CHAPTER VI
CHAPTER VI – Measures to prevent Corporate Frauds and to improve corporate governance in India – conclusions and suggestion

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6.1 Fraud prevention and risk management: Effective tool for Corporate Governance

6.1. (i) Introduction:

Scams are integral to the corporate history of India and as well as rest of the world. It’s almost inevitable that in the mad race for growth, someone or the other would be caught taking steroids. Therefore it was just a matter of time before someone’s skeleton tumbled out of the closet.

To deal with the risks of fraud, individual efforts of corporate India members require support of the State in the form of rule of law consisting regulations, adequate institutions, knowledge and skills and efficient justice delivery mechanism. India has adopted several laws, regulations and guidelines providing preventive and curative measures to address the burgeoning number of frauds in the country. Several of these are, however, a fallout of incidents of fraud and financial crimes as well as regulatory developments in the US or European markets.

The Banking and financial services sector continues to be the target of corporate scam and hence the most frequent victim of fraud in India. These suffer heavily by frauds committed by borrowers, employees and hackers.

With the introduction of critical anti-fraud provision being adopted worldwide, India has made a modest beginning to create a regulatory framework pertaining to fraud risk management. However, at macro level, there are still areas that require significant improvement. One should first get a broad understanding of the field of Fraud Examination — from what fraud is, to how it is committed, detected, and deterred. Coverage begins with an explanation of fraud examination methodology, followed by detailed examination of the most prevalent fraud schemes used by employees, owners, managers, and executives. Fraud poses a threat to consumers and the economy as a whole. Instances of corporate frauds remain a constant threat to public trust and confidence in the capital markets.

6.1. (ii) Meaning of fraud?

In broadest sense, a fraud is a deception made for personal gain or to damage another individual. The specific legal definition varies by legal jurisdiction. Fraud is a crime, and is also a civil law violation. Many hoaxes are fraudulent, although those not made for personal gain are not technically frauds. Defrauding people of money is

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presumably the most common type of fraud, but there have also been many fraudulent “discoveries” in art, archaeology, and science.

A bank fraud is a deliberate act of omission or commission by any person carried out in the course of a banking transaction or in the books of accounts maintained manually or under computer system in bank, resulting into wrongful gain to any person for a temporary or otherwise, with or without any monitory loss to the bank.

6. 1. (iii). Fraud for profit

Fraud for profit involves industry professionals. There are generally multiple loan transactions with several financial institutions involved. These frauds include numerous gross misrepresentations including:

- income assets are overstated,
- the length of employment is overstated or fictitious employment is reported,
- collateral is overstated,
- The borrower's debts are not fully disclosed, nor is the borrower's credit history, which is often altered. Often, the borrower assumes the identity of another person (straw buyer).
- The borrower states he intends to use the property for occupancy when he/she intends to use the property for rental income, or is purchasing the property for another party (nominee). Appraisals almost always list the property as owner-occupied. Down payments do not exist or are borrowed and disguised with a fraudulent gift letter. The property value is inflated (faulty appraisal) to increase the sales value to make up for no down payment and to generate cash proceeds in fraud for profit.

6. 1. (iv). Corporate accounting fraud

Accounting fraud, or corporate accounting fraud are political and business scandals which arise with the disclosure of misdeeds by trusted executives of large public corporations. Such misdeeds typically involve complex methods for misusing or misdirecting funds, overstating revenues, understating expenses, overstating the value

http://www.fraud.org
of corporate assets or underreporting the existence of liabilities, sometimes with the cooperation of officials in other corporations or affiliates.

There is hardly any authentic information on the companies that engage in creative accounting. This type of creative accounting can amount to fraud and investigations are typically launched by government agencies, such as Serious fraud Investigation office (SFIO) in India and the Securities and Exchange Commission (SEC) in the United States.

Fraud is a broad legal concept that refers to an intentional act committed to secure an unfair or unlawful gain, generally referring to violations of laws, regulations, internal policies, and market expectations of ethical business conduct. They fall into the following categories of risk that can undermine public trust and damage a company’s reputation for integrity:

- Fraudulent financial reporting (e.g., improper revenue recognition, overstatement of assets, understatement of liabilities)
- Misappropriation of assets (e.g., embezzlement, payroll fraud, external theft, procurement fraud, royalty fraud, counterfeiting)
- Revenue or assets gained by fraudulent or illegal acts (e.g., over-billing customers, deceptive sales practices, accelerated revenue, bogus revenue)
- Expenses or liabilities avoided by fraudulent or illegal acts (e.g., tax fraud, wage and hour abuses, falsifying compliance data provided to regulators)
- Expenses or liabilities incurred for fraudulent or illegal acts (e.g., commercial or public bribery, kickbacks)

6.1. (v). Organisation’s role in preventing fraud

As organizations strive to achieve compliance with an array of new antifraud laws and regulations that are not prescriptive on the design of controls in this area, management’s agenda is focusing on efforts to understand the fraud risks that can undermine their business objectives with a view to –

- determine whether antifraud programs and controls are actually effective in reducing instances of fraud.
• gain insight on better ways to design and evaluate controls to prevent, detect, and respond appropriately to fraud.
• reduce exposure to corporate liability, sanctions, and litigation that may arise from violations of law or market expectations
• derive practical value from compliance investments by creating a sustainable process for managing risk and improving performance
• Achieve the highest levels of business integrity through sound corporate governance, internal control, and transparency.

6. 1. (vi). Management’s role in preventing fraud

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6. 1. (vii). Anti fraud programmes

In the wake of high-profile corporate scandals as well as new regulations worldwide, many business leaders are increasingly becoming aware of the need to create company-specific antifraud measures to address internal corporate fraud. While acknowledging that no single approach to fraud risk management can fit every organization’s needs, this article spotlights key practices that organizations have generally found to be effective when tailoring a company-specific antifraud program, and offers Corporate Fraud Risk Management a strategic approach to aligning corporate values with performance.
6. 1. (viii) Anti fraud laws world wide\textsuperscript{139}

In recent years, a variety of laws and regulations have emerged worldwide, providing organizations with an array of criteria to incorporate into their antifraud efforts. These laws include:

**United States:** The USA PATRIOT Act, the Foreign Corrupt Practices Act, the Sarbanes-Oxley Act of 2002, SAS 99, various NYSE & NASDAQ listing standards, and Public Company Accounting Oversight Board (PCAOB) Standard #2

**United Kingdom:** Companies (Audit, Investigations, and Community Enterprise) Act of 2004

**Australia:** The Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2004

**Canada:** The Canadian Criminal Code

**European Union:** Financial Services Action Plan (FSAP)

**Three Key Objectives: Prevention, Detection, Response**

An effective, business-driven fraud risk management approach encompasses controls that have three objectives:

**Prevent.** Reduce the risk of fraud from occurring.

**Detect.** Discover fraud when it occurs.

**Respond.** Take corrective action and remedy the harm caused by fraud.

\textsuperscript{139} Statement of Auditing Standard No. 99 introduces a new era in auditors’ requirements by Michael Ramos, \textit{P - 226}
The **challenge for companies** is to develop a comprehensive effort to prevent fraud:

- Understand all of the various control frameworks and criteria that apply to them.

- Categorize risk assessments, codes of conduct, and whistleblower mechanisms into corporate objectives.

- Create a broad ranging program that manages and integrates fraud prevention, detection, and response efforts.

6.1. (ix) **Steps in fraud control**

Effective fraud risk management provides an organization with tools to manage risk in a manner consistent with regulatory requirements as well as the entity’s business needs and marketplace expectations. Such an approach has four phases:

- **Assess Risks.** Identify the scope of the analysis and key stakeholders, profile the current state of fraud risk management, set targets for improvement, and define steps necessary to close the “gap.”

- **Design.** Develop a broad ranging program that encompasses controls to prevent, detect, and respond to incidents of fraud or misconduct.

- **Implement.** Deploy a strategy and process for implementing the new controls throughout the organization and assign responsibility for leading the overall effort to a senior individual.

- **Evaluate.** Assess existing controls compared with legal and regulatory frameworks as well as leading practices, such as internal investigation protocols or due diligence practices.
Such an undertaking begins with understanding all of the various control frameworks and criteria that apply to the company. When this categorization is complete, the organization has the information it needs to create a comprehensive program in which the elements of prevention, detection, and response can be integrated and managed. Hence this process should be a continuous process.

6.1. (x) Various methods of fraud control

6.1. (x). (a). Preventive method of fraud control

1. Board/Audit Committee

An organization’s board of directors plays an important role in the oversight and implementation of controls to mitigate the risk of fraud. The board, together with management, is responsible for setting the “tone at the top” and ensuring institutional support is established at the highest levels for ethical and responsible business practices. Directors have not only a fiduciary duty to ensure that an organization has programs and controls in place to address the risk of wrongdoing but also a duty to ensure that such controls are effective. As a practical matter, the board may delegate principal oversight for fraud risk management to a committee (typically audit), which is tasked with, among other things:

- Reviewing and discussing issues raised during the entity’s fraud risk assessment
- Reviewing and discussing with the internal and external auditors findings on the quality of the organization’s antifraud programs and controls
- Establishing procedures for the receipt and treatment of questions or concerns regarding questionable accounting or auditing matters.

2. Senior Management

To help ensure that fraud controls remain effective and in line with governmental standards, responsibility for the organization’s fraud risk management approach should be shared at senior levels (i.e., individuals with substantial control or a substantial role in policy-making). This critical oversight begins with prevention and must also be part of detection and response efforts. The chief executive officer is ideally positioned to influence employee actions through his or her executive leadership, specifically by setting the ethical tone of the organization and playing a
crucial role in fostering a culture of high ethics and integrity. For instance, the chief executive can lead by example, allocating resources to antifraud efforts and holding senior management accountable for compliance violations.

Direct responsibility for antifraud efforts should reside with a senior leader, often a chief compliance officer who works together with internal audit staff and designated subject matter experts. The chief compliance officer is responsible for coordinating the organization’s approach to fraud prevention, detection, and response. When fraud issues arise, this individual can draw together the right resources to deal with the problem and make necessary operational changes. The chief compliance officer may also chair a committee of cross-functional managers who: Coordinate the organization’s risk assessment efforts, Establish policies and standards of acceptable business practice, Oversee the design and implementation of antifraud programs and controls, Report to the board and/or the audit committee on the results of the organization’s fraud risk management activities.

3. Internal Audit

The modern organization’s internal audit function is a key participant in antifraud activities, supporting management’s approach to preventing, detecting, and responding to fraud. Such responsibilities represent a change from the more traditional role of internal audit (that is, examining the effectiveness of the entity’s controls). In general, internal audit should be responsible for:

- Planning and conducting the evaluation of design and operating effectiveness of antifraud controls
- Assisting in the organization’s fraud risk assessment and helping draw conclusions as to appropriate mitigation strategies
- Reporting to the audit committee on internal control assessments, audits, investigations, and related activities.

4. Fraud Risk Assessment

All organizations typically face a variety of fraud risks. Like a more conventional entity-wide risk assessment, a fraud risk assessment helps management understand the risks that are unique to its business, identify gaps or weaknesses in control to mitigate those risks, and develop a practical plan for targeting the right resources and controls to reduce risk.
Management should ensure that such an assessment is conducted across the entire organization, taking into consideration the entity’s significant business units, processes, and accounts.

While management is responsible for performing a targeted risk assessment process and considering its results in evaluating control effectiveness, the audit committee typically has an oversight role in this process. The audit committee is responsible for reviewing management’s risk assessment, ensuring that it remains an ongoing effort, and interacting with the entity’s independent auditor to ensure that assessment results are properly communicated.

Some instances of Fraud are:

1. Credit facilities granted without authority, sanction and proper documentation
2. Advances granted against fraudulent/fabricated documents
3. Non delivery of machinery items by the supplier for machinery loans granted
4. Issue of Inland Letter of Credit and Bank Guarantee without accounting the transaction and without authority and documentation
5. Irregularities in Bill Purchase transactions
6. Advance granted against spurious gold ornaments
7. Misappropriation or criminal breach of trust
8. Unauthorized credit facilities extended for illegal gratification
9. Cheating and forgery in advance accounts
10. Irregularities in foreign exchange transactions

5. Due Diligence

An important part of an effective fraud prevention strategy is the use of due diligence in the hiring, retention, and promotion of employees, agents, vendors, and other third parties. Such due diligence may be especially important for those employees identified as having authority over the financial reporting process. The scope and depth of the due diligence process typically varies based on the organization’s identified risks, the individual’s job function and level of authority, and the specific laws of the country in which the organization resides.

Due diligence begins at the start of an employment or business relationship and continues throughout. For instance, taking into account behavioral considerations—such as adherence to the organization’s core values—in performance evaluations provides a powerful signal that
management cares about not only what employees achieve but also that those achievements were made in a manner consistent with the company’s values and standards.

6. Communication and Training

Making employees aware of their obligations concerning fraud control begins with practical communication and training. While many organizations communicate on such issues in an ad hoc manner, efforts taken without planning and prioritization may fail to provide employees with a clear message that their control responsibilities are to be taken seriously. In formulating a training and communications plan, management should consider developing fraud awareness initiatives that are:

- Comprehensive and based upon job functions and risk areas
- Integrated with other training efforts, whenever possible
- Effective in a variety of settings, using multiple methods and techniques
- Regular and frequent, covering the relevant employee population.

6. 1. (x), (b). Detective method of fraud controls

1. Mechanisms for Seeking Advice and Reporting

With the oversight and guidance of senior management, organizations tend to provide employees with multiple channels for reporting concerns about fraud. Many typically request that employees follow a process that would begin with alerting their own managers, if possible, or a designated human resources or compliance officer.

Following can be considered as Fraud:

In order to have uniformity in reporting cases of frauds, the question of classification of bank frauds on the basis of the provisions of the Indian Penal Code be considered and frauds may be classified as under:

I. Misappropriation and criminal breach of trust.

II. Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

III. Unauthorized credit facilities extended for reward or for illegal gratification.

IV. Negligence and cash shortages.
V. Cheating and forgery.
VI. Irregularities in foreign exchange transactions.
VII. Any other type of fraud not coming under the specific heads as above.

Fraud Reporting in Banks

Reserve Bank of India has, from time to time, has issued a number of guidelines/instructions/directives to banks in regard to matters relating to classification and reporting of frauds, dacoities, robberies etc. Increasing incidence of frauds, corruption and dacoities/robberies in banks is a matter of concern. Frauds perpetrated in banks show an increasing trend mainly on account of non-adherence/improper implementation of various guidelines.

The primary responsibility for preventing frauds is that of bank managements. At this point it is important to quote the title of the famous book on frauds written by William Kurt Black "The best way to rob a Bank is to own one". Reserve Bank of India, on its part, has been advising banks from time to time about the major fraud prone areas and the safeguards necessary for their prevention.

Reserve Bank of India has also been circulating to banks details of frauds of ingenious nature, which come to its notice so that individual banks could introduce necessary safeguards by means of appropriate procedures and internal checks having regard to the modus operandi of the frauds.

Earlier SEBI had exempted body corporates such as public and private sector banks, financial institutions, insurance companies and those incorporated under separate statute from corporate governance framework. Recently SEBI has suggested to RBI to consider issuing appropriate guidelines to banks and financial institutions so as to ensure that all listed companies would have uniform standards of corporate governance. As requested by SEBI, RBI has now decided to adopt the SEBI Committee's guidelines for commercial banks listed in stock exchanges so that they can harmonize their existing corporate governance requirements with the requirements of SEBI, wherever considered appropriate.
On a review by RBI of the existing corporate governance requirements in banks, it is observed that many of the recommendations may not require further action since they are already implemented in Banking Sector. However, the Audit Committee of the board may look into the reasons for default in payment to depositors, debenture holders, shareholders (nonpayment of dividends) and creditors, wherever there are any cases of defaults in payment. As regards the appointment and removal of external auditors, the practice followed in banks is more stringent than that recommended by the Committee and hence will continue. Further, fixation of audit fee and also approval of payment for any other services are already subject to the instructions of RBI. As regards recommendation for obtaining a certificate from auditors regarding compliance of conditions of Corporate Governance, it may be stated that the compliance of banks with RBI instructions is already being verified by the statutory auditors. Therefore, a separate certificate from the auditors is not necessary.

With a view to further improving the Corporate Governance standards in banks, the following measures are recommended for implementation:

a) In the interest of the shareholders, the private sector banks and public sector banks, which have issued shares to the public, may form committees on the same lines as listed companies under the Chairmanship of a nonexecutive director to look into redressal of shareholders' complaints.

b) All pecuniary relationship or transactions of the nonexecutive directors should be disclosed in the annual report.

c) Emphasis should be laid on the caliber of the non-executive directors, especially independent directors.

d) Adequate compensation package be given to the nonexecutive independent directors so that these positions become sufficiently financially attractive to attract talent and that the non-executive directors are sufficiently compensated for undertaking this work.
e) Nominee directors should have the same responsibility, be subject to the same 
discipline and be accountable to the shareholders in the same manner as any 
other director of the company.

f) The audit committee should 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 and head of internal audit and when required, a representative 
of the external auditor should be present as invitees for the meetings of the 
audit committee.

g) Half-yearly declaration of financial performance including summary of the 
significant events in last six months, may be sent to each shareholder.

2. Auditing and Monitoring

Auditing and monitoring systems that are reasonably designed to detect fraud are 
important tools that management can use to determine whether the organization’s 
controls are working as intended. Since it is impossible to audit every fraud risk, 
management should develop a comprehensive auditing and monitoring plan that is 
based on risks identified through the organization’s fraud risk assessment process. An 
auditing and monitoring plan should thus encompass activities that are tailored in 
depth to the nature and degree of the risk involved, with higher-risk issues receiving 
priority treatment. An organization’s managers involved in auditing and monitoring 
efforts should not only have sufficient training and experience but also be seen as 
objective in evaluating the controls for which they are responsible.

Auditors role (as under SAS no 99 in U.S.)\textsuperscript{140}

Auditors will enter a much expanded arena of procedures to detect fraud as they implement 
SAS No. 99. The standard aims to have the auditor’s consideration of fraud seamlessly 
bleded into the audit process and continually updated until the audit’s completion. SAS No. 
99 describes a process in which the auditor 
(1) gathers information needed to identify risks of material misstatement due to fraud.

\textsuperscript{140} SAS No. 99 introduces a new era in auditors’ requirements by Michael Ramos.
(2) assesses these risks after taking into account an evaluation of the entity’s programs and controls and
(3) responds to the results. Under SAS No. 99, Auditor will gather and consider much more information to assess fraud risks than you have in the past.

6.1. (x). (c). Responsive methods of fraud control

1. Investigations

When information relating to actual or potential fraud is uncovered, management should be prepared to conduct a comprehensive and objective internal investigation. The purpose of such an investigation is to gather facts leading to a credible assessment of the suspected violation, so management can decide on a sound course of action. By conducting an effective internal investigation, management can address a potentially troublesome situation and have an opportunity to avert a potentially intrusive government investigation.

2. Enforcement and Accountability

A consistent and credible disciplinary system is a key control that can be effective in deterring fraud. Appropriate discipline is, additionally, a requirement under leading regulatory frameworks. By mandating meaningful sanctions, management can send a signal to both internal and external parties that the organization considers managing fraud risk a top priority.

3. Corrective Action

Once fraud has occurred, management should consider taking action to remedy the harm caused. For example, management may wish to consider taking the following steps, among others, where appropriate:

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141 Backgrounder on fraud risk management by Adam Bates. Corporate Fraud Risk Management
• Voluntarily disclosing the results of the investigation to the government or positions who failed to prevent or detect such events

• Communicating to the wider employee population that management took appropriate, responsive action.

Although public disclosure of fraud may be embarrassing to an organization, management may nonetheless wish to consider such an action in order to combat or preempt negative publicity, demonstrate good faith, and assist in putting the matter to rest.

Faced with an increasing array of rules and standards governing business conduct, many organizations worldwide continue to struggle with how to mitigate the innumerable risks posed by fraud. The development of a broad ranging fraud risk management program is an important step in managing this challenge.

Organizations undertaking the effort should begin by assessing how well they are managing fraud risk. Identifying known risks and existing controls is an important first step. Then the organization can determine its ideal future state, perform a gap analysis, and prioritize activities that will help enable the development of a company-specific antifraud program. Such a program will not only help enable appropriate compliance with regulatory mandates but also help the organization align its corporate values and performance as well as protect its many assets, including its reputation.

