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Introduction

1.01 The global movement for better corporate governance progressed in fits and starts from the mid-1980s up to 1997. There were the odd country-level initiatives such as the Cadbury Committee Report in the United Kingdom (1992) or the recommendations of the National Association of Corporate Directors of the US (1995). It would be fair to say, however, that such initiatives were few and far between. And while there were the occasional international conferences on the desirability of good corporate governance, most companies — global and Indian alike — knew little of what the phrase meant, and cared even less for its implications.

1.02 More recently, the first major stimulus for corporate governance reforms came after the South-East and East Asian crisis of 1997-98. This was no classical Latin American debt crisis. Here were fiscally responsible, healthy, rapidly growing, export-driven economies going into crippling financial crises. Gradually, governments, multilateral institutions, banks as well as companies began to understand that the devil lay in the institutional, microeconomic details — the nitty-gritty of transactions between companies, banks, financial institutions and capital markets; the design of corporate laws, bankruptcy procedures and practices; the structure of ownership and crony capitalism; sharp stock market practices; poor boards of directors showing scant regard to fiduciary responsibility; poor disclosures and transparency; and inadequate accounting and auditing standards. Suddenly, 'corporate governance' came out of dusty academic closets and moved centre stage.

1.03 Barring Japan and possibly Indonesia, countries in Asia recovered remarkably fast. By the year 2001, Thailand, Malaysia and Korea were on the upswing and on course to regain their historical growth rates. With such rapid recovery, corporate governance issues were in the danger of being relegated to the back stage once again. There were projects to be executed, under-valued assets to be bought, and profits to be made. International investors were again showing bullishness. In such a milieu, there seemed no urgent need to impose concepts like better accounting practices, greater disclosure, and independent board oversight. Corporate governance once again settled into a phase of extended inactivity.

1.04 India’s experience was somewhat different from this Asian scheme of things. First, unlike South-East and East Asia, the corporate governance movement did not occur due to a national or region-wide macroeconomic and financial collapse. Indeed, the Asian crisis barely touched India. Secondly, unlike other Asian countries, the initial drive for better corporate governance and disclosure, perhaps as a result of the 1992 stock market “‘scam~~”, ~~’, and the onset of international competition consequent on the liberalisation of economy that began in 1990, came from all-India industry and business associations, and in the Department of Company Affairs.[1] Thirdly, it is fair to say that, since April 2001, listed companies in India are required to follow some of the most stringent guidelines for corporate governance throughout Asia and which rank among some of the best in the world. Even so, there is scope for improvement. For one, while India may have excellent rules and regulations, regulatory authorities are inadequately staffed and lack sufficient number of skilled people. This has led to less than credible enforcement. Delays in courts compound this problem. For another, India has had its fair share of corporate scams and stock market scandals that has shaken investor confidence. Much can be done to improve the situation.

1.05 Just as the global corporate governance movement was going into a bit of hibernation, there came the Enron debacle of 2001, followed by other scandals involving large US companies such as WorldCom, Qwest, Global Crossing, and the exposure of auditing lacunae that eventually led to the collapse of Andersen. Having shaken the foundations of the business world, that too in the citadel of capitalism, these scandals have triggered another more vigorous phase of reforms in corporate governance, accounting practices and disclosures — this time more comprehensively than ever before. As a US-~~-~~based expert recently put it, “Enron and WorldCom have done more to further the cause of corporate transparency and governance in less than one year, than what activists could do in the last twenty.”

1.06 This is truly so. In June 2002, less than a year from the date when Enron filed for bankruptcy, the US Congress introduced in record time the Sarbanes-Oxley Bill. This piece of legislation (popularly called SOX) brought with it fundamental changes in virtually every area of corporate governance — and particularly in auditor independence,

[1] In December 1995, the Confederation of Indian Industry (CII) set up a committee to prepare a comprehensive voluntary code of corporate governance for listed companies. The final draft report was ~~prepared by April 1997, whose almost unedited version~~ was released in April 1998. ~~as a booklet, *Desirable Corporate Governance: A Code*~~. Thereafter, ~~the Securities and Exchange Board of India (~~SEBI~~)~~ appointed a committee under Mr. Kumar Mangalam Birla to draft a code for corporate governance. Much in common with the CII report ~~code~~, the recommendations of this committee ~~report~~ were then incorporated as Clause 49 of the Listing Agreement ~~o~~for all stock exchanges.

conflicts of interest, corporate responsibility and enhanced financial disclosures. The SOX Act was signed into law by the US President on 30 July 2002. While the US Securities and Exchanges Commission (SEC) is yet to formalise most of the rules under various provisions of the Act, and despite there being rumbles of protest in the corporate world against some of the more draconian measures in the new law, it is fair to predict that the SOX Act will do more to change the contours of board structure, auditing, financial reporting and corporate disclosure than any other previous law in US history.

1.07 Although India has been fortunate in not having to go through the pains of massive corporate failures such as Enron and WorldCom, it has not been found wanting in its desire to further improve corporate governance standards. On 21 August 2002, the Department of Company Affairs (DCA) under the Ministry of Finance and Company Affairs appointed this Committee to examine various corporate governance issues. Among others, this Committee has been entrusted to analyse and recommend changes, if necessary, in diverse areas such as:

- the statutory auditor-company relationship, so as to further strengthen the professional nature of this interface;
- the need, if any, for rotation of statutory audit firms or partners;
- the procedure for appointment of auditors and determination of audit fees;
- restrictions, if necessary, on non-audit fees;
- independence of auditing functions;
- measures required to ensure that the management and companies actually present ‘true and fair’ statement of the financial affairs of companies;
- the need to consider measures such as certification of accounts and financial statements by the management and directors;
- the necessity of having a transparent system of random scrutiny of audited accounts;
- adequacy of regulation of chartered accountants, company secretaries, and cost accountants, and other similar statutory oversight functionaries;
- advantages, if any, of setting up an independent regulator similar to the Public Company Accounting Oversight Board in the SOX Act, and if so, its constitution; and
- the role of independent directors, and how their independence and effectiveness can be ensured.

1.08 As is evident, the terms of reference to this Committee lie at the heart of corporate governance.[2] Before outlining the scheme of this report and moving on to other chapters, it is necessary to give a thumbnail sketch of the basic theory of corporate governance — if only to indicate how the chapters that follow derive from its core tenets.

The Theory of Corporate Governance – A Résumé

1.09 The fundamental theoretical basis of corporate governance is *agency costs*. Shareholders are the owners of any joint-stock, limited liability company, and are the *principals*.[3] By virtue of their ownership, the principals define the objectives of a company. The management, directly or indirectly selected by shareholders to pursue such objectives, are the *agents*.[4] While the principals might wishfully assume that the agents will invariably do their bidding, it is often not so. In many instances, the objectives of managers are quite different from those of the shareholders.[5] Such misalignment of objectives is called the *agency problem*; and the cost inflicted by such dissonance is the *agency cost*.[6] The core of corporate governance is designing and putting in place disclosures, monitoring, oversight and corrective systems that can align the objectives of the two sets of players as closely as possible and, hence, minimise agency costs.

1.10 Corporate history suggests that there are two types of agency costs, and both relate to the basic concept of *separation*. The first is the separation of ownership from management, and is based largely on the examples of large US and British listed companies up to the mid-1980s. Vast Anglo-American corporations were characterised by very widely dispersed shareholding coupled with little or no managerial ownership of shares. Hence, managers had little incentive to align many of their decisions in line with those desired by the shareholders. Until the late-1980s, such differences were abetted by widely held share ownership, and the absence of powerful pension and mutual funds

[2] The constitution of this Committee and its terms of reference are given in Appendix 1 to this report.

[3] This is the reason that, when addressing a body of shareholders, the Chairman refers to the company as "Your company".

[4] In the context of a democratic government, the principals are the elected representatives of the people, while the agents are the civil servants.

[5] For instance, a chief executive may want to increase his managerial empire and personal stature by using the company's funds to finance an unrelated, flavour-of-the-times diversification, which could reduce long term shareholder value. The shareholders and other stakeholders of the company may not be able to counteract this — because of inadequate disclosure about such a foray and because the principals may be too dispersed to effectively block such a move.

[6] Examples of agency costs abound in corporate governance literature, the most recent being the case of Enron. The objectives of senior management (the agents) were clearly not aligned to those of the shareholders (the principals). Thanks to the inability of the principals to monitor and rein in the actions of Enron's senior management, the company did things that led to its eventual bankruptcy.

which could have used their relatively concentrated stockholdings to demand greater shareholder value. Such huge, and *de facto* uncontrolled managerial playing fields led to wrong investment decisions, unconnected diversification and taking of excessive risks with shareholders’ funds — which often resulted in falling efficiency and declining long-term corporate value. In the US, such agency costs had their denouement in the spate of hostile takeovers from the late 1970s right up to the late 1980s. Although the modern champion of this *corporate efficiency* aspect of agency cost is Michael Jensen of the Harvard Business School,[7] the essence of this concept was highlighted as early as in 1776, when Adam Smith wrote:

> “The directors [managers] of such companies, however, being managers of other people’s money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own… Negligence and profusion, therefore, must always prevail more or less in the management of the affairs of such a company.”
>
> Adam Smith, *An Inquiry into The Nature and Causes of The Wealth of Nations*, p.31.

1.11 There is, however, a second dimension to agency costs — which also has to do with separation. This form of agency cost does not adversely affect corporate efficiency as it does minority shareholder rights. Consider, for instance, the three dominant characteristics of South-East and East Asian conglomerates. First, relative to their size, most Asian companies have low equity. This was traditionally facilitated by highly geared, credit and term-lending driven growth. Secondly, given the low equity base, the promoters found it relatively cheap to own majority shares. This is still true for many companies in Hong Kong, Indonesia, Malaysia, Philippines, Thailand and China, where the entrepreneur and his family own up to 75% of the equity, which thwarts all possibilities of equity-triggered take-overs. Thirdly, equity ownership was camouflaged through complex cross-holdings.

1.12 None of this conforms to the model of the modern Anglo-American corporation, with its large equity base, dispersed shareholding and profound separation of ownership from management. However, that doesn’t reduce the importance of agency costs. A

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[7] See Michael C. Jensen, and William J. Meckling (1976), ‘Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure’, *Journal of Financial Economics*, 3(4), 305-360; Michael C. Jensen (1986), ‘Agency Cost of Free Cash Flow, Corporate Finance and Takeovers’, *American Economic Review*, Papers and Proceedings, 76(2); and, Michael C. Jensen (1988), ‘Takeovers: Their Causes and Consequences,’ *Journal of Economic Perspectives*, 2(1); ~~and Michael C. Jensen (1993), ‘The Modern Industrial Revolution, Exit and Failure of Internal Control Systems’, Presidential address to the American Finance Association, *Journal of Finance*, 47(3).~~

promoter who controls management and directly or beneficially owns over 75% of a company's equity is not expected to perform in a value-destroying manner like many US corporate managers and boards did up to the late-1980s. However, he can do a great many things that deprive minority shareholders of their *de jure* ownership rights, without adversely affecting pre- or post-tax profits. These involve fixing the election of board members, packing the boards with crony directors, ensuring that key shareholder resolutions are vaguely worded and inadequately discussed at shareholders' meetings, fobbing off minority shareholder complaints, issuing preferential equity allotments to the promoters and their allies at discounts, transferring shares through private bought-out deals at prices well below those in the secondary market, and the like.

1.13 In the Indian context not only a large number of retail investors, but also several creditors, especially financial institutions, will echo this sentiment. Sharp practices may, on their own, add to agency costs, and the consequent depletion of shareholder value. Stakeholders ~~almost~~ seem to believe that this is a necessary evil that they will have to live with, especially if returns on their investment are perceived by them to be higher than the market average. However, in India a lot more has happened. Vanishing companies are a down~~-~~right fraud, where shareholder money has simply disappeared. There have been subtler frauds too, such as the promoter-manager of a listed company utilising shareholder money to buy small private companies at exorbitant prices with every likelihood of the promoter-manager having a beneficial interest in such private companies; or, that of the promoter-manager using shareholder money to artificially raise the price of the company's shares, to induce existing investors to invest more, and new investors to invest anew. Even where frauds have not been committed, and promoter-managers have not actually destroyed share value, it can be safely said that more often than not wealth has not been ~~fully or~~ fairly ~~been~~ shared; in fact, such promoter-managers seem to have fine-tuned their ability to keep returns just above expectations of the shareholders. ~~, to a fine art.~~

1.14 It will take much more research before one can definitively apportion agency cost effects between efficiency and expropriation. However, the point to recognise is that poor corporate governance is not only about destroying shareholder value through managerial inefficiency arising out of the disjunction between share-~~–~~ownership and corporate control. Efficiently run firms that consistently outperform the competition and earn returns that exceed the opportunity cost of capital can also have poor corporate governance. And this can manifest itself in a steady expropriation of minority shareholder rights.

1.15 Two broad instruments that reduce agency costs and hence, improve corporate governance, are *financial and non-financial disclosures* and *independent oversight of management*. A company that discloses nothing can do anything. Improving the quality of financial and non-financial disclosures not only ensures corporate transparency among a wide group of investors, analysts and the informed intelligentsia, but also persuades companies to minimise value-destroying deviant behaviour. This is precisely why law insists that companies prepare their audited annual accounts, and that these be provided to all shareholders and be deposited with the Registrar of Companies (ROC). This is also why a good deal of effort in global corporate governance reform has been directed to improving the quality and frequency of disclosures.

1.16 Independent oversight of management comprises two aspects. The first relates to the role of the independent, statutory auditors — who are appointed by shareholders to audit a company's accounts and present a 'true and fair' view of the financial health of the corporation. Indeed, the quality and independence of the statutory auditors are fundamental to corporate oversight. While it is the job of management to prepare the accounts, it is the fundamental responsibility of the statutory auditors to scrutinise such accounts, raise queries and objections (if the need arises), arrive at a true and fair view of the financial position of the company, and report their independent findings to the board of directors and, through them, to the shareholders and investors of the company. No doubt, auditors have the skills to scrutinise complex accounts of today's multi-divisional, multi-segmental corporations, but these skills would come to nought if an auditing firm did not have a strict, arm's length independent relationship with the management of the companies they audit.

1.17 The second aspect of independent oversight is the board of directors of a company. A joint-stock company is owned by the shareholders, who appoint directors to supervise management and ensure that it does all that is necessary by legal and ethical means to make the business grow and maximise long term corporate value.

1.18 The point to note is that the board is appointed by the shareholders and are, therefore, accountable to them. Directors are fiduciaries of the shareholders, not of the management. That doesn't mean an adversarial or a non-collegial board. However, where the objectives of management differ from those of the wide body of shareholders, the non-executive directors on the board must be able to speak in the interest of the ultimate owners, discharge their fiduciary oversight functions, and stand up and be counted. This is precisely the reason why ‘independence’ has become such a critical issue to determining the composition of any board.

1.19 Clearly, a board packed with executive directors or friends and cronies of the promoter or CEO cannot be normally expected to exercise independent oversight judgement at times when it is most needed. The failure of many large corporations in recent times, be these Japanese *keiretsu*s, Korean *chaebol*s, Indonesian empires, Indian groups or US conglomerates, has much to do with the poor quality of boards and the lack of independent oversight. Part of this failure is related to inadequate disclosure of key corporate information to boards as well as shareholders and other stakeholders — an issue that will be addressed in the course of this report. But much has to do with poor board composition where directors, due to their close business and social relationships with promoters, did not feel the necessity of asking the right questions when occasions demanded much more detailed scrutiny and debate. They were, as US observers picturesquely put it, “parsley on the fish” — meant for decoration and little else.

Structure of the Report

1.20 A look at the ~~abbreviated~~ terms of reference to this Committee outlined in paragraph 1.07 above shows that it is entrusted to look into the two key aspects of corporate governance: (i) financial and non-financial disclosures, and (ii) independent auditing and board oversight of management. There are related aspects — the need for independent oversight of auditors, and efficacious disciplinary procedure for professionals. Having outlined the basic theory of corporate governance that will inform the recommendations of the Committee, we now turn to the structure of the report.

1.21 Chapter 2 deals with the entire range of the statutory auditor-company relationship. The objective is to suggest ways of ensuring, and enhancing, the independent, professional nature of this key corporate governance link. Among other things, the chapter examines issues such as the rotation of audit firms versus that of auditing partners, restrictions on non-audit work and fees from such work, the procedure for appointment of auditors, determination of audit fees, and allied subjects. It also looks into measures that may be required to ensure that management and auditors actually present the ‘true and fair’ statement of financial affairs of the company and, in light of section 302 of the SOX Act, whether it is necessary to introduce measures such as CEO and CFO certification.

1.22 Chapter 3 focuses on the issue of who audits the performance of auditors — and examines whether the present system of regulation of chartered accountants, company secretaries and cost and works accountants is sufficient and has adequately served the interests of corporate shareholders and stakeholders. In this context, the chapter analyses the need for setting up an independent regulatory body to oversee the quality of audit of public limited companies as has been done in the case of the Public Company Accounting Oversight Board prescribed by the SOX Act.

1.23 Chapter 4 relates to the independence of the board of directors. It examines the definition of 'independence' currently used in India, and reviews whether there is a need to tighten such a definition. The chapter then goes on to discuss the composition and size of corporate boards, and steps that can be taken to ensure and enhance independence of judgement. Thereafter, it examines in detail the role and functions of the Audit Committee of the board, and suggests things that can be done to strengthen this key committee. The chapter then looks at the remuneration and liabilities of non-executive and independent directors, and finally suggests the need for a concerted nation-wide training programme for directors.

1.24 The report concludes with Chapter 5, which discusses some related or allied matters, and recommendations of a consequential nature. It covers some of the concerns that emanated during discussions on the terms of reference, such as improving the conditions and functioning of ROC offices, strengthening the inspection wing of the DCA, harmonisation of action between SEBI and DCA, the need to set up a Corporate Serious Frauds Office, random scrutiny of accounts, and the like.

Approach of the Committee

1.25 The Committee has had the good fortune of being able to benefit from hearing the views of a large cross-section of players — academics specialising in corporate governance, regulators such as SEBI and the DCA, representatives of Comptroller and Auditor-—General, RBI, banks, financial institutions and insurance companies, professionals involved in audit and secretarial functions, lawyers, representatives of investors, industry associations and business chambers, and others. Appendix 2 gives a list of those who the Committee met. Given the shortage of time, the Committee could not meet with more people and organisations, but has taken on record papers, notes and depositions sent by all. Appendix 4 gives a list of all documents that were received by the Committee.

1.26 Before moving on to the substantive chapters, it is necessary to clarify the approach taken by this Committee in framing its recommendations. In a sentence, the approach has been to maximise corporate governance reforms, keeping in mind pragmatic considerations and ground realities of India. In the past, well-~~—~~meaning recommendations have been often discarded as unrealistic, or have been distorted to bestow excessive monitoring and supervisory powers upon ~~to~~ otherwise ill-equipped government departments and regulatory authorities. The Committee has been acutely conscious of the attendant risks, even as it has been aware of its responsibility to recommend substantive changes.

