure the best informed decision-making. The Report recommended that companies and auditors should apply certain principles regarding Financial reporting, Internal control, Relationship with auditors, External auditors. It also accepted the dual responsibility of auditors, i.e., the public report to shareholders on the statutory financial and on other matters and additional reporting to directors on operational matters.

The Higgs Report (2003) reviewed the role and effectiveness of non-executive directors.[31] The London Stock exchange produced its own code, which acted as a consolidation of the trilogy with the added dimensions of the Turnbull Report (1999).[32] The Report was focused upon the maximization of shareholder wealth through the management of risk. The basic aim is to ensure operational effectiveness and efficiency, and reliability of internal and external reporting and compliance.

Blue Ribbon Committee on improving the effectiveness of Corporate Audit Committees (1999)[33] The committee recommended that the members of audit committee to be independent; audit committee to consist of independent directors only; audit committee to have minimum of three directors and each one should be financially literate; audit committee to have formal written charter, approved by board, specifying responsibilities, structure, process and membership; charter to specify outside auditors responsibility towards the board and the audit 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 audit committee; outsiders auditors discussed with the audit committee their judgments; committee believes that company's financial statements are fairly presented in conformity with generally accepted accounting practices (GAAP).

In USA, the Foreign Corrupt Practices Act, 1977 made specific provisions regarding establishment, maintenance and review of system 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.

As a consequence, the Committee of Sponsoring Organisations took birth. It produced and stipulated in 1992, a control framework. After the Enron debacle of 2001, came other scandals involving large US Companies such as WorldCom, Qwest, 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.

The *Sarbanes- Oxley Act* (SOX):[34] The Act was passed in July 2002 by the US Congress is the most sweeping reform of corporate governance and corporate social responsibilities. It measures everything from board composition to regulation of auditors. It emphasizes on the audit function and financial disclosures. It strengthens the power, importance and independence of audit committee. It provides for constitution of Public company Accounting Oversight Board to oversee the audit of public companies that are subject to securities laws, establish audit report standards and rules, and inspect, investigate and enforce compliance by auditors. It emphasizes on audit independence and prohibits an auditor from performing specified non-audit services along with the audit. It also requires pre-approval by the audit committee for those non-audit services that are not expressly forbidden. It confers responsibility upon audit committee for the appointment, compensation and oversight of any audit firm employed to perform audit services. It requires an audit committee member to be a member of the board and to be independent. Audit firms will be appointed by and will report directly to the audit committee and subjected to rotation of partner and firm. *In India, the Office of Comptroller and Auditor General (CAG) functions as oversight audit body for audit of public sector companies.*

The SEC (Securities and Exchange Commission) announced the details of the rules in January 2003. They are designed to make public companies transparent proactive in sharing material financial information with auditors, audit committees, analysts and investors. The Act provides a legislative template for financial reporting and compliance. The most relevant sections are 302 and 404 that govern rules of disclosure and financial reporting respectively.

Section 302 mandates that CEO and CFO shall personally certify corporate financial statements and filings. They shall also affirm that they are responsible for establishing and enforcing disclosure controls and procedures at all levels of their corporations. In addition they must disclose to the audit committee all significant deficiencies, material weaknesses and acts of fraud.

Section 404 requires an annual evaluation of internal controls and procedures for financial reporting. Every corporation must document its existing controls that have a bearing on financial reporting, test them for efficacy and report on gaps and deficiencies. Furthermore, the company's independent auditors must issue an annual report that attests to management's assertion regarding these controls. Thus, SOS-404 deals with internal control process, a matter of governance and qualitative process management. All the foreign companies listed on the US bourses have to comply with the Act. The compliance deadline for foreign issuers is the year 2006. SOA throws up opportunities for several professions – accountants, lawyers, software companies, EPR professionals, and consulting companies.

The major recommendations of the Naresh Chandra Committee and the Narayana Murthy are based on these committee reports and principally influenced by the SOX Act of the USA.

Legislative Process and the relevant actors

Usually a debate is held before the enactment or amendment of any Act on an important issue. In this debate, the political parties, academics and business sector take part in the debates if the concerned Act is going to affect the sector. With the liberalization, international organizations have played a crucial role in the enactment of various Acts. In fact for the last few years, most of the Acts or amendments have been made under the pressure of MNCs or international bodies.

3. Evaluation of Legal Reform

The most recent legislative attempt of the Government had been the introduction of the Companies (Amendment) Bill, 2003, which, under industry pressure has since been withdrawn. It was aimed towards providing a growth oriented regulatory framework for companies as well as ensuring discipline and professionalism in the management of the corporate sector. The Bill also sought to ensure greater investor protection, good corporate governance, increased transparency and improved accountability. The Bill was based on the recommendations of the Naresh Chandra Committee, Joint Parliamentary Committee, R D Joshi Committee and the provisions of the Companies Bill, 1997.