The Role of Government in preventing fraud should be (for example):

• To carry surprise audit of selected companies on a random basis every five to ten years on a through scale.

• To fix a maximum limit for the owners to be in charge of the companies as Managing Directors or Directors sitting on the Board.

• Investigation methods need to improve with more and more use of high technology.

• Fast track courts must be set up for serious offence to ensure that such cases are decided in less than six months.

• Enact a special law on corporate accountability with deterrent punishment and an empowered integrated enforcement organization.

6. 2. Risk Management

142 en.wikipedia.org and www.GARP.com
6. 2. (1) Introduction and meaning

Risk is perceived differently by various people and there are any numbers of definitions of the term. No one definition is complete. In common parlance it refers to the exposure to adversity of danger; the happening of uncertain events which may have undesirable or negative consequences. Accidental fires, acts of God such as floods and earthquake, outbreak of disease are some of the risks to which all of us are exposed. Broadly risks can be classified as being either a Pure risk or Speculative risk. A pure risk exists when there is a chance of loss but no chance of gain. For instance, the owner of a factory faces the risk associated with an occurrence of a fire which would lead to a financial loss as a result of damage to building, plant and machinery, stocks besides reduced profits due to loss of production for the period it takes to restore normal scale of activities. In case the fire had not happened the owner does not gain, status quo is maintained. On the other hand a speculative risk exists where there is a chance of gain as well as a chance of loss. Investments in shares, gold, real estate, setting up a business are examples of speculative risks.

6. 2. (2) Broad steps involved in risk management

With relation to a business enterprise ‘risk management’ is that management function that deals with the identification, measurement and treatment of pure risk exposures. The process of risk management involves the following steps :-

1. Identification - The risk manager identifies the uncertain events to which the firm is exposed.
2. Evaluation - The next step is to measure the potential losses associated with these exposures. It involves the assessment of the probability of a loss and also the probable maximum loss.
3. Selection - The risk manager selects the best methods of protecting against the consequences of happening of the uncertain event which inter alia include (a) avoiding the exposure, (b) reducing the chances of the event happening, (c) retaining the losses internally and d) transferring the risk to a third party.

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4. Implementation - After deciding upon the best possible method of risk management which may include all or any of the aforementioned methods the risk manager must implement the decision made.

Transferring the risk is what is commonly understood as insurance. For a price, which is called premium the insurance company takes over the consequences and losses as a result of the happening of an uncertain event. Arranging adequate insurance protection at the best available terms is one of the essential functions of a risk manager. The insurance companies through the experience gained out of insuring risks over a period of time also act as risk managers for the insured. They carry out the inspection of the premises of the insured, suggest ways of minimizing risks and risk improvements, study the risk management philosophy of the insured and suggest the best possible methods of obtaining insurance covers.

The premium charged by the insurance companies is essentially linked to the physical features of the risk. When the insurers undertake risk evaluation as a part of risk management initiative the process include (a) inspection of the premises, (b) evaluating the accumulation of values in various blocks/section (c) study the fire protection installation such as fire hydrants, sprinklers etc. (d) suggest methods of risk improvements together with offers of reduction in premium as a result of adoption of suggestions towards this end (e) advise the insured regarding fixing of sum insured etc. Business enterprises have to identify the various risks involved in running the organization and ultimately decide in transferring the risk to an Insurance Company which they feel should not be retained by them.

Since insurance companies are accepting risks of different types and magnitude, it is also important for them to evaluate their risk bearing capacity beyond which they should not accept the risks or there should be a proper Reinsurance arrangement to take care of the risk beyond their capacity. Insurance companies are not only exposed to usual type of risks that result due to fire, flood and other accidents but coverage is also given due to terrorism, tsunami, typhoon and earthquake. Hull Insurance covering Ships and Aircrafts are also being underwritten by the insurance companies which increases the risk exposure considerably. In view of this, it becomes essential for the insurance companies to give details of reinsurance support to the Insured when they underwrite a mega project or cover the risk of an organization which is
beyond their capacity. Insurance Industry has undergone changes in the recent past with the opening up of the industry the private sector Stand alone health insurance companies have also started their operations apart from a number of Private insurance companies in life and general insurance business. One of the major changes that had taken place in General insurance industry is removal of restrictions on the pricing of a product by IRDA subject to few restrictions.

These few restrictions are also likely to be removed shortly and the policy wordings are also likely to undergo changes from 1st April, 2008. This implies that insurers are free to price their products based on risk evaluation, claims experience and perception. Hence risk evaluation as a part of risk management exercise assumes greater importance for both the Insurer and the Insured in order to issue proper policy with adequate coverage and also by charging adequate premium. The insurers while accepting various risks have to take care of not only the Growth in top line but must also protect their bottom line. This has to be continuously monitored in order to maintain the solvency margin as stipulated by IRDA. From the insured’ point of view, particularly when mega policy is required to be underwritten the claim paying capacity of the Insurers have to be evaluated as well as the details of Reinsurance arrangement/support in accepting the risk of that magnitude. In these cases, pricing should not be the only deciding factor in offering the risk to the insurance company.

6. 3. Whistle Blower Policy – A detail study

6. 3. (i) Introduction:

It was against the above scenario that Mr. Jerry Rao, the Chairman and CEO of Mphasis emphasized at a recent ICSI seminar at Bangalore on ‘ Championing Corporate Compliances’ that ‘a whistle-blower policy needs to be encouraged to ensure that wrong-doing and misdemeanors are identified and fixed’. He is reported to have added that ‘while earlier one would have disregarded these anonymous notes, today they assume significance’. When, in June 2005 Mr. Anil Dhirubhai Ambani, then joint MD of RIL, raised several corporate governance issues in public and

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reportedly submitted a 500-page document to the Ministry of Company Affairs and sought a probe into the alleged missing papers of the flagship company RIL from the records of ROC, he perhaps registered himself as the first and significant corporate whistleblower of the New Millenium.

6.3. (ii) What is whistle-blowing?

The term ‘Whistle blowing’ has been defined by Jonathan Bigg (Internal Auditor, USA, April 2000) as a ‘disclosure of information by an employee or contractor who alleges willful misconduct carried out by an individual or group of individuals within a company’. In his Article in THE HINDU of March 2005, KAV Shetty defines thus (in general/federal context): ”It refers to the process by which insiders ‘go public’ with their claims of malpractices by, or within, organizations – usually after failing to remedy the matters from the inside, and often at great personal risk to themselves” He adds “it is this willingness to stand up for a principle and court risk openly that distinguishes whistle blowing from such related practices as in-house criticism, anonymous leaks, and the like. The whistleblower is considered a hero or a traitor, a do-gooder or a crank, a role model or a nonconformist troublemaker- depending upon one’s point of view.

Basically, whistle blowing in a company is a tool for containing economic crimes in corporate sector (‘corporate’ includes all incorporated bodies like the Depositories, Share-Registrars, Banks, etc) and thus promote ethical behaviour among the rank and file. Whistle blowing is termed ‘internal’ when an employee airs his complaint internally and ‘external’ when an employee blows the whistle outside the organization eg to media or a regulatory body.

A survey of 125 chief internal auditors conducted by the University of Massachusetts and Bentley College in early 2000 concluded that ‘76% of employee-whistle blowing complaints were found to be true’. The survey revealed that a bulk of the allegations have begun and remained within the organization.

And that most common whistle blowing incidences consisted of thefts of assets, fraudulent business practices, money-laundering, production & supply of health-
hazardous products, sexual assaults at workplace, environmental pollution and the like. A further survey if conducted now may reveal the reasons for the failure of world-renowned companies like Enron and WorldCom despite whistleblower regime. Maybe these are exceptions that prove the rule.

As Jerry Rao rightly put it recently “99% of the wrong doings are internal and done by house people.” A recent high-level professional research study abroad threw further light by adding that a large majority of the said 99% (wrong-doers) was from the senior levels of management in companies including the Directors, CEOs and CFOs. Even the PwC study referred to earlier stated that a typical fraudster was graduate or a post-graduate male between 31-50 years of age and that nearly one-third of the frauds in the country were perpetrated by insiders i.e. persons involved in the day to day management of the organisations who had good knowledge of the systems within an organization and its weaknesses and, furthermore, that in 37 percent of the cases, the internal fraud-perpetrator was a member of the senior management and in 32 percent of the cases, from middle management. The malpractices/frauds complained against included asset misappropriation, corruption and fraud, environmental hazards like toxic leaks from the company’s plant, non-adherence to safety standards in respect of fire, flood, environment and public security, cheating, false pretence, counterfeiting, financial misrepresentation, money laundering and plagiarism in scientific research, creative accounting and false declarations by a company—the overriding public interest may lie in protecting the public’s right to be told, and the whistleblowers right not to be punished for doing so.

6. 3. (iii). Whistle-blowing in banks- by staff and by branch statutory auditor

Public Sector Banks have in-house vigilance departments to track down suspected frauds/other misdeeds and irregularities by the rank and file of the Banks concerned by themselves and through information received from the staff. In addition, pursuant to the recommendations of the Amitabh Ghosh Committee statutory auditors of public sector Banks branches are required by RBI to report whether the branch has a system by which an employee coming across an irregular practice in any of the operational areas is made responsible to report the same to higher authorities for remedial action.
Again, pursuant to Mitra Committee’s recommendations, the auditor is required to report on any instances of suspected fraud or fraudulent activity or any foul play in any transaction noticed by him during the course of his audit. Such report is required to be sent to the Managing Director of the Bank with a copy to RBI. In cases where the amount of fraud involved is Rs.100 lakh or above, such instances should be reported directly to RBI. Any deliberate failure on the part of the Auditor would invite RBI action.

In January 2006, RBI announced a scheme for protection of whistleblowers in all private sector banks and foreign banks and required the Boards of Directors of these banks to frame a ‘protected disclosure scheme’ laying down norms for protection of identity of whistleblowers and safeguarding them from any adverse personal action. Under the scheme, not only the bank employees but also the customers, stakeholders and non-government organizations can lodge complaints. However, anonymous and pseudonymous complaints are not be covered. RBI is the nodal agency to receive complaints and to verify the genuineness of the complaints on the basis of independent scrutiny conducted by it and to recommend appropriate action to the bank concerned.

The scheme is likely to cover, in due course, also the primary co-operative banks, local area banks and NBFCs. The new guidelines bar the banks from disclosing the identity of the informant. If anyone discloses the informant’s identity, the RBI may, apart from taking appropriate action against the entity, ask the entity to compensate the complainant. RBI, as the designated agency under the Scheme, will receive complaints on areas such as corruption, misuse of office, criminal offences, suspected frauds and failure to comply with rules and regulations of RBI. (It remains to be seen whether this will extend to Auditors as well).

6.3. (iv) Whistle blowing in Insurance Company

Pursuant to The Prevention of Money Laundering Act (PMLA), 2002 that took effect on July 1, 2005, GOI has established a Financial Intelligence Unit (FIU) at New Delhi with a view to coordinate and strengthen collection and sharing of financial
intelligence through an effective regional, national and global network to combat money laundering and related crimes. The FIU-IND, a multi-disciplinary unit for establishing links between suspicious or unusual financial transactions and underlying criminal activities and a central national agency is responsible for receiving, processing and analyzing and disseminating information relating to suspect transactions. It is a statutory duty of any person in insurance sector, who knows or suspects that any property in whole or in part directly or indirectly represents the proceeds of drug trafficking or of indictable offence, or was or is intended to be used in that connection, to make a disclosure to the Director, FIU-IND.

6. 3. (v). Whistle Blowing in Stock Market

Pursuant to SEBI’s circular No.ISD/CIR/RR/AML/2/06 dated 20th March 2006 (under PMLA, 2002 a stock broker has to maintain a record of all suspicious transactions whether or not made in cash. Suspicious cash or non-cash transaction is one made to a person acting in good faith that (a) gives rise to a reasonable ground of suspicion that it may involve the proceeds of crime, or (b) appears to be made in circumstances of unusual or unjustified complexity, or (c) appears to have no economic rationale or bona fide purposes. The stock-broker has not only to maintain a record of such suspicious transactions but also inform the same to the Director, FIU-IND.

6. 3. (vi). Suggested Whistle Blower administration in Companies

If, for administrative convenience, whistle blowing complaints are divided broadly into Financial (e.g. embezzlement, siphoning of funds, money fraud etc) and Non-Financial (e.g. sexual harassment at workplace, environmental pollution etc), the line of communication for the financial wrongs could ideally be the Chief Internal Auditor (CIA) while the non-financial complaints could be routed to the Company Secretary/Chief Compliance Officer (in view of its good working relationship with the employees enterprise-wide) with the Audit Committee being the final destination for all the complaints.- whether or not they are routed further through MD/CEO as the Committee may have already decided taking into consideration special factors and
sensitivities such as the size & nature of the organization, financial gravity of the complaint, union-intervention, reputation risk, degree of confidentiality and the like.

6.3 (vii) Key ingredients for successful whistle blowing

The key to containing whistle blowing complaints in-house is to establish staff confidence that their issues will be addressed seriously and pursued to their logical conclusion of satisfactory resolution by the management. ‘Best practices aimed at inspiring such confidence include a clear and well-communicated anti - retribution policy as well as staff involvement in the development of such policies (bottom-up, top-down approach) in addition to offering prompt and continuous responses to internal complaints.’ If an employee is unclear about the tone at the top, then he might be swayed to blow the whistle outside the organization’. The Ministry of Company Affairs/SEBI may also consider the feasibility of earmarking a portion of the Investor Education & Protection Fund for supporting successful implementation of the whistle blowing mechanisms in companies by ensuring adequate (even attractive) compensation to cover not only possible loss of earnings suffered by the whistleblowers but also a suitable, in fact attractive, reward in deserving cases as, in the ultimate analysis, the benefits of whistle blowing – through better governance and improved working results- trickle down to the investors at large through better and more consistent dividends, greater capital appreciation in the market apart from rights and bonus issues.

6.3 (viii). Role of Senior Management Team in effective implementation of Whistle Blower Policy

The Code of Conduct to be observed by Senior Managers (as mandated by SEBI under the revised Clause 49 of LA for listed companies) should require the senior managers to foster a cooperative culture that encourages the employees to report misconduct whenever witnessed or experienced by them in the organization and allow such complaints to be thoroughly investigated in-house.

The alternative – external whistle blowing - could prove crippling to the reputation and finances of the company.
6.3. (ix). Role of internal auditor in effective implementation of Whistle Blower Policy

Internal Auditors can help their organizations by encouraging best practices suitable for the industry concerned and promote an ideology that allows complaints to be addressed in a manner that can benefit the company. Internal Audit however enters the whistle blowing equation only after an allegation is made and an investigation is required for which it is ideally equipped. IA may also develop an annual Report Card for use by the Company and others including regulators showing the degree of success achieved by the company in successful implementation of the whistleblower policy.

The debate whether Internal Audit itself can blow the whistle is a theoretical one since IA is not only the torch-bearer for verification and validation of compliances within the organization including internal checks and controls but also the self-appointed trustee and promoter of the written/unwritten ethical code of conduct and work culture of the company. It can thus make its own investigation informally or formally and build the results into its regular audit report without having to blow the whistle – inside or outside. Also, the Code of Ethics of the The Institute of Internal Auditors, Florida, USA does not require its members – the internal auditors – to resign or to report their issues externally when faced with a whistle blowing dilemma.

If the organization or the law does not demand its members to blow the whistle, the matter remains in the personal domain of the member concerned. In the past, however, many internal auditors were reported to have resigned and joined organizations that recognized and valued their standards of corporate ethics.

6.3. (x). Legal protection to Whistle Blowers abroad

In July 1999, UK The Public Interest Disclosure Act (PIDA) with unanimous support of the legislators, business leaders and the public to grant virtually blanket protection to whistleblowers in private, public and non-profit organizations. It encourages and shields the whistleblowers that, with good reason, voice their concerns outside the organizations. This reassures employees that their organizations genuinely want them
to blow the whistle. If, however, the employee does not believe the management will address the issue, he has the right to blow the whistle outside for the regulators and the Government. The UK legislation is declaratory, offering absolute protection to anyone who raises a genuine suspicion inside the organization as also to the one who blows the whistle to a regulatory authority.

Whistle blowing to media or Parliament is however not protected. Also, PIDA does not offer any financial incentive for such disclosure but compensates the whistleblower for loss of wages suffered due to termination of employment. In US, following OECD's mandate, the Corporate and Criminal Fraud Accountability Act—popularly called The Whistleblower Protection Act—authorizes the whistleblower—employees who are unfairly terminated to receive not only compensation for loss of wages (as in UK) but also claim punitive damages (sometimes of a large magnitude). Also, the US law applies to concerns of malpractice even in their overseas branch/office. The US law also overrules gag orders or confidentiality clauses of the US employers irrespective of the location of the employee anywhere on the globe. The whistleblower law is now incorporated in the Sarbanes-Oxley Act of 2002. Companies/Organisations that conduct their business in an ethical and responsible manner should have nothing to fear from such legislation which targets only the fly-by-night (vanishing), reckless and unethical companies.

6.3. (xi). Legal implementation of Whistle Blower policy in India Corporate sector

If powerful national public institutions like RBI, IRDA, SEBI have voluntarily positioned Ombudsmen/Appellate bodies to oversee their functioning, it is time for the India Inc to introduce a whistle-blowing mechanism among its employees to provide muscle to the on-going corporate governance measures being put in place by the Government and SEBI. In the context of adoption of inclusive approach, it is time for the corporate employees, as one of the key stakeholders, to be empowered with whistle blowing power for ensuring good quality corporate governance in their respective companies. If properly implemented whistle blowing should prove itself to be a right step forward in the long chain of our endeavours in achieving a true
corporate democracy with an enviable record of corporate governance and participation of employees in management in a different way.

Pending the enactment of a general Whistle blowers Protection Act to cover all government and industrial/other specified employees in the country in due course, it is suggested that a suitably adapted version of the USA & UK legislation as well as the RBI Scheme be enacted forthwith for Listed Companies having share capital of Rs.10 crore and above not only to protect the whistleblower-employees of such companies but also as a measure for strengthening financial stability and enhancing public confidence in the robustness of the significant listed corporate sector.

Initially, whistle blowing may be encouraged in matters relating to corruption, misuse of office, criminal offences, suspected / actual fraud, compliances-failure, operational risk, reputation loss, public interest relating to corporate securities, audited accounts, public issues, important documents filed with RoC or MCA/IRDA/SEBI, etc in the wake of a spate of recent scandals involving large companies and capital market intermediaries which are large companies by themselves. Consequently the capital markets of the country went into a tailspin affecting the fortunes of millions of investors all over the country and abroad.

Legal protection to whistleblowers should extend to all forms of retaliation and the remedies should be similar to or better than those contained in the US Sarbanes-Oxley Act of 2002 including the 'fast-track mechanism and criminal liability. Are the State and Central Governments, Apex Chambers of Commerce, Stock Exchanges, Corporate Regulatory bodies, Apex Trade Unions, Investor Associations, Professional bodies, Universities, Members of Legislatures and Parliament, capital market intermediaries at home and abroad listening? Just as a rupee unspent is a rupee saved, an effort in blocking negative avenues of misdeeds and malpractices in our existing economic endeavours is as good as- perhaps even more than– making a new positive one.

6. 4. Periodic Performance Evolution of Board of Directors of the Company
6. 4. (i). Introduction and Background

Defeating the average global age of companies which is about only 40 years, there are companies which have survived and grown over the years and have become a respectable stakeholder-caring company due to continuous good governance with the support of extremely prudent Board on the top of the Management. There are companies having very long dividend track record and employee caring culture besides credibility to the banks and creditors.

It is needless to mention that good governance is the first duty of any Board of Directors and most of the Boards set out the standards for good corporate governance from time to time and ensure that the management of the company follows that. It is common to all stakeholder-caring companies that their Boards of Directors always successfully predicted the changes and helped the management to adopt the changes in its own way of doing business.

6. 4. (ii). Purpose of evaluation

Learning from Indian and internationally known examples on corporate debacles it could be clearly stated that the basic reasons of debacles have always been that people responsible for certain responsibilities did not discharge their duties, and that too across the levels, whether outsiders or insiders, i.e., directors or members of the management, auditors or bankers. In the recent past in many companies, resources of every kind have been largely wasted due to failing corporate governance duties and in some cases the board as a collective body never tried to evaluate itself, though the board has the strength and authority to select, lead and direct management to the extent that it is the directors collectively and not the management which drives the success or failure of the company. Hence a need is being felt amongst the stakeholders for a structured evaluation process for the Board of Directors.