1.27 Suggesting major reforms in the structure and practice of corporate governance is fraught with yet another hazard. Given the nature of the subject, one has to deal with polarised points of view of various parties and interest groups. At the one extreme is the view that all corporations are intrinsically 'bent'. Those with such a view inevitably propose more regulation and a heavier arm of the law — without realising that the way in which the machinery of enforcement might work may ~~often~~ result~~s~~ in unintended consequences. The other extreme is the pure *laissez faire* view, which naively believes that the market itself can take care of all structural ills, without the need for more focused regulatory oversight. Like most things, the truth lies somewhere in between.

1.28 Hence, the leitmotif of this Committee has been pragmatic radicalism. Every recommendation in this report has been the outcome of careful debate. And each has been derived from well-defined theoretical and empirical arguments, and reinforced by transparent, workable institutional arrangements, with clear guidelines and time tables. In its deliberations, the Committee was conscious of improving regulatory oversight without diminishing managerial initiative and risk-taking —which are the lifeblood of any business enterprise. Thus, wherever possible, the Committee has imposed reasonable bounds upon the regulatory powers of Government — based on the well-proven ground that excess of regulation invariably begets *dirigisme*, delays, discretionary abuse and rent-~~-~~seeking. This does not mean that regulation is not ~~un~~important. Far from it, and readers will see several new regulations and disclosures that have been recommended in this report. But, all such regulations need to be transparent, fair and incentive-compatible — so as to deliver the desired results.

1.29 Finally, the Committee wishes to emphasise that the recommendations have to be viewed as an integrated package. There is an overarching logic that knits all of them together; each recommendation can be feasibly implemented; and, given the strong empirical basis and realistic bias, none of the recommendations should result in unintended, adverse outcomes. It might be imprudent to pick and choose proposals according to expediency. Hence, the Committee advocates that the recommendations be viewed in their totality, and implemented in integrated fashion.

2
The Auditor – Company Relationship

2.01 Without information there would be no investment; and without investment there would be no industry. This truism is the cardinal basis of corporate governance, and explains why so much store is placed on the frequency, quality and quantity of financial and non-financial disclosures.

2.02 The statutory auditor is the lead actor on the disclosure front. This is recognised in corporate laws of all countries. Consider, for instance, the Companies Act, 1956. Sections 209 through 223 of the Act lay down the provisions related to maintaining of accounts. Schedule V gives the contents and form of the return that a company with share capital must annually provide to its shareholders and the ROC. Schedule VI defines the form of the balance sheet and disclosure requirements in the profit and loss account.[8] Sections 224 through 233A exhaustively deal with statutory auditors, and are worth outlining:

- At each annual general meeting (AGM) of any company, the shareholders shall appoint the auditor who will, ~~under~~ in normal circumstances, hold office until the next AGM (section 224) — which implies that auditors are fiduciaries of shareholders, and not of the management of a company.
- The rules for removing or replacing an auditor are more stringent than for reappointment. An auditor is generally appointed by shareholders through an ordinary resolution. However, section 225 clearly states that a special resolution -- ~~notice~~ has to be passed for appointing someone other than the retiring auditor. Thus, the law makes it more difficult for management or the board to ~~arbitrarily~~ change auditors — and this is intended to facilitate auditor independence.
- Section 227 states the powers and duties of auditors. The statutory auditor of a company can, at all times, have the right of access to all books of accounts and vouchers of a company. After thoroughly auditing all aspects of a company's finances including the balance sheet and profit and loss account, he has to make a report to the shareholders on whether the accounts give the information required by law, and whether these represent a 'true and fair' view of the company's financial affairs. This auditor's report can be quite exhaustive, and has to also specify whether:

[8] In addition, listed companies must append an annual cash flow statement in line with the heads of items prescribed by the SEBI.

    - the auditor could obtain from management all information and explanations that were necessary for the purpose of audit;
    - proper books of accounts have been kept by the company;
    - branch offices have been audited by him and, if by other auditor(s), whether such audited branch accounts were forwarded to him, and how he dealt with such accounts and reports;
    - the company's balance sheet and profit and loss account are in agreement with the books of accounts and whether these conform to all applicable accounting standards set by the Institute of Chartered Accountants of India (ICAI); and,
    - there are any observations, comments or qualifications of the auditor that can have an~~y~~ adverse effect on the functioning of the company. These qualifications have to be made separately, and highlighted in italics or bold face.
- Moreover, the annex to the auditor's report must also certify :
    - the adequacy of internal controls commensurate to the size of the company and its nature of business;
    - the adequacy of records maintained for fixed assets and inventories, and whether any fixed assets were re-valued during the year;
    - loans and advances that were given by the company, and whether the parties concerned were regular in repaying the principal and interest;
    - loans and advances taken by the company, and whether these were at terms prejudicial to the interest of the company and also whether these were being properly repaid according to contracted schedules;
    - transactions, including loans and advances, with related parties as defined by section 301 of the Companies Act;
    - fixed deposits accepted by the company from the public and, if so, whether these conform to the provisions laid down by section 58A of the Companies Act;
    - regularity of depositing of Provident Fund dues, and whether the Employees' State Insurance Act, 1948, was applicable to the company;
    - no personal expenses of directors and employees were charged to the profit and loss account; and,

- in the case of any manufacturing company, whether the management has conformed to the Manufacturing and Other Companies (Auditors' Report) Order, 1988 (called MAOCARO)~~.~~
- Section 229 specifies that only the statutory auditor can sign the auditor's report, the balance sheet, profit and loss account, and (for listed companies) the cash flow statement, and any other certificate or document that law requires signature and authentication of the auditor.
- Section 230 states that the auditor's report shall be read before the shareholders in the AGM and shall be open to inspection by any shareholder of the company.
- Section 231 confers on the auditor the right to attend and, if necessary, be heard at the AGM on any matter that relates to audit functions.
- Section 232 prescribes the penalties on any company not complying with these provisions.
- Section 233 outlines penalties for auditor's non-compliance.[9]

2.03 All these provisions assume that shareholders have an inalienable right to get the independent, professional opinion of the financial affairs of their company, and that the statutory auditor has a fiduciary duty to provide such a view. Independent audit function, therefore, is a key respected agency in corporate governance, and must not only be credible, professional and above board, but also be perceived to be so. In fact, this is clearly recognised by the ICAI:

> "The Chartered Accountant is a person on whom every section of society could rely upon, and rely strongly. His certificate would be one by way of a seal and a hallmark which would at once inspire confidence in the minds of all concerned as certification by a person fully competent and holding a charter from the supreme legislature of the country for the purpose… He must be above reproach; he must reflect the highest ethics of the profession; he must possess the expert knowledge which can throw light on important problems and issues… Any malpractices at the hands of the client should not be tolerated, and in matters where there is even a semblance of doubt in his mind about any malpractice, it should be his bounden duty to stand up against it and make his comments without fear or favour."
>
> ICAI, *History of the Accounting Profession in India, v.II*, pp.viii-ix.

Not surprisingly, a major task of the Committee is to suggest measures that enhance the reputation of credibility and independence of India's statutory auditors.

[9] It is a different matter that the penalties are paltry, and hardly serve as a deterrent~~s~~. Each instance of corporate non-compliance attracts a fine of Rs.5,000, while that for auditors penalty for non-compliance of Rs.10,000.

Independence of Auditors – Basic Principles

2.04 Like hunger, independence is easy to perceive, but difficult to define. At the basic level, independence requires:

- ***Independence of mind***, which permits arriving at an informed and reasoned opinion without being affected by factors that compromise integrity, professional scepticism and objectivity of judgement.
- ***Independence in appearance***, which requires avoiding facts, circumstances and instances where, an informed third party could reasonably conclude that integrity, objectivity and professionalism has, or may have, been compromised.

2.05 These are essential tenets for any auditor — the more so today because of the problems faced by the profession in the wake of Enron, Worldcom and the collapse of the auditing giant, Andersen. Moreover, there are real threats to independence. The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five such types of threats.[10] These are:

1. *Self-interest threats*, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.
2. *Self-review threats*, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.
3. *Advocacy threats*, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.

[10] See IFAC, Code of Ethics for Professional Accountants (Section 8 — Independence), pp.7-8.

4. *Familiarity threats* are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.
5. *Intimidation threats*, which occur when auditors are deterred from acting objectively with an adequate degree of professional scepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

2.06 The Committee felt that a sixth threat was the inadequate remuneration that audit firms in India receive for conducting statutory audits. This perhaps prompts audit firms to look towards non-audit work, such as consultancies, to augment their income. Given these threats, the Committee felt it necessary to outline some guiding principles regarding auditor's independence. These are:

- For the public to have confidence in the quality of audit, it is essential that auditors should always be — and be seen to be — independent of the companies that they are auditing. In the case of audit, the key fundamental principles are integrity, objectivity and professional scepticism, which necessarily require the auditor to be independent.
  - Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence. In such instances, risk aversion is a desirable virtue. In other words, it is better to reject a task as a potential threat to independence even when it may not be so, than to assume otherwise and risk being even remotely compromised.
  - Where such threats exist, the auditor should either desist from the task or, at the very least, put in place safeguards that eliminate them or reduce the threats to clearly insignificant levels. All such safeguard measures need to be recorded in a form that can serve as evidence of compliance with due process. If the auditor is unable to fully implement credible and adequate safeguards, then he must not do the work.

2.07 The chapter now moves on to recommending certain practices that can help preserve independence. In the course of meetings with chartered accountants, it was often argued that auditors' independence is about knowledge of the discipline, professionalism, integrity and fiduciary responsibility — and that none of these attributes can be substituted by legislated restrictions and prohibitions. The Committee certainly agrees with the first part of this sentiment. Even so, there is a case for recommending some judicious restrictions in order to facilitate independence — or, to put it more accurately, to prevent the possibility of dependence. This brings us to the first set of recommendations, which relate to disqualifications for audit assignments.

Recommendation 2.1: Disqualifications for audit assignments

In line with international best practices, the Committee recommends an abbreviated list of disqualifications for auditing assignments, which includes:

- ***Prohibition of any direct financial interest in the audit client*** by the audit firm, its partners or members of the engagement team as well as their 'direct relatives'. This prohibition would also apply if any 'relative' of the partners of the audit firm or member of the engagement team has an interest of more than 2 per cent of the share of profit or equity capital of the audit client.
- ***Prohibition of receiving any loans and/or guarantees*** from or on behalf of the audit client by the audit firm, its partners or any member of the engagement team and their 'direct relatives'.
- ***Prohibition of any business relationship*** with the audit client by the auditing firm, its partners or any member of the engagement team and their 'direct relatives'.
- ***Prohibition of personal relationships***, which would exclude any partner of the audit firm or member of the engagement team being a 'relative' of any of key officers of the client company, i.e. any whole-time director, CEO, CFO, Company Secretary, senior manager belonging to the top two managerial levels of the company, and the officer who is in default (as defined by section 5 of the Companies Act). In case of any doubt, it would be the task of the Audit Committee of the concerned company to determine whether the individual concerned is a key officer.
- ***Prohibition of service or cooling off period***, under which any partner or member of the engagement team of an audit firm who wants to join an audit client, or any key officer of the client company wanting to join the audit firm, would only be allowed to do so after two years from the time they were involved in the preparation of accounts and audit of that client.
- ***Prohibition of undue dependence on an audit client***. So that no audit firm is unduly dependent on an audit client, the fees received from any one client and its subsidiaries and affiliates, all together, should not exceed 25 per cent of the total revenues of the audit firm. However, to help newer and smaller audit firms, this requirement will not be applicable to audit firms for the first five years from the date of commencement of their activities, ~~or~~ and for those whose total revenues are less than Rs.15 lakhs per year.
- This recommendation has to be read with Recommendation 2.3 below.

Note: A 'direct relative' is defined as the individual concerned, his or her spouse, dependent parents, children or dependent siblings. For the present, the term 'relative' is as defined under Schedule IA of the Companies Act. However, the Committee believes that the Schedule IA definition is too wide, and needs to be rationalised for effective compliance.

Non-Audit Services of Firms to Audit Clients

2.08 The Committee believes that non-audit services is a complex area that can't be resolved by simplistic solutions. These need to be carefully dealt with, keeping in view the twin objectives of maintaining auditor's independence and ensuring that clients get the benefit of efficient, high quality services. The Ramsay Report (Australia) underscores this point: "There is no solid evidence of any specific link between audit failures and the provision of non-audit services… A ban should not be imposed in the absence of compelling evidence of a problem." In fact, it is possible for audit firms to end up being more dependant on their audit clients if other services were to be totally banned. In general, the Committee tends to agree with this view.

2.09 However, having said so, the Committee also believes that certain types of non-audit services could impair independence and possibly affect the quality of audit. It also believes that, given the well-publicised failures of an auditing firm as large as Andersen, some judicious prohibitions are in order. Indeed, the accounting regulatory agencies of most OECD countries prescribe negative lists. More recently, section 201 of the SOX Act has disallowed eight types of non-audit services, with the provision to disallow more as may be determined by the newly legislated Public Company Accounting Oversight Board (see Box 2.A).

Box 2.A: Prohibited non-audit services legislated by the SOX Act

According to Section 201 of the SOX Act, auditors performing audit functions for a company are prohibited from contemporaneously carrying out any non-audit service, which includes:

- Bookkeeping, or any other service related to maintaining accounting records or financial statements of the audit client.
- Financial information systems design and implementation.
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.
- Actuarial services.
- Internal audit outsourcing services.
- Management or human resource functions.
- Broker, dealer, investment adviser or investment banking services.
- Legal and other expert services unrelated to audit.
- Any other service that the Public Company Accounting Oversight Board may determine to be impermissible.

Moreover, for any public accounting firm to engage in any non-audit services, including tax services, excluding those prohibited above, prior permission and pre-approval must be taken from the Audit Committee of the concerned client company, and full disclosure of all such payments to the auditing firm be made in the annual accounts and report to the shareholders.

2.10 Most of these prohibitions already exist in India. The ICAI prohibits its members, as auditing firms, from services such as bookkeeping, maintaining accounts, internal audit, designing any information system which is a subject of audit or internal audit, brokering, investment advisory and investment banking services. Even so, the Committee believes that it is necessary to provide an explicit list of prohibited non-audit services.

Recommendation 2.2: List of prohibited non-audit services

The Committee recommends that the following services should ***not*** be provided by an audit firm to any audit client:

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

Further in case the firm undertakes any service other than audit, or ~~and~~ the prohibited services listed above, it should be done only with the approval of the audit committee.

Independence of Affiliated Consulting and Associated Firms

2.11 It is one thing to mandate strict independence standards for an audit firm--qua--audit functions;~~.~~ b~~B~~ut, as ~~it~~ was raised in the Committee, what about the status of consulting and associated entities affiliated to audit firms? Shouldn't these also have some independence guidelines?

2.12 The problem is something like this. Suppose an audit firm, A, has a subsidiary, B, that engages in consulting services. Further, suppose that the A's audit revenue is Rs.10 crore, and B's revenue from consulting is Rs.30 crore. Now, if a common corporate client accounts for only 10 per cent of A's audit revenue (and, thus, meets the criteria outlined in Recommendation 2.3), but accounts for a third of B's consulting income. Would that not create self-interest threats, and possibly affect the auditors' independence?

2.13 A caveat is in order at this stage. Not once is the Committee stating that audit firms must not have affiliated consulting firms (or firm) engaged in specialised practices such as taxation or valuation. Indeed, it has been often demonstrated that consulting skills lead to a wider understanding of business strategy and, hence, can foster positive knowledge externalities for auditors. It makes a great deal of sense for good auditors to widen their horizons by occasionally engaging in the business of consulting, just as it does for business consultants to intermittently get involved in the nitty-gritty of auditing. There is human resources dimension as well. Nowadays, rare is a good chartered accountant who wants to spend his entire life as a pure auditor; he also wants to do consulting assignments. Preventing the talented from straddling both worlds could easily result in a secular decline in the quality and expertise of auditors. This Committee has no qualms *per se* about audit firms having subsidiaries or associate companies engaged in consulting or other specialised business services.

2.14 However, it is also a fact that such affiliations could cause potential threats to auditor independence and, therefore, it would be prudent to create realistic safeguards against such contingencies. This leads to the following recommendation.

Recommendation 2.3: Independence Standards for Consulting and Other Entities that are Affiliated to Audit Firms

- ***Prohibition of undue dependence***. Where an audit firm has subsidiary, associate or affiliated entities, yardstick of no more than 25 per cent of revenues coming from a single audit client stated in Recommendation 2.1 should be widened to accommodate the consolidated entity. Thus, no more than 25 per cent of the revenues of the consolidated entity should come from a single corporate client with whom there is also an audit engagement.
- The other prohibitions listed in Recommendation 2.1 should also apply in full to all affiliated consulting and specialised service entities of any audit firm that are either subsidiaries of the audit firm, or have common ownership of over 50 per cent with the audit firm. And all the tests of independence outlined in Recommendation 2.1 should be carried over to the consolidated entity.
- Therefore, this recommendation has to be read with Recommendation 2.1.

Consolidation tests should test fully, line-by-line, for all subsidiaries, whether the audit firm, or its partners, own over 50 per cent of equity, or share of profit.

Rotation of Audit Firms

2.15 The Committee heard the views of two distinct schools of thought: the minority, which believed in the compulsory rotation of audit firms (the notable proponents were the office of the Comptroller and Auditor-General, Life Insurance Corporation of India and

ASSOCHAM); and the overwhelming majority (notable amongst them being the CII, FICCI and some of the ex-presidents of the ICAI) which was against it, but argued in favour of the rotation of audit or engagement partners.

2.16 Those who advocated rotation of audit firms held the view that changing engagement partners did not suffice to promote independence. According to this view, replacing engagement partner A by B every three, five or seven years was only a cosmetic change. The other school of thought also brought to bear its arguments in favour of rotating engagement partners, but not necessarily the audit firm. Their arguments were as follows. First, auditing of multi-divisional, multi-segmental companies in today's environment has become an increasingly complex task — one that requires high levels of accounting and income recognition skills as well as detailed, industry-specific knowledge. Secondly, such knowledge doesn't come overnight. It needs sustained training, exposure and understanding of business practices as well as rapidly changing global accounting rules and standards. Thirdly, if auditing firms know that they will be changed every few years, then one of two things could happen. At best, the ten or fifteen large and reputable audit firms could swap the big clients among themselves to no great purpose. At worst, most firms would have no incentive to invest in the necessary knowledge of complex industries and businesses, and so reduce the quality of auditing to its lowest common denominator — to the detriment of the company, its investors and other stakeholders.

2.17 The Committee deliberated long and hard over the issue of rotation. In doing so, it did not find sufficient international evidence favouring compulsory rotation of audit firms. Various independent accounting studies made available to the Committee indicated no discernible benefits from rotation.[11] In fact, these studies universally indicated the opposite — that rotation tends to enhance the risk of audit failures in the last year of the tenure of the outgoing auditor (who has no further incentive to invest in quality), and the first two years of the new auditor (who is yet to get to grips with the nitty-gritty of the business). Further, even the politically charged, crusading post-Enron world has not legislated in favour of compulsory rotation of audit firms. For instance, while section 203 of the SOX Act prescribes rotation of the lead (or coordinating) audit partner, or the audit reviewing partner once every five years, it does not mandate compulsory rotation of audit firms.

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[11] See, for instance, studies by the SDA University of Bocconi (2002) and Arunada and Paz-Ares (1995).

