Chapter 4

LEGAL FRAMEWORK OF CORPORATE SOCIAL RESPONSIBILITY IN INDIA

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4.1 Introduction

Of late, Corporate Governance has become an issue with regulatory bodies like the Stock Exchange Board of India (SEBI) and concepts of 'Independent Directors', 'Independent Auditors', Global Generally Accepted Accounting Principles (Global GAAP) have become increasingly popular with corporate bodies in India. Transparency being the 'catch-word', there has been many instances corporate bodies have been called upon by regulatory bodies in India like SEBI to explain/ account for substantial share transfers, suppression/manipulation of Governance Government facts, share acquisition without conforming to relevant regulatory guidelines etc.

Corporate Governance has become an important issue in India for a number of reasons e.g. increasing demand for/insistence on clean 'corporate governance' track-record by business partners, strict Corporate Governance Guidelines of Regulatory Bodies, need for transparency for growth and progress, in-house 'expertise' and 'independent advice' requirement, statutes like the Competition Act, 2002, the Companies Act, 1956 etc.
The Indian Companies Act, Clause 49 (as per the directives of SEBI) provides with certain guidelines (revised on 29th March 2005) for the listed companies to follow their Corporate Social Responsibility.

**4.2 Appointment of Director**

If the company is listed company then as per Clause 49 I (C) (ii) of the listing agreement ensure that:

1. The director to be appointed is not a member in more than 10 committees or acts as Chairman of more than five committees across all companies in which he is a director.

2. Further more it should be a mandatory annual requirement for every director to inform the company about the committee position he occupies in other companies and notify changes as and when they take place.

3. For the purpose of considering the limit of committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.
4. For the purpose of reckoning the limit under this sub-clause, Chairmanship/Membership of the Audit Committee and the Shareholders' Grievance Committee alone shall be considered.\textsuperscript{1}

5. Lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.

6. 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 by the CEO.

7. The term "senior management" shall mean personnel of the company who are member of its core management team excluding Board of Directors. Normally, this would compromise all members of management one level below the executive directors, including all functional heads.

8. Ensure that the non-executive directors of the company disclose their shareholding in the listed company in which they are proposed to be appointed as directors, prior to their

appointment. These details should be disclosed in the notice of general meeting called for appointment of such directors.

9. In case of appointment of new director or re-appointment of a director the shareholders are provided with the following information:\(^2\)

- A brief resume of director:
- Nature of his expertise in specific functional areas:
- Name of companies in which the person also holds the directorship and the membership of Committees of the Boards; and
- Shareholding of non-executive directors as stated in Clause 49 (IV) (E) (v) above.

**4.3 Appointment of Managing Director**

The CEO that is the managing director appointed in terms of the Companies Act, 1956 certifies to the Board of Directors of the company following:

1. He has reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief.

\(^2\)ibid p 273
2. These statements do not contain any materially untrue statements or omit any material fact or contain statement that might may be misleading.

3. These statements together present a true and fair view of the company's affairs and incompliance with existing accounting standards, applicable laws and regulations.

4. There are, to the best of his knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

5. He accepts responsibility for establishing and maintaining internal controls and that he has evaluated the effectiveness of the internal control systems of the company and he has disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any of which he is aware and the steps he has taken or proposed to take to rectify these deficiencies.

6. He has indicated to the auditors and the Audit Committee the following:
   - Significant changes in internal control during the year;
• Significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

• Instances of significant fraud of which they have become aware and the involvement there in, if any, of the management or an employee having a significant role in the company's internal control system.

4.4 Appointment of Financial Director

CFO i.e. the whole-time finance director or any other person heading the finance function discharging that function certifies to the Board of Directors of the company the following:

1. He has received financial statements and the cash flow statements for the year and that to the best of their knowledge and belief.

2. These statements do not contain any materially untrue statements or omit any material fact or contain statement that might be misleading.

3. These statements together present a true and fair view of the company's affairs and incompliance with existing accounting standards, applicable laws and regulations.
4. There are, to the best of his knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

5. He accepts responsibility for establishing and maintaining internal controls and that he has evaluated the effectiveness of the internal control systems of the company and he has disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any of which he is aware and the steps he has taken or proposed to take to rectify these deficiencies.

6. He has indicated to the auditors and the Audit Committee the following:

   a. Significant changes in internal control during the year;
   
   b. Significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
   
   c. Instances of significant fraud of which they have become aware and the involvement there in, if any, of the management or an employee having a significant role in the company's internal control system.
This proves that the role, functions and other legal obligations of CEO and CFO are duplicated. Hence companies are given a liberty to appoint one person for two different post or they can even appoint two different personals for the posts.