Findings from unbiased evaluation by the directors explain how the Board of Directors of a company is currently performing for its stakeholders. This should not be guided or influenced by the present financial performance alone, so that planning for the future could be done more seriously. In a tough competitive environment
influenced by globalization, span of plan period is also a debatable issue, because due to competition planning requires more flexibility.

<table>
<thead>
<tr>
<th>Which discussion satisfied the Director at the Board meeting and why</th>
<th>Which are the matters (agenda items or other items) that require improvement and why</th>
<th>Rating within a scale of 1-10</th>
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The purpose of Board's evaluation is not to be critical, rather it may be considered by the directors as an integral part of the overall planning process and to be a successful evaluation it has to be absolutely non-confrontational in every possible manner.

Evaluation of Board's performance is not very common, but it is a fact that the companies which are involved seriously in business have always adopted prudent paths before they are prescribed as norms by regulatory bodies for better governance. Evaluation of Board's performance helps to ensure greater effectiveness of the Directors and employees as well to keep the quality of governance effective in a transparent manner.

In a structured manner, the Board may consider adopting a evaluation process for its own performance after taking confidential feedback from all the stakeholders, i.e., creditors, banks, employees, consumers, shareholders, and even from the internal auditors, statutory auditors, management consultants, auditors, practicing company secretaries attached to the company. Periodical evaluation is one way of helping to overcome group anonymity and pronouncing standards for effective governance. As a feedback cycle the evaluation process may help evaluate performance of the Board at the end of every meeting. From the following table a format of evaluation of Board proceedings may be developed:

6. 4. (iii). Format for Evaluation of Board Proceedings

The feedback to be received from the Directors present at the meeting on this matter should be optional to form a part of the minutes of the Board Meeting but the above
table could be used by the Chairman of the meeting and the owner of the company to ascertain the contribution of the directors on every item of agenda. Findings from the Directors should be shared by the Chairman at the end of the meeting immediately before concluding the Board meeting. For the purpose of this evaluation every Director shall be provided a form similar to the above table before the commencement of the meeting and the Directors should submit the same to the Chairman without signature. The Chairman shall advise the concerned persons of the team of management, including the directors about the findings of the evaluation. The Chairman should also insist on not following the middle line tendency at the time of putting the rate-markings, the directors should avoid markings between 4 and 6. If they like any approach they should give high rating otherwise low, this could only reflect the mind of the participating directors at the meeting.

The above table may be circulated with the agenda papers, for the Directors to be able to read and comprehend the same in a useful manner. Alternatively, it may be circulated and dealt with in the manner specified above.

Self-appraisal by the directors about their own functioning immediately after each of the board meetings may be absolutely topical on agenda related issues or meeting related issues and the opinion may have tremendous influence of immediate impulsive response.

To balance such an impulsive response, there could be an annual process of evaluation to be done by all the Directors and by the Company Secretary. Yes, by the Company Secretary also because it is he who remains present at the Board as a non-director, and probably can provide unbiased opinion to arrive at a proper evaluation of the Board. The annual evaluation could be done by answering the following 22 questions as suggested in 'Winning ways through Corporate Governance' by Neville Bain and David Band.

If the answer is found to be "yes" to all 22 questions, the concerned company definitely has an exemplary Board: Table 6.1
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<tr>
<th>Sr. No.</th>
<th>Question</th>
<th>Yes</th>
<th>No</th>
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<tbody>
<tr>
<td>1.</td>
<td>Are there three or more outside directors for every insider?</td>
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<td>2.</td>
<td>Are the internal whole-time directors on the Board limited to the position of Managing Director, the Chief Operating Officer and the Chief Finance Officer?</td>
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<td>3.</td>
<td>Does the concerned internal directors routinely share information to concerned senior managers who are not represented on the board?</td>
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<td>4.</td>
<td>Is the board having the right size (8 to 15 members)</td>
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<td>5.</td>
<td>Does the Audit Committee meet without the representatives of the management?</td>
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<td>6.</td>
<td>Does the audit committee routinely review &quot;high-exposure&quot; areas?</td>
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<td>7.</td>
<td>Does the board seek consultants' report relating to compensation payable to employees and directors?</td>
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<td>8.</td>
<td>Has the Board formed any compensation committee with the courage to establish formulas for managerial remuneration for the directors based on long-term results -even if the formulas differ from industry norms?</td>
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<td>9.</td>
<td>Are the activities of senior management sufficiently contained to prevent the emergence of a &quot;two tier&quot; board?</td>
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<td>10.</td>
<td>Does non-executive or independent directors annually review succession plans, for senior management?</td>
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<td>11.</td>
<td>Does non-executive or independent directors formally evaluate the MD's strengths and performance every year?</td>
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<td>12.</td>
<td>Is there any nominating committee rather than the MD to direct the search for new board members and invite candidates in stand for election?</td>
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<td>13.</td>
<td>Is there a way for non-executive or independent directors to alter the meeting agenda, set by the MD?</td>
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<td>14.</td>
<td>Does the company help directors prepare for meetings by sending relevant routine information, as well as analyses of key agenda items, ahead of time?</td>
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<td>15.</td>
<td>Is there sufficient meeting time for thoughtful discussion in addition to management monologue?</td>
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<td>16.</td>
<td>Do the non-executive or independent directors meet without management at least once in a year?</td>
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<td>17.</td>
<td>Is the board actively involved in formulating long-range business strategy from the start of the planning cycle?</td>
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<td>18.</td>
<td>Does the board select the new chief executive?</td>
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<td>19.</td>
<td>Is at least some of directors’ pay linked to corporate performance?</td>
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<td>20.</td>
<td>Is the performance of each of the directors reviewed on quarterly or half-yearly basis?</td>
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<td>21.</td>
<td>Are the directors who are no longer pulling their weight discouraged from standing for re-election?</td>
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<td>22.</td>
<td>Does the Board through MD take the right measures to build trust among directors?</td>
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The above list of questions is not exhaustive but only a model. The companies may develop a suitable list of questions, and circulate to the directors, may be with the reminders on Annual Disclosures of interest in the last month of the financial year. It may be reverted to the company in the first month of the next financial year by the directors. Considering the confidentiality and sensitivity of the information furnished by the Directors, the same should ideally be sent in a closed
envelope, to the Chairman of the Board of Directors of the company or to a person duly authorized by the Board. Based on the findings of the evaluation done by the Directors, the Chairman should intimate the Directors about the findings suitably at the Board meeting.

6. 4. (iv). Objective of evaluation

There are glaring examples of passing unanimous resolutions by the Board of Directors of some companies. To maintain such a rare and notable feature of the functioning the Board of Directors, evaluation of the Board's performance shall help the Directors for better planning, direction and suitable deliberation.

The objective of this evaluation should be to see the deviations between the original goal and the Board's effectiveness and performance, through information obtained, and to adopt necessary measures for further improvement. The annual review by the directors requires to see how best the company has taken care of its stakeholders and how best a blend of ethics and business have been made within the company and lastly, how transparent the operations of the company are, and whether it requires any further improvement.

The following questions need to be addressed to have a meaningful Board evaluation process on a continuous basis within the company:

1. Whether the board is doing the right thing collectively and how best the board is helping the company to achieve its Mission.
2. How views of the non-whole time directors could be made useful for achieving greater transparency and Mission of the company.
3. Is the Board required to declare a policy relating to payment to the Creditors.
4. Is the Board required to declare a policy relating to employment.
5. Is the Board required to declare a policy relating to increasing shareholders value.
6. Is the Board required to declare a policy relating to social contribution.
7. How the board should consider matters which require deliberations today for building up a better future.
8. How robust the board could be while considering those futuristic plans for betterment of the Company.
9. Through evaluation process it may be seen whether it is pro-active or re-active, or an extension of Management.

10. How minimum standards of compliance would be sought on various legal matters over and above the legal requirements.

11. How the Committees appointed by the Board, should provide their action taken report to the Board and how the Board should analyze the functions and examine the effectiveness of such committees, and provide a report in the Annual Report and Accounts.

12. How best constructive criticism can create better climate in the board-room through frank, open, direct but critical discussion.

13. Does the Board need to discuss all the matters that are now being considered and discussed by it regularly or matters of lesser significance and importance may be allowed to be handled by means of manning and authorizing the lower management suitably.

If these questions are addressed positively, it shall set a platform for evaluation of Board function at the end of every meeting and at the end of every financial year. It is needless to mention that the questions set out above are in no way exhaustive. Instead, it is a suggestive enumeration. The Directors should suggest change, if they feel the same is necessary to refer correct evaluation of the functioning of the Board.

6. 5. Need for Corporate Governance Assessment and Rating system

Undoubtedly, corporate governance (CG) is a hot topic across the globe. Not a day seems to go by without press comment, a conference or the launch of a new code, all on the subject of CG. The increasing number of corporate scandals in the last few years have stained CG reputation and questioned the effectiveness of its current structure. As a result, CG has received attention from policymakers, investors, corporate boards and rating agencies. During this period, many top executives of giant corporations, such as WorldCom Inc., Enron Corporation, Tyco International Ltd., Adelphia Communications Corporation, Credit Suisse First Boston, to name a few, have been convicted of conspiracy, orchestrating schemes to hide their company’s

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debts and exaggerate profits while embezzling millions of dollars. Shareholders as well as legislators have been appalled at such intolerable actions. These actions and practices have created an urgent need for CG assessment and rating systems.

Professional rating agencies came up with CG rating methodologies and rankings. Different rating systems were introduced in order to rank companies, such as the Governance Metrics International (GMI) Ratings, the Corporate Governance Quotient (CGQ), the Corporate Governance Score (CGS) of Standard & Poor’s and the Board Effectiveness Rating (BER) of the Corporate Library (TCL). These CG ratings seemed to concentrate on the following general categories: (a) board characteristics, (b) ownership structure, (c) compensation plans, (d) anti takeover devices, (e) financial disclosures, (f) internal controls, and (g) director education. Recent high-profile corporate failures, many of which were caused by governance weaknesses, have convinced an increasing number of once skeptical investors that governance is a separate risk class that certainly requires attention and specialist analysis. However, there still remains much skepticism from many quarters, particularly investors, who doubt the existence of the link between good CG and performance indicators, such as share price performance. However, it is also true to say that many companies still remain unconvinced and the practical adoption of good CG principles has been “patchy” at best, with “form over substance” often the norm. Whilst there have been many attempts to measure governance from a compliance perspective, there are currently no global benchmarks with which to measure CG standards.

**Need of rating companies on Corporate Governance**

Chief executive and chief financial officers of any business wield a great deal of power. That is not an indictment; CEOs and CFOs need to be able to lead their organizations with confidence and authority. But when other people’s money (public at large) is involved, especially in big publicly held companies, the law and the markets have created a set of checks and balances to ensure that the shareholders’ and

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public interest is well-protected. These checks and balances include: the board of
directors, accountants, lawyers, security analysts, proxy advisors, investment bankers,
audit committees, regulators, even the press. While some have tried their best and
some have clearly fallen down on the job, there is still a gap in this system. It lacks an
organized effort from the private sector to monitor CG at publicly held companies on
a regular basis, and to provide the institutional investor market and corporate issuers a
simple tool to gauge who is doing well and whose governance practices represents a
real investment risk— a “numerical” ratings system, in other words. If investors
continue to buy the stocks of companies, irrespective of their governance standards,
there is little motive for companies to improve. Although codes and guidelines are
essential for setting minimum standards, it is often all too easy for companies to
comply with the letter, but not the spirit, of these codes. For example, the worst board
in the world may well comply with certain CG Codes—a majority of non-employed
directors, for example—but if these same directors are unable or unwilling to devote
the appropriate time to their positions, the substance of ‘good’ governance is suspect.
Moreover, codes are quite correctly designed to be complied with, being minimum
standards; they are not capable of identifying the “best in class” companies.

Rationale for the Corporate Governance Ratings System

With increasing emphasis being placed on CG across the globe, it is not surprising
that a number of governance rating systems have been developed. Some examples of
firms, which have developed CG rating systems, are the Deminor, Governance
Metrics International, the Corporate Library, Standard and Poor’s, Moody’s Investors
Service, etc. Their rating systems cover several markets and should be of long-term
benefit to investors and to the companies themselves. Moreover, the ratings will be
useful to the governments in identifying the perceived levels of CG in their country
(compared to other countries in their region or outside of it) whose companies may be
competing for limited foreign investment. In emerging market countries in particular,
those companies with a strong CG infrastructure will be less subject to cronyism and
its attendant effects on corporate wealth.
These companies would tend to be more transparent and accountable, and hence,
more attractive to foreign investors. This is because a company with good CG is
generally perceived as more attractive to investors than one without. Good CG should.
for example, indicate a board that is prepared to participate actively in dialogue with its shareholders, ensuring the effective exercise of voice, thus, enabling investors to articulate their interests.

An appropriate approach for a CG rating system is firstly to have a rating of the CG in a given country. For example, how transparent are accounting and reporting practices generally in the country; are there existing CG practices in place; is there a code of best practice, to what extent is that code complied with and what sanctions are there against companies which do not comply? Having set the overall CG scenario in any given country, the individual company can then be given a CG rating. With regard to the individual company, the ratings would generally be based on the company’s approach to the rights of shareholders; the presence of independent non-executive (outside) directors, the effectiveness of the board; the accountability and transparency of the company, etc. In nutshell, CG rating systems should provide a useful indication of the CG environment in specific countries, and in individual companies within those countries. Such rating systems will provide a useful “benchmarks” for the majority of investors who identify good CG with a well-run and well-managed company.

**Main goals of the Corporate Governance Score Approach**

During the last few years, several rating systems have been proposed and implemented. In their assessment, these rating services rely on public domain information be it electronic or printed. These systems are based on what is known as the Scorecard. The CG rating systems scorecard should:

- Facilitate the work of analysts and investors through a systematic and easy overview of all relevant issues of good governance.

- Enable companies to easily assess the ‘reach’ and the ‘quality’ of their own governance situation.

- Allow setting of minimum scores by investors for governance as part of general investment politics.
• Enable comparisons across-industries and across-countries.

• Be readily available to all interested parties via the Internet.

• Ensure high degrees of usage: the completion of the Scorecard via programmed tools (MS Excel) should therefore be possible.

**Assessment Criteria**

During the last few years, several rating systems have been proposed and implemented. The most recognized four rating services provide the matrix that rank the quality of the firm's directors. These rating services are: (a) Institutional Shareholder Services (ISS); (b) Standard and Poor's (S&P); (c) Governance Metric International (GMI); and (d) The Corporate Library (TCL). For their assessment purposes, these services rely on public domain information be it electronic or printed. After rating corporations, as per their specific methodology, finally, they generate scorecards.

Corporate rating is indicative and done for the enterprise that pays for it. It is not meant to aid investors to take investment decisions. At the end of the rating process, the system produces the "total score," say out of hundred, that is further segmented to ranges of performance (%)s to categorize enterprises as excellent, very good, good, etc. These ratings can be used for making proxy voting decisions and screening portfolios for investment risks.

In the following section, we present a brief discussion of the most popular rating system categories.

**Category 1: Board Structure and Accountability**

The simple fact that the board and executives structure exists on the scoreboard rating system is in itself a positive sign as it ensures some kind of improvements and adjustments after each report card is issued for the company. The following topics are usually considered in this category: independence of board members; board size; board attendance; chairman/CEO separation; directors serving on boards of other
companies; composition of audit, nomination and compensation committees; annual
election of the board of directors; disclosure of CG guidelines and code of conducts
and ethics; and share ownership of executive directors.
Rating agencies evaluate firms with more independent (no affiliated) board members
higher than firms with less independent board members. Independent board members
may be more critical towards ethical and fraud issues, as well as restructuring
activities than dependent members. However, it is questionable whether more
independent board members would improve firm performance. More disclosure of
CG guidelines, codes of conduct and ethics by a firm generally means a higher
ranking.

Category 2: Executive and Director Compensation

In this category, the following topics are rated: level and form of compensation;
performance evaluation criteria; independence and integrity of compensation setting
process; shareholder approval of compensation policy; pension plans; option re­
pricing policy; directors and executives are subject to stock ownership guidelines;
presence of company loans to employees.
Fixed and variable compensation policies and practices that reward management with
little regard to for shareholder interest indicate weak, ineffective board. When long­
term compensation is tied to shareholder returns then it is considered good
governance. Recently, many CEOs salaries exceeded the one million dollar barrier
and their compensation plans include bonus and variable pays in form of stocks and
stock options. Such conditions are a recipe for bad governance. This category is not
examined thoroughly in any of the four rating systems. In our view, a compensation
plan should be related to the corporate performance and performance of peer
companies

Category 3: Audit

The crucial issue in this category is the audit committee: who appoints it, its mandate,
and its authority? Are the members of the audit committee independent and do they
discuss financial issues on a regular basis with the external auditor?
Category 4: Shareholder Rights and Takeover Practice

In this category, the following issues are considered: one-share, one-vote system; a simple majority vote of shareholders is required to amend the charter or bylaws; shareholders may call special meetings; shareholders may act by written consent. Takeover is the mechanism to control enterprises. The rating of this category is based on public data, which rarely represent this activity. Also, it is difficult to rate enterprises based on an assumption that never took place, i.e., takeover did not happen. One important point to rate here is that corporate laws varies from one state to another and from one country to another, and it is unfair to measure or rate corporate by the same yardstick.

An overview of Corporate Governance rating systems

There are quite a few firms offering domestic-only CG ratings services. These include some initiatives taken in Australia, Brazil, Germany, Greece, India, Malaysia, Philippines, Russia, South Korea, Thailand, etc. There are also a few businesses offering cross-border governance rating services. Each rating service obtains most of its data from publicly available disclosure documents, but some also seek additional information from press releases, news articles, and company websites. For a fee, most provide the rated companies an opportunity to review how scores are compiled. We would like to focus on the latter category comprising of the Deminor, Corporate Library, Standard and Poor’s (S&P), and Governance Metrics International (GMI). For the benefit of the readers, a brief overview about the mainservices and methodology used is provided below.

(A) Deminor Rating Service

Deminor is an independent consulting practice founded in 1990 and based in Brussels. Its focus is on Western Europe. Its services include investment advice on corporate transactions, proxy voting recommendations, litigation support and shareholder activism. The Deminor Rating Service was introduced in 1999 and is available to both corporations and investors. At the company’s request, Deminor offers a solicited CG analysis, rating and investor report to the company. It is up to the company to decide whether or not it wants the rating and investor

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report to be made public. For example, Deminor’s rating report on Suez, the French-based utility, was released in April and is available on the Suez company website. Deminor also sells subscriptions to investors for unsolicited ratings. This service currently covers the FTSE Eurotop 300 and employs a methodology based on approximately 300 CG indicators. The company website address is www.deminor.com.

(B) Institutional Shareholder Services (ISS)

The ISS started offering its services in 1985 by advising investors on how to vote on resolutions put before their shareholders.

From June 2001, it started rating companies in the Russell 3000 Index using its Corporate Governance Quotient (CGQ). In its expanded release of CGQ, the universe of companies ranked has increased to more than 5,000 and covers more than 98% of the U.S. equity universe. Each company is scored individually, based on 61 variables, and is ranked relative to its index and industry peer group. ISS rates companies on a 0% to 100% basis relative to firms within their peer group and publishes firms’ CGQ overall score, and additional scores on each of eight categories. The key new variables added to the ratings include auditor fees, auditor rotation, changes in board size, board attendance at meetings, options expensing and corporate loans.

To find out the details of their scores, companies must pay a $10,000 to $17,000 subscription fee to ISS. The CGQ is published in ISS proxies of each rated company, which are used primarily by institutional investors. ISS claims that in the service’s first six months, more than 30 major institutions signed up, including JPMorgan Fleming, Alliance Capital and National City Corporation. Additionally, 110 corporate issuers are using CGQ data for peer group comparison and business analysis, says Jamie Heard, CEO of ISS. Thus, investors and other interested parties, for a fee, can use the CGQ as a distinctive element in investment decisions. ISS is encouraging companies to use a specially designed Web portal to submit any material changes related to CG structure, policies and/or procedures. Updates are date-stamped, and the information is verified by ISS analysts within two business days.
S&P assesses a company’s Corporate Governance Scores (CGS) based on the interactions among management, the board of directors, and financial stakeholders, but it emphasizes interactions with shareholders. The purpose of the S&P CGS is to enable senior management and directors to benchmark their own corporate policies. However, the assessment can be done on a public or confidential basis and involves the analysis of public and non-public information, as well as, meetings with directors and senior management.