2.18 Given international practice, and the fact that there is no conclusive proof of the gains while there is sufficient evidence of the risks, the Committee does not recommend in favour of any statutory rotation of audit firms. However, in line with the SOX Act, the Committee is in favour of compulsory rotation of audit partners.

Recommendation 2.4: Compulsory Audit Partner Rotation

- There is no need to legislate in favour of compulsory rotation of audit firms.
- However, the partners and at least 50 per cent of the engagement team (excluding article clerks and trainees) responsible for the audit of either a listed company, or companies whose paid up capital and free reserves exceeds Rs.10 crore, or companies whose turnover exceeds Rs.50 crore, should be rotated every five years.
- Also, in line with the provisions of the European Union and the IFAC, persons who are compulsorily rotated could, if need be, allowed to return after a break of three years.

Disclosures by Auditors

2.19 Nothing works like disclosures. The guidance, "When in doubt, disclose" is probably the simplest and best yardstick for evaluating good corporate governance. The Committee felt that while amendments in the Companies Act, Clause 49 of the Listing Agreement, and other regulations laid down by the SEBI and the DCA have significantly enhanced disclosures in recent times, more can be done in the interests of shareholders, other investors, stakeholders and the community at large.

2.20 Disclosure by different agents are dealt with throughout the various chapters of this report. This section focuses only on additional disclosures by auditors.

Contingent liabilities

2.21 Many small shareholders do not know how to read the minutiae of balance sheets, profit and loss accounts, cash flow statements and notes on accounts. When this is juxtaposed with the language of auditors, cost accountants and company secretaries — replete with long and dense sentences — the result is often one of profound non-comprehension. This is particularly true in the case of contingent liabilities.

Recommendation 2.5: Auditor's disclosure of contingent liabilities

It is important for investors and shareholders to get a clear idea of a company's contingent liabilities because these may be significant risk factors that could adversely affect the corporation's future health. The Committee recommends that management should provide a clear description in plain English of each material liability and its risks, which should be followed by the auditor's clearly worded comments on the management's view. This section should be highlighted in the significant accounting policies and notes on accounts, as well as, in the auditor's report, where necessary.

Qualifications

2.22 What is true for contingent liabilities is even more germane for auditor's qualification of the accounts of a company. A qualification can be a serious indictment of the financial affairs and management of a company. Yet, far too few shareholders really understand what a qualification means, and companies are hardly ever questioned by regulators such as the SEBI and the DCA regarding such qualifications. The Committee believes that this must change — and the only way of doing so is by mandating greater disclosures.

Recommendation 2.6: Auditor's disclosure of qualifications and consequent action

- Qualifications to accounts, if any, must form a distinct, and adequately highlighted, section of the auditor's report to the shareholders.
- These must be listed in full in plain English – what they are(including quantification thereof), why these were arrived at, including qualification thereof, etc.
- In case of a qualified auditor's report, the audit firm may read out the qualifications, with explanations, to shareholders in the company's annual general meeting.
- It should also be mandatory for the audit firm to separately send a copy of the qualified report to the ROC, the SEBI and the principal stock exchange (for listed companies), about the qualifications, with a copy of this letter being sent to the management of the company. This may require suitable amendments to the Companies Act, and corresponding changes in The Chartered Accountants Act.

Disclosure in the event of replacement of auditors

2.23 As mentioned earlier, the Companies Act makes it more difficult to replace an auditor than to re-appoint one. While this is as it should be, the Committee felt that corporate governance would benefit from some additional disclosure. The Committee felt that if the management were to be more accountable to the shareholders and the audit committee, in the matter of replacing auditors, this is likely to make the auditors more fearless. This is a step which would meet, to some extent, intimidation threats to auditors.

Recommendation 2.7: Management's certification in the event of auditor's replacement

- Section 225 of the Companies Act needs to be amended to require a special resolution ~~to~~of shareholders, in case an auditor, while being eligible to re-appointment, is sought to be replaced.
- The explanatory statement accompanying such a special resolution must disclose the management's reasons for such a replacement, on which the outgoing auditor shall have the right to comment. The Audit Committee will have to verify that this explanatory statement is 'true and fair'.

Disclosure regarding independence of auditors

2.24 Even if the shareholders and the audit committee are satisfied about the independence of the auditors when appointing them, this independence might, somewhere along the way, get compromised: a financial or employment relationship could develop. Faith in the continued independence of the auditors must be renewed. The Committee, therefore, felt that it will be a good practice for the audit firm to annually file a certificate of independence to the Audit Committee or the board of directors of the client company.

Recommendation 2.8: Auditor's annual certification of independence

- Before agreeing to be appointed (along with 224(1)(b)), the audit firm must submit a certificate of independence to the Audit Committee or to the board of directors of the client company certifying that the firm, together with its consulting and specialised services affiliates, subsidiaries and associated companies:

1. ~~A~~are independent and have arm's length relationship with the client company;~~.~~
2. ~~H~~have not engaged in any non-audit services listed and prohibited in Recommendation 2.2 above; ~~.~~and
3. ~~A~~are not disqualified from audit assignments by virtue of breaching any of the limits, restrictions and prohibitions listed in Recommendations 2.1 and 2.3.

In the event of any inadvertent violations relating to Recommendations 2.1, 2.2 and 2.3, the audit firm will immediately bring these to the notice of the Audit Committee or the board of directors of the client company, which is expected to take prompt action to address the cause so as to restore independence at the earliest, and minimise any potential risk that ~~may~~might have been caused.

Appointment and Remuneration of Auditors

2.25 By and large, the Committee had no issues with the method of appointing the statutory auditor, as laid down by the Companies Act and Clause 49 of the Listing Agreement. However, it was noted that audit fees in India were generally quite low —

which might, over time, impinge upon the quality of audit. Nevertheless, the Committee felt that it would be imprudent to mandate a minimum audit fee.

2.26 The Committee also felt that, in general, the primary point of reference for the appointment, terms of reference and fees of the auditing firm must be the Audit Committee of the board of directors. The second level of decision-making should rest with the full board, subject to a positive recommendation by the Audit Committee. And the final approval must rest with the shareholders at the company's AGM. The Committee also recognised that, in India, there would be two notable sets of exceptions to this practice — and these relate to government companies and public sector banks. Under ~~S~~section 619 of the Companies Act, ~~–~~auditors are appointed by the Comptroller and Auditor-General of India; while those of scheduled commercial banks need to be approved by the RBI.

2.27 Chapter 4 discusses Audit Committees of boards in detail. It has been pointed out that lack of skill, commitment required in terms of time, inadequate financial compensation to members, and inadequate regulatory oversight are some of the reasons why audit committees have not been able to play the effective role that was envisaged for them. Here, the Committee felt that ~~it needs to be emphasised that~~ Audit Committees should play ~~have~~ a key role ~~to play~~ vis-à-vis auditing itself, by involving itself in areas such as discussing the annual work programme with the auditors, reviewing the independence of the audit firm, recommending appointment/re-appointment or removal of external auditor, along with the annual audit remuneration.

Recommendation 2.9: Appointment of auditors

The Audit Committee of the board of directors shall be the first point of reference regarding the appointment of auditors. To discharge this fiduciary responsibility, the Audit Committee shall:

- ~~D~~discuss the annual work programme with the auditor;~~.~~
- ~~R~~review the independence of the audit firm in line with Recommendations 2.1, 2.2 and 2.3 above; and
- ~~R~~recommend to the board, with reasons, either the appointment/re-appointment or removal of the external auditor, along with the annual audit remuneration.

Exceptions to this rule may cover government companies (which follow section 619 of the Companies Act) and scheduled commercial banks (where the RBI has a role to play).

CEO and CFO Certification

2.28 Section 302 of the SOX Act specifies that the CEO and CFO of all listed companies must certify to the SEC regarding the veracity of each annual and quarterly financial report. This is a far more expanded certification compared to the ones that were earlier required for mandatory SEC filings. In addition, under section 304 of the SOX Act, if there is an accounting restatement because of either misconduct or material non-compliance of this certification and other requirements, the CEO and CFO will have to reimburse the company for any excess incentive- or equity-based compensation arising out of the misstatement (the disgorgement clause). Furthermore, the Act has prescribed enhanced criminal penalties for any false certification.

2.29 The Committee examined this certification issue in detail, and concluded that it constitutes a good corporate governance practice. However, it was not in agreement with instituting criminal proceedings. Instead, the Committee felt that there should be significantly enhanced penalties — ones that should act as a credible deterrent~~s~~.[12]

Recommendation 2.10: CEO and CFO certification of annual audited accounts

For all listed companies as well as public limited companies whose paid-up capital and free reserves exceeds Rs.10 crore, or turnover exceeds Rs.50 crore, there should be a certification by the CEO (either the Executive Chairman or the Managing Director) and the CFO (whole-time Finance Director or otherwise) which should state that, to the best of their knowledge and belief:

- They, the signing officers, have reviewed the balance sheet and profit and loss account and all its schedules and notes on accounts, as well as the cash flow statements and the Directors' Report.
- These statements do not contain any material untrue statement or omit any material fact nor do they contain statements that might be misleading.
- These statements together represent a true and fair picture of the financial and operational state of the company, and are in compliance with the existing accounting standards and/or applicable laws/regulations.
- They, the signing officers, are responsible for establishing and maintaining internal controls which have been designed to ensure that all material information is periodically made known to them; and have evaluated the effectiveness of internal control systems of the company.

[12] At the time of writing this report, another committee under the Chairmanship of Mr. Shardul S. Shroff is examining the issue of enhanced penalties for non-compliance. ~~We hope that such penalties will, indeed, be suitably enhanced in the near future. As it stands today, penalties of Rs.5,000 or Rs.10,000 can hardly be considered as deterrents.~~

- They, the signing officers, have disclosed to the auditors as well as the Audit Committee deficiencies in the design or operation of internal controls, if any, and what they have done or propose to do to rectify these deficiencies.
- They, the signing officers, have also disclosed to the auditors as well as the Audit Committee instances of significant fraud, if any, that involves management or employees having a significant role in the company's internal control systems.
- They, the signing officers, have indicated to the auditors, the Audit Committee and in the notes on accounts, whether or not there were significant changes in internal control and/or of accounting policies during the year under review.
- In the event of any materially significant misstatements or omissions, the signing officers will return to the company that part of any bonus or incentive- or equity-based compensation which was inflated on account of such errors, as decided by the Audit Committee.

2.30 The Committee believes that such a certificate, coupled with significantly enhanced penalties, will induce CEOs and CFOs to be far more careful in their disclosures to shareholders and investors.

3

Auditing the Auditors

3.01 Who audits audit? This question has vexed economists as well as corporate governance specialists. Simply put, the auditor performs a critical role in informing the shareholders of the true and fair picture of the state of financial and operational affairs of a company. However, the ability to play this role well depends upon the auditor's knowledge, skills, independence, professional scepticism and integrity. It has been often argued that there ~~are ought to be a~~is great need to ~~credibly~~ regulate auditors effectively~~so as~~ to ensure that they ~~have~~ properly discharge~~d~~ their fiduciary responsibilities.

3.02 In most countries, the regulatory role is carried out, to greater or lesser degree, by professional bodies representing certified public accountants. Whilst in some countries the regulator is a ~~re are merely voluntary "~~non-statutory~~"~~ ~~self~~ self-regulating organisation, in some others they are creatures of a specific statute~~s~~. ~~In India~~Here, the Institute of Chartered Accountants of India (ICAI) has been set up under the Chartered Accountants Act, 1949, to examine and regulate the profession. Similarly, the Institute of Company Secretaries of India (ICSI) has been set up under the Company Secretaries Act, 1980, ~~to regulate its members. Analogously,~~ and ~~–~~the ~~cost accountants are regulated by the Institute of Cost and Works Accountants of India (ICWAI)~~Institute of Cost and Works Accountants of India (ICWAI) regulate the cost accountants. Indeed, these three professional organisations are statutory bodies~~ created by acts of Parliament~~, and not mere self-regulating organisations.

3.03 Until recently, most countries felt no need for any kind of public oversight board acting as ~~to be~~ an independent ~~apex~~ organisation to regulate the conduct of these fiduciary intermediaries. The US corporate scandals have changed all that. Spurred by the public spectacle of senior auditors claiming little knowledge of the financial skulduggery of top-level executives of Enron and Worldcom, shareholders and corporate governance specialists as well as people~~the world~~ at large have been ~~are increasingly~~ demanding the setting up of credible public oversight bodies.

3.04 The first such move ~~has been~~was initiated by the SOX Act, which ~~has~~ legislated in favour of setting up the Public Company Accounting Oversight Board (PCAOB). Box 3.A synopsises the basic elements of the PCAOB. Its provisions are worth reading in some detail, for it is the most comprehensive legislative intermediation in the history of auditing.

3.05 At the time of writing, there are reports that the financial community in the US is up in arms against the severe provisions governing the PCAOB. In fact, expert commentators believe that the rules and regulations governing PCAOB will have to be modified to suit reality. Irrespective of what happens in the US, it is a fact that providing for the PCAOB has raised similar demands in other countries. And, the Committee has been entrusted in its terms of reference to examine this matter.

Box 3.A: Public Company Accounting Oversight Board of the SOX Act

- **Objective**: To oversee the audit of listed companies in order to protect investors' and public interest in matters relating to the preparation of audited financial statements.
- **Status**: A non-profit body corporate, and agency or establishment of the US government.
- **Duties**: (i) Register all audit firms, (ii) establish and/or adopt rules for auditing, quality control, ethics, independence and other standards relating to the preparation of audited financial reports, (iii) conduct periodic inspection of auditing firms, (iv) conduct investigations and disciplinary proceedings where justified and, if necessary impose appropriate sanctions and penalties, and (v) enforce compliance with the SOX Act, securities laws relating to preparation and issuing of audit reports and the rules of the SEC.
- **Composition**: Five full time members, who are prominent individuals of integrity, possess an understanding of financial disclosures and have a demonstrated commitment to the interests of investors and the public. While serving on the board, none of the members can be employed or be engaged in any other professional or business activity. Only two members out of five may be certified public accountants and if such a member is the chairperson, then s(he) cannot be practicing certified public accountant for at least five years prior to his or her appointment to the board.
- **Powers**: The board has powers to (i) sue, be sued, complain and defend, (ii) conduct its operations, maintain offices and exercise all other rights and powers authorised by the SOX Act, (iii) appoint employees, accountants, attorneys and others, define their duties and fix their compensation, and (iv) allocate, assess and collect support fees from registered public accounting firms.
- **Registration**: All public accounting firms have to register with the board within 180 days from the passing of the Act.
- **Auditing, quality control and independence standards and rules** The board shall establish by rule all auditing, attestation, quality control and ethics standards that need to be used by audit firms. These standards may be formulated either by adopting those of professional groups or by recommending new ones.
- **Inspection of audit firms**: The board shall have the powers to conduct a continuing programme of inspections of audit firms to assess their degree of compliance to its rules as well as those of the SEC. In general the board will annually inspect each audit firm that audits

more than 100 companies, and once in three years those that audit 100 or less companies.

Investigation and disciplinary proceedings: The board has the powers to conduct investigations of any act by an auditing firm or its partners that may violate the provisions of SOX Act

and other laws and rules. Non-cooperation with such investigations can result in suspension and revoking of the registration or licence of the audit firm. Moreover, the board has powers to initiate and conduct disciplinary proceedings against any registered audit firm.

- **Sanctions**: If the board finds that there have been violations, it is allowed to impose sanctions such as (i) temporary suspension, (ii) permanent suspension and revocation of licence, (iii) fines ranging from $50,000 to $100,000 for a natural person for each such violation, and between $2 million and $15 million for each violation committed by any other person.
- **Extra-territorial jurisdiction**: These provisions will apply to non-US auditing firms that prepare audited financial statements for US publicly listed companies.

Should India have its Public Accounting Oversight Board?

3.06 The Committee took note of the Statement on Peer Review issued by the ICAI in March, 2002. According to this statement, the ICAI has decided to aid professional firms in their quest for enhancement of quality of work through peer review, and have recognised that a professional should be always ready to show the quality of his work.

3.07 Quality has now come to be defined as the degree to which a set of inherent characteristics (distinguishing features) fulfils requirements, a requirement being the need or expectation that may be stated or generally implied, or obligatory.

3.08 The Committee, after some deliberation, came to the conclusion that while the ICAI statement on Peer Review is indeed a good one, it was time to think of a more independent and refined arrangement to ensure the quality of attestation services assignments performed by chartered accountants in relation to the technical standards prescribed for them.

3.09 The opinions expressed ~~of~~by those who met with the Committee were split along the middle: one set of people ~~fervently~~ advocated the setting up of an independent Public Accounting Oversight Board, while another — most notably, many chartered accountants, argued otherwise. We feel that it is important for the Committee to record both arguments before arriving at a conclusion.

3.10 Those who favoured an oversight board based their arguments on the perception of the efficacy and independence of ICAI. According to this school of thought, while the ICAI is legally empowered to carry out most of the regulatory, oversight and disciplinary functions outlined in the SOX Act (barring prosecution and levying of penalties), the public perception is that ICAI mechanisms are ~~very~~ slow and that the Institute seems to be loath to ~~sufficiently~~adequately discipline its errant members;~~.~~ ~~T~~therefore, ~~it was argued,~~ the need for a new, independent body to carry out such critical oversight functions.

3.11 Not surprisingly, many chartered accountants and spokespersons for ICAI believe otherwise. According to them, the Chartered Accountants Act, 1949, the regulations framed thereunder, and the organisational structure of ICAI enjoin the Institute to conduct all the necessary disciplining functions. The ICAI did agree that the procedures prescribed under the Chartered Accountants Act and its regulations tend to be slow, and favoured legislative amendments. They, however, contended that speeding up the process accompanied by changes suggested by them, should suffice to strengthen effective oversight over the disciplinary mechanism within the structure of ICAI. Hence, they felt that perhaps there was no need to create yet another ~~legally~~ mandated quasi-independent supervisory institution.

3.12 After considerable deliberation, the Committee came to the view that there was merit in the~~to~~ ICAI argument. The reasons are as follows:

- First, the powers that are sought to be vested in the PCAOB of the United States under the SOX Act are today, in India distributed across a plethora of regulatory agencies — the DCA, SEBI, RBI, ICAI, ICSI, ICWAI, the power to proceed under the Information Technology Act, 2000, and residual powers under the ~~Civil Procedure Code~~Code of Civil Procedure and the Code of Criminal Procedure. ~~Code.~~
- Secondly, ~~therefore,~~ if there were to be an Indian version of the PCAOB, then such powers would need to be withdrawn from the existing regulatory agencies and concentrated ~~o~~in the proposed public oversight board. Without these powers, the board would be yet another toothless agency — maintained ~~for the matter of form,~~ pro forma~~but~~ without any significant operational content. ~~India, it was argued, had enough such cosmetic agencies, and did not need another one.~~
- Thirdly, it was argued that the need of the hour was reform of auditing oversight functions — but that such reforms did not necessarily entail circumscribing the powers of existing institutions to create yet another one. Instead, it was necessary to empower the organisations that are on the ground and, if need be, provide additional safeguards to ensure that they can expeditiously achieve~~d~~ their ~~stated~~ objectives.

3.13 On balance, the Committee opted in favour of this view, and therefore rejected the idea of setting up yet another new regulatory oversight body. However, it also felt that the ICAI must now show more determination and speed — and so prove that it is an efficient body that can be always entrusted to provide transparent and expeditious auditing oversight in the interest of investors and the general public.