The statement of Objects & Reasons to the Bill of 2003 states that the said bill includes: (1) certain provisions of the Companies Bill of 1997 which are relevant today with or without modifications; (ii) recommendations of the Naresh Chandra Committee Report regarding prohibition of relationship between the auditor and his clients, prohibition of certain non-audit services by auditors, appointment of independent directors and women directors on the board of companies etc; and the (iii) recommendations of the Joint Parliamentary Committee relating to restrictions on intercorporate loans made to share broking companies, preventing vanishing companies by proper identification of directors at the time of incorporation of companies etc. The salient features of the bill relating to Corporate Governance, among others, were as follows:

1. Concept of independent director strengthened: The provision of independent directors to form a majority on the boards and reservation for women directors was provided.

2. Consolidation of group accounts: The series of amendments in the area of accounts, audit and investigations were incorporated with a view to strengthen the financial regulation and prevent the corporate scams.

3. Prescribing heavy penalties for duping investors: The industry admitted that the bill was in the right direction, but some of the provisions were restrictive and would have hampered smooth functioning of companies. The most contentious issue was having only one level of subsidiaries. The industry had serious apprehensions on prohibition of second-tier subsidiaries, which, it was felt could act as a roadblock to inhibit inward FDI.

This is detrimental to industrial growth and will also constrict and restrict much needed investment.

The industry also felt that the provision of independent directors in the Bill to form a majority on the board of directors is not fair and equitable, considering the shareholding pattern of most companies in India where the promoters continue to hold majority shareholding. There is no logic why, as majority shareholders, they should not be allowed to have majority of seats on the board of directors. Secondly, by forcing companies to have a majority of independent directors, the government is taking away the right of the shareholders to appoint directors of their choice. There is also a question whether the independent directors will have enough knowledge of the business of the company and the industry to be able to take sound business decisions.

Thirdly, if the sole purpose of having majority independent directors is the protection of minority shareholders, then that purpose could be achieved in different ways. For example, the composition, powers and functions of the audit committee can be enhanced, or the list of matters requiring assent of all the directors be increased, or the list of matters requiring shareholders' approval may be increased.

The new provision meant that, listed companies would have to follow the norms of independent directors even on the boards of their subsidiaries companies as well. Boards of parent company have to keep a close watch on matters related to financial, investment and corporate governance of their subsidiaries. This has created a piquant situation for such subsidiaries, which are in the form of a joint venture (JV), especially those involving MNCs. The norms on independent directors run contrary to the articles of association of JVs under which each partner gets the right to nominate a certain numbers of directors depending on the extent of its equity stake in the venture. As the independent directors are generally picked up from India, this could put the foreign partner in a JV in a discomfortable position, even though the foreign company has a 51% stake in the venture.

Restricting the retiring age of managing director, directors and independent director to 75 years was also a controversial issue. Industry wants to leave this to shareholders to decide through a special resolution. It also means writing-off old persons who are still fit, efficient, and who have vast knowledge and are still in a position to contribute immensely to a company. The provision for reservation for women directors was also considered

retrograde, as the industry feels that a board position should be based on expertise, knowledge and qualification and not on gender.

Though the withdrawal of Bill by the government would affect the confidence of shareholders, it is felt that the basic objective of any amendment to legislation is to act as a facilitator and not a hindrance. Before any amendment in Companies Act, 1956 is put on the statute book, it should be ensured that the intended reforms provide a conductive environment for healthy corporate growth and development.

The impact of every legislative initiative on different sections is varied; good governance demands that the choice of a course of action is dictated by principles of greater common good. So, the government has considered the redrafting of the Bill so as to alleviate the concerns of the industry. This will also assist in grooming a perfect legislation through a collaborative approach of all concerned.

III Related Information on Corporate Governance

1. Enforcement of Accounting Standards

During 2003, new international accounting standards, guidance notes, auditing and assurance standards came into play. This has brought Indian Corporate accounting closer to International Accounting Standards (IAS). As on November 2003, there were 30 subjects covered by both Indian accounting and the IAS. The subjects include like earning per share, segment reporting, leases, consolidated financial statements and impairment of assets which are dealt both in India as well as under IAS.

Chartered Accountants Act, 1949:
The Government has moved a bill on 22 December 2003 in Rajya Sabha called *the Chartered Accountants (Amendment) Bill, 2003* to enlarge the definition of 'professional misconduct'. The bill, when passed, will equip the Department of Company Affairs (DCA) with powers to specify acts and omissions that amount to professional misconduct, in order to keep both the professionals and professional bodies under control. The bill lists 23 acts and omissions that could amount to misconduct for CAs, as against 13 already listed in the Act.