After meeting with a company’s management and directors, and grading their responses based on OECD’s “Principles of CG” and other criteria, S&P assigns an overall CGS to the company plus a score for each of the four separate components. They use a grading scale of 1 (lowest) to 10 (highest), unless a company refuses to provide meaningful information, in which case the company receives a “zero”. This is the most expensive rating service of the four. S&P does not publish these scores, but companies, who pays between $75,000 and $200,000 for the reviews can use their scores as they choose.

S&P analyses four key components when evaluating a company’s CG standards. The first is “ownership structure and influence,” where the transparency of the ownership structure and the influence (whether positive, negative or neutral) of major shareholders or block holders is analyzed. In the second component, “shareholder rights and stakeholder relations,” the quality of the interaction of the company with its financial stakeholders (for example, shareholder meeting procedures) and the rights afforded to financial stakeholders (whether economic and legal rights are proportionate) are evaluated. The impact of any anti-takeover provisions that might thwart an otherwise legitimate takeover attempt or entrench an unsatisfactory management is also taken into consideration. In the third component, “financial transparency and information disclosure,” the quality, accessibility and timeliness of financial (including the integrity and independence of the audit process) and operational disclosures to financial stakeholders are measured. The analysis includes evaluations of a company’s public filings, annual reports and websites. Finally, the analysis looks at “board structure and process,” and evaluates the structure and
effectiveness of the board of directors, the role and independence of non-employed directors, risk management, strategy setting and remuneration and succession issues. However, it should be noted that S&P CG Scores are designed specifically for financial stakeholders, primarily shareholders. Currently, S&P focuses on a firm’s internal governance structure and processes, but in the future it intends to score individual countries within which a firm operates since various countries may have either weak or strong governance standards. For example, two companies with the same CGS, but domiciled in countries with contrasting legal, regulatory and market standards, present different risk profiles. In the event of deterioration in governance standards at a particular company, investors and stakeholders are likely to receive better protection in a country with stronger and better-enforced laws and regulations. One can find more details about S&P’s “Criteria, Methodology and Definitions” under the section CG Scores & Evaluations at www.standardandpoors.com.

(D) Governance Metrics International (GMI)\(^{148}\)

At heart, the GMI is in the business of accountability research. GMI is an organization that rate companies on CG criteria and deliver ratings and rating reports to customers over a web-based delivery platform. The GMI (www.gmiratings.com) is in the process of developing profiles for companies in the S&P 500, and expand coverage to include more US companies and add non-US coverage. Its long-term goal is to develop the first truly independent CG ratings agency with a global research universe. “Our hope is that GMI research and ratings will help diligent investors and corporations focus on governance on an ongoing basis, identify companies and particular items that need improvement and recognize companies that are trying to set the best example with a positive rating.” GMI subscription fees start at $18,000 and increase to $50,000 for a comprehensive rating, which is a review initiated by a company’s request to augment its ratings. As for GMI product line, they are offering two types of ratings reports: “basic” ratings, based on public data sources only (e.g., SEC filings, news services, public websites) and completed at no cost to the company, and “comprehensive” ratings, a fee-based review, which includes information gleaned from an in-depth interviews with senior management and outside directors, as well as, commentary from the company on its CG and corporate ethics.

GMI reports describe each company’s governance profile, explain the GMI ratings and also include profiles of each member of the company's board of directors. All GMI ratings and company reports are delivered through a proprietary web-based platform. Besides allowing subscribers to view or print company reports, the GMI website offers standard sort and view options (e.g., sort by industry, sort companies in order of rating from biggest to lowest).

The GMI rating system is based on more than 1000 data points per company that cut across seven broad categories of analysis: board accountability, financial disclosure, shareholder rights, compensation policies, market for control, shareholder base and corporate reputation. The latter category includes litigation patterns, regulatory actions, environmental conduct, labor relations and more. GMI rating criteria is based on global CG Code, such as those developed by the OECD. They have also recently incorporated many of the recommendations included in the NYSE’s release on corporate accountability. While GMI apply normative policy statements within its metrics to determine whether companies adhere to those standards, all companies in their systems are rated relative to one another on a score scale of 1 (lowest) to 10 (highest). In addition, GMI also calculates a rating for each of the seven broad categories of analysis, allowing shareowners to look into areas in which a company excels or may be weak. GMI ratings and company reports are updated twice a year. They are posting summary stories on the website to alert subscribers about governance changes at the companies; they rate in between the semi-annual ratings releases. Similar to the way ISS works, GMI produces an overall score and ratings on seven categories, but the number of variables is more than 600 rather than 61. The seven categories listed are somewhat different from those used by ISS but include many of the same issues. GMI’s website is www.gmiratings.com.

(E) The Corporate Library (TCL)

The TCL launched its online repository for CG information in 2003. This is a web-based research service, and their rating service is called The Board Analyst. It covers 1800 companies, including the S&P 500, Russell 1000, FTSE 100 and the FT Global 500. TCL’s Board Analyst System rates companies on CG and boards’ relationships among company management, their boards, and shareholders. TCL’s Board
Effectiveness Ratings (BER) grading scale is “A” to “F” and it assigns an overall score and one on each of six key areas, as shown in Table-2. Ratings include individual directors’ performance in terms of meeting attendance, willingness to question management decisions, stock ownership, and other boardroom actions. However, TCL’s system differs greatly from the others. It uses different criteria than the others do, and where ISS, for example, may give a firm a very high grade, TCL may give the firm an “F”. The key, TCL attempts to grade actions and policy implementation as opposed to policy making and what boards say they will do.

Its ratings are primarily for sale to institutional investors, with subscription services ranging from $8,000 to $35,000. Because it does not accept fees from companies it rates, TCL advertises itself as the only independent rating system, and BER is the only one of the four systems to exclude the term “governance” from its rating name. Unlike GMI, or Deminor, it does not appear that TCL will be offering a solicited rating service to corporations.

However, the clients can access The Board Analyst’s database and sort companies based on screens developed by the Library. Their methodology emphasizes board relationships, stockholdings and related party transactions. Interestingly, TCL says, “it plans to rate individual directors, as well as, the boards and companies they are associated with.” The TCL’s website is www.thecorporatelibrary.com.

Choosing the right rating service?149

If a corporation embraces the scorecards, the next decision is which rating service to purchase, either for internal use or for evaluations of other organizations. Of course, there are some commonalities across the four scorecards. CGQ, CGS, and TCL look at board structure and CEO compensation. CGS and GMI include ownership structure and financial disclosure. CGQ, CGS, and GMI examine control in terms of takeover practices or financial stakeholders’ rights. And there are some notable differences too. Only CGQ and BER include auditing. GMI is the only one to examine social responsibility. These four services are not the only ones that evaluate CG and

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boardroom activities. Some shareholder activists and institutional investors are also
developing their own rating systems for various purposes.

**The Pros and Cons**

The CG Scorecard may be worth purchasing for several reasons. First, a company can track improvements in its own governance practices. Second, board scorecards give companies another way to compete by adopting better standards of performance, which becomes a motivation for change and may demonstrate evidence of change at the higher echelons. High ratings will provide an additional marketing tool for investor relations departments.

Third, meeting the letter of the law might increase the actual spirit of the law, particularly for proactive companies. But CG Scorecards are not always perfect. First, the providers of rating services appear to have a conflict of interest. For some services, companies must pay to discover how they were scored, so that they can learn how to change their scores next time. Scorecards can appear to be a type of bribery when (by paying) companies find out how to improve their scores. The rating service then charges the investors fees for the scores, which results in the appearance of lack of independence.

Second, the subscribing company is often the one that must find any error in the grading, which may result in costly and time consuming use of company resources. One concern is whether the rating service (or corporation being rated) verifies the data. In many cases, a corporation’s accountants and financial analysts will be the ones to review the data and provide the feedback for necessary corrections. Finally, simply improving the score does not mean the board actually performs better within closed meetings. Good CG may be used to prevent business failures, but investors and others are really interested in success. Therefore, the ultimate issue is whether the corporation can make the leap from good CG and able to show good financial performance too.

Finally, every CG rating system generates a final score (an overall number) that may give numerous explanations and erroneous conclusions. Various rating systems seek
to reduce a complex CG process and related performance into a single score. Such outcomes, does not in any way reflect the real nature of CG or its performance. Ranking, if it is all needed, should be interpreted very carefully, and not be used as a simple measurement of “good or bad” CG practice.

Undoubtedly, these scorecards are relatively new and only time will tell the relative-value of each one. Financial analysts and management accountants will certainly be involved in assessing the credibility and usefulness of these scorecards. However, different user groups may find different scorecards useful to them. Given this, a corporation may choose to pay for one or all of the scorecards, which is an issue to be decided by the corporate accountants and investor relations departments.

**Board-driven evaluation**

Another scorecard is the internal board evaluation. The Board Institute developed a new Web-based, confidential index that directors complete. At the directors’ discretion, those who work closely with the board may also complete it. The questions require both objective and subjective responses. The Board Index results, which cost $10,000 to $20,000, are tabulated and provided to all the directors, along with guidelines for best practices and benchmarks developed from participating companies. The Board Index covers board structure and composition, role of directors, and leadership of the board. The Board Institute is developing additional modules to evaluate board committees, such as the audit and compensation committees.

**SOX and Stock Exchange Requirements**

Among the new requirements in the Sarbanes-Oxley Act are greater independence of members of corporate boards of directors, and increased accountability for accuracy of financial statements and adequacy of internal controls. SOX also imposes new requirements for a company’s principal executive officer and principal financial officer, the audit committee of the board of directors, other directors, executives, principal stockholders, attorneys, and financial research analysts.

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The most important SOX requirements related to corporate boards concern to the audit committee, which must be composed of independent directors, one of whom should be a financial expert. The audit committee is to handle the contract with the auditors, has the power to hire other advisors, and must establish procedures to deal with accounting complaints and whistleblowers. Audit committees are also supposed to develop a written charter, discuss the financial reports, and meet separately with the external auditors, management, and internal auditors. If the external auditors experience any problems, they should discuss those with the audit committee members. Finally, companies are to develop CG guidelines and codes of ethics and business conduct, and the audit committee should evaluate the company’s risk management. Additional NYSE rules include allowing the audit committee members to receive higher fees than other directors in recognition of greater work requirements.

Other SOX requirements related to the board of directors include prohibition of loans to directors and executive officers. Directors, officers, and 10 per cent shareholders must report transactions in the company stock within two business days. These transactions must be posted at the SEC and the company’s websites. Finally, directors and executive officers are prohibited from trading company stock during pension blackout periods. Also, NYSE and NASD Exchange have altered their listing standards to comply with audit committee independence rules. As in the SOX requirements, the audit committee is given oversight responsibility for the external auditors and other non-audit engagements with the audit firm. Beyond SOX, the NYSE rules require that a majority of directors be independent, defining independent to include no material relationship with the company in the previous five years.

How do scorecards relate to the Sarbanes-Oxley Act and stock exchange rules? The SOX and the stock exchange requirements for directors focus on independence and audit committee supervision of the external auditor. The scorecards' criteria are much broader and incorporate other aspects of board performance, particularly financial results, viz., corporate governance quotient (CGQ) and board effectiveness rating (BER), and executive compensation. For example, the CGQ scorecard looks at financial transparency and information disclosure, the GMI metric looks at reputation and socially responsible investment issues, and CGQ evaluates takeover practices and director education. While fulfilling SOX and stock exchange requirements is in keeping with the letter of the law, scorecard ratings services appear to be increasing
the stakes. Companies that earn higher ratings may, in fact, be responding to the spirit of the law.

**Global Credit Rating Agencies**

Credit rating agencies are an integral part of modern capital markets. Their assessments on sovereign and corporate entities have been increasingly used as benchmarks by regulators and investors. Financial decision-makers need an independent, and objective data and information to analyze options, make decisions and manage operations. Therefore, every day large number of investors and financial professionals, from across the world, are looking forward to one or more rating firms for financial market intelligence that is authoritative, objective as well as credible. The rating industry counts only three major world players—Moody’s, S&P, and Fitch—that have become global following the dramatic growth of international financial markets. These agencies assign domestic and external ratings at the borrower’s request. However, each of them is present in most of the countries and has a universal rating scale.

Undoubtedly, credit rating agencies are systematically following their own rating criteria and revising them from time to time. Criteria encompass both qualitative and quantitative indicators. In general, a firm’s growth potential, its capital requirements, the degree of competition in its market and industry, its productive diversification and ownership structure are included as business risks. It will be up to the analysts to evaluate by probing managers about their risk profiles, strategies and management philosophy. Subjective judgments often play an important role in this part of the rating process. Activities of rating agency are public and all the necessary information on rating decisions is available on the Internet. However, keeping in view the core title of the article (CG Rating Systems), a very brief account about these three global credit agencies is provided below.

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(a) Standard & Poor’s (S&P’s)

This agency was established in 1860 by Henry Varnum Poor (www.standardandpoors.com). Undoubtedly, S&P’s credit ratings, indices, investment research and data provide financial decision-makers with the valuable information and opinions they need to feel confident about their decisions. In fact, this is a leading provider of financial market intelligence. Nowadays, S&P’s is a global leader in credit ratings and credit risk analysis, with ratings on debt issued in more than 100 countries. They analyze issuers and debt obligations of corporations, states and municipalities, financial institutions, insurance companies and sovereign governments. Also, they provide insight into the credit risk of structured finance deals, providing an independent view of credit risk associated with a growing array of debt-securitized instruments. With over $4.5 trillion benchmarked to S&P’s family of indices (including the S&P 500, the S&P Global 1200, the S&P Europe 350, and S&P Global Equity Indices), they are one of the world’s largest index provider. S&P’s Indices provide a full spectrum of services assisting investors and asset managers to measure market performance.

(b) Moody’s Investor Service

This is a leading global credit rating agency, which is offering credit ratings, and research and risk analysis for debt securities and other instruments in the financial markets. They provide research data and analytical tools for assessing credit risk and also publish investor-oriented credit research. In fact, Moody’s has actively built alliances with leading local credit ratings agencies worldwide. The company also ranks the creditworthiness of borrowers using a standardized ratings scale, and has captured over 40% share in the world credit rating market.

The company was established in New York by John Moody in 1900 (www.moodys.com). Now, Moody’s Corporation comprises two subsidiaries: Moody’s Investors Service and Moody’s KMV. Moody’s Investors Service is among the world’s most respected, widely utilized sources for credit ratings, research and risk analysis. The firm regularly publishes market-leading credit opinions, performs research and commentary that reach large number of institutions and subscribers around the globe.
(c) Fitch Ratings

This credit rating agency was founded in 1913 by John Knowles Fitch in New York City (www.fitchratings.com). They provide credit ratings to corporate, municipal bonds, preferred stocks, commercial paper, and to non-commercial organizations in over 75 countries. In fact, Fitch was one of the three rating agencies first recognized by the Securities and Exchanges Commission in 1975.

This agency bases its ratings analysis and rating decisions upon established criteria, methodologies and ratings definitions, and applies them in a consistent manner during the rating and surveillance processes. Their credit ratings provide an opinion on the relative ability of an entity to meet financial commitments for global spectrum of corporate, financial, bank, insurance, municipal and other public finance entities. Credit ratings express risk in relative rank order and they provide various types of ratings, such as international credit ratings, national credit ratings, country ceiling ratings, national equity ratings, and shadow ratings.

These three leading international rating agencies have established a universal and open methodology of drawing up the rating reports and immaculate reputation. Because of that, assigned ratings have great meaning to investors. The following leading credit rating agencies are offering their services in India: Credit Rating Information Services of India Limited (CRISIL), Investment Information and Credit Rating Agency of India (ICRA), Credit Analysis & Research Limited (CARE), Duff & Phelps Credit Rating India Private Limited (DCR India) and ONICRA Credit Rating Agency of India Limited. Ratings awarded by major credit rating agencies are: AAA- (Highest Safety), AA– (High Safety), A– (Adequate Safety), BBB- (Moderate Safety), BB- (Sub-moderate Safety), B- (Inadequate Safety), C- (Substantial Risk), D- (Default). Reputation for rating agencies is very important because rating conclusion is subjective opinion of rating agency. There have been several instances of manipulation of credit ratings by various rating firms across the globe. The Committee on Oversight and Government Reform (USA) held a hearing on October 22, 2008 titled “Credit Rating Agencies and the Financial Crisis” (see www.nytimes.com). The hearing examined the actions of the three largest credit rating agencies, Standard & Poor’s, Moody’s Corporation, and Fitch Ratings, leading
up to the current financial crisis. Two former high-ranking officials at Moody’s Investors Service and Standard & Poor’s said in Congressional testimony: “Conflicts of interest were largely responsible for the disastrous performance of credit rating agencies in assessing the risks of mortgage-backed securities.

The securities issuers pay the agencies to issue ratings, and the agencies’ interests can eclipse those of investors. While the methods used to rate structured securities have rightly come under fire the business model prevented analysts from putting investor interests first.”. According to another official the story of the credit rating agencies is a story of colossal failure. The credit rating agencies occupy a special place in the financial markets. Millions of investors rely on them for independent, objective assessments. The rating agencies broke this bond of trust, and federal regulators ignored the warning signs and did nothing to protect the public.

Analysis and conclusion

CG remains a complex and dynamic issue as it deals with cultural, political, technological, and market variations. Like the Altman “Z-score,” which became a powerful predictor of potential bankruptcy of a company, a CG rating score could be a powerful indicator of the extent to which a company is currently adding to its shareholders’ value. An appropriate approach for a CG rating system is firstly to have a rating of the CG in a given country. Having set the scene in any given country, the individual company can then be given a CG rating. Five observations can be drawn for comparing the rating systems. First, the rating consists of a limited number of CG categories, built on a detailed set of criteria. Second, the total number of indicators that are used to measure the level of CG of an individual company varies substantially. Third, the way of scoring and scale used is similar in all rating systems. Four, for the majority of rating systems, weights are assigned to the CG indicators. Finally, the methodologies used for obtaining the required information are similar. Overall, CG rating systems should provide a useful indication of the CG environment in specific countries, and in individual companies within those countries. Such systems will provide a useful benchmark for the majority of investors who identify good CG with a well-run and well-managed company. CG codes are designed to be complied with, being minimum standards; they are not capable of identifying “best in
class” companies. Why are these ratings important to companies? Among the reason is the reliance of the institutional investment community on agencies, such as ISS, GMI and TCL for guidance and counsel on shareholder issues. To ignore institutional investors, the largest aggregate holders of corporate equity, is at a minimum ill-advised. Moreover, given the scrutiny accorded to matters of board independence in CG and rating, these are issues that all parties will want to handle with great care. CG rating services take the view that market solutions are crucial to the long-term implementation and adoption of substantive governance improvements: if investors are rewarded for investing in those companies with good governance, by better equity performance, then companies whose cost of capital will be lower will be motivated to make these improvements. Is governance just a current fashion accessory for the current bull and/or bear market, or will governance continue to be part of the financial landscape when shares recover?

6. 6. Need for a systematic approach and process for Corporate Compliance Management

6. 6. (i) Introduction:
Compliance by itself involves adherence to set regulations or standards, fulfillment of certain conditions or restrictions. It includes conformity in practices and processes followed to ensure that there is no default of the said obligations. Compliance could be a statutory compliance or non-statutory compliance. A statutory compliance pertains to adherence to statutory requirements, whereas non-statutory compliance involves adherence to the internal guidelines, norms, recommendations, reports which could be issued by statutory authorities, which are yet to absorb colour of statutory obligation e.g. Secretarial Standards issued by the ICSI are non-mandatory until they become part of the law, directives from the Board of Directors. At times, certain committees constituted by the Government or authorities such as Reserve Bank of India submit their recommendations or guidelines which are expected to be complied as a matter of corporate discipline or better corporate governance in the interest of corporate stakeholders. These recommendations or guidelines form part of the non-statutory category e.g. non-mandatory requirements specified in Clause 49. In addition, each company could

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internally drive certain policies, processes and practices that form part of overall compliance requirements, despite being the fact that they are non-statutory in nature.