3.14 If not a new public oversight board, then what? The Committee considered two major steps. First, recommending legislative and organisational support for the setting up of independent Quality Review Boards to strengthen and ~~extend~~reform the peer review system within the ICAI. Secondly, recommending significantly enhanced and expeditious disciplinary action within the framework of the Chartered Accountants Act, 1949 to bring errant auditors to book . The former is discussed in section 3.2, while the latter is examined in section 3.3 below.

Independent Quality Review Boards

3.15 ~~Before recommending the setting up of independent Quality Review Boards (QRBs), it should be stated that t~~The Committee examined the ICAI's recently introduced system of peer review of audit firms, which is going to be operational from 1 April 2003. While ICAI's Peer Review Statement seems to be an adequate, self-contained document that addresses most of the issues regarding 'who audits the auditors', it is still necessary to recommend a process of quality review that is publicly perceived to be independent and expeditious. The committee noted that such a system has ~~already~~ been established in Sri Lanka recently. The committee recommends setting up of independent QRBs — one each for the ICAI, the ICSI and the ICWAI.

Recommendation 3.1: Setting up of independent Quality Review Board

- There should be established, with appropriate legislative support, three independent Quality Review Boards (QRB), one each for the ICAI, the ICSI and ICWAI, to periodically examine and review the quality of audit, secretarial and cost accounting firms, and pass judgement and comments on the quality and sufficiency of systems, infrastructure and practices.
- In the interest of realism, the QRBs should, for the initial five years, focus their audit quality reviews to the audit firms, which have conducted the audit for the top 150 listed companies, ranked according to market capitalisation as on 31 March. ~~This should give investors the comfort that the audited financial and secretarial reports of all important listed companies are being reviewed.~~ Depending upon the record of success of such reviews, the DCA may subsequently consider altering the sample size or criterion.
- **Composition of ICAI's QRB**: The board shall consist of 11 members, including the chairman. The chairman shall be nominated by the DCA, in consultation with, but not necessarily from, the ICAI. Five members of the board, excluding the chairman, shall be nominated by the DCA who will be people of eminence, professional reputation and integrity including, but not limited

to, nominees of the Comptroller and Auditor-~~-~~General of India, RBI, SEBI, members or office-bearers of the Bombay Stock Exchange or the National Stock Exchange, the three apex trade and industry associations (CII, FICCI and ASSOCHAM), reputed educational and research institutions, bankers, economists, former public officials and business executives. The remaining five members of the Board will be nominated by the Council of the ICAI.[13]

- **Composition of ICSI's QRB**: A five-member board, including the chairman. The chairman shall be nominated by the DCA, in consultation with, but not necessarily from, the ICSI. Two members, excluding the chairman, shall be nominated by the DCA, who will have the same attributes suggested for ICAI's QRB above. The remaining two members will be nominated by the Council of the ICSI.
- **Composition of ICWAI's QRB**: A five-member board, including the chairman. The chairman shall be nominated by the DCA, in consultation with, but not necessarily from, the ICWAI. Two members, excluding the chairman, shall be nominated by the DCA, who will have the same attributes suggested for ICAI's QRB above. The remaining two members will be nominated by the Council of the ICWAI.
- **Funding**: Each of these QRBs will be funded by their respective institutes in a manner that ~~each sees fit.~~will enable it to discharge its functions adequately.
- **Appellate forum**: In the instance of a dispute between the findings of the QRBs and reviewees, the matter should be referred to an appropriate appellate forum. This appellate forum should be the same as that suggested for disciplinary matters, which is discussed in Recommendation 3.2 below.
- ~~*DCA should adopt transparent procedures while nominating people of eminence to the QRBs*~~

Disciplinary Action ~~for~~against Professional Misconduct

3.16 The ~~area~~subject of disciplinary mechanism requires careful consideration. Spurred by revelations of significant audit failures in the US, there have been reports in the Indian media expressing concern over the alleged lack of disciplinary action on auditors who have failed to perform their duties. It has ~~also~~ been stated by many who interacted with the Committee that the ICAI has been unable to adjudicate disciplinary cases within reasonable time. Similar concerns have been expressed for the other two Institutes, even though they have much fewer disciplinary cases.

3.17 Under the current legal framework, failure on the part of auditors regarding their civil and/or criminal acts or omissions are dealt with under the respective laws. Auditors are also liable under the common law of the country. But law proceeds in ponderous ways. And the hallmark of any reputed profession, especially one discharging key

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[13] In the interest of independence, it was suggested to the Committee that professionals should not be members of the QRB at all. However, the job of QRB is not that of inspection or review of audit. Rather, it is to ensure that standards, procedures and practices that are required to be met or followed, are indeed being met and followed. This is a technical area, the absence of professionals from which would tell upon the quality of the QRB itself. Therefore, the Committee has suggested a structure that has them on the QRB, but the majority of the Board is made up of eminent persons from other fields.

fiduciary obligations, is the code of ethics that it imposes on its members, and the mechanism for reviewing and punishing professional misconduct. In fact, The Chartered Accountants Act, Company Secretaries Act and the Cost and Works Accountants Act do provide for ~~a~~the framework for taking disciplinary action against ~~the~~ erring members.

3.18 As far as chartered accountants are concerned, section 21 of the Chartered Accountants Act provides for disciplinary action against a member of the ICAI for professional and/or other misconduct; while regulations framed under the ~~a~~Act defines the framework and procedures by which the disciplinary proceedings must be conducted. The existing mechanism is quite elaborate. However, procedures that were framed in the past have not been able to cope with the changed scenario, which must deal with complex businesses and over 70,000 practicing members.

3.19 Not surprisingly, there have been professional as well as public concerns ~~about~~over ~~–~~the time taken in the disposal of disciplinary proceedings.[14] The existing system suffers from the following limitations :

- Inability of the ICAI to enforce information/documents from the concerned agencies before the *prima facie* stage.
- Inability to deal with ~~dilatory~~ obstructive practices resulting in delay at every stage of proceeding.
- Inability to adopt a prioritised approach, which can ~~distinguish~~ classify cases according to the severity of misconduct and importance to the public, and deal with the serious ones expeditiously.

3.20 Indeed, a note from the ICAI has itself highlighted the problems which occur at each stage of the process. These require some elaboration.

- *Prima facie* opinion on whether or not a member is guilty is required to be formed at the level of the full Council. The Council of ICAI consists of 30 members, and can only meet eight to nine times a year. This ~~leads~~causes ~~to~~ delay~~s~~ at the very first stage of the disciplinary proceedings.
- Under section 21 of the Chartered Accountants Act, all cases where ICAI's Council has held the respondent *prima facie* guilty have to be taken up for enquiry by the Disciplinary Committee, which consists of five members, with no provision for benches. This worked when ICAI had far fewer practising members.

[14] During the last five years, 613 complaints were received by ICAI, of which 454 were disposed of— a disposal rate of 74 per cent. The remaining 26 per cent are pending at different stages, including at the High Courts. During the same period, the Council of ICAI has awarded or recommended punishment up to five years in 72 cases. Barring very few exceptions, the recommendations of the ICAI on the punishment to be awarded ~~to~~ have been invariably endorsed by the High Courts.

It can no longer adequately handle over 300 complaints received every year — a number which is expected to increase in the future.

- The Council must then deliberate on the reports of the Disciplinary Committee. In doing so, a Supreme Court judgement has determined that it must give hearing to the complainant and respondent. This entails further delays and, at times the process has been misused by one or both of the concerned parties.
- If a member is held guilty, the Council either awards punishment or recommends punishment to the High Court. Where the recommendation on the award of punishment is not required to be sent to the High Court, the procedure requires giving yet another opportunity to the respondent. Moreover, according to the rules, the report and recommendation of punishment cannot be considered in the same meeting. Therefore, the punishment part must necessarily await another meeting of the Council.
- In cases where the case is forwarded to the High Court, it takes even more time for the Court to confirm the Council's award of punishment ~~under section 21(5 and 6)~~under sub-sections (5) and (6) of section 21.

3.21 The Committee believes that such delays just have to be avoided. The confidence of the investing public, especially small investors, cannot be nurtured unless disciplinary cases are dealt with more expeditiously and transparently.

3.22 The Committee has been given to understand that in its various representations to government, the ICAI has suggested changes in the ~~process~~procedure. Some of these changes are:

- Merging the two existing ~~two~~ schedules of the Chartered Accountants Act, that describe professional misconduct, into a composite schedule, and clear categorisation of offences. According to ICAI, this ought to help focus on cases having larger public interest and also relate the quantum of punishment to the gravity of offence.
- Constitution of a new Standing Committee (Screening Committee) for forming *prima facie* opinion.
- Broad-basing the Disciplinary Committee with more representation for nominees of Central Government, and empowering it to function through regional benches.
- The Council, Screening Committee and benches of the Disciplinary Committee should be given powers similar to those vested in a Civil Court regarding matters like discovery and production of documents.
- The benches of the Disciplinary Committee should also recommend punishment

in its report submitted to the Council.

- The Council must consider the report and, in cases where it upholds the punishment recommendation of the bench, simultaneously award punishment.
- The Council ~~must~~ may be empowered to award all types of punishment for ~~all~~ each~~types~~ of the offences.
- Provision for withdrawal of specified type(s) of complaint case(s) up to a specified stage. Provision for summary disposal, in the event of respondent pleading guilty up to a specified stage.

3.23 While the Committee appreciated the changes suggested by the ICAI, it felt that the need of the hour was something more. Shareholders, investors and other stakeholders of companies rely on the audited financial statements for making investments and other major decisions. The auditing profession, therefore, needs to respond to the confidence reposed in them, and has to be seen to be responsive.

3.24 Moreover, in most instances, disciplining the auditors need not be a matter requiring consideration of High Courts. For one, there are significant delays whenever a case is recommended by ICAI to the High Court. For another, the High Courts have enough on their plate to be further burdened by ICAI cases. Hence, there is a need not only to have more expeditious disciplinary processes within the ICAI, but also to have a quasi-judicial appellate body outside the High Courts to hear most of the appeals.

3.25 The existing disciplinary cases fall under two specific categories: ‘complaint’ and ‘information’ cases. While this categorisation may continue, the procedures to be followed need significant changes not only to overcome the bottlenecks but also to ensure effective and expeditious delivery of justice. Accordingly, the Committee has recommended an entirely new disciplinary procedure which, while keeping the process within the framework of the ICAI and The Chartered Accountants Act, will bring about greater speed while~~and~~ ensuring independence and fair play.

3.26 After considering the matter at some length, the Committee arrived at the conclusion that the right to appeal to the High Court or making certain penalties subject to confirmation by the High Court was not strictly necessary. The Committee noted that such a provision was not there in the Advocates Act. Given the nature of cases involved, it would be more appropriate to establish a high-powered Appellate Body comprising two senior chartered accountants, two eminent persons having qualifications similar to the ones prescribed for independent members of the Disciplinary Committee but of a higher standard and experience and a Presiding Officer who should be a retired Judge of the Supreme Court or a retired Chief Justice of High Court.

Recommendation 3.2: Proposed disciplinary mechanism for auditors

- **Classification of offences and merging of schedules**: At present there are two schedules of offences and misconduct – with the second schedule requiring action by High Courts. These two schedules need to be merged, so that the Council is empowered to award all types of punishment for all types of offences. Further, offences need to be categorised according to the severity of misconduct, so that processes can be designed, and punishments awarded, according to the severity of the offence.
- **Prosecution Directorate**: An independent permanent directorate within the structure of ICAI shall be created, which shall act as the Prosecution Directorate. This office will exclusively deal with all disciplinary cases and, hence, expedite the process of enquiry and decision-making by fully devoting its time and energy towards processing these cases. The office should be headed by a person of the level of Director, and should be one with a legal background and conversant with the provisions of The Chartered Accountants Act and its regulations. He and his office shall be independent of the electoral process of ICAI. Suitable regulations need to be framed to uphold the independence of this office. The Prosecution Directorate shall have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, regarding (i) the discovery and production of any document; and (ii) receiving evidence on affidavit.

Procedure for dealing with complaint cases

1. The complaints received in the appropriate form, manner, and complete in all respects, shall be registered by the Prosecution Directorate, and sent to the member or firm within 15 days of registration of such a complaint.
2. Depending on the category of the complaint, the Prosecution Directorate shall ask for and obtain necessary documents such as written statements, rejoinders, comments, and other evidence from the complainant as well as the respondent. The time frame for this should be, under normal circumstances, no more than 60 days. Not submitting such documents within the prescribed time shall be treated as an offence, risking the initiation of additional obstruction of justice proceedings.
3. On receipt of the relevant documents, the complaint, along with the views, if any, of the Prosecution Directorate, will be placed before the Disciplinary Committee. This has to be done within 20 days of receiving all relevant accompanying documents.

Procedure for dealing with information cases

1. Information received shall be examined by the Prosecution Directorate. After forming his views, the Director of the Prosecution Directorate will place the matter before the Secretary of ICAI.
2. If the Secretary agrees with the view expressed by the Director, then the information case will be placed before the Disciplinary Committee.
3. In the event of the Secretary differing with the views of the Director, the matter would be placed before the President of ICAI and, thereafter, it would be discussed at a meeting between the President, Secretary and the Director. If in this meeting, it is decided to refer the matter to the Disciplinary Committee, then reference be made accordingly. Upon such referral, the Prosecution Directorate shall argue the case before the Disciplinary Committee. If, however,

the Secretary and President of ICAI decide that the information should be filed and closed, then the Director of the Prosecution Directorate will have the choice to either follow the majority opinion, or dissent and refer such a case to the Disciplinary Committee, with his as well as the Secretary's and President's opinion. In such instances, however, the President shall not function as the Presiding Officer of the Disciplinary Committee. Further, if the Director Prosecution does not feel that a reference to the Disciplinary Committee is warranted, the Institute would still be free to take such cases to the Committee if it feels there is a need to do so.

4. After registering the 'information' case, the procedure outlined for the complaint case may be followed *mutatis mutandis*.

Disciplinary Committee

Enquiries in relation to misconduct of members shall be held by the Disciplinary Committee. To expedite decision-making, the Council of ICAI shall be empowered to constitute one or more bench of the Disciplinary Committees in cities where there are regional headquarters of ICAI.

Composition: Each bench should consist of five members. The President or the Vice-President of ICAI will be the Presiding Officer. However, in "information" cases put before the Committee by the Prosecution Director after disagreeing with the views of the President and the Secretary, the President shall not act as the Presiding Officer. In such cases, the Vice-President will perform this role. Two of the other four members will be nominees of ICAI's Council, while the remaining two will be nominees of the DCA viz. people of eminence, professional reputation and integrity such as, retired judges, bankers, professionals, educationists, economists, business executives, former members of regulatory authorities and former public officials. As far as practicable, members of the Disciplinary Committee should be from the regions other than the one in which it is being constituted.

It needs to be stated that in terms of the existing requirement, a nominee of the Central Government is required to be nominated to the Disciplinary Committee. Until very recently, such a nominee was an official of the DCA. However, DCA officials have rarely had the time to attend the meetings of the Disciplinary Committee. ***Hence, the Committee recommends that, given their pre-occupation in the department, ~~paucity of time,~~ a sitting government official should not be nominated to the Disciplinary Committee~~s~~****.*

It is pointed out that for each stage in the process, strict time lines should be prescribed. This is especially important in respect of scrutiny of "information cases".

Quorum: Three of the five members.

Tenure: Co-terminus with the duration of the ICAI Council.

Functions: The Disciplinary Committees shall hear the complaint and information cases referred by the Prosecution Directorate and record their decisions and conclusions in a report. This report shall also record the punishment to be awarded, if any, to the member, which can constitute (i) reprimand, (ii) removing the name of the member either permanently or for such a period as thought fit, (iii) monetary penalty, and/or (iv) a combination of any two.

Council

Any report submitted by the Disciplinary Committee should normally be considered by the Council within 45 days from the date of the report. It shall be the duty of the Council of ICAI to act upon the decisions of the Disciplinary Committee. While performing such a duty, the Council can:

1. Endorse the decisions of the Disciplinary Committee, and implement them.
2. Refer any case back to the Disciplinary Committee for further enquiry, when it finds that certain issues need further enquiry. However, in doing so, the Council will have to frame the specific issues.
3. Direct the Prosecution Directorate to place the case before the Appellate Body, in the event of the Council deciding to appeal against the decisions of the Disciplinary Committee.

Appellate Body

Headquartered in New Delhi, the Appellate Body shall consist of a Presiding Officer and four other members. The Presiding Officer shall be a retired judge of the Supreme Court or a retired Chief Justice of a High Court. Two members shall be Past Presidents of ICAI, nominated by the Council. The remaining two shall be persons of eminence nominated by the DCA (but excluding any officer of the Department or member of the Council). The quorum shall be three.

Publication of decisions of the Disciplinary Committee

- Due publicity shall be given by the Prosecution Directorate about the punishment ultimately awarded, through periodicals, newsletters, website and any other means considered appropriate. However, no decision taken by the Disciplinary Committee be published unless and until the punishment is endorsed and implemented by the Council.

Funding

1. Appellate Body: Required funding arrangements should be made by the Central Government. This is essential for ensuring independence, and on the ground that the High Court stage can be said to have been always funded by the Government.
2. Disciplinary Committee: The expenses shall be borne by ICAI's Council, which shall also fix the emoluments, sitting fees, allowances, and other expenses of the members.
3. Prosecution Directorate: All expenses will be borne by the Council of ICAI.
4. Every complaint, other than a complaint made by or on behalf of the Central or any State Government shall be accompanied by a fee Rs.5,000, which will be returned as soon as the

Disciplinary Committee recommends that case is not frivolous. Fees not refunded for frivolous cases will be used to partly defray the cost of investigation.

3.27 Independent disciplinary mechanisms may be designed on similar lines in respect of Company Secretaries and Cost Accountants. The Committee believes that the mechanism outlined above is realistic and should work, given adequate funding and determination. This should bring to bear a transparent and expeditious disciplinary procedure that could contribute to enhancing the prestige and public trust that the Institutes have today.

4

Independent Directors: Role, Remuneration and Training

4.01 At the core of corporate governance lies the board of directors. A joint-stock company is owned by the shareholders, who appoint a board of directors to supervise and direct the management of the company and ensure that the board does all that is necessary by legal and ethical means to make the business grow to maximise long-term corporate value.

4.02 The first point to be noted is the one that is usually forgotten: *viz.*, that the board is appointed by the shareholders and other key stakeholders, and are accountable to them. Simply put, the *directors are fiduciaries of shareholders, not of the management.* This does not imply that the board must have an adversarial relationship with the CEO and top management. Far from it. Most successful boards have remarkable collegiality and, more often than not, agree to most managerial initiatives. However, in instances where the objectives of management differ from those of the wide body of shareholders, the non-executive directors on the board must be able to speak up in the interest of the ultimate owners and discharge their fiduciary oversight functions. This is the reason why 'independence' has become such a critical issue in determining the composition of any board.

4.03 It was forcefully argued before us that while the Government does not hesitate to legislate for ~~a large number of~~great expectations from independent directors, its own record of nominating directors on boards of public sector companies or banks has been less than exemplary. The Committee feels that just as the Government would like non-government companies to have ~~fiercely~~ independent directors of ~~exemplary~~ quality, it too should start nominating its directors on the basis of merit, rather than ~~the narrow~~ considerations that ~~require no explanation~~need no elaboration.