4.5 Board of Director

A listed company should ensure that:

1. The Board of Directors of the company being a listed company has an optimum combination of executive and non executive directors with not less than fifty per cent of the Board of Directors comprising of non-executive directors.

2. Where the Chairman of the Board is a non-executive director, and at least one-third of the Board comprises of independent directors and in case he is an executive director, at least half of the Board comprises of independent directors.

3. The expression 'independent director' means a non-executive director of the company who:

   - apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;

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3 ibid p 474
• is not related to promoters or persons occupying management positions at the board level or at one level below the board;

• has not been an executive of the company in the immediately preceding three financial years;

• is not a partner or an executive during the preceding three years, of any one of the following:
  (i) the statutory audit firm or the internal audit firm that is associated with the company, and
  (ii) the legal firm(s) and consulting firm(s) that have a material association with the company.

• is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and

• is not a substantial shareholder of the company i.e. owning two percent or more of the block of voting shares.

4. The Associate as referred to above means a company which is an “associate” as defined in Accounting Standard (AS) 23, “Accounting for Investments in Associates in Consolidated Financial Statements”, issued by the Institute of Charted Accountants of India.⁴

⁴ ibid p 475
5. Senior management means personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.

6. Relative means “relative” as defined in section 2(41) and section 6 with Schedule 1A of the Companies Act, 1956.5

7. Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be independent directors.

8. Institution’ as mentioned above means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a “corresponding new bank” as defined in section 2(d) of the Banking Companies Act, 1980.6

9. The Board meets at least four times a year, with a maximum time gap of three months between any two meetings. The minimum information to be made available to the Board should be as given in Clause 49 of the act.

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5 ibid p 475
6 ibid p 475
10. The Board of Directors of the company periodically reviews compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliance.

11. Lay down procedures to inform Board members about the risk assessment and minimization procedures. Review these procedures periodically to ensure that executive management controls risk through means of a properly defined framework.

4.6 Remuneration to Director

If the company is listed then

1. They have all fees/compensation, if any paid to non-executive directors, including independent directors of the company fixed by the Board of Directors and obtain previous approval of shareholders in general meeting.

2. Ensure that the shareholders’ resolution specifies the limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

4.7 Audit Committee

A qualified and independent audit committee shall be set up, giving the terms of reference subject to the following:
1. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

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

3. The Chairman of the Audit Committee shall be an independent director.

4. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries.

5. The audit committee may invite such of the executives, as it considers appropriate 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.

6. The Company Secretary shall act as the secretary of the committee.
7. The term "financial literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account and statements of cash flows.

8. A member will be considered to have accounting or related financial management expertise if he or she possess 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.

9. 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.

10. The audit committee shall have powers, which should include the following: 7

   • To investigate any activity within its terms of reference.

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7 ibid p 748
• 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.

11. The role of the audit committee shall include the following:

- Oversight of the company’s financial reporting process and the disclosure of its financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
- 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.
- Approval of payment to statutory auditors for any other services rendered by the statutory auditors.
- Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:
  (i) Matters required to be included in the Director’s Responsibility Statement to be included in the Board’s report in terms of clause (2AA) of section 217 of the Companies Act, 1956;

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8 ibid pp 748-749
(ii) Changes, if any, in accounting policies and practices and reasons for the same;

(iii) Major accounting entries involving estimates based on the exercise of judgment by management;

(iv) Significant adjustment made in the financial statements arising out of audit findings;

(v) Compliance with listing and other legal requirements relating to financial statements;

(vi) Disclosure of any related party transactions;

(vii) Qualification in the draft audit report.

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

- Reviewing, with the management, 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 a material nature and reporting the matter to the board.
• Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussions to ascertain any area of concern.

• To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders and creditors.

• To review the functioning of the Whistle Blower mechanism, in case the same is existing.

• Carrying out any other function as is mentioned in terms of reference of the Audit Committee.

12. The term “related part transactions” shall have the same meaning as contained in the Accounting Standard 18, Related Part Transactions, issued by The Institute of Charted Accountants of India.⁹

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

14. The Audit Committee shall mandatory review the following information:

⁹ ibid p 749
• Management discussion and analysis of financial condition and results of operation;
• Statement of significant related party transactions submitted by management;
• Management letters/letters of internal control weaknesses issued by the statutory auditors;
• Internal audit reports relating to internal control weaknesses; and
• The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

15. A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.

16. Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.