In the Indian context, unfortunately, the laws and the rules, regulations issued there under are enormous in number and that multiplies the complexity of the issues involved not only in terms of reading and understanding, but also in applying, interpreting and monitoring those. To stretch this further, the litigations arising from interpretation as well as defaults are again in multiples and the whole of the legislature, judiciary and executive arms need to deploy resources and efforts for monitoring the whole system of governance and measuring the performance against the set regulations/ standards. Specific to corporate sector, there are again multiple laws and regulations that drive obligations for each of the corporates e.g. legislations such as, corporate laws, taxation laws, industrial, economic and labour laws cover up most of the applicable regulatory environment. Every company has got its own mechanism to ensure compliance of these laws apart from internal process and guidelines. Further, certain industries such as chemicals, pharmaceuticals, consumer goods etc. have additional set of regulations that are significant from compliance perspective.

The companies that are in existence for years or those forming part of big corporate houses, have comparatively better systems and formats to monitor compliances on a regular basis, while the others are usually in developing stage. It is always better to have a proper system in place and keep it improving to ensure a company moves in right direction and increases the compliance from letter to spirit.

The fact however, remains that one cannot accept non-compliance to any degree e.g. a company which does not have a compliance mechanism in place could start focusing on select legislations which are critical and start devise processes and formats to capture the compliance requirements under those legislations and allocate the responsibility to someone who is qualified or understands those legislations and are in a position to interpret and implement the same. At the end, default is a default howsoever minor it is.
6. 6. (ii) Management of Compliance

Management of compliance is a specialized activity and needs attention. It is recommended that a top-down approach would be of help. Again if the organization structure is clear in terms of defining roles and responsibilities of people who would be involved in ensuring the compliance of relevant laws, the same avoids defaults, duplication of efforts and confusions within organization. The people at middle and lower management level also need to understand the significance of compliance process and shall report all facts to the top management to enable it to take appropriate measures to improve the level of compliance. While the Board of Directors would guide and appreciate providing detailed disclosures as to compliances, it is the responsibility of the middle and lower management to provide complete view of the compliances for the company.

Since the listing agreement does include compliance of the applicable laws, the Boards of the companies have initiated practices in terms of submitting compliance reporting in each Board meeting to ensure compliance on quarterly basis. Typically therefore, the Secretarial function would be driving the compliance process since the Company Secretary would need to report to the Board of Directors in accordance with the guidelines given by the Board or the recommendations by the internal and external auditors. Compliance could be monitored by Legal department if a company has a separate Legal department.

Alternatively, the responsibilities could ideally be shared between respective functions, led by Secretarial and Legal departments. It needs to be understood that considering the size at which corporates operate, the complexity of business transactions, cross border application of business issues and complexities of the laws in the country, it is essential that the Subject Matter Experts (SMEs) are deployed to look after respective areas of compliance. Any compliance should not be looked at as a mere formality, rather a respectful obligation to do or not to do certain things in the interest of the organization as well as the stakeholders at large.
Reality of life is that a single individual is unable to ensure compliance of all the applicable laws. And hence, it is essential to appoint various personnel qualified in
not only the corporate laws, but also in the economic, industrial, labour and taxation
laws apart from compliance of local laws. Further, considering the nature of
industry companies would also need to comply with the applicable regulations.
Geographically spread companies would need to comply with the state laws,
municipal regulations as well. Where company has a presence outside India,
compliance of the laws of the respective country is a job in itself requiring
understanding of the requirements of such laws and ensuring procedural
compliances from time to time. This could also involve issues such as selection of a
good law/ consultant firm, getting right understanding on the choice available e.g.
choice as to form of organization to be set up, language issues (e.g. in a place like
China, Germany and such others, all legal documents need to be submitted in the
local language). This not only adds up to the persons involved, but also the time and
costs of getting the right things done at right time.

6. 6. (iii) Follow a systematic approach

Companies have been deploying perfection tools such as Six Sigma, Balanced Score
Card and other Codes of Conduct. It is desirable to apply these tools to Secretarial
and Legal function as well, to the extent the same could be deployed to these
functions. It could bring in a degree of improvement in overall performance of these
functions to the extent the same is result oriented and is measurable.

It is recommended that companies follow a systematic approach and put in place a
mechanism to ensure total compliance. Following steps are suggested in that regard:

Organization Level

- Company should have a separate Secretarial and Legal department or people
handling these functions (it would however depend on the nature and size of
the organization). This provides organization level focus to the function per
se and its significance in the interest of the organization. It is desirable if
both these functions are situated closest to each other and closer to finance.
the same works well in terms of sharing of activities, databases and work flows.

- Specific objectives and key performance areas need to be well defined to bring in better clarity and set functional initiatives in line with the organizational goals.

- Measurable improvement standards to be identified to monitor progress.

- Top management support is a must for running a very effective Secretarial and Legal function. Top management should realize the importance of compliance with the laws and accordingly set out the expectations for the functions.

- Recognition to the achievements of these functions via limited publicity within the organization, either through e-mails, making mention in organizational newsletters etc. augments motivation for people within these functions.

**Staffing and Infrastructure**

The Secretarial and Legal functions need to be empowered with adequate number of qualified personnel and suitable infrastructure including desired software, hardware, books etc. These functions need to be staffed properly, since in many cases, two persons carry the job responsibilities of five. Having adequate number of people would help spreading the responsibilities allowing people to focus on their area, promote knowledge sharing, engage in other activities such as study meetings, participating in company initiatives including social activities and sports etc. which not only builds up the knowledge growth, but also supports developing relationships in the corporate world, maintaining rapport with people in the field, acquiring knowledge on new topics and personality growth. Having qualified people at important locations as well could be necessary for some corporates having geographical spread.
• Having good reference books on applicable laws and subscription to a reference journal is a must.

• If space allows, a small reading hall or a study centre would be of help.

• The number of persons should be adequate to deal with the secretarial work requiring specialized jobs for routine matters, Board related matters including agenda, minutes, Directors' communication, special matters (mergers, takeovers, preferential issues, buy-back etc.). Also w.r.t. the Legal work depending on the nature and size of business, many persons are ideally required for contract drafting and negotiation, obtaining and maintaining licenses, permissions (Liaisoning with government offices), litigations, compliance issues.

• It is desirable to have a well-structured department for Secretarial and Legal functions including trainees who could also take up projects for benefit of the Company including preparing of checklists, confirming a stand that company proposes to take on a specific issue, for opinions, creating databases and peons for proper record keeping and handling document logistics inward and outward.

• Infrastructure would also include reference library, pen drives, CD and DVD writers, air cards for laptops and superior photocopying and scanning machines which all impact on the quality and add to efficiency of the function.

These things do make a lot of difference in terms of the sophistication in approach in implementation. In building up of the infrastructure and adequate manpower, costs should not be the deterrent factor. Most of the times money invested in compliance is treated as waste/dead investment. If people in these functions are provided with good resources the Managements of these companies could also see remarkable improvement in their quality of output, that being drafting a contract, an opinion or timely submission of Returns.
Consult External Legal Professional Firms

- It is advisable to retain an outside professional firm to have access to independent opinions apart from conducting audit and routine requirements.

- Subscriptions to relevant legal web-site could prove useful for reference material as well as the same could be useful on urgent requirements with regards to case laws, provisions of Bare Acts etc.

- Nominating people to attend training programs, seminar helps in terms of getting knowledge on various subjects, material circulated at such programs could be useful. Further, it adds up to contacts with the people in the field and generates overall good impression about the organization.

Standardization

- It is desirable to devise templates for various agreements and forms that are required to be used by a company.

- Formats for various documents such as Opinion, internal communication, communication with directors, Board agendas, legal notices and amendment drafts, compliance reports etc.

- The templates should be prepared in such a manner that change in personnel should not affect the working style, the drafting approach and record keeping.

- Manner of creating folders in the computer data, filing of documents should be well defined including setting up of a robust filing system needs attention.

- Proper stationery/ folders should be used for keeping all original certificates/ approvals/ license copies and such documents should be kept in the Safe.

General Processes

- Each company could set up processes for routine matters e.g. Board agenda, filing of documents, making entries in the registers and records, sending
intimations to Stock Exchanges, obtaining various confirmations from Directors.

- Processes could be supported by flow charts.
- Interim update to the processes is a must.
- Communication of the processes to new joinees would prove useful.
- It is desirable to devise a short induction program internal to the function for new joinees. This induction would focus on the background, filing system, key information, processes followed by the department (right from ordering the stationery up to submission of documents to government authorities, introduction to all members of the team etc.).
- Companies should consider all such activities of Secretarial and Legal function in its financial budget and allow growth in these functions.

**Compliance Process**

- Installing proper compliance process is a must. Systematic approach would help chalking out a plan of action in right direction. Installing a process presupposes planning for the activity, having desired objective identified, having availability of resources, detailed plan of action with provision for eventualities and continuous monitoring and corrective actions by the concerned function led by the functional head.

- It is desirable to generate a complete MIS for secretarial and legal data preferably in tabular form providing for the key information requirements including company details, key dates, brief information about company’s business, certifications obtained, addresses of office locations, details of Board of Directors, shareholding pattern, key registration nos. such as company registration no., scrip code, ISIN code etc., contact details of agencies such as auditors, consultant, banker, government agencies, printers, R&I agents etc. Purely for a legal function database of immovable properties, on-going litigations, compliance reports, list of power of attorneys issued etc. would prove immensely useful and provide timely information.
• It is essential to segregate roles and responsibilities within the function to ensure proper distribution of work, rotation of responsibilities where possible, avoid confusion and set focus for each person within the function.

• Considering the number of laws that are extant in India, it is worth doing an exercise to go through a list of laws and identifying those relevant to the industry and business to which the company belongs and categorizing them in future to focus on A grade or critical compliances. Critical compliance means the severity of compliance and its impact on business, while it is true that all laws are of equal importance and should be complied with in letter and spirit.

Again it would be ideal if in addition to the relevant laws, the rules, regulations, guidelines and notifications/circulars are also looked at. A table on the following lines could be prepared:

<table>
<thead>
<tr>
<th>Serial Number</th>
<th>Section/Rule reference</th>
<th>Brief description</th>
<th>Tenure prescribed</th>
<th>Form No... Fees etc.</th>
<th>Applicability to (name the function/division)</th>
<th>Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Name of the legislation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Name of the legislation</td>
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</tr>
</tbody>
</table>

• Above list needs continuous monitoring and updates. A process should be set out to communicate the changes to the chart from time to time with version and date references. All such amendments should be subject to confirmation by the functional head. Post identification of the applicable laws etc. the next step should be to confirm the applicability of the rules and regulations.
• Detailed discussion and review meetings should be held in the presence of all team members to seek suggestions and choose a path to ensure compliance with the applicable laws. This would require participation of various functional heads to segregate the responsibilities and to carve out the scope of responsibility where there is a room for overlap. This could require further level detailing in terms of listing down the compliance requirements and developing processes and formats to comply with the same and then allocating the responsibilities to each individual within the function. Need could arise for organizing lectures within the function for better understanding of the subject or nominating the personnel for training programs and buying out the latest books at the beginning of the compliance exercise.

• If the number of applicable laws turn out to be huge, compliance of a part of such laws could be partially outsourced to a law firm or a company secretary in practice to ensure compliance, facilitate delegation, resource management, for logistical reasons (considering the locations where the company’s offices, factories are based) and to focus on critical aspects of compliance which need better attention and effort.

• It is recommended that every company presents in every Board meeting a report of compliance for the calendar quarter beginning the month in which last Board meeting was held and ending with the month preceding the month in which the next Board meeting is convened. Such compliance report shall be a certification by the operating management to the top management (typically the Board of Directors) confirming the compliance of various laws and informing any incidences of defaults to bring them on the surface in the spirit of disclosure and to seek proper advice from the Board to resolve the same.

Usually the Managing Director or the Chief Executive Officer (where a company does not have a Managing Director) signs such compliance report. Internally, all functional heads should submit a report of compliance to the Managing Director/CEO stating full facts about compliance of the laws and regulations and
reporting separately the default events. These reports form basis for the report to be presented to the Board.

It is advisable to minute the status of compliance and the decisions taken to resolve the default events to ensure a proper record keeping in terms of the steps taken by the Board to ensure that the company complies with the laws of the land.

While different companies follow their own formats for such compliance reports, it is recommended that such reports should be brief and to the point. Given below is the suggested format for such certification:

**Compliance Report**

To : The Board of Directors,  
.............................................. Limited  
Period : From ..................... to .....................

**Sub : Report of Compliance**

**Part A :**

The undersigned hereby confirms that subject to contents of paragraph ............. of this Report:
(a) the Company has complied with all the applicable laws, rules, regulations, guidelines and directions issued by the Government of India and any Government authorities.
(b) no instances of defaults/non-compliances have occurred.
(c) no show cause or other legal notices were received by the Company.
(d) the Company has obtained all requisite approvals, permissions, licenses, certifications from concerned authorities in carrying out its activities.
(e) the Company has not engaged in any activity which would amount to a gross negligence, material breach, misrepresentation or fraud.
(f) the Company has not failed to take necessary steps in respect of any litigations or other court/dispute related matters.

*Systematic Approach to Corporate Compliance Management*
Part B:

(g) the Company has complied with its contractual obligations and none of the contracts were terminated for default by the Company.
(h) the Company has not paid or is required to pay any damages or losses under the contracts.
(i) the Company has not breached any of its confidentiality obligations vis-a-vis outsiders.

Part C:

(j) the Company has installed proper systems and processes to provide basis for implementation of good corporate policies including health, safety and security policies.
(k) The Company has obtained proper insurance cover to protect against all risks from losses and damages to business.
(l) None of its personnel were terminated from employment with the Company. If yes, brief details to be provided.

Part D:

(m) the Company has paid all taxes, duties, cesses and other dues to the government.
(n) the Company has paid all necessary filing and other statutory fees.
(o) the Company has paid all its liabilities which were due and payable from time to time.

Part E:

(p) the Company has obtained compliance reports from all functional heads confirming all compliances applicable to each respective function.
(q) the Company has taken steps to protect its rights, title and interest in the properties both tangible and intangible properties
(r) the Company has obtained all documentary evidences to establish its rights, title and interests to all its assets and properties.
(s) the Company is not engaged in any activity which could be interpreted to mean an unethical, immoral act or an act against public policy and Company has made sincere attempts to maintain transparency in all its dealings.

Any defaults/non-compliances/qualifications should be stated categorically in bold font, stating the impact to the organization.

Hiding of defaults from reporting to top management is not a healthy practice.

Alternative to submission of compliance report could be presenting a default report in the following format, if any defaults have taken place during the period under consideration:

**Default Report**

**Period:**

<table>
<thead>
<tr>
<th>Serial Number</th>
<th>Function responsible</th>
<th>Nature of default</th>
<th>Reference rule</th>
<th>Legal Impact (actual/likely)</th>
<th>Suggested remedial action</th>
<th>Improvement required to avoid repetition</th>
<th>Remar</th>
</tr>
</thead>
<tbody>
<tr>
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</table>

Date and place:

Signature:

Except for the above, the Company has complied with all the applicable legal requirements.

Such report could also state in the remarks column about any opinion obtained or consultation sought in this matter. During the next report, a confirmation be added to state that all necessary actions have been taken to remedy the default or if the same is in process (e.g. application has been filed to court or other authority such as RBI, Income tax, Octroi etc.), the report should state accordingly.
**Secretarial Audit Report:**

While some companies are mandated to obtain an audit report from a company secretary in practice, it is desirable to obtain such report from a Practicing Company Secretary to provide business opportunity to professional brothers, at the same time getting a certification on compliance in secretarial matters by having an independent review. Such report should form part of the compliance reporting to the Board. Secretarial auditor could be invited to attend the Board meetings to allow outside professional to provide independent and quality inputs to the Board to avoid any possible defaults. This would be of help where the agenda item includes an item to consider the Secretarial Audit Report.

**Investor Grievance Report:**

Companies listed on the stock exchanges, are required to convene meeting(s) of the Investor Grievance Committee.

It is suggested that a report be presented to such Committee in the following format:

**Investor Grievance Report**

<table>
<thead>
<tr>
<th>Serial Number</th>
<th>Nature of Investor</th>
<th>Number of grievance/complaints RECEIVED during the period</th>
<th>Number of grievance/complaints RESOLVED during the period</th>
<th>Number of grievance/complaints PENDING during the period</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date :</td>
<td>Name :</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Designation:</td>
<td></td>
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</table>

**Compliance Reporting Mechanism:**

It is desirable to prepare a manual specifying all the relevant activities of the function. The manual should set out the version no., date of update, functional objectives,
organization chart, roles and responsibilities, achievements in the past and planning for the future, formats and templates to be used and functional processes to be followed. Only authorized persons should be allowed to have access to master copy of the manual.

Along with the manual, Company should circulate a Compliance Policy containing the following:

- Objective of the policy
- Background
- List of applicable laws
- Functions responsible for compliance
- Format of the Compliance Report
- Manner and frequency of reporting
- Actions to be taken in case of any default/ legal notice/ litigation/ dispute
- List of statutory registers to be maintained
- Persons authorized under various laws (e.g. Companies Act, Factories Act, Income Tax Act etc.)

The manual should also include things like processes for record keeping, data backup, data security, book purchase etc. Though it's a pain to create a manual, it creates in icon for the department in the long run.

A communication should be sent out across the Company conveying the creation of such Compliance Policy and its significance to the organization.

**Contract Reporting**

Companies need to focus on their obligations imprinted in the contracts signed by the company. This includes obligations vis-avis all stakeholders and government authorities. It is definitely an achievement if companies could maintain complete database of all contracts, including those which have expired or been terminated. Suitable contract management software could be deployed to carry out the analysis to contracts and generate MIS reports to be referred by the Company Secretary and/or Head Legal. Ensuring compliance of the contracts is a Herculean Task.

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Other Initiatives

Depending on the availability of resources, companies could initiate other activities such as internal study meetings, presentations on recent amendments, moots, sharing of experiences, discussion on case laws, motivating personnel to prepare notes for internal references, revising contract templates, creating check-lists and processes for compliances relating to various business activities, conducting training programs/lectures for non-secretarial, non-legal personnel to increase awareness about the activities of the function as well as brief them about Compliance policy and their responsibility for compliance. If possible, outside faculties could be invited to conduct lectures on various topics relevant to people in various functions to add value to their knowledge.

Analysis and conclusion

Compliance of applicable laws is a full time job requiring companies to deploy adequate personnel to set up and monitor the compliance process and protect interest of the organization from legal perspective. Companies that comply in letter and spirit are always recognized by its personnel, vendors, customers and government authorities. Good managed companies include those which are legally compliant as well. It is quite imperative that the Management of the organization considers compliance as not the formality issue but as legal and social obligation of being a matured corporate in order to drive the compliance process.

At times a business mind starts thinking whether compliances are a support to businesses or even precede business. However, considering the importance of compliance with the laws of land, it is better to start an overhauling exercise to ensure thorough compliance of all applicable rules and regulations. Companies could adopt a suitable approach to compliance management depending on the availability of resources and the desire to comply with the laws in letter and spirit. In spirit of the game, compliance cannot be enforced, rather should come from within. Compliance should not be used for the sake of finishing up a mere formality rather it should form part of the organizational systems and processes so as to get absorbed in the organizational behavior. We do see good organizations or business groups which are
well-known for their approach to compliance against those which intend to comply with the minimum statutory requirements. Companies could install service levels to ensure that the performance of secretarial and legal function add value to business apart from the compliance perspective. Ultimately, companies that go ahead and set standards of compliance definitely succeed in the long run since those build up a distinct reputation in the corporate sector and investor community at large reflecting a compliance healthy corporate life.

6. 7. Measures for preventing Corporate Frauds and to Improve Corporate Governance in India: Suggestion and Conclusion

Even before corporate scandals made headlines, American companies were waging war against fraud. Not counting the impact of Enron, WorldCom and other stricken companies, annual fraud losses were topping $600 billion, according to the Association of Certified Fraud Examiners’2002 Report to the Nation on Occupational Fraud and Abuse.¹⁵⁵

Despite tough economic times and seemingly rampant misconduct, now is not the time to panic. There are simple, practical steps you can take to protect your company from fraud.

6. 7. (i) Set an ethical tone that starts from the top management of the company.

Every company needs a written code of conduct that reflects their ethics and values. But it can't just be on paper. Management must take that code to heart and demonstrate their commitment through their actions. Like any aspect of corporate culture, expectations regarding ethical behavior need to be communicated, understood, and supported from the top down.

6. 7. (ii) Establish regular fraud detection procedures.