Definition of Independence

4.04 What, then, defines independence of directors? This is an issue that has vexed the minds of most corporate governance experts and has spawned myriad definitions. At the core, it means something very simple — a person should be able to exercise his or her reasoned judgement without being constrained or unduly influenced by pressures either from management or any dominant shareholder or stakeholder. To rephrase Bertolt Brecht, independence is a bit like communism: very easy to understand, very hard to achieve.

4.05 As a starter, an independent director must be a non-executive member of the board. This is obvious and doesn't require elaboration. However, that is only the starting point. Independence is more than just being a non-executive director. The questions are: How much more? And how much of it should be mandated? The *Report of the Kumar Mangalam Birla Committee on Corporate Governance* (January 2000) discussed this matter and arrived at the definition given below:

> "Independent directors are [those] who apart from receiving director's remuneration do not have any material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may affect their independence of judgement." [p.13].

4.06 In arriving at this definition — now mandated for listed companies through Clause 49 of the listing agreement — the Birla Committee was concerned that while "independence should be suitably, correctly and pragmatically defined", it should be "sufficiently broad and flexible" so that it did not "become a constraint in the choice of independent directors on the boards of companies".

4.07 While there might be merit in the pragmatism of the Birla Committee, we believe that the time has come to move away from such a circular and almost tautological definition and examine alternatives that follow the spirit of the Birla Committee while being in line with best international practices. There are five key reasons which have prompted us to examine somewhat more rigorous definitions.

- First, thanks to Enron, Worldcom, Global Crossing and other international corporate scandals, much water has flown since January 2000 and today. In such a context, we believe that an inherently loose definition of independence will no longer suffice to attract domestic as well as international investor confidence.
- Secondly, capital markets are now getting closely integrated. For instance, there are virtually no constraints today on either foreign equity funds investing in India or in Indian companies listing in the US or elsewhere. A definition of independence that is at considerable variance from other relevant international yardsticks can diminish the ability of Indian corporations to tap global risk capital

at international prices — something that our companies have to do to grow in an increasingly globally competitive milieu.

- Thirdly, global agencies such as Standard & Poor have already begun to rate companies according to corporate governance standards. Domestic rating agencies like CRISIL and ICRA have also got into this act. It is, therefore, both meaningful and strategically important for us to reconsider the Birla Committee definition and raise the bar.
- Fourthly, in the course of our meeting with various stakeholders, we have felt that Indian investors, too, would be more comfortable with a somewhat tighter definition of independence.
- Fifthly, while there seems to be shortage of adequate independent directors, we believe that this is neither a reflection of a serious supply problem, nor one arising out of the definition of independence. Simply put, there are enough capable people in India to play key fiduciary roles in boards of Group A, B1 and B2 companies — which together account for almost 95 per cent of market capitalisation. Good independent directors are not ubiquitous enough because they are not sought enough by companies, and because they are not adequately compensated for their time. If the compensation problem is taken care of, then it is feasible to attract better talent on boards, despite a more stringent definition of independence.

4.08 This brings us to various international definitions of independence. We examined definitions of General Motors Board Guidelines, Australia's IFSA guidelines, France's Hellebuyck Commission recommendations, the Hermes Statement, PIRC Guidelines, CalPERS Core Principles and Guidelines, TIAA-CREF Policy Statement, AFL-CIO Voting Guidelines, and several other recent ones.

4.09 After going through these, and keeping in mind pragmatic ~~issues~~factors, the Committee came to the conclusion that the definition of independence can be made more precise without either compromising the spirit of independence or constraining the supply of independent directors.

Recommendation 4.1: Defining an independent director

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

1. Apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;
2. Is not related to promoters or management at the board level, or one level below the board (spouse and dependent, parents, children or siblings);
3. Has not been an executive of the company in the last three years;
4. Is not a partner or an executive of the statutory auditing firm, the internal audit firm that are associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity.
5. Is not a significant supplier, vendor or customer of the company;
6. Is not a substantial shareholder of the company, i.e. owning 2 per cent or more of the block of voting shares;
7. Has not been a director, independent or otherwise, of the company for more than three terms of three years each (not exceeding nine years in any case);

- An employee, executive director or nominee of any bank, financial institution, corporations or trustees of debenture and bond holders, who is normally called a 'nominee director' will be excluded from the pool of directors in the determination of the number of independent directors. In other words, such a director will not feature either in the numerator or the denominator.
- Moreover, if an executive in, say, Company X becomes an non-executive director in another Company Y, while another executive of Company Y becomes a non-executive director in Company X, then neither will be treated as an independent director.
- The Committee recommends that the above criteria be made applicable for all listed companies, as well as unlisted public limited companies with a ~~paid~~ paid-up share capital and free reserves of Rs.10 crore and above or turnover of Rs.50 crore and above with effect from the financial year beginning 2003.

Composition and Size of the Board

4.10 According to the Birla Committee (and now in Clause 49 of the listing agreement as well as the Companies Act), at least 50 per cent of the board of a listed company should consist of non-executive directors. Furthermore, in the case of there being a non-executive Chairman, at least a third of the board should be independent directors; and if the Chairman is an executive, at least half the board should be independent.

4.11 We believe that there is no reason to make complex distinctions between non-executives and independents, or to create two different standards depending upon the executive or non-executive status of a corporate chairman. Further, the Committee felt that to be really effective, independent directors need to have a substantial voice, by being in a majority. In a country where promoters are directors in a large number of companies, there was obviously a counter view. On the balance, however, it was felt that rather than the management or the promoters, the Committee should put its weight behind minority shareholders and other stakeholders such as consumer or creditors. ~~Time has come for this board composition requirement to be simultaneously simplified and strengthened.~~ A question also arose regarding the ‘independence’, or otherwise, of the nominee directors of financial institutions. On one hand, it was felt that since these directors were not functional directors and had no personal interest, as such, in the company, they could be considered to be independent; on the other, it was argued that as representatives of the major creditors, these directors had a particular interest to safeguard, and could hardly be deemed to be independent from the point of view of other stakeholders and minority shareholders. The Committee, therefore, decided that in implementing the following recommendation, nominee directors should not be counted either towards the numerator, or the denominator.

Recommendation 4.2: Percentage of independent directors

No less than 50 per cent of the board of directors of any listed company, as well as unlisted public limited companies with a paid-up share capital and free reserves of Rs.10 crore and above, or turnover of Rs.50 crore and above, should consist of independent directors – independence being defined in Recommendation 4.1 above.

However, this will not apply to: (1) unlisted public companies, which have no more than 50 shareholders and which are without debt of any kind from the public, banks, or financial institutions, as long as they do not change their character, (2) unlisted subsidiaries of listed companies.

Nominee directors will be excluded both from the numerator and the denominator.

4.12 The Committee believes that Recommendations 4.1 and 4.2 will not only build upon the corporate governance measures already mandated by SEBI and the DCA, but also foster greater transparency through clearly verifiable, non-discretionary ~~metrics~~criteria. For instance, in the last two years, the discretion implicit in the phrase, “which in the judgement of the board…” has been often employed to classify several non-executives as independent directors — an arrangement that would have clearly failed the objective criteria set out in Recommendation 4.1.

4.13 Determining the ‘right’ size of a board is the matter for individual companies, and not a Government-appointed Committee such as ours. However, public limited companies access larger amounts of risk capital than their private limited counterparts; and listed companies access even larger risk capital and also have much more widely dispersed share-~~-~~ownership. The negative effects of corporate scandals and concomitant failures, therefore, are much more for listed and large non-listed public limited companies than for the private limited ones. Given the greater fiduciary responsibilities of boards of listed and large unlisted public limited companies, the Committee felt that there is a case to suggest the minimum board size.

Recommendation 4.3: Minimum board size of listed companies

The minimum board size of all listed companies, as well as unlisted public limited companies with a ~~paid ~~paid-up share capital and free reserves of Rs.10 crore and above, or turnover of Rs.50 crore and above should be seven – of which at least four should be independent directors.

However, this will not apply to: (1) unlisted public companies, which have no more than 50 shareholders and which are without debt of any kind from the public, banks, or financial institutions, as long as they do not change their character, (2) unlisted subsidiaries of listed companies.

Ensuring Independence of Judgement

4.14 Defining independence is necessary, but not sufficient to ensure independence of judgement. That has much to do with the choice of directors and the skills that they bring to the board; the conduct of board meetings; the quality and quantity of financial, operational and strategic information supplied by the management to the board; management's appetite for independent evaluation and criticism of strategies and performance; the extent to which promoters and management truly want healthy debate and independent oversight; the *de facto* role of the various committees of the board; and, of course, how much a company is willing to pay for the experience and skill sets of professional, independent directors.

4.15 Many of these aspects are, and should be, beyond the pale of law and regulation. They are, nevertheless, critical. And it is therefore necessary to discuss some of them in reasonable detail.

Choice of directors and their skill sets

4.16 While it is important to follow the laws and regulations defining corporate governance, it should be self-evident that independent directors ought not to be chosen merely to comply with statutory requirements. Independent directors of respected, well-governed, board-driven companies are usually acclaimed professionals who possess clearly defined skills and attributes and requisite experience.

4.17 Naturally, the skill sets needed at the board level will vary across corporations as well as over time. However, international experience suggests that all boards benefit from a few specialised skills. One of these is financial expertise. At least one — and preferably two or three — independent directors ought to possess sound financial knowledge. This does not imply that such a director or directors necessarily must be chartered accountants. However, they should have sufficient skills and experience to carefully read profit and loss accounts, balance sheets, cash flow statements, notes on accounts, significant accounting policies, qualifications (if any), question internal and statutory auditors about their audit findings, and be able to satisfactorily conduct meaningful Audit Committee proceedings.

4.18 With global competition becoming more intense than ever before, the Committee also felt that it would be useful for boards to have independent directors who can comment, if not lead discussions, on a company's business strategies, as well as its strengths, weaknesses, opportunities and threats. Despite major strides in corporate governance and disclosures in the last five years, most companies — including those listed in Groups A and B1 — still do not have enough independent directors who can contribute in this field.

4.19 Equally, given discontinuous leaps in the knowledge component of any product or service, human resource development has become a critical issue. How to design policies and strategies that attract, identify, nurture, motivate and reward the best talent — and penalise the chronic under-performers — will be more and more critical in separating the corporate winners from the also-rans. Here, too, the Committee felt that boards will benefit enormously from the services of those who have HR expertise.

4.20 The Committee noted four other areas that are also rapidly gaining prominence in ~~the business of~~ modern business. These are (i) integrated logistics and end-to-end supply chains, (ii) R&D, (iii) the creation, maintenance and scalability of web-based IT systems that deal with internal processes as well as relationships with customers and vendors, and (iv) sophisticated, transparent investor relations. All these are key management functions where the initial expertise may be sought from various consulting firms and specialised service providers. Nevertheless, the Committee felt that it might be useful to have one or more independent director with ~~more than passing~~some knowledge of these subjects.

4.21 These are not matters for mandating. The point to be emphasised is that the fiduciary responsibility of a board of directors goes far beyond ticking an exhaustive compliance check-list. No doubt, the compliance function is important, and has to be discharged with due diligence. Like quality, compliance is an irreducible given. However, boards of truly great global companies do much more than compliance. They strategise, help locate key inputs, identify growth drivers, steer the company from icebergs and shoals and, thereby play a critical role in maximising long-term corporate value. The Committee believes that better search processes, less onerous liabilities and significantly higher compensation for independent directors will help identify and induct much more talent into corporate boards of India.

4.22 The other point worth noting is that excellence attracts excellence. Respected, well--run and transparent companies in India have never faced the problem of getting top class independent directors. The market knows that such companies choose the best-in-class people, and give them the oversight strategic space that they would ordinarily expect. The Committee, therefore, urges companies in India to make a sustained effort to attract requisite talent at the board level — people who can contribute their expertise to make a difference not only to governance, but also to long-term corporate performance.

Duration and conduct of board meetings

4.23 With our penchant to legislate and regulate as much as possible, boards of Indian companies have always been over-burdened with a plethora of regulatory and statutory resolutions. If anything, these have significantly increased with Clause 49 of the listing agreement and recent amendments in the Companies Act. A typical quarterly or half-yearly board meeting can have anything between 25 to 30 resolutions that have to be debated and passed only in order to satisfy legal and regulatory requirements. Taken together, these resolutions can take up as much as an hour of the board's time. Of course, the number of statutory functions increase significantly at the time of considering annual audited accounts.

4.24 A cursory glance at the timings of many board meetings will reveal that they begin somewhere between 10.30 am and 11 am, and conclude by 1 pm to 1.30 pm —in time for a well-earned lunch. Given the increasing amount of time needed to deal with pure regulatory and compliance issues, the Committee wondered how the boards and Audit Committees of a large number of Indian companies could have discharged their compliance obligations as well as their strategic functions in less than half a day.

4.25 It is not only difficult but also undesirable to mandate somewhat longer board meetings. Nevertheless, the Committee felt that there ought to be some disclosure about the timings of a listed company's board and Audit Committee meetings. For that would allow shareholders to know how much time their appointed fiduciaries formally spend in discharging their oversight duties.

Recommendation 4.4: Disclosure on duration of board meetings / Committee meetings

The minutes of board meetings and Audit Committee meetings of all listed companies, as well as unlisted public limited companies with a ~~paid~~ paid-up share capital and free reserves of Rs.10 crore and above or turnover of Rs.50 crore must disclose the timing and duration of each such meeting, in addition to the date and members in attendance.

4.26 This is not a radical suggestion. Clause 49 already mandates that listed companies must fully disclose the attendance records of directors at board and board-level committee meetings in their annual report — a recommendation that was adopted from the Confederation of Indian Industry's *Desirable Corporate Governance: A Code* (April 1998). This disclosure has played a major role in exposing absentee directors and, in many instances, has forced them to either improve their attendance or exit from the boards. The Committee believes that the additional disclosure mandated in Recommendation 4.4 will induce companies to allocate more time for their board and committee meetings which should, hopefully, improve their agenda and scope.

Tele-conferences and Video conferences

4.27 Members of the Committee felt that while all best-in-class independent directors have the ability and motivation to fully discharge their fiduciary duties, they occasionally find it difficult to attend board meetings. This is especially true for international directors — such as strategists and professors of business schools who are increasingly joining the boards of well-run companies. For them, it is sometimes difficult to travel for three days to attend two days of board and committee meetings. In today's age of communication, this problem can be easily resolved.

Recommendation 4.5: Tele-conferencing and video 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 proceedings of a tele-conference 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 should be signed and confirmed by the director/s who has/have attended the meeting through video conferencing.

Financial and non-financial information at the board level

4.28 Clause 49 of the listing agreement clearly mandates the information that must be placed before the board of directors. Adopted from the *Report of the Working Group on the Companies Act* (1997) ~~and the CII code~~, ~~the~~ these disclosures are:

- Annual operating plans and budgets, and up-dates.
- Capital budgets and updates.
- Quarterly results for the company, and its operating divisions or business segments.
- Minutes of meetings of the audit committee and other committees of the board.
- Information on recruitment and remuneration of senior officers just below the board level, including appointment and removal of the CFO and the Company Secretary.
- Show cause, demand and prosecution notices which are materially important.
- Fatal or serious accidents, dangerous occurrences, and any material effluent or pollution problems.
- Material default in financial obligations to and by the company, or substantial non-payment for goods sold by the company.
- Any issue which involves possible public or product liability claims of a substantial nature, including any judgement or order which may have either passed strictures on the conduct of the company, or taken an adverse view regarding another enterprise that can have negative implications for the company.
- Details of any joint venture or collaboration agreement.
- Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
- Labour problems and their proposed solutions.
- Materially significant sale of investments, subsidiaries and assets which re not in the normal course of business.
- Quarterly details of foreign exchange exposure, and the steps taken by management to limit the risks of adverse exchange rate movement, if material.

- Non-compliance of any regulatory, statutory nature or listing requirements, and shareholder services such as non-payment of dividends, delay in share transfer, etc.

4.29 The Committee believes that this list of mandated disclosures is adequate to properly inform independent directors about the basic financial and non-financial state of the company. Only one more disclosure needs to be specified, and it relates to the press releases and analysts' presentations made by companies.

> **Recommendation 4.6: Additional disclosure to directors**
>
> In addition to the disclosures specified in Clause 49 under 'Information to be placed before the board of directors', all listed companies, as well as unlisted public limited companies with a ~~paid~~ paid-up share capital and free reserves of Rs.10 crore and above, or turnover of Rs.50 crore and above, should transmit all press releases and presentation to analysts to all board members. This will further help in keeping independent directors informed of how the company is projecting itself to the general public as well as a body of informed investors.

4.30 Besides this, nothing further needs to be done at this stage to increase the list of minimum mandated disclosures at the board level. Having said this, it is necessary to observe that good board-driven companies usually spend one to two extra days each year for a 'strategy retreat' — where board members together with senior management discuss different dimensions of the company's strategic map for the next few years.

Audit Committee and its Independence

4.31 Audit Committees are now mandatory under the Companies Act as well as Clause 49 of the listing agreement. Moreover, over three closely typed pages, Clause 49 exhaustively sets out the role, composition, functions and powers of such a committee, which are in line with some of the most stringent international standards — itself a testimony of the SEBI's and DCA's commitment to corporate governance. The law can hardly be bettered. And the Committee sees no reason to reproduce in this report the mandated Audit Committee guidelines in Clause 49 of the listing agreement. Readers can refer to these by looking up SEBI's website (www.sebi.gov.in).

4.32 One area, however, requires some legislative change. Clause 49 says that the Audit Committee of listed companies must consist exclusively of non-executive directors, of whom the majority must be independent. The Committee felt that this needed some improvement and tightening. There were doubts on the advisability of excluding nominee directors of financial institutions from audit committees. The Committee preferred to be consistent in not considering directors with a certain mandate to be really independent.

Recommendation 4.7: Independent directors on Audit Committees of listed companies

Audit Committees of all listed companies, as well as unlisted public limited companies with a paid-up share capital and free reserves of Rs.10 crore and above, or turnover of Rs.50 crore and above, should consist exclusively of independent directors, as defined in Recommendation 4.1.

However, this will not apply to: (1) unlisted public companies, which have no more than 50 shareholders and which are without debt of any kind from the public, banks, or financial institutions, as long as they do not change their character, (2) unlisted subsidiaries of listed companies.

4.33 No doubt, all Audit Committees claim to do what is mandated. It is, however, moot whether Audit Committees of most listed and unlisted public limited companies have the capability or inclination to follow the spirit of the law. There are four major reasons why many Audit Committees are not functioning as well as they should.

4.34 First, there are skill gaps. While one member of the committee may be positioned as the one having “financial and accounting knowledge”, it is worth asking how deep that knowledge is, especially given the new accounting standards and complexities. Incidentally, this is not a unique Indian problem. Many Audit Committees of Fortune 1000 US corporations face similar problems.