17. Details of material individual transactions with related parties or others, which are not on an arm's length basis should be placed before the audit committee, together with Management's justification for the same.
4.8 Secretary

If the company is a listed company then it is required to obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in Clause 49 VII (1) of the Agreement 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 report filled by the company.

4.9 Share Transfer

In a listed company it is to be ensured that

1. The Board of Directors of the company delegates the power of share transfer to an officer or a committee or to the registrar and share transfer agents to expedite the process of share transfers. Such delegated authorities shall attend to share transfer formalities at least once in a fortnight.

2. If the transfer shares or convertible debentures of the company is from resident to non-resident and vice-versa then approach the authorized dealer banks to deal with it as delegated by RBI.

4.10 Holding Company

If the holding company is a listed company then as per Clause 49 III of the Listing Agreement ensure the following:
1. At least one independent director of the Board of Directors of the holding company is a director of Board of Directors of a material non listed Indian subsidiary company.

2. The Audit Committee of the listed holding company also reviews the financial statements, in particular, the investments made by the unlisted subsidiary company.

3. The minutes of the Board meetings of the unlisted subsidiary company is placed at the Board meeting of the listed holding company.

4. The management of the subsidiary company periodically brings to the attention to the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

5. The term “material non-listed Indian subsidiary” shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth exceeds 20 per cent of the consolidated turnover or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.\(^\text{10}\)

\(^\text{10}\) ibid p 58
6. The term "significant transaction or arrangement" shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10 per cent of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.¹¹

7. Where a listed holding company has a listed subsidiary which is itself a holding company, the above provision shall apply to the listed subsidiary insofar as its subsidiaries are concerned.

4.11 Boards Report

If the company is a listed company then:

1. Give as part of the directors' report or as an addition thereto, a Management Discussion and Analysis report forming part of the Annual Report to the shareholders. This Management Discussion and Analysis should include discussions on the following matters within the limits set by the company's competitive position:¹²

   • Industry structure and developments.
   • Opportunities and Threats.
   • Segment-wise or product-wise performance.
   • Outlook

¹¹ ibid p 59
¹² ibid p 539
• Risks and concerns.
• Internal control systems and their adequacy.
• Discussions on financial performance with respect to operational performance.
• Material developments in Human Resources/Industrial Relations front, including number of people employed.

2. Ensure that senior management makes disclosure to the Board relating to all material financial and commercial transaction, where they have personal interest, that may have a potential conflict with the interest of the company at large.

3. The term “senior management” as mentioned above means personnel of the company who are member 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.

4. Annex the certificate obtained from either the auditors or practicing company secretaries regarding compliance of corporate governance as stipulated in this clause with the directors’ report which is sent annually to all the shareholders of the company.
4.12 Balance Sheet

If the company is a listed then ensure that the Board of Directors of the company delegates the power of share transfer to an officer or a committee or to the registrar and share transfer agents to expedite the process of share transfers. Such delegated authority shall attend to share transfer formalities at least once in a fortnight.

4.13 Annual Report and Disclosure

If the company is a listed company then ensures that:

1. All pecuniary relationship or transactions of the non-executive directors vis-à-vis the company are disclosed in the company’s Annual Report.

2. The company is further required to make the following disclosures on the remuneration of directors in the section of the corporate governance in the company’s Annual Report:13

   • All elements of remuneration package of individual directors summarized under major groups, such as salary, bonuses, stock options, pensions, etc.

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

   • Service contract, notice period, severance fees.

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13 ibid p 700
3. The company shall publish its criteria of making payments to non-executive directors in its annual report. Alternatively, this may be put up on the company’s website and reference drawn there to in the annual report.

4. Ensure that there is a separate section on Corporate Governance in the Annual Reports of the company, with a detail compliance report on Corporate Governance. Non-compliance of any mandatory requirement of this clause with reasons there of and the extend to which the non-mandatory requirements have been adopted should be specifically highlighted.

5. The company is required to submit a quarterly compliance report to the stock exchanges with in fifteen days from the close of quarter as per the format given. The said report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.

6. The disclosure of the compliance with mandatory requirements and adoption/non-adoption of the non-mandatory requirements
are made in section on corporate governance of the Annual Report.

7. Send to the Stock Exchanges along with the Annual Report filled by the company the certificate obtained from either the auditors or practicing company secretaries regarding compliance of corporate governance.

4.14 Conclusion

All the company's registered under the Indian Companies Act, 1956 and especially which are listed are required to comply by the above laws and regulations. This lays the foundation of the structure of corporate social responsibility in India. The detailed discussion on the Indian perspective of corporate social responsibility is mentioned in the next chapter.