Regular internal auditing procedures specifically designed to detect major fraud are valuable tools. Simply having these procedures discourages employees from committing fraud in the first place. Recent events have illustrated the importance of having a strong internal audit function that watches out for fraud.

6. 7. (iii) Have a helpline which should serve as a hotline.

A confidential, 24/7 hotline operated by a third-party professional is the best option for uncovering fraud. Companies are now legally required to have a way for employees to anonymously submit concerns. A hotline is the ideal tool, helping the company to identify issues early, investigate them and take action. In fact, the Association of Certified Fraud Examiners’ 2002 Report to the Nation found that companies with fraud hotlines cut their losses by about 50% per scheme, because activity was detected earlier through tips.

Today many companies with long-standing internal hotlines are seeing the value of adding an external hotline. From a legal perspective, this can help the company demonstrate strong due diligence because employees have every possible opportunity to report issues and the company can address them.

6. 7. (iv) Educate employees about fraud.

A hotline can't be effective if employees forget it's there and why to use it. Use tools like posters in break rooms, town-hall meetings and employee newsletters to continually talk about ethical behavior. It is best to use a mixture of media to reach the key audiences, employees and suppliers. The company can educate them on identifying and preventing fraud and encourage their involvement in bringing illegal or unethical behavior to light. The company's ongoing communication about ethical behavior needs to include what is acceptable, what is not acceptable, and how to report unacceptable activities.

By communicating regularly, investigating incidents and taking corrective action, the company's commitment to ethics gains credibility among employees. It becomes a part of the corporate culture.
6. 7. (v) Educate internal audit staff.

Detecting fraud is not an easy task, and special training can help. The internal audit staff should be educated on the latest techniques for detecting fraud by taking these courses, and some or all should study to become Certified Fraud Examiners\textsuperscript{156}. Alternatively, hire some independent CFEs who can assist the company.

6. 7. (vi) Involve the company’s suppliers in fraud detection efforts.

Look beyond the company’s employees for tips on potential misconduct. Vendors and suppliers can be a valuable source. Offer the employees of the key supplier’s access to the same hotline that has been provided internally, so that they also have the means to confidentially report any concerns.

Honest employees who work for the company’s suppliers may be aware of fraudulent schemes that their employer or other suppliers may be committing. They may also know of employees within the organization who are taking kickbacks or committing other illegal acts. Once the company receive a tip from a supplier, it can look for a paper trail to validate the allegation.

6. 7. (vii) Take all tips seriously and investigate.

Once any tip is received, it’s critical that it gets to the right people within the company and is thoroughly investigated. This way, every tip is documented, acted upon, or even prosecuted. One common mistake in dealing with tips is spending time trying to discover the identity of an anonymous source, rather than getting right to the business of looking for evidence. It really doesn't matter who made an allegation; what matters is whether or not it is true.

6. 7. (viii) Decide who will be notified about tips in the company.

Companies handle anonymous tips in a variety of ways. The best way to handle hotline tips is to have the hotline provider do a sort of triage to determine where the

\textsuperscript{156} http://www.acfe.com/
tips are sent. For example, allegations of discrimination should be sent to both to the Human Resource department and the legal department of the company, while allegations of fraud should be sent to both to the internal audit department and a representative of the board's audit committee.

It is vital that reports of fraud are sent automatically to the audit committee or the external auditors because of the risk that the fraud could involve corporate executives. These individuals could intercept the report unless it is automatically disseminated beyond their reach.

6. 7. (ix) Conduct background checks of the employees before hiring.

This is a simple action that can prevent the company from hiring someone who has a history of stealing from employers. No hiring effort is so urgent that this step can be skipped, because creating an ethical environment begins with hiring the best possible employees. If there is an incident in the candidate's past, it is best to know about it from the start, so that the company can decide if it is an issue.

6. 7. (x) The senior management or the board member should have oversight on the affairs of the company. Fraud is the great unmanaged risk, exposing companies to costly and potentially catastrophic losses. A senior member of management should be tasked with implementing fraud risk assessment and fraud risk management activities. The board should oversee this effort to ensure it is done thoroughly. All executives should be held responsible for managing fraud risks in their part of the company.

By following these simple tips, the companies/corporates can reduce fraud and its financial impact on it. But beyond the bottom line, the companies can find this approach shall help create a positive, productive work environment and demonstrate good corporate citizenship to its employees, customers and stockholders.

6. 7. (xi) Better board preparedness and balance of power

The first area of focus is bringing better balance of power between the management and the board. As we have seen, governance reform has, so far, failed to create an effective balance of power between shareholders, management and the board of directors in our earlier chapters. Board independence from management continues to be affected by directors who have limited accountability to shareholders, and are ill-equipped in exercising management oversight. It is estimated that, on average, one-third of the board members of American corporations lack the necessary industry knowledge and experience to contribute effectively to management oversight. The researcher’s guess is that this percentage is even higher among most other countries. This lack of expertise has resulted in an asymmetry of power favoring management in most of the decision-making of corporate boards.

Hence, the first step is to select informed people with integrity and independence of mind for board positions. These people must be taken through a robust training and certification program on board governance. The business-specific part of the program may be held by the officers of the corporation, while the board governance training can be held by specialist organizations.

Secondly, every year, there should be a peer evaluation for each member of the board. At Infosys, this exercise is handled by the chairman of the Nominations Committee. The parameters used for such an evaluation are in the realm of board governance. The Chairman of the board then sits with each board member, discusses his / her evaluation, and suggests remedies and course-corrections. The chairman’s performance review is handled by the lead-independent director.

6. 7. (xii) Increased accountability to shareholders

Corporate governance suffers in companies where the allegiance of independent directors is to the officers of the company rather than to its shareholders. To make the shareholder board relationship more effective, we need better shareholder surveillance. Shareholders must actively step up as owners, and engage directors on corporate issues. Independent directors, in general, and chairmen of all committees, in
particular, must participate more actively in annual general meetings, by owning up to their board decisions and answering shareholder queries.

6. 7. (xiii) The company should create a mindset that decency and honesty shall lead to positive results in long run

The abuse of corporate power results from incentives within firms that encourage a culture of corruption. For example, former employees within a now-demised corporation described a "yes man" culture in which only those employees who did everything to please their bosses prospered. As Tom Tierney, former managing partner of Bain Consultancy remarked, “Corporate culture is what determines how people behave when they are not being watched.” Unethical companies have typified corporate cultures that voiced their commitment to one value system, while their processes and incentives reflected an entirely different value system in practice. The responsibility to change this lies with the top management.

Clearly, good governance requires a mindset within the corporation which integrates the corporate code of ethics into the day-to-day activities of its managers and workers. As the sociologists Rossouw and van Vuuren note, companies must move from the “reactive and compliance mode” of corporate ethics, to the “integrity mode”, where the functions of the entire organization are completely aligned with its value system. To achieve this, we must address the system of incentives that exists within corporations.

Corporations must integrate their value systems into their recruitment programs. They must mandate compliance with the value system as a key requirement from each potential employee. They must ensure that every employee owns responsibility for accountability and publicized. Additionally, there should be strong whistleblower mechanisms within the corporation for exposing unethical or illegal activities.

The need of the hour is for all voices in the corporation to unanimously extol the value of decency, honesty and transparency. In other words, every employee has to appreciate that the future of the corporation is safe only if he / she does the right thing
in every transaction. At Infosys, every Infoscion is encouraged to act according to our belief that, “The softest pillow is a clear conscience”.

Corporations have to create systems, structures and incentives to promote transparency, since transparency brings accountability. At Infosys, every employee remembers and follows the adage, “When in doubt, disclose”.

6.7. (xiv). **The company should evolve a model code of conduct**

Each company should evolve a model code of conduct which it expects all its internal stakeholders to adhere to.

6. 7. (xv) **Model Code of Conduct**

A standard format for Code of Conduct has not been prescribed by SEBI. However, based on the recommendations of various committees and groups, the code as evolved is expected to include the following:

6. (xv). (a). **Compliance of Laws**

The Directors shall comply and satisfy themselves that appropriate policies and procedures are in place for compliance by employees, officers and other directors, with laws, rules and regulations applicable to the company, including insider-trading regulations. The employees to whom the code is made applicable must comply with applicable laws, regulations, rules and regulatory orders. They should acquire sufficient knowledge of the attributes relating to their duties and understand the potential risk inherent therein. Wherever necessary they should seek advice on company policies and procedures from the appropriate authority within the company. Ignorance of law should not be accepted as an excuse and violation of laws, regulations, rules and regulatory orders may invoke legal and disciplinary action from the company.

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158 SOX and Code of Business Conduct – Article in Chartered Secretary by Mr. B.L. Gagar, FCS, Executive Vice President Finance, MRF Ltd., Chennai – April 2008 issue
6. 7. (xv). b. Adoption of fair and appropriate Accounting and Reporting Practices

The accounts should be prepared, maintained and presented fairly and accurately in accordance with the generally accepted accounting and financial reporting standards, guidelines, principles, laws and regulations. Accounting and audit procedures should fairly and accurately reflect all of the company’s business transactions and disposition of assets. All required information should be accessible to company auditors and other authorised parties. There shall be no wilful omission of any company transactions from the books and records, no advance income recognition, and no hidden bank account and funds. Any willful material misrepresentation of financial accounts and reports should be regarded as a violation to the code.

6. 7. (xv). (c) Effective participation in corporate meetings

Effective participation of directors and senior management personnel in company meetings is pre-requisite for good corporate governance. As a good corporate practice it is expected that the members of Board and committee and members of the management committee should be regular in attending their respective meetings, actively participate in deliberations and express their opinion / suggestions without hesitation with open and independent mind. They should not bring any prejudiced mind for discussion on any item of the agenda.

6. 7. (xv). (d). Avoidance of Conflict of Interest

Conflict of interest can occur when a director’s or an employee’s personal interest is adverse or may appear to be adverse to the interest of the company. Directors, senior officers and the employees must avoid any conflicts of interest between themselves and the company. Conflict of interest may arise –
(i) when a director or an employee engages in a business relationship or activity with anyone who is party to a transaction with the company ;
(ii) when a director or an employee or a member of his or her immediate family receives personal benefits by making or influencing decisions relating to any transaction with the company ;
(iii) when a director or an employee is having a significant ownership interest in any supplier, customer, business associate or competitor of the company.

In any situation that involves, or may reasonably be expected to involve, a conflict of interest with the company,

(i) the concerned director must make full disclosure of all facts and circumstances thereof that may come before the Board and abstain from discussion and voting on the matter in which he may have a conflict of interest;

(ii) the concerned officer or employee must disclose to the Managing Director or other appropriate authority, any material transaction or relationship that may give rise to any violation of the code including actual or apparent conflict with the interests of the company.

Some of the possible conflict of interest from which a director or officer must refrain are set out below:

- Relationship of company with third parties: Directors or employees should not engage in any conduct or activities that are inconsistent with the company’s best interests or that disrupt or impair the company’s relationship with any person or entity with which the company has or proposes to enter into a business relationship.

- Outside employment: Directors or employees are expected to devote their full attention to the business interests of the company and should not engage in any activity that interferes with the performance or responsibilities to the company.

- Compensation from non-company sources: Directors or employees should not accept compensation in any form for services performed for the company from any source other than the company.

- Acceptance of gifts: Directors or employees and members of their families should not accept gifts, donations, hospitality and or entertainment beyond a nominal value from existing or potential suppliers, customers or other third parties which have business dealing with the company.

- Directorship in competing entity: Director or an employee should not accept the position as director or any other significant role in any company that competes with the company without information and approval of the Board.

- Related party transaction: Directors or employees should avoid conducting company business with a relative or with a business entity in which a relative is associated in any
significant role with the company. For any avoidable related party transaction, full
disclosure should be made about the nature of transaction and dealings must be
conducted in such a way that no preferential treatment is given.
If a director or an employee fails to make a disclosure as required herein in respect of
possible conflicts of interest, the management shall take a serious view of the matter
and may consider suitable action against the concerned person.

6. 7. (xv). (e). Protection of Confidential information

Directors and all employees of the company shall protect and hold confidential, the
company's proprietary and confidential information and shall not disclose such
information to anyone or use it to benefit anyone other than the company. Confidential information of a company include information about product design, product costing, manufacturing process, research & development, innovations, technological details, particulars about customers, suppliers and technology providers, strategic plans, privileged documents, financial information and all such other information about the company which is proprietary, not in public domain and which may constitute insider information.
The confidential information is valuable asset of the company and leakage thereof
could severely affect the business and the competitive strength of the company. The confidential information can be protected by patent, trademark, copyright, trade secret laws and confidentiality/non-disclosure agreement.

6. 7. (xv). (f). Insider Trading

A director or an employee of the company shall not use or spread information, which is not available to the investing public and which therefore constitute insider information, for making or giving advice on investment decisions on the securities of the company on which such insider information has been obtained.
Such insider information may include the following:
(i) Periodical financial results ;
(ii) Declaration of dividends ;
(iii) Acquisition and divestiture of businesses or units ;
(iii) Issue or buy back of securities;
(iv) Amalgamation, merger or takeover;
(v) Disposal of whole or substantial part of undertaking;
(vi) Major expansion plans or execution of new projects;
(vii) Significant changes in policies, plans or operations of the company.

In the normal course of business, directors, officers or employees of the company may come into possession of significant, sensitive information that can be used to buy or sale shares or securities of the company with intent to make profit. Insider Trading Rules, 2002 intends to prevent the directors or employees of the company from taking advantage of possessing the price sensitive information. Price Sensitive information means 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 in securities market.

In order to prevent directors or employees to take advantage of price sensitive information made known to them, the company should specify the period known as Trading Window during which a director or the employee or his immediate family member is restricted to deal in the share and securities of the company. The directors and the employees are also required to disclose their holdings of shares and securities of the company from time to time.

Pursuant to the terms of the Insider Trading Rules laid down by Infosys Technologies Ltd., a director, officer or certain other designated employees of the company may buy or sell the company's equity shares only after prior notification to the company during an open trading window, and must notify the company within one working day following the execution of such transaction. The company recently levied a penalty of Rs. Five lacs on Mr. S. Batni, an executive director, who inadvertently failed to notify the company about the sale of the equity shares within one working day after the transaction. The audit committee of Infosys held that failure to timely notify the company of the sale of equity shares was a technical violation of the Insider Trading Rules, which forms a part of the company's Code of Conduct.
6. 7. (xv). (g). Protection of Company Assets

The assets of the Company may consist of tangible assets such as machinery or equipment, systems, facilities, materials and resources and intangible assets such as proprietary information, brand, logo, patent, trademark, copyright, relationship with customers and suppliers. Protection of the company's assets and its efficient use to advance the interest of the company is the key responsibility of every director and employee of the company. Every director and employee of the company must ensure that assets are not misappropriated, loaned to others, sold, or donated without appropriate authorization.

6. 7. (xv). (h) Adoption of transparent gift giving policy and anti-bribery rules

The company and its directors, officers or employee shall neither receive nor offer or make, directly or indirectly, any illegal payments, remuneration, gifts, donations or comparable benefits which are intended or perceived to obtain business or uncompetitive favours for the conduct of the business. WIPRO in its policy describes that the company shall uphold the highest standards of integrity in all third party dealings and it should ensure that third parties do not violate the company's policies and should never give, offer, or authorize the offer, directly or indirectly as proxy bribing, of any thing of value such as money, goods or service to any third party including government official to obtain any improper advantage. The policy further states that modest gifts of the value not exceeding USD 25 or equivalent currency, which is appropriate to give in normal course of business may be accepted if it is in consistent with accepted business practice, does not violate applicable law, can not be reasonably construed as payment or consideration for influencing and the public disclosure of which would not embarrass the Company.

6. 7. (xv). (i). Political non-alignment

The company shall neither support directly or indirectly, any specific political party or candidate for political office nor shall it offer or give any company funds or property as donation, to any specific political party or a candidate.
6. 7. (xv). (j). Equal opportunities to all employees

The company provides equal opportunities to all employees without regard to their race, caste, religion, colour, ancestry, marital status, sex, age, nationality, disability and veteran status. Policies and practices shall be administered in a manner that ensures that in all matters equal opportunity is provided to those eligible and the decisions are merit based.

6. 7 (xv). (k). Reporting mechanism – Have a Whistle Blower Policy

Every employee of the company shall promptly report to the Board of Directors or the designated authority any actual or possible violation of the code or an event he or she becomes aware of that could affect the business or goodwill of the company. The Company may prescribe a Whistle Blower Policy as reporting mechanism for erroneous happenings.

Whistle Blower Policy

The concept of “Whistle Blower Policy” is to provide access to employees to raise their concerns and feelings of erroneous happenings within the organisation. In order to allow such employees to communicate their concerns, the listing agreement provides that company should establish the mechanism for employees to report to management their concerns about unethical behavior, actual or suspected fraud, serious malpractice, violation of company’s code of conduct or business ethics policy so that management can take timely action before it is too late. The mechanism should also provide adequate safeguards against the victimisation of employees who avail the mechanism and also provide direct access to Chairman of Audit committee in exceptional cases. As part of corporate governance code “Whistle Blower Policy” and affirmation therein that no personnel have been denied access to the audit committee has been prescribed by SEBI as non-mandatory compliance described in Annexure 1D of revised Clause 49.

Employees generally find themselves caught with their employment terms, which provide for upholding confidentiality and mutual trust, fear of reprisal by those against whom the complaints are made, and thus would not like to humiliate their
employer or harm their own interest by reporting on unethical practice. Apart from just introducing the whistleblower policy and providing for mechanism of reporting, an environment needs to be created across the organisation to encourage culture of openness and create feeling of trust.

Prescribing formal procedure for voicing of their concerns by the employees is now becoming an accepted practice in Fortune 500 companies. Exxon Mobile Corporation has made a procedure to encourage its employees to ask questions, voice concerns, report suspected violations of laws, the policies and internal control procedures and make appropriate suggestions regarding the business practices. As per the procedure laid down by the corporation, the employees are expected to discuss their concern with their immediate superiors and if dissatisfied, the employees are encouraged to take up the matter with controller, internal audit, human resource, law, safety-health-environment, security and treasury department concerning to their respective function.

Suspected violation of law or the corporation’s policies involving director or executive officer as well as questionable accounting or auditing matters are directly reported to the General Auditors of the corporation and the board affairs committee takes such matter further to the Board of Directors. Employees are also allowed to address communications to non-executive director.

Anonymous communication can be voiced over designated phone or by writing to global security manager of the corporation. The authority dealing with employees’ concerns are expected to preserve anonymity and confidentiality. The policy provides that no action shall be taken against any employees for voicing concerns unless it is attempted with wilful disregard of the truth.

The SEBI prescribed corporate governance code being non mandatory not many companies in India have formally prescribed procedure for granting access to the employees to report their grievances and concerns. Many of the public sector undertakings have not prescribed formal procedure for open communication. The code of conduct prescribed by Tata group for implementation within its group companies provides that every employee of the Tata group Company shall promptly report to the management any actual or possible violation of the code, or an event that
the employee has become aware of and that could affect the business of the Company. The group has also outlined a detailed whistle blower policy and described procedures therein to deal with protected disclosure by any employee.

Code of Conduct and Business Ethics policy of Infosys Ltd. describes, “We consider honest conduct to be conduct that is free from fraud or deception and marked with integrity. We consider ethical conduct to be conduct conforming to accepted professional standards of conduct. Ethical conduct includes the ethical handling of actual or apparent conflicts of interest between personal and professional relationships. By expecting the highest standards of honesty and ethical conduct, we expect our officers to stay far from the line differentiating honesty from dishonesty and ethical conduct from unethical conduct.” The company in its code has described that an employee who is concerned for questionable accounting, accounting controls, auditing matters, fraudulent financial information, grave misconduct involving violation of law or substantial mismanagement of company resources and violation of company policies should voice his concern to his immediate superior and the corporate counsel. The audit committee of Infosys has adopted a Whistleblower policy that encourages employees to report to the management questionable accounting matters, fraudulent financial information or any conduct that results in a violation of law by the company. The employee is encouraged to report his concern anonymously either by e-mailing at whistleblower@Infosys.com or by sending letter to corporate counsel or to the audit committee of Board of Directors. The policy sets out norms for receiving, retaining and treating complaints; describes procedure for maintaining the confidentiality in respect of anonymous complaints by employees, and assures full protection from discrimination and harassment.