4.35 Secondly, it takes a considerable amount of additional time for an Audit Committee to successfully discharge its obligations in letter and ~~in~~ spirit. The members have to review internal audit processes, have detailed discussions with internal as well as statutory auditors, independently meet with the CFO and the finance team, examine audit plans, review the adequacy of internal control systems, follow up on fraud or irregularities, if any, evaluate the company’s risk management policies, get a fix on all materially significant legal agreements, look into all key aspects of the financial reporting process, ensure compliance with financial, accounting and stock exchange standards, and much more. These have to be done every quarter, and much more intensively before adopting the annual audited accounts.

4.36 Such tasks are quite substantial even for Audit Committees of companies known for their excellent financial housekeeping. They are monumental for others. In the early stages — the 12- to 18-month period that is needed for well intentioned companies to get their financial hygiene in order — it can take an Audit Committee five to seven additional working days per year for it to dutifully discharge its obligations. Few, if any, Audit Committee members are willing to commit to this extra time.

4.37 Thirdly, the problem gets compounded by inadequate remuneration of directors. Very few companies offer commissions on profits to the independent directors. And loss-making companies — where Audit Committee tasks are all the more critical — can offer no commission whatsoever. Naturally, nobody except one who is seeped in altruism will want to spend an extra five to seven days doing Audit Committee work, all for a sitting fee of Rs.5,000. So they don't.

4.38 Fourthly, there is the issue of selective monitoring by regulators. All companies faithfully report the composition of their Audit Committees and frequency of such meetings, and synopsise their role and functions ~~of from Clause 49~~. More often than not, that is what constitutes the typical annual report disclosure. And the regulators and stock exchanges accept these 'reports' as such. Indeed, it could be argued that what is perhaps the most important statutory reform in corporate governance has not been adequately monitored by the SEBI, DCA or the relevant stock exchanges.

4.39 ~~Under~~ In the present circumstances — lack of skill, the extra time dimension, paltry compensation for directors, and inadequate regulatory oversight — it would be heroic to assume that most Audit Committees would immediately tone up their act and become best-in-class overnight. That would require significant upward revision of independent directors' remuneration going hand in ~~glove~~ hand with some additional disclosures. However, it is also true that the process of change has definitely begun. At least two dozen Group A and a dozen Group B1 companies are now reported to have good Audit Committees — a significant improvement compared to five years ago. If we get the compensation, additional disclosures right and mitigate some of the unnecessary liabilities of independent directors, we should be able to have, in the next three to five years, well-performing Audit Committees for companies that together represent at least 75 per cent of India's market capitalisation. ~~That would rank among the best in the world.~~

4.40 In what remains of this section, we set out recommendations on the desirability of having Audit Committee charters, and on a set of disclosures that ought to be mandatory for such committees.

Recommendation 4.8: Audit Committee charter

- In addition to disclosing the names of members of the Audit Committee and the dates and frequency of meetings, the Chairman of the Audit Committee must annually certify whether and to what extent each of the functions listed in the Audit Committee Charter were discharged in the course of the year. This will serve as the Committee's 'action taken report' to the shareholders.
- This disclosure shall also give a succinct but accurate report of the tasks performed by the Audit Committee, which would include, among others, the Audit Committee's views on the adequacy of internal control systems, perceptions of risks and, in the event of any

qualifications, why the Audit Committee accepted and recommended the financial statements with qualifications. The statement should also certify whether the Audit Committee met with the statutory and internal auditors of the company without the presence of management, and whether such meetings revealed materially significant issues or risks.

4.41 We now move on to three key issues: remuneration of independent directors, legal liabilities of non-executive and independent directors, and the training of directors. The Committee wishes to emphasise that without addressing these three issues, one cannot expect sustainable, long-term reforms in corporate governance.

Remuneration of Independent Directors

4.42 The maximum sitting fee permitted by the DCA is Rs.5,000. Small wonder, then, that it is virtually impossible to get independent directors, except from the class of retired people and those who feel important by claiming that they are on many boards.

4.43 Some might argue that sitting fees underestimate independent directors' pay. Profit-making companies are permitted to pay up to 1 per cent of their net profits as commission to the independent directors, and this could be quite a handsome amount in the Indian context. The argument is flawed logically and empirically. A look at the annual reports of the 3,723 companies belonging to Groups A, B1 and B2 of the BSE will reveal that no more than 5 per cent of this sample pay a commission on profits. To give an example, neither banks nor public sector enterprises can pay commissions to their independent directors.

4.44 The logical flaw is more severe. The need of the day is to get independent directors of the highest standards of skill and probity to discharge critical oversight functions for loss-making companies and help them to turn around. Consider two examples: one of a company whose profits have reduced from Rs.100 crore to Rs.10 crore over three years; and another of a company whose losses have been brought down from Rs.100 crore to Rs.10 crore over the same period. The independent directors of the former — who have presided over the decline in national wealth — can, in addition to their sitting fees, still share a commission of Rs.10 lakh. Their counterparts in the latter — who have supervised the re-building of national wealth — can only get their sitting fees.

4.45 In such a context, it is not surprising that non-profit making companies cannot get the services of the best independent directors, even though these are precisely the entities where such services are most needed. The Committee believes that we as a nation cannot hope to get the best talent on to the board rooms of corporate India with such remuneration structures. It is time for a major revamp.

Recommendation 4.9: Remuneration of non-executive directors

- The statutory limit on sitting fees should be reviewed, although ideally it should be a matter to be resolved between the ~~company~~ management and ~~its~~ the shareholders.
- In addition, loss-making companies should be permitted by the DCA to pay special fees to any independent director, subject to reasonable caps, in order to attract the best restructuring and strategic talent~~s~~ to the boards of such companies.
- The present provisions relating to stock options, and to the 1 per cent commission on net profits, is adequate and does not, at present, need any revision. However, the vesting schedule of stock options should be staggered over at least three years, so as to align the independent and executive directors, as well as managers two levels below the Board, with the long-~~-~~term profitability and value of the company.

4.46 The Committee believes that, if implemented, Recommendation 4.9 will play a major role in increasing the supply of first-~~-~~rate independent directors and, in the process, genuinely improve the quality of boards throughout the country. The converse is equally true. ~~Without~~ Not implementing such a recommendation will stultify ~~widespread~~ corporate governance reforms — which have just begun to take root in India.

Liabilities of Non-Executive and Independent Directors

4.47 No one would deny that, by virtue of being a fiduciary, an independent director must be liable for certain explicitly proven acts of omission and commission. For instance, wrongful disclosures by the Chairman and members of the Audit Committee in a company's annual report should attract ~~dismissal~~ disqualification and stringent penalties. Equally, if non-executive directors had knowledge of unlawful acts by the management or the board and, despite such information, failed to act according to ~~the~~ law, then they should be certainly legally liable for such infringements.

4.48 It is also true that Indian case law distinguishes between the liabilities of executive directors and their non-executive or independent counterparts. Section 5 of the Companies Act clearly defines an officer ~~who is~~ in default for contraventions committed by a company. These are (i) the managing director(s); (ii) executive or whole-time director(s); (iii) manager(s); (iv) the Company Secretary; (v) any person in accordance with whose instructions the board is accustomed to act; and (vi) any person who has been entrusted and charged by the board to be an officer in default, subject to his/her consent. It is only when none of these conditions hold that the board in its totality is considered liable as the officer ~~who is~~ in default under the Companies Act. Moreover, the DCA in a circular of 24 June 1994 further clarified that non-executive, independent directors would ordinarily not be prosecutable for corporate offences. Case law has also upheld this view.

4.49 Therefore, it would seem that non-executive, independent directors are generally far less liable for infringements of provisions in the Companies Act than their executive counterparts.

4.50 However, several bodies, associations and professionals who deposed before the Committee have expressed their concerns about criminal liabilities that fall upon independent directors on account of breaches in other laws. The Committee has been specifically informed about the serious liabilities arising out of:

- The Companies Act — various provisions, such as those relating to filing of statement of affairs in winding up proceedings, non filing of Annual Reports with ROC, default in payment of debt etc.
- The Negotiable Instruments Act — especially section 138 which deals with bouncing and dishonouring of cheques (issued by the management of the company).
- The Factories Act — under which there have been repeated instances of non-executive directors, along with the occupier, being issued non-bailable arrest warrants.

- The Industrial Disputes Act — under which, like the Factories Act independent directors have been threatened with prosecution along with executive directors and managers.
- The Provident Fund Act and the Employees State Insurance Act — where outside directors have been threatened with criminal prosecution for a company's non-payment of provident fund or pension dues, even in instances where there have been only technical infringements.
- The Electricity Supply Act — under which electricity suppliers, especially the State Electricity Boards have brought cases of criminal breach of trust against all directors of companies irrespective of whether they are executive or non-executive and independent.

4.51 Not even the most stringent international tenet of corporate governance and oversight assumes that an independent director — who interfaces with the management for no more than two days every quarter — will be in the know of every technical infringement committed by the management of a company in its normal course of activity. Indeed, making independent board members criminally liable for such infringements is akin to assuming that they are, in effect, no different from executive directors and the management of a company. This is certainly not the case, and there is nothing in the literature of ~~the~~ corporate governance to even remotely suggest that the role of an independent director is identical to that of his executive brethren. In fact, the principle is quite the opposite: independent directors are not managers; they are fiduciaries who perform wider oversight functions over management and executive directors.

4.52 At a more practical level, the Committee is of the opinion that it would be very difficult to attract high quality independent directors on the boards of Indian companies if they have to constantly worry about serious criminal liabilities under different Acts.

Recommendation 4.10: Exempting non-executive directors from certain liabilities

Time has come to insert provisions in the definitions chapter of certain Acts to specifically exempt non-executive and independent directors from such criminal and civil liabilities. An illustrative list of these Acts are the Companies Act, Negotiable Instruments Act, Provident Fund Act, ESI Act, Factories Act, Industrial Disputes Act and the Electricity Supply~~ies~~ Act.

Independent directors should also be indemnified from litigation and other related costs, as outlined in paragraph 4.54.

4.53 Going forward, there is one possible legal issue that has concerned members of the Committee. Clause 49 of the listing agreement as well as the new corporate governance provisions in the Companies Act ~~seem to~~ have created three strata of directors: executive directors, non-executive/independent directors who are members or chairmen of Audit Committees, and other non-executive/independent directors. Clearly, executive directors are, and ought to be, more liable than their non-executive or independent counterparts. But, given the well-~~-~~defined legal responsibilities of the chairmen and members of Audit Committees, it could be argued by some plaintiff or another that they are more liable than other non-executive or independent directors. In fact, in a recent case, the US Federal Court in Delaware ruled that members of the Audit Committee have a different relationship to the company than other non-executive, non-employee directors (Reliance Securities Litigation, District Delaware, 2001). It should not surprise us that such an argument could be raised, and a ruling made, in an Indian court as well.

4.54 ~~Under~~ In such circumstances, the Committee feels that it would be prudent for companies to purchase a reasonable amount of directors’ and officers’ (D&O) insurance. This should cover independent directors even after they have ceased to be directors, if the offences relate to the period when they were directors. Such policies pay for the cost of litigation and pecuniary penalties, if any, and hence mitigate the corporate and individual risk of being an independent director.

Training of Independent Directors

4.55 Finally, there is the~~a~~ problem in India about the training of directors. A professional might~~ay~~ be able to give excellent corporate advice and guide a company in ways that maximise long-term shareholder value. But he or she might not be aware of the nitty-gritty of the rights, responsibilities, duties and liabilities of a legally recognised fiduciary. Barring corporate lawyers, chartered accountants and company secretaries, these technical aspects are not obvious to some of the best qualified directors. Fully understanding such issues requires ~~concentrated~~ specialised training.

4.56 Consider the minimal size of the task. Even if we were to limit the exercise to only listed companies belonging to Groups A, B1 and B2 of the BSE, we are still looking at 3,723 companies. Assuming an average board size of 7, and that 4 of them are independent directors, there will be almost 15,000 such directors coming on to corporate boards. More than two-thirds of such directors will need at least a couple of days of formal training. This is a mammoth mission. Even if one were to further limit this to Groups A and B1, we are talking about 776 companies and over 3,000 independent directors. This is ~~no less~~ an stupendous task.

4.57 The Committee understands that some business schools, few industry associations such as the CII and FICCI, and professional bodies such as the ICAI and ICSI are aware of the magnitude of the ~~issue~~task. Some have also begun training and workshop programmes in selected cities of India. However, given the sheer size of the task, there is a need to recognise that DCA has a special role in promoting and encouraging training programmes in leading institutions such as the Indian Institutes of Management, industry associations, other institutes of repute, and in the Centre for Corporate Excellence that they intend to set up.

Recommendation 4.11: Training of independent directors

- DCA should encourage institutions of prominence including their proposed Centre for Corporate Excellence to have regular training programmes for independent directors. In framing the programmes, and for other preparatory work, funding could possibly come from the IEPF.
- All independent directors should be required to attend at least one such training course before assuming responsibilities as an independent director, or, considering that ~~inner~~ enough programmes might~~may~~ not be available in the initial years, within one year of becoming an independent director. An untrained independent director should be disqualified under s~~S~~ection 274(1)(g) of the Companies Act, 1956 after being given reasonable notice.
- Considering that enough training institutions and programmes might~~may~~ not be available in the initial years, this requirement may be introduced in a phased manner, so that the larger listed companies are covered first.
- The executing bodies must clearly state their plan for the year and their funding should be directly proportionate to the extent to which they execute such plans.
- There should be a 'trainee~~student~~ appraisal' system to judge the quality of the programme and so help decide, in the second round, which agencies should be given a greater role and which should be dropped.

4.58 The Committee believes that the funding requirement is quite ~~minimal~~ modest — no more than Rs.5 crore to Rs.7 crore per year. The benefits are huge. A methodical execution of such a coherent training programme will create the knowledge base needed for otherwise very capable men and women to be first-~~-~~rate independent directors.

5

Other Recommendations

~~The Roles of DCA and SEBI~~

5.01 With the abolition of the office of Controller of Capital Issues (CCI) in the Department of Economic Affairs, the work relating to public issues and regulation of the capital market has been entrusted to SEBI, set up under the Securities And Exchange Board of India Act, 1992.

5.02 The DCA administers the Companies Act, 1956, and provides for the regulation of companies from their birth (registration) to their death (winding up). There are about six lakh companies registered in India. Of these, about 9,000 have accessed the capital market and are, therefore, listed companies, subject to the discipline and the rigours of the SEBI Act and its regulations.

5.03 It has been strongly argued before the Committee that this has caused an increasing overlap, with adverse consequences. First, investors, companies and other stakeholders seem to be falling between the cracks. This was sufficiently demonstrated in the recent stock market investigations, when the suspect companies were inspected by both the DCA and SEBI, but neither was able to take effective action in providing relief to the investors, or quickly punishing the perpetrators. The lack of concerted action against vanishing companies was cited as another example of neither accepting responsibility for the subterfuge that could take place, and the remedial action that did not.

5.04 Secondly, there is considerable duplication. Several examples were placed before the Committee. The Government have set up an Investor Education and Protection Fund (IEPF) and an Investor Education and Protection Committee (IEPC) in accordance with section 205C of the Companies Act, 1956. In parallel, the SEBI has set up an Investor Education and Protection Fund/Committee at the same time. Similarly, section 210A of the Companies Act provides for setting up the National Advisory Committee on Accounting Standards (NACAS), and a national level c~~C~~ommittee has been accordingly set up. However, the SEBI, too, is prescribing accounting standards as part of its listing agreements under clause 49 of its regulations. Often, different directions are given on the same subject. For instance, the Companies Act allows presentation of accounts in an abridged form, while SEBI's listing requirements do not permit this.

5.05 While the SEBI should have the power to prescribe additional requirements for listed companies, it seems reasonable to the Committee that SEBI ought not to, in deference to the doctrine of 'occupied space', exercise its powers of subordinate legislation in areas where specific legislation exists — as in the Companies Act. It was pointed out to the Committee that section 11A of the SEBI Act is subject to the provisions of the Companies Act, which reinforces the Committee's view that SEBI may not legislate in matters that have already been legislated upon by Parliament.

5.06 The US Securities Exchanges Commission (SEC) model is often cited, in support of the comprehensive listing requirements being laid down by SEBI. The analogy is not on all fours, because the system in the USA is radically different. Company laws in the US are state subjects, and ~~companies are controlled by the state laws~~ the state laws control companies. Due to the strong federal character of the American polity, there is a great variance in the administration of companies from state to state. For instance, some states do not even require that company accounts have to be audited by public accountants. As a result, the SEC has had to perform a central unifying legal and regulatory role for companies listed on the stock exchanges. Since, in India, company law is a Central subject, and there is uniformity across the country, it is probably not necessary for SEBI to have ~~some~~ all of the powers of the SEC.[15] In any case, the Committee feels that there should be much greater consultations between the SEBI and the DCA prior to crafting materially significant laws and regulations.

Recommendation 5.1: SEBI and Subordinate Legislation

- ~~Wherever possible,~~ SEBI may refrain from exercising powers of subordinate legislation in areas where specific legislation exists as in the Companies Act, 1956.
- If any additional requirements are sought to be prescribed for listed companies, then, in areas where specific provision exists in the Companies Act, it would be appropriate for SEBI to have the requirement prescribed in the Companies Act itself through a suitable amendment.

[15] There are variations across different regulatory jurisdictions. For instance, the Financial Services Authority in the UK does not lay down accounting standards.

- In recognition of the fact that SEBI regulates activities in dynamic market conditions, the DCA should respond to SEBI's requirements quickly. In case the changes proposed by SEBI necessitate a change in the Companies Act, the DCA should agree to the requirement being mandated in clause 49 of SEBI regulation until the Act is amended.
- It would be appropriate for SEBI to use its powers of subordinate legislation, in consultation with the DCA, and *vice versa*. All committees set up either by SEBI or DCA to consider changes in law, rules or regulations should have representatives of both SEBI and DCA.
- A formal structure needs to be set up to ensure that the DCA, which regulates all companies, and SEBI, which regulates only listed companies, act in coordination and harmony.

Strengthening the DCA and ROC Infrastructure

5.07 With the current strength of officers in the Inspection Wing, the DCA is able to carry out only about 200 to 250 inspections per year. Consequently, instead of being a system of regular, random reviews, inspections have become instruments of a complaint-based regime. Naturally, then, there is stigma attached to each inspection carried out by the DCA. Worse, these inspections focus only on the contents of the complaint (often inspired, the Committee was told, by ~~corporate~~ rivals); there is no review of systems, or of practices being followed by companies. There is inadequate feedback on the difficulties that companies are facing in coping with the compliance of laws and practices prescribed by the department, or of the loopholes discovered by the unscrupulous.

5.08 The DCA informed the Committee that outsourcing work to professionals is also being considered. While supporting this proposal, the Committee felt that official manpower will still need to be augmented to do the traditional work more expeditiously, as well as to process the reports received from such professionals for launching remedial action. Given the phenomenal increase in the number of companies in the country, and even after accounting for the efficiencies resulting from the use of IT and selective outsourcing, the Government should consider setting norms for strengthening the inspection wing of DCA — especially by providing for, and encouraging, medium-term contractual appointments of relevant specialists. DCA should be enabled to annually inspect at least 6,000 registered companies, and that the Department would carry out such inspections regularly and on the basis of random selection.