Wipro Ltd. has described the process for reporting query and concern at different levels of management. However, the company considers that anonymous allegations are less credible and further action on such matters is left on the discretion of the Company.
6. 7. (xv). (l). Amendment, modification and waiver

The code may prescribe that it shall be reviewed, amended, modified, or waived by the Board of Directors, subject to disclosure and other provisions of SEBI, and rules there under and the applicable rules of stock exchanges.

**Analysis and conclusions**

Unlike some countries, efforts to compile a corporate governance code in India were not precipitated by evidence of accounting or corporate irregularities. It was Indian industry that provided the impetus towards a corporate governance code. Thus, when SEBI first introduced a corporate governance code in 1999, it put India ahead of many others. The joint report of CLSA Asia Pacific Market and Asian Corporate Governance Association issued in 2005 concludes that India ranks among the top three in terms of corporate governance. Meticulous provisions to deal with corporate governance has brought numerous plaudits from investors as well as the Institute of International Finance (IIF), Washington D.C., whose India task affirmed that Indian corporate governance norms strengthen domestic capital formation and foreign portfolio investment. While appreciable efforts have already been put to improve transparency and reporting of financial statements, much needs to be done with respect to designing a prudent Code of Business Conduct and ethics that is well accepted by all employees and implemented across the organisation.
DATA ANALYSIS

STRUCTURE OF INDIAN BOARD\textsuperscript{159}

The average numbers of directors on a company's board increased from 9.74 (in 2006-07) to 9.87 (in 2007-08). The Board size of companies in India generally ranges from 6 to 15 members.

Figure 1: Average size of Boards in India

\textsuperscript{159} The Indian Board Report 2009 on 'Board Composition Effectiveness and Best Practices
A well-defined board is vital to manage, direct and control the conduct and operations of a company. The research indicates that directors view the lack of talented Independent Directors as a major hindrance to changing a company’s board structure.

Figure 2: Impediments in changing Board Structure
FINANCIAL DISCLOSURE

Laws determine the timeline and format for the declaration of a company’s financial statements. Presently, an Indian corporate entity is required to present quarterly and annual financials in Indian generally accepted accounting practices (GAAP). Owing to the diverse and often, international nature of the investor community, companies may also be required to prepare their financial statements as per international GAAP.

The research shows that 45% of the companies in India follow international and Indian GAAP.

Figure 3: Accounting Standards Followed
MONITORING PERFORMANCE: A BOARD PRIORITY

The research shows that the boards accord low priority to many key issues such as guiding leadership and succession planning.

Among the other objectives, monitoring overall compliances have increased while management of risks is moreover constant.

Figure 4: Priorities of the Board
FREQUENCY OF BOARD EVALUATIONS

Annual board evaluations are a part of good corporate governance practices and many leading corporations across the world rely on external consultants for the assessment. The need for an increase in board evaluations has been further substantiated by the results of the research. With respect to frequency of the board evaluations, 60% of the Directors said that their boards do not evaluate their own performance. Of the remaining, 35% of the directors confirmed that their boards perform an annual evaluation while 5% said that they evaluate their performance every two years. However, it is important to note that a majority of the board evaluations are done via self-assessment and not via third party consultants.

Figure 5: Frequency of Board Evaluation
NO CLARITY ON PERFORMANCE REQUIREMENTS

Over 82% of the directors are of the opinion that the roles and responsibilities of the Non-executives Directors are not clearly defined and documented. In the research, this number stood at 37.5%. This indicates a stark rise in the number of directors not knowing what is expected of them, as a part of a company’s board.

Figure 6: Directorial roles and responsibilities
Board/Strategy Meetings

According to the research, 87% of the directors said that there was an increase in the time they have invested on boards. Of these, 48% said that there was a moderate increase and 39% said that there was a significant increase in the time they invest. Ideally, an increase in the time spent by the directors on the boards should lead to an increase in its effectiveness. The research indicates that directors have rated the effectiveness of the time spent on the company boards at 3.19 on a scale of 4, in meeting expectations.

![Figure 7: Time spent on Board](image_url)

Figure 7: Time spent on Board
Number of Independent Directors Increases

Independent Directors formed 50.6% of the average board size which was 9.87 in 2007-08. Clause 49 states that if a board has a Non-Executive Chairman then the Board should have one third of its members as Independent Directors; a condition fulfilled by 98% of the research respondent. Around 36% of the companies changed the number of Independent Directors present on their boards in 2007-08 while it remained the same in 27.3% of the cases.

![Bar Chart]

Figure 8: Number of Independent Directors in a Company
For over a decade, the Confederation of Indian Industry (CII) has been at the forefront of the corporate governance movement in India. In April 1998, it released a Task Force report entitled "Desirable Corporate Governance: A Code", which outlined a series of voluntary recommendations regarding best-in-class practices of corporate governance for listed companies. It is worth noting that most of the CII Code was subsequently incorporated in SEBI's Kumar Mangalam Birla Committee Report and thereafter in Clause 49 of the Listing Agreement. Moreover, the CII Code was the first and probably a unique instance where an industry association took the lead in prescribing corporate governance standards for listed companies.

Corporate governance guidelines - both mandated and voluntary - have evolved since 1998, thanks to the efforts of several committees appointed by the Ministry of Corporate Affairs (MCA) and the SEBI. Indeed, it is fair to say that in terms of norms, guidelines and standards set for the board of directors, financial and non-financial disclosures and information to be shared by the management to stakeholders and the wider public, Indian corporate governance standards rank among the best in the world. And CII is privileged to be a part of this movement.

Unfortunately, history tells us that even the best standards cannot prevent instances of major corporate misconduct. This has been true in the US - Enron, Worldcom, Tyco and, more recently gross miss-selling of collateralised debt obligations; in the UK; in France; in Germany; in Italy; in Japan; in South Korea; and many other OECD
nations. The Satyam-Maytas Infra-Maytas Properties scandal that has rocked India since 16th December 2008 is another example of a massive fraud. Satyam is a one-off incident - especially considering the size of the malfeasance. The overwhelming majority of corporate India is well run, well regulated and does business in a sound and legal manner. However, the Satyam episode has prompted a relook at our corporate governance norms and how industry can go a step further through some voluntary measures.

With this in mind, the CII set up a Task Force under Mr Naresh Chandra in February 2009 to recommend ways of further improving corporate governance standards and practices both in letter and spirit. The recommendations of the Naresh Chandra Task Force evolved over a series of meetings. The leitmotif of the report is to enunciate additional principles that can improve corporate governance in spirit and in practice. The report enumerates a set of voluntary recommendations with an objective to establish higher standards of probity and corporate governance in the country. The recommendations outlined in this report are aimed at listed companies and wholly owned subsidiaries of listed companies.

Report of the CII Task Force on Corporate Governance

Another comment is in order. Large, highly visible and publicised corporate scandals often provoke legislative and regulatory actions. CII advocates caution against overregulating. It needs to be recognised that while the super-structure of corporate governance is built on laws and regulations, these cannot be anything more than a basic framework. Much of best-in-class corporate governance is voluntary – of companies taking conscious decisions of going beyond the mere letter of law. The spirit of this Task Force Report is to encourage better practices through voluntary adoption - based on a firm conviction that good corporate governance not only comes from within but also generates significantly greater reputational and stakeholder value when perceived to go beyond the rubric of law.
Therefore, it is only natural that this report should focus on recommendations, which are being placed before corporate India for adopting voluntarily. It is the belief of CII that Indian Industry would respond spontaneously and help set standards, which would define global benchmarks in the medium term.

Venu Srinivasan
President, CII (2009-10)
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Members of the Task Force

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2. Dr J J Irani, Director, Tata Sons Ltd
3. Mr Uday S Kotak, Chairman, CII Corporate Governance Council & Executive Vice Chairman and Managing Director, Kotak Mahindra Bank Limited
4. Mr Y H Malegam, Chairman Emeritus, S B Billimoria & Co
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6. Mr Deepak M Satwalekar, Independent Director
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8. Mr Amal Ganguli, Independent Director
9. Mr Ajay Bahl, Partner, AZB & Partners
The CII Task Force Report

Introduction

Good corporate governance involves a commitment of a company to run its businesses in a legal, ethical and transparent manner - a dedication that must come from the very top and permeate throughout the organisation. That being so, much of what constitutes good corporate governance has to be voluntary. Law and regulations can, at best, define the basic framework - boundary conditions that cannot be crossed. CII has always held the view that while law may need to be strengthened when occasions so demand, there are fundamental limits to using legislative and regulatory instruments to enforce better corporate governance. The thrust of this report, therefore, is to suggest certain voluntary recommendations for industry to adopt.

The report is structured according to the different elements of corporate governance:

• The Board of Directors
  o Non-executive and independent directors
  o Committees of the board
  o Significant related party transactions

• Auditors
  o Independence of Auditors
  o Rotation of Audit Partners

• Regulatory Agencies
  o Legal and regulatory standards
  o Effective and credible enforcement

• External Institutions
  o Institutional investors
  o The Press
The Board of Directors

1. Appointment of independent directors

An active, well-informed and independent Board is necessary to ensure highest standards of corporate governance. Getting the right people is crucial; as is the process of seeking, vetting and appointing such people.

Good Boards have a Nomination Committee typically comprising entirely of independent directors (or where independent directors constitute the majority), with the Committee chairman being an independent director. The Board as a whole decides the skill sets that are needed going forward, keeping in mind the present and the desired composition; and the specialised oversight needs of the company in the foreseeable future. The Nomination Committee then takes up the task of seeking such directors - either through its own network of contacts or by a formal search process with the help of external consultants. The shortlist, along with the CVs, is then discussed in the full Board, and the final candidate(s) is/are recommended to the Chairman of the Board. The Chairman, then, gets in touch with the selected people and invites them to join the Board as additional directors - after which their appointment is sought to be ratified by shareholders in the next shareholders’ meeting.

Recommendation 1: Nomination Committee

The Task Force believes that having a well functioning Nomination Committee will play a significant role in giving investors substantial comfort about the process of Board-level appointments. It, therefore, recommends that listed companies should have a Nomination Committee, comprising a majority of independent directors, including its chairman. This Committee’s task should be to:

• Search for, evaluate, shortlist and recommend appropriate independent directors and NEDs, subject to the broad directions of the full Board; and
• Design processes for evaluating the effectiveness of individual directors as well as the Board as a whole.

The Nomination Committee should also be the body that evaluates and recommends the appointment of executive directors.
A separate section in the chapter on corporate governance in the annual reports of listed companies could outline the work done by the Nomination Committee during the year under consideration.

2. Duties, liabilities and remuneration of independent directors

The Task Force felt that there must be some formality in the appointment of NEDs and independent directors that goes beyond the ratification by the shareholders. It thus makes the following recommendation.

Recommendation 2: Letter of Appointment to Directors

- The Task Force recommends that listed companies should issue formal letters of appointment to NEDs and independent directors - just as it does in appointing employees and executive directors. The letter should:
  - Specify the expectation of the Board from the appointed director;
  - The Board-level committee(s) in which the director is expected to serve and its tasks;
  - The fiduciary duties that come with such an appointment;
  - The term of the appointment;
  - The Code of Business Ethics that the company expects its directors and employees to follow;
  - The list of actions that a director cannot do in the company;
  - The liabilities that accompany such a fiduciary position, including whether the concerned director is covered by any Directors and Officers (D&O) insurance; and
  - The remuneration, including sitting fees and stock options, if any.

The letter stating the terms and conditions of appointment of any NED or independent director should form a part of the disclosure to shareholders at the time of the ratification of his/her appointment or re-appointment to the Board. The Companies Act, 1956, prescribes the ceiling on remunerations that can be paid to NEDs and independent directors, including stock options, restricted stocks, sitting fees and commissions on net profit, if any, subject to approval of shareholders. Currently, NEDs, including independent directors, may be paid compensation within the limit of
1% of the company's stand-alone net profits for the year (or 3% in case it does not have any whole-time director). While such remunerations are eventually approved by shareholders, the task is usually delegated to the Board. Since propriety demands that the NEDs and independent directors recuse from discussions regarding their remunerations, in practice the remunerations are actually approved by the promoters or management.

The Task Force felt that linking the remuneration of NEDs and independent directors to the net profit of the stand-alone company has problems. Well oiled, More on this is in Recommendation well-running constantly profitable companies typically need less intensive Board oversight than start-ups, companies that are in financial and/or operational distress, or those that are in the beginning of a turnaround. These need best-in-class directors who will give considerably more time in debating strategy, closely monitoring progress and ensuring that systems are put in place for profitable growth. Here lies the difficulty! Such companies are either loss-making or do not make sufficient profits to be able to pay for the proven talents of real experts on the Board. And yet, their requirement for such expertise is the greatest. This is why there is a need to amend the current law which only allows for remuneration from net profits for such companies.

**Recommendation 3: Fixed Contractual Remuneration**

The Task Force recommends that the Companies Act, 1956, be amended so that companies have the option of giving a fixed contractual remuneration to NEDs and independent directors, which is not linked to the net profit or lack of it. Therefore, companies should be given the option to choose between:

a. Paying a fixed contractual remuneration to its NEDs and IDs, subject to an appropriate ceiling depending on the size of the company; or b. Continuing with the existing practice of paying out up to 1% (or 3%) of the net profits of the stand alone entity as defined in the Companies Act, 1956.

For any company, the choice should be uniform for all NEDs and independent directors, i.e. some cannot be paid a commission of profits while others are paid a fixed amount.
If the option chosen is (a) above, then the NEDs and independent directors will not be eligible for any commission on profits. The current limits and constraints on sitting fees and stock options or restricted stock may remain unchanged.

If stock options are granted as a form of payment to NEDs and independent directors, then these must be held by the concerned director until one year of his exit from the Board.

This is also recommended by the Combined Code of the UK. It is a good practice that will forever eradicate all suspicions of insider trading of vested stocks.

Some argue that since an NED or an independent director is primarily a fiduciary of the shareholders, and since the variable cash flow rights of shareholders depend upon the profitability of the company, why should these fiduciaries be given a fixed compensation at all? The argument is flawed on three counts. First, the fiduciaries and overseers appointed by the shareholders should be looking at maximising long term enterprise value, just as the management. If management can get fixed contractual payments approved by shareholders, so too can NEDs and independent directors. Second, even when a company does not make a profit, it can pay dividends from reserves. So, shareholders may get some cash return on equity even in the absence of profits; NEDs and independent directors cannot.

Third, it is very difficult to get first rate NEDs and independent directors to give up a sizeable chunk of their time to serve on boards that make no profits and, hence, pay no commission.

Whether it is from net profits or as a fixed contractual payment, the structure of remuneration to NEDs and independent directors needs to be transparent, well specified and made available to shareholders in the annual report of the company. As the Combined Code of the UK states, “Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role.” To be sure, this can neither be legislated nor completely specified. However, there are best practices in transparently setting remuneration guidelines - one of which is given below.
Recommendation 4: Structure of Compensation to NEDs

The Task Force recommends that listed companies use the following template in structuring their remuneration to NEDs and independent directors

- **Fixed component**: This should be relatively low, so as to align NEDs and independent directors to a greater share of variable pay. Typically, these are not more than 30% of the total cash remuneration package.
- **Variable Component**: Based on attendance of Board and Committee meetings (at least 70% of all meetings should be an eligibility pre-condition)
- **Additional payment for being the chairman of the Board**, especially if he/she is a non-executive chairman
- **Additional payment for being the chairman of the Audit Committee**
- **Additional payment for being the chairman of other committees of the Board**
- **Additional payment for being members of Board committees**: Audit, Shareholder Grievance, Remuneration, Nomination, etc.

The Task Force also recommends that if such a structure (or any structure) of remuneration is adopted by the Board, it should be disclosed to the shareholders in the annual report of the company.

3. *Remuneration Committee of the Board*

All over the developed world, a major source of shareholder grievance has been the levels, structures and payouts of executive compensation. Although Indian senior executive pay has been significantly lower than those who occupy top slots in the Fortune 500 companies — even when calculated in terms of purchasing power parity — there is a case for creating a sound Board-level process for approving Paying a fixed contractual amount is, indeed, the practice in most OECD countries, such as the USA, UK, Australia, France, Germany, Italy, Spain, the Netherlands, the Scandinavian countries, and others remunerations to executive directors and for those who are one level below the Board. The basic principle is best stated in the Combined Code of the UK: “There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.”
**Recommendation 5: Remuneration Committee**

The Task Force recommends that listed companies should have a Remuneration Committee of the Board.

- The Remuneration Committee should comprise at least three members, majority of whom should be independent directors.

- It should have delegated responsibility for setting the remuneration for all executive directors and the executive chairman, including any compensation payments, such as retirement benefits or stock options. It should also recommend and monitor the level and structure of pay for senior management, i.e. one level below the Board.

- The Remuneration Committee should make available its terms of reference, its role, the authority delegated to it by the Board, and what it has done for the year under review to the shareholders in a separate section of the chapter on corporate governance in the annual report.

**4. Audit Committee of the Board**

In its present form, Clause 49 of the Listing Agreement contains detailed mandatory provisions for the Audit Committee of the Board. Even so, it has one flaw that needs immediate remedy. In the earlier version of Clause 49, only NEDs could be members of the Audit Committee. The revised Clause 49 omitted this requirement. Under the present dispensation, two-thirds of the members of the Audit Committee must be independent directors as must the chairman, but the rest may be either NEDs or executive directors. This is clearly a mistake, and runs counter to a fundamental operating principle of good corporate governance, namely that the Audit Committee must comprise entirely of non-executive directors with independent directors forming the majority.

Another counter-view that the Task Force also considered was that the presence of executive directors on the audit committee needs to be appreciated since they are well versed with the internal working of the company and bring first-hand information to the table which helps an objective and meaningful analysis of the discussions by the Committee.
The Task Force, however, suggests that for bolstering the independence of the internal as well as the external auditors and ensuring a free and frank discussion with the audit committee, it is important that the Audit Committee must necessarily constitute of NEDs. The executive directors can be invited to attend the audit committee meetings to provide the necessary clarifications.

**Recommendation 6: Audit Committee Constitution**

Listed companies should have at least a three-member Audit Committee comprising entirely of non-executive directors with independent directors constituting the majority.

**5. Separation of the offices of the Chairman and the Chief Executive Officer (CEO)**

The Task Force deliberated at length on whether it is desirable to separate the offices of the Chairman of a publicly listed company from that of the CEO. While it was observed that there is no obvious causality between such a separation and better corporate governance or performance, it was nevertheless true that there is a growing trend internationally of separating the offices of the Chairman and the CEO. It is the dominant practice in the UK; increasingly so throughout continental Europe; and even the USA — which has had a long tradition of having the same person as Chairman and CEO — is increasingly moving towards a separation of offices. This trend towards separation of the role of Chairman and the CEO has never been mandated by the legislation or regulation — which is exactly as it should be. Instead it has been driven either voluntarily or by major long-term institutional investors such as pension funds.

The Task Force felt that the situation is different in India. Most Indian listed companies are controlled by promoters, often holding over 50 per cent of the voting stock. Indeed, many in corporate India feel that the separation is not desirable — that the dominant, risk taking shareholder being both the Chairman and Chief Executive of a company gives a greater notion of commitment than otherwise.

A view running counter to the argument was also presented for consideration of the Task Force quoting absence of evidence supporting that separation of the two offices
improves corporate performance or promotes good corporate governance practices. Further, separating Chairman & CEO provides no guarantee of better leadership and can add to a layer of potential conflict.

3 The Chairman and CEO roles are separate in 65% of the Fortune 500 – this figure is significantly skewed by the US, which accounts for 152 of the 500, and where only 36% of companies have separate roles. Companies from countries other than the US that contribute significantly to the Fortune 500 have generally high rates of CEO-Chairman separation (usually upwards of 80%). Company size (revenue) does correlate with role separation trends, and is predominantly skewed by the number of companies from a particular country (especially US).

2 of the 7 Indian companies in the Fortune 500 have separate CEOs and Chairmen.

After extensive deliberation on the subject, on balance, the Task Force expressed its preference for separating the two offices.

**Recommendation 7: Separation of Offices of Chairman & Chief Executive Officer**

The Task Force recognised the ground realities of India. Keeping these in mind, it has recommended, wherever possible, to separate the office of the Chairman from that of the CEO.

**6. Attending Board and Committee Meetings through Tele-conferencing and video conferencing**

E-presence of a director would ensure larger participation at Board/Committee meetings and shall also step up the frequency of such meetings as well as the interaction of Board members, while at the same time bringing down the cost of holding physical meetings. The Companies Bill, 2009 has also proposed participation of Directors in board meetings through electronic means. Even prior to the adoption of the Companies Bill, in a meeting in relation to matters which do not require a physical meeting, directors ought to be able to participate through epresence (where they would otherwise not be able to attend). The decisions may be subsequently
recorded as a circular resolution signed by the directors physically present and those participating through audio or video-conferencing.