5.09 The Committee also observed that the DCA's inspecting officers lack adequate transportation or communication facilities necessary for better discharge of their functions. Mobility is essential if DCA's inspectors are to do a timely and effective job. Perhaps because of the pressure of arrears and limited staff, the DCA has not actively pursued a programme of upgrading the skills of its inspectors. There is hardly any training programme worth the name. In fact, both in terms of their equipment and their skill sets, DCA's inspectors seem to be caught in a time-warp — trapped, as it were, in a mindset of the 1950s. DCA needs to re-fashion its inspection wing as a crack investigation team, well equipped not only in staff strength, but also in skills and knowledge of the dynamic corporate world in which they must now function.

5.10 Business and industry associations brought to the notice of the Committee that against a collection of about Rs.300 crore, the Government spends (as non-plan revenue expenditure) only about Rs.45 crore on providing services to companies through the DCA. As a result, the ROC and allied offices are ill-organised, ill-equipped, cramped, unfriendly and poorly furnished. Companies representations have stated that fees should not be treated as a source of income — and the quality of services provided should match the income ~~to~~ the Government realises from fees and charges.

5.11 It was also brought to the notice of the Committee that most of DCA offices are in cramped rented buildings, often without adequate space for visitors, or for public inspection of documents. This is a permanent Department of the Government, unlikely to be ever wound up. As such, there is a need for the DCA to establish its own buildings, which are modern offices, designed around its functional requirements. The Committee felt that this was as important as computerisation; in fact, to the extent that the DCA does not have its own requirement-defined buildings, the success of the computerisation programme would be diluted.

5.12. The ROC offices are clearly overstretched, as Table 1 below shows. In 1980, there were 3,100 companies per ROC. By 2001, the number of companies per ROC had risen to 28,500 — over a nine-fold increase. Similarly, number of documents being filed with each ROC, on the average, has risen from about 3,00,000 per ROC per year to over 28,00,000 per ROC. This has contributed to the declining standards of service, abysmal standards of maintenance and offices that are bursting at the seams. There is clearly a need to increase the number of ROCs offices to handle such large number of companies. While modernisation and computerisation will ensure that such an increase need not be in direct proportion, one cannot get away from the need to increase the number of ROC offices as well as staffing in each.

Table 1
Increase in workload of ROCs, from 1980 to 2001

Parameters	As on 31.3.1980	As on 31.3.1990	As on 13.3.2000	As on 31.3.2001
No. of ROCs	18	19	20	20
No. of companies	56,493	2,02,128	5,42,434	5,69,100
No. of documents @ 5 documents per company	2,82,465	10,10,640	27,12,170	28,45,500
No. of companies per ROC	3,139	10,638	27,122	28,455
No. of documents per ROC	15,693	53,192	1,35,609	1,42,275

5.13 The panacea seems to lie in outsourcing (including random scrutiny, and pre-certification), contractual appointments, computerisation, a continuous increase in staff strength on a normative basis, better transportation and communication facilities, and a regular honing of skills through training. The Committee felt that the Government's intent to clean up the corporate sector should, first of all, be reflected in cleaner, more efficient, professionally managed and client-friendly Government offices. The Government should lead by example.

Recommendation 5.2: Improving facilities in the DCA offices

- The Government should increase the strength of DCA's offices, and substantially increase the quality and quantity of its physical infrastructure, including computerisation.
- This should be accompanied by increased outsourcing of work, contractual appointments of specialists and computerisation – all of which will reduce, though not eliminate, the need to increase the officer-level strength of the Department.
- The inspection–capacity of the Department needs to be increased sharply; inspections should be a regular administrative function, carried out largely on random basis.
- Officers of the DCA need to go through refresher and training courses regularly. In view of the very dynamic world in which they function, continuous upgrading of their skills is essential

Corporate Serious Fraud Office (CSFO)

5.14 Economic and corporate growth in the country can not be sustained at the desired levels without large-scale public participation in corporate investments. The body of small investors must have adequate confidence in the market, directly, or even better, through the mutual funds. One important element of this faith is the ability of the regulator to quickly investigate ~~and punish~~ frauds and punish the guilty.

5.15 Investigations into the recent stock market 'scam' have underscored the limitations of a fragmented approach in our enforcement machinery. Though a number of agencies investigated the highly publicised fraud, none really got the holistic picture of what really happened. The chances of effectively punishing the fraudsters, in such a situation, are very slim.

5.16 Financial frauds in the corporate world are very complex in nature, and can be properly investigated only by a multi-disciplinary team of experts; there are limits to what even gifted amateurs can achieve, especially when they do not have a common platform and different enforcement agencies concerned play a lone hand from their respective turfs. There is a need to provide for a more concerted approach, perhaps by creating an office along the lines of the Serious Fraud Offices (SFO) in the United Kingdom.

5.17 The CSFO ~~could consist of the following~~ should consist of several multi-disciplinary teams of investigators – each team being entrusted with one, or a maximum of two investigations at one time. Such team or unit could consist of some, or all of the following, depending on the exigencies of the case:

- Two experts in company law, (chartered accountants/company secretaries) including one with experience in corporate management;
- One expert in taxation;
- One expert, with experience of launching prosecution in the area of economic offences;
- One expert in the area of overseeing or guiding research into cases of serious corporate malfeasance;
- One expert in the area of information technology, with ability to conduct IT audits (computer forensics);

- One expert in the field of criminal investigation ;
- One expert in forensic auditing ;and
- One expert on capital markets, with experience in regulation of capital markets and international financing.

5.18 The above posts, wherever suitable serving officials are available, may be filled by inducting officers on transfer/deputation. In other cases, competent persons would need to be inducted from outside the Government on contract. The Committee noted that such persons, especially in the fields of computer or audit forensics, or chartered accountants experienced in investigation of frauds (similar in qualification to the certified fraud examiners [CFE]), are unlikely to be available on government scales of pay. To provide necessary flexibility in this regard, t~~T~~he work of selection/appointment may be entrusted to a c~~C~~ommittee comprising the following:

- Cabinet Secretary
- Finance Secretary
- Secretary, Department of Company Affairs
- Secretary, Department of Revenue
- Secretary, Department of Personnel

5.1~~8~~9 The CSFO should only take up investigation of serious frauds characterised by complexity in the sense of having inter-departmental and multi-disciplinary ramification and involving large sums of money. Only a few cases on the most selective basis should be taken up at any given time.

5.~~19~~20 The success of operations to be entrusted to the proposed CSFO would chiefly depend upon the level of coordination that can be achieved among the various enforcement agencies. It would be prudent to anticipate inter-departmental disputes as one or the other agency would be reluctant to share with others the jurisdiction vested in it~~them~~ under law or extant orders of Government. It will be necessary, therefore, to provide for a high-level coordination ~~C~~committee to monitor, review and direct progress of cases handed over to the CSFO. The functioning of the CSFO should be overseen by a monitoring/review c~~C~~ommittee comprising the following:

- Cabinet Secretary ~~– Chairperson~~
- Secretary, Department of Company Affairs
- Finance Secretary (Secretary, Economic Affairs)~~/Chairman SEBI~~
- Secretary Revenue ~~Chairman CBDT/Chairman CBEC~~
- Law Secretary
- Dy. Governor, RBI
- Chairman SEBI
- Director CBI
- Director CSFO – Member Secretary

Whenever required Chairman CBDT/Chairman CBEC/Director Revenue Intelligence/Director of Enforcement may be invited as special invitees.

5.~~20~~21 The proposed mechanism should be able to coordinate the efforts required from the various agencies and regulators — which alone can generate the synergy required for achieving results. This ~~C~~committee itself should be empowered to sanction posts and expenditure for the CSFO. The CSFO should have the powers to launch investigation and prosecution under various laws, such as the Income Tax Act, Foreign Exchange Management Act, SEBI Act, etc apart from the Companies Act and the Indian Penal Code in respect of cases entrusted to the CSFO.

5.~~21~~22 Investigations by the CSFO should be directed to yield the following results:

- ~~A~~a quick unravelling of the fraud or scam, the persons who committed offences or were in the conspiracy, with the intent to bringing them to justice quickly;
- ~~M~~maximum recovery of the gains from the fraud, and the restoration of such assets/moneys to their rightful owners; and
- ~~I~~identification of weaknesses in law or monitoring and reporting systems etc. that have allowed the fraud to take place, to enable the Government to take corrective action.

5.~~22~~23 The Committee noted that in the USA, a Corporate Task Force envisaged as a SWAT team has been set up. The Committee feels that a composite task force including relevant experts should be constituted for each case in order to do full justice to the investigation in depth to ferret out full facts of the case.

Recommendation 5.3: Corporate Serious Fraud Office

- A Corporate Serious Fraud~~s~~ Office (CSFO) should be set up in the Department of Company Affairs with specialists inducted on the basis of transfer/deputation and on special term contracts.
- This should be in the form of a multi-disciplinary team that not only uncovers the fraud, but ~~is~~is able to direct and supervise prosecutions under various economic legislations through appropriate agencies.
- There should be a Task Force constituted for each case under a designated team leader.
- 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 departments and agencies as described in paragraphs 5.17 and 5.20.~~.~~
- Later, a legislative framework, along the lines of the SFO in the UK, should be set up to enable the CSFO to investigate all aspects of the fraud, and direct the prosecution in appropriate courts.

Changes in Law

5.~~23~~24 Basically, good corporate governance, like honesty, is a matter of personal conviction, and internal creed, rather than of discipline enforced from without. At another level, it is good business ~~that~~ because it inspires investor confidence, which is ~~–~~so essential to attracting capital. All the confidence, however, that the good companies ~~may~~ build, and the good work that they do over time can be largely undone by a few unscrupulous businessmen, and fly-by-night operators. Vanishing companies are a case in point; in fact, several bad apples have surfaced in the basket of corporate India resulting in frauds and scams on a large scale.

5.~~24~~25 The Committee has identified various sections in the Companies Act which require strengthening to provide for action and penalties that have adequate deterrent effect. The Committee has noted the inadequacy of penalties in several sections of the Companies Act. A few examples will demonstrate this. S~~s~~ection 77 of the Companies Act places restrictions on the purchase by a company of its own shares or that of its holding company. Companies often indulge in such practice only to exaggerate their volume of trading, and to drive up its share prices. This amounts to misleading the various stakeholders, a case of corporate mis-governance, if not downright fraud. And yet the maximum penalty prescribed in this area is only Rs. 10,000/-. The Committee recommends that the penalty should be linked to the amount of ill-gotten gains involved in the illegal purchase, and prescribed as a percentage of that amount. Sections 370 and 372 of the Companies Act has placed limitations on the loans/guarantees that a company may give, or investments in shares that it may make; or seek the approval of Central Government. In the year 1999, a new section, 372A was inserted in this Act (made effective from 31.10.1998) which effectively did away with the need for Government approval. This was a step in the right direction to give companies more freedom of operation. However, some managements regretfully have misused the provisions of the new section 372A to transfer, indirectly, huge sums of money to the stock market, specifically to entities associated with a particular operator through smaller private limited companies or partnership/proprietorship firms. It is recognized that greater freedom implies greater accountability. The liberalizing intent of section 372A was not to give freedom to the management to play the stock market, and 'lose' huge sums of company money on it. The Committee feels that if a company violates or misuses the provisions of section 372A, those responsible should be severely punished. A term of imprisonment be provided as a penalty under this section, and the offence made non-compoundable.

5.26 The above discussion shows that to conceal the actual recipients of the moneys, the company often uses partnership/proprietorship firms as intermediaries and cut-outs. Since the latter are not 'companies', the trail, as it were, ends there. Similarly, subsidiaries have been used, merely for intermediate transfers. This is indeed a clever ruse to beating the intent of the law. The Committee, therefore, recommends that the Department of Company Affairs should, find a way to put appropriate checks and balances.

5.~~25~~27 The Committee was informed that another c~~C~~ommittee headed by Shri Shardul Shroff is already examining the issue of rationalization of penalties. Therefore, the Committee is not making any further recommendations on the subject. It hopes that the Shroff Committee would finalize its recommendations, and the Department would act on them, expeditiously.

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~~subsidiaries have been used, merely for intermediate transfers. This is indeed a clever ruse to beating the intent of the law. The Committee, therefore, recommends that the Department of Company Affairs should, in consultation with the Law Department, find a way to close these loopholes through a suitable amendment to the law.~~

5.~~27~~28 Section 274(1)(g), inserted in the Companies Act in December, 2000, now provides for disqualification of directors in certain circumstances. This is clearly an attempt to improve corporate governance. However, the disqualification, at present, is attracted only if annual accounts/returns are not filed or if there is failure in the repayment of deposit or interest thereon. The Committee feels that conditions attracting disqualification should be widened to include repayment on debentures, or interest thereon, or serious offences such as those covered under sections 77 and 372A of the Act. The Committee, therefore, recommends that the Department should further amend section 274(1)(g) so that disqualification is also attracted by directors of companies which indulge in what the Department considers serious offences of betrayal of fiduciary responsibilities. However, only willful defaults should be covered, to distinguish from defaults arising from genuine business failures. Further, institutional investors need not be protected~~,~~ from default, through this section, as they should be able to protect their own interests.

5.~~28~~29 However, in doing so, the Department also needs to re-examine the extent to which it would want the disqualification to apply to independent directors. The Committee was informed that institutional directors had already been exempted by the department from the rigours of this section; similar exemption needs to be given in case of independent directors.

5.~~29~~30 It was brought to the notice of the Committee that when large advances were routed, by listed public companies such transfers were often disguised as ‘~~“~~trade advances’~~”~~, or advances for purchase of particular shares. It is not clear to the Committee as to why any company should return to do so in totally unrelated areas. It seems this is just a ploy to either fund the purchase of its own shares, or to play the stock market. This is established from the facts that tens of crores of rupees were ‘~~“~~lent’~~”~~ by listed public companies recently to entities having very small paid up capital, and that these smaller companies transferred the moneys to the stock-~~-~~brokers within hours of receiving it. The Committee feels that managements/boards should not be able to misapply shareholders funds in this manner. Above a certain limit, companies should need to immediately disclose such transfers to a prescribed authority.

5.~~30~~31 The Committee would like to make several recommendations in this regard. First, any company that buys or sells shares, a stock-broking company, should be subject to a different, stricter regime, especially with regard to laws that govern borrowing or lending of funds by companies. Secondly, loans or deposits to such a company should be limited to a proportion/multiple of its paid-up capital and share reserves; conversely, a company should not be able to borrow more than a proportion/multiple of its paid-up capital and free reserves. This is justified also on the ground that companies need to maintain a rational debt to equity ratio. Thirdly, the unanimous resolution under section 372-A of the Companies Act should in fact be signed by all the directors, and not merely approved by those present and voting. Finally, this resolution should state unambiguously that no part of such moneys shall be used, directly or indirectly, for a purpose other than that stated in the resolution, or for earning interest in private limited companies, or for the purpose of playing the stock market. This additional responsibility is a concomitant of the liberalized provisions of section 372A.

5.~~31~~32 Judicial delays in this area are well known. The Committee was not surprised to learn that prosecutions are pending in Courts for years together, it is, astonishing nevertheless that DCA have perhaps been unable to secure a jail term in even a single case in the last five decades. The Committee noted that prosecutions once filed are followed up by an officer designated for the task. Often, this post remains vacant, with the result that this important aspect is looked after by another officer in addition to his regular work. The Committee would like to make two recommendations in this regard. First, the prosecution wing in the DCA needs to be strengthened by increasing the strength of personnel in the wing, and supplementing it by hiring better advocates, perhaps on a retainer basis, instead of relying only on the over-worked government advocates. Secondly, the Department should examine the possibility of introducing shortened procedures, along the lines of the recent amendment to the Code of Civil Procedure e.g. recording evidence through commissioners.

5.~~32~~33 A major issue confronting the regulators today is the absence of special law that would permit disgorgement, from the perpetrators, of the proceeds of frauds or illegally earned proceeds, or its return to rightful owners such as the shareholders. Vanishing companies are a case in point. Prosecuting promoters may lead to imposition of fines, perhaps even imprisonment. But the money that the investors have been cheated of is out of reach, as per the provisions of the existing law. From the point of view of the investors, prosecution of such promoters is a case of locking the barn after the horse has bolted. The Committee noted that the SEBI Act has been recently amended to give it certain preemptive powers, such as attachment of bank accounts, so that the ill-gotten gains do not disappear. The Committee recommends that similar provisions be made in the Companies Act, subject to the necessary safeguards, such as approval of the Company Law Board, or its successor body (when formed).~~.~~

5.~~33~~34 Corporate mis-governance, with or without breach of the law, is often about managements/promoters taking the minority shareholders for a ride. Yet, the offence lies on the company itself; thus, if a heavy monetary penalty is imposed then, in a way, the minority shareholders are being penalised for the ride that they were taken on. Worse, expensive advocates are hired, air journeys undertaken and hotel accommodation paid for, with the money of the shareholders, to defend the management/promoter who has cheated them in the first place. This double jeopardy needs to be removed, if necessary, by inserting a new section in the Companies Act. The manager/promoter held guilty should be asked to pay the legal cost after proven~~being~~ ~~proved~~ guilty ~~(including by way of compounding the offence)~~, after disposal of appeal, if any.

5.~~34~~35 With regard to subsidiaries, another point needs to be made. Investments in, returns from and dealings with subsidiaries should be known to the shareholders of the parent company, in easily understandable formats. For this reason, consolidated financial statements (CFS) have come to be internationally accepted. The ICAI has also prescribed accounting standards for CFS. The Committee recommends that CFS be expeditiously ~~be~~ provided for in the Companies Act.

Recommendation 5.4

- ~~Wherever possible,~~Penalties ought to be rationalized, and related to the sums involved in the offence. Fees, especially late fees, can be related to the size of the company in terms of its paid-up capital and free reserves, or turnover, or both.
- Disqualification under section 274(1)(g) of the Companies Act, 1956 should be triggered for certain other serious offences than just non-payment of debt. However, independent directors need to be treated on a different footing and exempted as in the case of nominee directors representing financial institutions.
- A stricter regime should be prescribed for companies registered as brokers with SEBI. Greater accountability should be provided for with respect to transfer of money by way of Inter Corporate Deposits, or advances of any kind, from listed companies to any other company, as a necessary concomitant of the liberalisation that section 372A of the Companies Act, 1956 provides.