**Recommendation 8: Board Meetings through Tele-conferencing**

If a director cannot be physically present but wants to participate in the proceedings of the board and its committees, then a minuted and signed proceeding of a teleconference or video conference should constitute proof of his or her participation. Accordingly, this should be treated as presence in the meeting(s). However, minutes of all such meetings or the decisions taken thereat, recorded as circular resolutions, should be signed and confirmed by the director/s who has/have attended the meeting through video conferencing.

**7. Executive Sessions of the Independent Directors**

While the independent directors are kept updated of all business-related issues and new initiatives by the management, it is imperative that the independent directors have executive sessions (as their internal discussion and debating process to evolve a consensus among independent directors). Having such interactions without the presence of any of the non-independent directors would promote open discussions among independent directors and also assist in independent appraisal of corporate performance, strategic issues, determining a “smell test” for “grey” or “border line” proposals.

**Recommendation 9: Executive Sessions**

To empower independent directors to serve as a more effective check on management, the independent directors could meet at regularly scheduled executive sessions without management and before the Board or Committee meetings discuss the agenda.

The Task Force also recommends separate executive sessions of the Audit Committee with both internal and external Auditors as well as the Management.
8. The role of the board and shareholders in related party transactions

The Audit Committee members, at a meeting held prior to the Board Meeting in which related party transaction shall be discussed, should be given access to the contract / terms of all proposed related party transactions, before they are entered into. In the event of the Company proposing to enter into or amending an existing related-party transaction which is not in the ordinary course of business or not on “arms length” basis, the management shall present it to the Audit Committee. The Committee should discuss all related party transactions which are not in the ordinary course of business or not on “arms length” basis and, in approving or rejecting the transactions shall consider all relevant facts and circumstances including (i) risks, costs and benefits to the Company (ii) impact on a director's independence, if such related party contract concerns an independent director (iii) availability of other sources /unrelated third parties for comparable services or products - and shall approve only those transactions that are in the best interests of the Company. The Task Force also noted that the J J Irani Committee had considered that, any contract by an independent director or his firm, which exceeds 10% of the director’s or the firm’s turnover renders such director dependent and shall be presumed to affect the independence of such a director.

Recommendation 10: Related Party Transactions

Audit Committee, being an independent Committee, should pre-approve all related party transactions which are not in the ordinary course of business or not on “arms length basis” or any amendment of such related party transactions. All other related party transactions should be placed before the Committee for its reference.

9. Auditor – Company Relationship

The report of the Naresh Chandra Committee on Corporate Audit and Governance had suggested that auditors should refrain from providing non-audit services to their audit clients and had recommended an explicit list of prohibited non-audit services. The Task Force, noted that the recommendation was endorsed by the Ministry of Corporate Affairs and has also been proposed under the Companies Bill, 2009. The
Task Force concurred with the recommendation that legislation should expressly prohibit auditors from rendering certain services to their audit clients. Audit firms should have to mandatorily disclose network agreements between audit firms and non-audit companies, pecuniary interests exceeding 2% between the audit firm and its affiliate non-audit service firm or company and measures of Chinese walls and data protection/confidentiality that are in place between them. The Task Force noted the existing practice in this regard. And found it to be sufficient.

10. Independence of Auditors

In order to build capacity, consulting firms undertake audit assignments through their associate/affiliates organisations. However, such affiliations could lead to too much revenue dependence on a particular client causing potential threats to auditor independence. While a blanket ban cannot be imposed on such business relationships, in case more than 10% of consolidated revenue of a firm or its network affiliate emanates from a single client, with whom there is also an audit engagement, the auditor should not be construed as independent of its client. However, to help newer and smaller audit firms, this requirement should not be applicable to audit firms for the first five years from the date of commencement of their activities, and for those whose total revenues are less than Rs.15 lakhs per year.

Recommendation 11: Auditors’ Revenues from the Audit Client No more than 10% of the revenues of an audit firm singly or taken together with its subsidiaries, associates or affiliated entities, should come from a single corporate client or group with whom there is also an audit engagement.

11. Certificate of Independence

The Task Force considered the requirement of ensuring Independence of Auditors throughout the period of engagement as recommended by the Naresh Chandra Committee on Corporate Audit and Governance and recommended the practice of seeking a Certificate of Independence from the Auditors before appointment / reappointment.
The Audit Committee must prescribe a specific form for disclosures concerning the auditor, any network relationship agreements rendering non-audit service firms or companies or group entities and any pecuniary interest between members or firms inter-se exceeding 2% of the network or the capital or the profit ratio, whichever is lower.

**Recommendation 12: Certificate of Independence**

Every company must obtain a certificate from the auditor certifying the firm’s independence and arm’s length relationship with the client company. The Certificate of Independence should certify that the firm, together with its consulting and specialised services affiliates, subsidiaries and associated companies or network or group entities have not / has not undertaken any prohibited non-audit assignments for the company and are independent vis-à-vis the client company, by reason of revenues earned and the independence test are observed.

**12. Audit Partner Rotation**

The Task Force considered the on-going debate on the requirement of rotation of auditor versus rotation of audit partner after a specified period of time. The view that audit firms should be changed after 9 or 10 years was discussed. In line with international practice, the Task Force considered it expedient to recommend mandatory rotation of audit partners after two terms of three years each. This would help discourage creation of any affinity between auditors and controlling shareholders or promoters or the management and may help to prevent “capture” of the audit process by corporate insiders. An initial experience of the impact of rotation of the audit partner should be studied. If this measure does not improve or prevent “capture of audit process by corporate insiders”, then the alternative of rotation of auditors after nine years should be made mandatory.

**Recommendation 13: Rotation of Audit Partners**

The partners handling the audit assignment of a listed company should be rotated after every six years. The partners and at least 50% of the audit engagement team
responsible for the audit should be rotated every six years, but this should be staggered so that on any given day there isn’t a change in partner and engagement manager.
A cooling off period of 3 years should elapse before a partner can resume the same audit assignment.

13. Auditor Liability

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The liability of the auditor for dereliction of duty needs to be prescribed for listed companies. This should not be limited to the signing partner only but the audit firm and / or any network affiliates providing non-audit services to the company, which have resulted in dereliction of duty should also be held liable.

Recommendation 14: Auditor’s Liability

The firm, as a statutory auditor or internal auditor, has to confidentially disclose its networth to the listed company appointing it. Each member of the audit firm is liable to an unlimited extent unless they have formed a limited liability partnership firm or company for professional services as permitted to be incorporated by the relevant professional disciplinary body (ICAI). Even in the case of a limited liability firm undertaking audit in the future, under the new law, the individual auditor responsible for dereliction of duty shall have unlimited liability and the firm and its partners shall have liability limited to the extent of their paid-in capital and free or undistributed reserves.

14. Appointment of Auditors

The Task Force decided to propose the recommendation of the Naresh Chandra Committee relating to appointment of auditors for adoption by companies.

Recommendation 15: Appointment of Auditors

The Audit Committee of the board of directors shall be the first point of reference regarding the appointment of auditors. The Audit Committee should have regard to the entire profile of the audit firm, its responsible audit partner, his or her previous
experience of handling audit for similar sized companies and the firm and the audit
partner’s assurance that the audit clerks and/or understudy chartered accountants or
paralegals appointed for discharge of the task for the listed company shall have done a
minimum number of years of study of Accounting Principles and have minimum prior
experience as audit clerks.

To discharge the Audit Committee’s duty, the Audit Committee shall:
• discuss the annual work programme and the depth and detailing of the audit plan to
be undertaken by the auditor, with the auditor;
• examine and review the documentation and the certificate for proof of independence
of the audit firm, and
• __________recommend to the board, with reasons, either the appointment/re-
appointment
or removal of the statutory auditor, along with the annual audit remuneration.

15. Qualifications Introduced by Statutory Auditors or Internal Auditors in their
Audit Reports, Tax Audit Report or CARO Reports.

The Task Force discussed the issues of the extensive disclaimers which are being
introduced time and again by firms of auditors, in relation to their certification
following their audit function. The auditors have to discharge a significantly
important responsibility concerning the accuracy of the accounts and the absence of
any systemic fraud due to controls established in the listed company. It is important to
provide regular audit information, thereby preventing clubbing of work towards the
end of a quarter or near the end of the financial year and audit period before
publishing the audited accounts; resulting in hurried and hasty clearance. The auditor
has the role of a watchdog and ought not to escape liability for dereliction of duty to
stakeholders by introducing qualifications in to their reports. The notes of accounts
ought to facilitate the Audit Committee and analysts by their ease of conversion into
financial terms having impact on the accounts presented.
The Task Force recommends that the ICAI appoint a committee with a significant
membership of government directors and invite management professionals and
lawyers having an understanding of accounts, to standardise the language of
disclaimers or qualifications permissible to the audit firms. Anything beyond the
scope of such permitted language should require the auditor to provide a sufficient explanation and should not create a new escape route for avoiding responsibility for discharging the audit function diligently, as the public relies upon them to do a thorough job.

**Recommendation 16: Qualifications in Auditor’s Report**

ICAI should appoint a committee to standardise the language of disclaimers or qualifications permissible to audit firms. Anything beyond the scope of such permitted language should require the auditor to provide sufficient explanation.

**16. Whistle Blowing Policy**

Clause 49 has recommended that companies establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics. Even though companies have adopted and communicated the existence of a whistle-blowing policy, we have not seen any success on this front in corporate India. The Task Force pondered over what organisations can do to create an environment which helps employees to prevent undesirable practices. It was felt that adoption and encouragement of the policy should be made mandatory for all listed companies.

This is bound to send a positive signal to employees that the management is willing and able to prevent any illegal activity and also ensure that there is a process by which the individuals can expose the problem to the appropriate authority who can take action. The employees would need to be oriented towards the company’s ethics policy. HR Department can play an effective role in the process by assigning ombudsmen, providing special telephone numbers and email IDs. Since whistleblowers need to be provided high degrees of protection, the Listing Agreement should consider providing statutory protection from dismissal or wrongful termination for acting as a whistle blower. There are adequate precedents in other jurisdictions for such laws and these could be examined. Fostering a culture which promotes and supports institutionalisation of whistle blowing policy shall deter corrupt practices and help in preventing corporate disgrace and debacles.
Recommendation 17: Institution of Mechanism for Whistle Blowing

The Task Force recommends institution of a mechanism for employees to report concerns about unethical behaviour, actual or suspected fraud, or violation of the company’s code of conduct or ethics policy. It should also provide for adequate safeguards against victimization of employees who avail of the mechanism, and also allows direct access to the Chairperson of the audit committee in exceptional cases.

17. Risk Management Framework

The sources of risk, and their magnitude, have changed dramatically. Due to globalisation, changing risks and their global dimension, pose challenges not only to business and governments but also to society and economies. Inadequate risk evaluation for credit derivatives is identified as one of the causes for the global meltdown of 2008. The Task Force felt that the board must be provided with information on the most significant risks and how they are being managed to integrate risk management in decision making activity. A strategy must be instituted to deal with and manage or mitigate each of the identified risks with an objective of creating equilibrium between risk minimisation and risk optimisation. While the policy need not be made public for reasons that confidential information ought not to be published as would compromise competitiveness, the fact that the risk management strategy has been implemented and responsibility allocated, as certified by the CEO and countersigned by the Chairman of the Audit Committee, would act as a deterrent to those who may take unjustifiable risks with the objective of increasing compensations and incentives by short-term individual performance.

Recommendation 18: Risk Management

The Board, its audit committee and its executive management must collectively identify the risks impacting the company's business and document their process of risk identification, risk minimisation, risk optimization as a part of a risk management policy or strategy. The Board should also affirm that it has put in place critical risk management framework across the company, which is overseen once every six months by the Board.
Role of Regulatory Agencies

18. The Legal and Regulatory Standards

Provisions under the existing and proposed company law pertaining to the requirement of independent directors, constitution of audit committee, definition of independent director, promoter, key managerial personnel should be aligned with the existing Listing Agreement and other SEBI legislations to achieve uniformity in corporate governance standards in the country. The Task Force recognises the varying degree of best in practice standards for SMEs, listed companies and unlisted public companies, which have significant impact on the economy. The Task Force suggests that regulations / prescriptions should be set under the Companies Law and its regulations from time to time and should be in-sync with SEBI, as far as listed companies are concerned. For that purpose, joint committees of SEBI and the Ministry of Corporate Affairs should be constituted so that uniform, agreed upon standards are prescribed for listed companies under both laws.

Recommendation 19: Harmonization of Corporate Governance Standards

The Task Force suggests that the Government and the SEBI as a market Regulator must concur in the corporate governance standards deemed desirable for listed companies to ensure good corporate governance.

19. The Capability of Regulatory Agencies - Ensuring Quality in Audit Process

Based on the recommendations of the Naresh Chandra Committee on Corporate Audit & Governance, an independent Quality Review Board (QRB) was set up, which could be entrusted to provide transparent and expeditious oversight. The Board was funded by ICAI and also depended on the Institute to provide infrastructural support. However, the ICAI QRB has not achieved the objectives for which it was established and the Task Force, thus considered it imperative that the QRB is made functional going forward to ensure quality in the audit process by a critical review of the intensity and integrity of auditors by peer auditors on an annual basis.
Recommendation 20: Audit Oversight Mechanism

In the interest of investors, the general public and the auditors, the Task Force recommends that the Government intervenes to strengthen the ICAI Quality Review Board and facilitate its functioning of ensuring the quality of the audit process through an oversight mechanism on the lines of Public Company Accounting Oversight Board (PCAOB) in the United States.

20. Effective and Credible Enforcement

Multiplicity of investigating agencies leads to delay in the overall judicial process and possible misinterpretation of information. Regulators under the Company Law, the Securities Laws and the Serious Fraud Investigation Office should have an inter-se cooperation agreement. In fact, the Naresh Chandra Committee Report on Corporate Audit and Governance (2002), set up by the then Department of Company Affairs, had recommended that there should be a Task Force constituted for each case under a designated team leader and in the interest of adequate control and efficiency, a Committee each, headed by the Cabinet Secretary should directly oversee the appointments to, and functioning of this office, and coordinate the work of concerned department and agencies. The mode of cooperation and the specification of inter-se duties, areas of investigation ought to be determined at the initiation of the investigation so as to avoid conflicting reports. The inter-regulator committee for instituting criminal and civil recovery proceedings should be supported by highly trained professionals so that serious frauds are controlled and adequate deterrence measures are put in place against defaulters. During the Harshad Mehta scandal, the Special Courts Act was empowered to consider both civil and criminal actions from the securities fraud transaction. A special bench of the Company Law Board or its successor, the National Company Law Tribunal should be invested with special powers for adjudication of civil recovery actions and for criminal offences and penalties to be levied thereunder. Such a bench should have time management processes for disclosure and pre-trial discovery admissions for determining the issues to be proved, leading of evidence on a day-to-day basis and a specified time line for rendering the judgement after a collaborative time-table between the court / NCLT / prosecutors and defence counsel is set at commencement after the charge sheet or the plaint is instituted. The bench should endeavour to dispose off matters concerning
securities frauds or serious frauds within a time frame of 6 to 12 months from commencement.

**Recommendation 21: Effective & Credible Enforcement**

The Task Force recommends that instances of investigations of serious corporate fraud must be coordinated and jointly investigated. Joint investigations / interrogation by the regulators for example, the SFIO and the CBI should be conducted in tandem. On the lines of the recommendations of the Naresh Chandra Committee Report on Corporate Audit and Governance, a Task Force should be constituted for each case under a designated team leader and in the interest of adequate control and efficiency, a Committee each, headed by the Cabinet Secretary should directly oversee the appointments to, and functioning of this office, and coordinate the work of concerned department and agencies. Civil recovery for acts of misfeasance, malfeasance, nonfeasance and recovery from the wrongdoers and criminal offences and penalties and punishments should be adjudicated appropriately, without conflicting reports and opinions, and disposed off between 6 to 12 months.

**21. Confiscation of Shares**

In case of securities fraud by a shareholder or other securities holder, the company should aide the regulators (i.e. Ministry of Corporate Affairs and SEBI) as decided by an inter-se agreement between the two to take actions such as freezing the shares, intimating the stock exchanges of the details of the relevant securities and in case of physical share certificates, confiscation and cancellation thereof; as fraud conveys no title. The power of confiscation and cancellation in relation to securities fraud, should extend to cancellation of such fraudulent securities even if it concerns creation of one or more (multiple) pledges subsequent to the first act of securities fraud.

**Recommendation 22: Cancellation of Fraudulent Securities**

A provision of confiscation and cancellation of securities of a person who perpetrates a securities fraud on the company or security holders ought to be prescribed for the protection of capital markets.
22. Personal Liability

In case any director or employee(s) of the company commits an offence with an intention to make personal monetary gains or profits, personal penalty should be imposed on such directors or the employees commensurate with the wrongful gains made in addition to disgorgement of wrongful gains. The Shardul Shroff Committee constituted by the Department of Corporate Affairs has provided for consequences of repeat offences and ad valorem fines and penalties based upon the magnitude of unlawful or unjust enrichment and gains from a fraudulent or illegal act under the Company Law. With mega frauds, the financial penalty of Rs.25 Crores prescribed under SEBI and Securities Laws are inadequate and an ad valorem rate based upon the extent of the securities fraud may be considered.

The collection of fines and penalties should be employed for restitution of those shareholders or the company which has been a victim of the fraud or the offence and should not be accumulated to government coffers. The deterrence aspect of a serious fraud must be significant and serious and the victims who suffer such frauds must enjoy the benefits of distribution of such fines and penalties after recovery of costs of the conduct of any trial to prove the offences or the recovery from the wrongdoer and the disgorgement of wrongful gains.

On the other hand, if a director is not informed or does not possess any knowledge of any non-compliance on part of the company, he should not be held liable, The Task Force drew a reference to the judgment in the case of Homi Phiroze Ranina Vs. The State of Maharashtra where it was held that "non-executive directors cannot be made to undergo the ordeal of a trial for offence of non-compliance with a statutory provision unless it can be established prima facie that they were liable for the failure on part of the company”

Recommendation 23: Liability of Directors & Employees

Personal penalties should be imposed on directors and employees who seek unjust enrichment and commit offence with such intentions. Such punishments should be commensurate with the wrongful act and be imposed in addition to disgorgement of
wrongful gains. Further, non-executive directors cannot be made to undergo the ordeal of a trial for offence of non-compliance with a statutory provision unless it can be established prima facie that they were liable for the failure on part of the company.

The Role of External Institutions

23. Institutional Investors
Long term institutional shareholders, pension funds or infrastructure funds with significant holdings in securities of listed companies across all of the West but largely in the United States, are known to be powerful players in shaping corporate governance norms. Hedge funds and FIIs have a shorter term view but are equally concerned with observance of corporate governance norms and the protection of capital markets. Their role assumes more significance as dispersed shareholders have neither resources nor incentive to invest the significant resources required to effectively monitor and sometimes agitate against ineffective or even fraudulent boards and managements.

Recommendation 24: Shareholder Activism

Long term institutional investors, pension funds or infrastructure funds can help to develop a vibrant state of shareholder activism in the country. The oversight by such investors of corporate conduct can be facilitated through internal participation of their nominees as directors or external proceedings for preventing mis-management. Such institutional investors should establish model codes for proper exercise of their votes in the interest of the company and its minority shareholders, at general meetings, analyze and review corporate actions intended in their investee companies proactively and assume responsible roles in monitoring corporate governance and promoting good management of companies in which they invest.

24. The Press
Capacity building in the area of corporate governance, has assumed critical importance in India, given the renewed emphasis on the subject in the light of the recent events. Media has an important part to play in raising general awareness and understanding of corporate governance and potentially as a watch dog in the area of
corporate governance. Being a significant stakeholder itself, the fourth estate should consider upgrading capacity to carry out analytical and investigative reporting in matters impacting best in practice standards of corporate governance as they can play the role of a responsible and an effective stakeholder in protecting capital markets or securities markets from injury from corporate fraud.

**Recommendation 25: Media as a stakeholder**

The Task Force recommends that media, especially in the financial analytics and reporting business should invest more in analytical, financial and legal rigour and enhance their capacity for analytical and investigative reporting.