- DCA's prosecution wing needs to be considerably strengthened. Streamlined procedures be prescribed in the Companies Act, on the lines of the recent amendments to the Code of Civil Procedure.
- To ensure that proceeds from illegal acts and frauds do not escape recovery, Companies Act needs to be amended to give DCA the powers of attachment of bank accounts etc., on the lines of the powers recently given to SEBI. Ill-gotten gains must be disgorged.
- Managers/promoters should be held personally liable when found guilty of offences. In such cases, the legal fees and other charges should be recovered from the officers in default, especially if the offences pertain to betrayal of shareholder's trust, or oppression of minority shareholders. It is patently unfair that the shareholder is penalised twice, once when ~~spulcted~~mulcted, and again to have to incur the legal expenses to defend the fraudster.
- Consolidated Financial Statements should be made mandatory for companies having subsidiaries.~~In such cases, the fees will also be recovered from the officers in default.~~

Compliance Audit

5.~~35~~36 An important element of good corporate governance is transparency; hence the provisions for disclosures and filing of accounts which can be inspected. The Committee noted that there is insufficient compliance of even these basic requirements, as Table 2 below would show:

Table 2
Compliance rate in filing of documents

Year	Companies	Annual returns filed	Compliance Rate (%)	Balance sheet / P&L account filed	Compliance Rate (%)
1994-95	353292	219705	62.19	221832	62.79
1995-96	409142	220318	53.85	201275	49.19
1996-97	450950	247423	54.87	267335	59.28
1997-98	484500	274814	56.72	277000	57.17
1998-99	511990	260530	50.89	270961	52.92

5.~~36~~37 This unsatisfactory situation is aggravated by the fact that the ROC offices are able to take only half of the documents filed on record. The documents not taken on record are not available for inspection. This further brings down the effective compliance rate as Table 3 below would show:

Table 3
Net Compliance rate

Year	Compliance in filing (Annual Returns)	%age of documents taken on record	Effective compliance rate
1994-95	62.19	50.04	31.12
1995-96	53.85	46.47	25.02
1996-97	54.87	47.22	25.91
1997-98	56.72	54.57	30.95
1998-99	50.89	58.79	29.92

5.~~37~~38 It was argued before the Committee that the Government is partly to blame for not ensuring these compliances so basic to good corporate governance. One answer in increasing the strength and facilities of ROC offices, in normative fashion, in proportion to the increase in the number of companies, as discussed in paragraph 5.09 above. The Committee, however, feels that the Government should explore two other avenues. First, since a large number of documents are not taken on record because they are defective, a system of ~~“~~‘pre-certification’~~”~~, by company secretaries, can be introduced. The system would replace the current ~~“~~pre-scrutiny~~”~~ that the Department attempts to do, with only a mixed degree of success. Monetary and other penalties should be prescribed for company secretaries who incorrectly certify that the documents being filed are as required by law. Secondly, the Government could consider introducing in the Companies Act a provision which empowers it to order a ~~“~~‘compliance audit’~~”~~, much in the same manner as the special audit that it can, at present, order under section 233-A of the Companies Act. The Committee would also recommend, from the point of view of not adding to the compliance costs, that this power be used ~~as~~ rarely and sparingly. ~~, as section 233-A has been invoked.~~ A natural concomitant of this added responsibility would be the responsibility, on the company secretaries issuing compliance certificates, to report to DCA any violations of the Companies Act that the company has willfully, or otherwise, committed.

Recommendation 5.5

- ~~Wherever possible,~~DCA should consider reducing workload at offices of ROCs by providing for a system of ~~"~~"pre-certification"~~"~~ by company secretaries; the system should provide for ~~strict~~ monetary and other penalties on company secretaries who certify incorrectly, even through error or oversight
- The Companies Act be amended to enable the DCA to order a ~~"~~"compliance audit"~~"~~, much in the same manner as it can order ~~"~~special audits~~"~~ under section 233-A of the Companies Act.

Miscellaneous

5.~~38~~39 It was brought to the notice of the Committee that in the UK, auditors are required to certify the company they are auditing as a "going concern". Apparently, inherent in the certification is the guarantee that the company would last for at least one more financial year. In the background of our own "vanishing companies", the Committee found such a proposition rather attractive. It therefore recommends that, in addition, auditors could be requested to bring to the notice of the concerned stakeholders if there is a default in re-payment of debt or interest, or failure in the redemption of debentures, or payment of interest thereon, or a disqualification of director/s. In fact, in the case of debentures, auditors must report non-creation of security where there is such a failure. The Committee felt that these requirements should form part of the Manufacturing and Other Companies Auditors' Report Order (MAOCARO) that is under revision currently. The Committee also felt that the provisions of section 293(1) (a) of the C~~c~~ompanies Act should be strengthened to prevent any unnatural stripping of assets by the company, or any notable divestment of shares by the promoters or directors.

5.~~39~~40 The Department currently carries out, as pointed out above, a technical scrutiny of documents filed by them. Due to pressure of work, inadequate training, and other reasons, this has been reduced to being a scrutiny ~~of "form"~~*pro forma*~~,~~ ~~as opposed to~~ rather than one of ~~-~~content. It was argued before the Committee ~~that audit should also be audited; that is,~~ that there should be a professional examination of the accounts filed by companies.~~,~~ ~~to exclude the possibility of the “true and fair view” not being presented on account of the incompetence or connivance of the auditor.~~ It was equally forcefully argued ~~equally forcefully argued~~, on the other hand, that merely going through the audited accounts of a company is not likely to add any value, as a correct picture can only emerge, if at all, when professionals look at the books of accounts, ~~and the company itself,~~ and a duplication of the entire audit process was not what was needed.~~being suggested.~~ The Committee feels ~~that the truth lies, as so often, somewhere in between. It feels~~ that a review, by professionals, of the accounts filed with ROCs could reveal, *prima facie*, errors of commission or omission. ~~;~~ ~~w~~When noticed, these could lead to a fuller investigation/inquiry, including the possibility of a full-~~-~~fledged supplementary audit. The Committee is aware that a large number of issues such as confidentiality, independence of those auditing audit, genuine differences of interpretation etc. would be involved in examining a proposal such as this. The Committee would therefore like to recommend, in principle, the concept of “random scrutiny of accounts”. However, the concept and its implementation needs to be more fully delineated by an independent group charged with the responsibility of examining only this proposal.

5.~~40~~41 In presenting, to the various stakeholders, a true and fair view of their company, the quality and professionalism of chartered accountants is crucial. A professional is as good as his training. It is, therefore, essential that those who join the profession are trained with the best assisting professionals. However, the ICAI prescribes the maximum number of articles that a firm can train. The Committee feels that this limitation is tantamount to denying the opportunity to a large number from joining the better firms. It was brought to the notice of the Committee that when there was no limit, some unscrupulous members of the Institute had issued false certificates of training. The Committee, however, felt that “capacity to train” of an accounting firm could easily be determined by the Quality Review Board being proposed in this report. It, therefore, recommends that this limit should be withdrawn as it promotes mediocrity rather than excellence. The ICAI, it was mentioned, is attending to this.

5.~~41~~42 It was repeatedly stated before the Committee that corporate ethics are more about the culture, or the “state of mind” of the organization, rather than an outcome of legal provisions. Thus, healthy internal systems and practices are more important than legal limitations from without. Therefore, the Committee recommends, as has been done in the SOX Act that each company be asked to establish an ‘internal code of conduct’, and that the company’s performance be measured against the stated code.

5.~~42~~43 The Committee noted the lack of research-based discourse on the impact of good corporate governance on economic performance. This is essential if companies are to be convinced that good governance makes for good business. Academic research will be of immense help to the DCA by bringing to its notice the shortcomings in the law and the suitable prescriptions. The Committee proposes that a part of the Investor Education and Protection Fund be earmarked for carrying out research in the area of corporate governance.

Recommendation 5.6

- ~~Wherever possible,~~MAOCARO should be amended to provide that auditors report certain violations, such as those listed in paragraph 5.39.
- Section 293(1)(a) should be strengthened to prevent any unnatural stripping of assets, or sale of shares by management/promoters
- To reduce ~~its~~ workload in ROC offices, as well as to improve auditing standards, the government should consider introducing a system of "random scrutiny" of audited accounts, in the same way as is done by the Accountancy ~~f~~Foundation in the UK, or is proposed to be done by the

Public Oversight Board in the USA. However, this recommendation should be implemented only if, and after, DCA can take care of concerns such as the genuineness of randomness, client confidentiality etc., and is confident of its own manpower strengths and skills

- ICAI should re-consider the limits it has set on the number of articles that a partner can train; something that has the unintended consequence of denying young prospective accountants the chance to train with the best in the profession.
- Companies should be required to establish, and publish, an 'Internal Code of Ethics".
- DCA should sponsor, and financially support, from the IEPF, research on corporate governance and allied subjects that have a bearing on investor/shareholder well- being.

5.44 Better quality of auditing would contribute to better corporate governance. Better professionals are likely to be produced when audit firms make higher investments in training, technology and human resource development. This is not possible if audit firms are small, as they cannot, and do not, have the wherewithal of bigger firms. In India, audit firms continue to remain chronically small. The country has as many as 43,000 audit firms, of which as many as three-fourths are single person proprietary firms. Less than 200 firms (0.5%) have more than 10 partners. Several reasons were advanced for this phenomenon. Some felt it was the regulatory regime set out by ICAI that discourages consolidation. Others felt that the small size of Indian audit firms was but a reflection of the small size of Indian businesses; that the audit firms were cast, as it were, in the image of their clients. Several other theories, including some very outlandish (cultural) ones, were advanced.

5.45 Whatever be the reasons, the adverse consequences for the profession are obvious. First, they are unable to compete with international firms in the lucrative consultancy/advisory and non-statutory work markets. Secondly, the profession seems to be in the constant fear of being swamped by international firms through the 'back door'. Thirdly, council decisions could be driven by the requirement of satisfying this very large constituency of small firms. This can catch the profession in a vicious circle of taking decisions that will keep them small for all times to come. Finally, perhaps not enough is being spent on, or done for, top class professional development. Consequently, arguably the best accountancy brains in the world are not being shaped into world class accountants.

5.46 That being so, the Committee feels that professionals in India need to consolidate and grow. Consolidation will, in fact, create a virtuous circle, allowing them to grow and consolidate further. If they do so, they can compete with the best and the biggest in the world. There was a view that in the west consolidation had perhaps gone too far; it was stated that regulators there were now looking for ways to create options to the limited number of dominant firms. However, it was felt that here the profession was so fractured, that it was too early to worry about 'over-consolidation'. The Committee felt that, for the present, a beginning should be made by the ICAI, and the government, by setting in place a regulatory regime that will foster, rather than hinder, this growth.

5.47 Related issues regarding the maximum number of partners, number of audits per partner etc. were discussed and reviewed by the Committee. Whilst the Committee received suggestions, both in favour and against these limits it felt that these issues are for the Institute of Chartered Accountants of India to decide after careful consideration of what is good in the long-term interests of the profession. However, the Committee accepted the suggestion of introducing the concept of 'limited liability', as per prevalent international norms, in India for partnership firms of professionals. This would encourage quality talent to be attracted to the profession, and allow for faster growth and consolidation of firms, by reducing the fear of unlimited liability for all partners The Committee therefore recommends that necessary changes in the law be made to allow for the incorporation/conversion of partnership firms to 'limited liability' firms.

Recommendation 5.7

- ~~Wherever possible,~~ ICAI should propose to the Government a regime and a regulatory framework that encourages the consolidation and growth of Indian firms, in view of the international competition they face, especially with regard to non-audit services.
- The Government should consider amending the Partnership Act to provide for partnerships with limited liability, especially for professions which do not allow their members to provide services as a corporate body.

Acknowledgements

It now remains for the Committee to acknowledge the help and assistance, it has received from many quarters.

The Department of Company Affairs readily supplied all the information and documents necessary for our work and provided full secretarial support.

The ICAI supplied us with complete documentation and background material and presented well-considered proposals which enabled the Committee to expedite deliberation on many important issues. The ICSI and ICWAI also presented useful memoranda of suggestions.

We were able to make frequent use of the nice meeting facilities of the ICSI at New Delhi. In particular, we wish to thank Dr. S. P. Narang, Secretary, ICSI.

ICICI Bank also made excellent arrangements at Mumbai for our discussions and meetings. We are thankful to Smt. Kalpana Morparia who took great interest in getting this organised.

Many persons expressed a wish to meet the Committee, but only a selected few could be given the opportunity for want of time. The Committee deeply appreciates the efforts put in by many experienced persons in providing us with relevant information and valuable suggestions. We benefited in particular from many experienced persons like Mr. A.N. Haksar, former Chairman, ITC and representatives of important organisations, like Comptroller and Auditor-General of India, Reserve Bank of India, Securities and Exchange Board of India and Life Insurance Corporation.

The Committee, excluding two members, would like to make specific mention of the valuable contribution that two of our members have made. Mr. Rajiv Mehrishi, Joint Secretary, had to bear the burden of collection of the background material, and providing the Committee with valuable analysis

and insights. He did this very thoroughly and cheerfully. He is also chiefly responsible for organising the required logistic support to the working of the Committee. Dr. Omkar Goswami accepted the onerous responsibility of producing the first draft of most of our report. He did an excellent job and helped facilitate the early completion of the report to the standard that we were able to achieve.

Appendix 1

Composition of and Terms of Reference to the Committee

No. 12/25/2002-IGC
GOVERNMENT OF INDIA
MINISTRY OF FINANCE & COMPANY AFFAIRS
DEPARTMENT OF COMPANY AFFAIRS

5th Floor, A Wing, Shastri Bhawan
New Delhi – 110 001
Dated, the 21 August, 2002.

ORDER

Sub: Constitution of a Committee to examine the Auditor-Company relationship, regulating auditors etc.

It has been decided to constitute a High Level Committee consisting of the following:-

(i)	Mr Naresh Chandra	Chairman
(ii)	Mr Ashok Chandak	Member
(iii)	Mr Aditya Vikram Lodha	Member
(iv)	Mr R. Krishnan	Member
(v)	Mr M. K. Sharma	Member
(vi)	Ms Kalpana Morparia	Member
(vii)	Mr Mahesh Vyas	Member

(viii)	Dr Omkar Goswami	Member
(ix)	Mr Rajiv Mehrishi	Member
(x)	Mr S.B.Mathur	Secretary

2. The terms of reference of the High Level Committee would be as under:
   - (a) to examine the entire gamut of issues pertaining to the Auditor-Company relationship with a view to ensuring the professional nature of the relationship; in this respect to consider issues such as (but not limited to) rotation of auditors/auditing partners, restrictions on non-audit fee/work, procedures for appointment of auditors & determination of audit fees, etc.
   - (b) to examine measures required to ensure that the managements and auditors actually present the true and fair statement of the affairs of companies; in this respect to consider measures such as (but not limited to) personal certification by directors, random scrutiny of accounts, etc.
   - (c) to examine if the present system of regulation of the profession of Chartered Accountants, Company Secretaries and Cost Accountants is sufficient and has served well the concerned stakeholders, especially the small investors, and whether there is advantage in setting up an independent regulator (along the lines of the recently passed Sarbanes-Oxley Act of 2002 in the USA) and, if so, what shape should the independent regulator take.
   - (d) to examine the role of independent directors, and how their independence and effectiveness can be ensured.
   - (e) To consider, with the permission of the Chairman, any other issue related, or incidental, to the above.

3. The Committee would function under the Chairman and would devise its own procedures.
4. The Committee will submit its report tot he Ministry of Finance and Company Affairs, Department of Company Affairs, within 45 days of its first meeting.
5. Secretarial assistance to the Committee will be arranged by Department of Company Affairs.

Sd./-

(Rajiv Mehrishi)
Joint Secretary to the Government of India

To

Chairman and Members of the Committee

Appendix 2

Individuals/Institutions heard by the Committee

The Committee was inclined to have as widespread a consultation as possible. In this, it was limited by the constraints of time. However, it did invite a large number of individuals and institutions to place their views before it. The list of those who met the Committee is given below:

S.No.	Date & Venue	Institutions/Individuals
1.	12.09.2002	Shri A.N. Haksar, Chairman, Emeritus ITC Ltd.
2.	New Delhi	Shri A.R. Chopra, Council Member, ICAI
3.		Shri Manoharan, Council Member, ICAI
4.		Shri Ashok Haldia, Secretary, ICAI
5.		Shri Pawan Vijay, Vice-President, ICSI
6.		Dr. S.P. Narang, Secretary, ICSI
7.		Dr. K.L. Jai Singh, Vice-President, ICWAI
		Shri Chandra Wadhwa, Council Member, ICWAI
8.		Lt. Gen. J.S. Ahluwalia, Institute of Directors
9.		Shri Kaushik Dutta, Partner, Price Waterhouse Coopers
10.	19.09.2002 Mumbai	Shri Kirit Somaiya, MP
11.		Investors Grievances Forum
12.		Reserve Bank of India
13.		LIC of India
14.		Indian Banking Association
15.		Confederation of Indian Industries
16.		Shri P.N. Shah, Chartered Accountant
17.		Shri YH Malegam, Chartered Accountant

18.	Shri Anil Singhvi, M/s Ambuja Cement
19.	Shri Bharat Doshi, M/s Mahindra & Mahindra
20.	Prof. N. Balasubramanian, IIM, Bangalore
21.	Shri P. Krishnamurthy, M/s JM Morgan Stanley
22.	M/s Infosys Technology Ltd.
23.	Shri PM Narialwala, Chartered Accountant, Kolkata
24.	Shri Arjun Sawhny, ANZ Investment Bank
25.	KPMG, Mumbai
26.	Shri S. Nawshir Mirza, FCA
27.	Smt. Bhavna Doshi, Chartered Accountant
28.	Shri S. Basu, ITC Limited
29.	Mrs. Sucheta Dalal, Financial Express, Mumbai

S.No.	Date & Venue	Name
30.	23.09.2002 New Delhi	Shri Arvind Avasthi, Principal Director & Secretary (Audit Board) C&AG of India
31.		Shri R.S. Lodha, President, FICCI
32.		Shri Ilam C. Kamboj, Member, ASSOCHAM Company Law Committee
33.		Shri Shardul Shroff, Advocate
34.	18.10.2002 New Delhi	Shri T.V. Mohan Das Pai, CFO, Infosys

The Committee gratefully acknowledges the contribution made by the above and wishes to thank them for their time and effort.

While every care has been taken to make this list exhaustive, inadvertent omissions, if any, are deeply regretted.

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Appendix 3
Summary of Sarbanes-Oxley Act of 2002

Section 3: Commission Rules and Enforcement.

A violation of Rules of the Public Company Accounting Oversight Board ("Board") is treated as a violation of the '34 Act, giving rise to the same penalties that may be imposed for violations of that Act.

Section 101: Establishment; Board Membership.

The Board will have five financially-literate members, appointed for five-year terms. Two of the members must be or have been certified public accountants, and the remaining three must not be and cannot have been CPAs. The Chair may be held by one of the CPA members, provided that he or she has not been engaged as a practicing CPA for five years.

The Board's members will serve on a full-time basis.

No member may, concurrent with service on the Board, "share in any of the profits of, or receive payments from, a public accounting firm," other than "fixed continuing payments," such as retirement payments.

Members of the Board are appointed by the Commission, "after consultation with" the Chairman of the Federal Reserve Board and the Secretary of the Treasury.

Members may be removed by the Commission "for good cause."

Section 101: Establishment; Duties Of The Board.

Section 103: Auditing, Quality Control, And Independence Standards And Rules.

The Board shall:

1. register public accounting firms;
2. establish, or adopt, by rule, "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers;"
3. conduct inspections of accounting firms;
4. conduct investigations and disciplinary proceedings, and impose appropriate sanctions;
5. perform such other duties or functions as necessary or appropriate;
6. enforce compliance with the Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto;
7. set the budget and manage the operations of the Board and the staff of the Board.

Auditing standards. The Board would be required to "cooperate on an on-going basis" with designated professional groups of accountants and any advisory groups convened in connection with standard-setting, and although the Board can "to the extent that it determines appropriate" adopt standards proposed by those groups, the Board will have authority to amend, modify, repeal, and reject any standards suggested by the groups. The Board must report on its standard-setting activity to the Commission on an annual basis.

The Board must require registered public accounting firms to "prepare, and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report."

The Board must require a 2nd partner review and approval of audit reports registered accounting firms must adopt quality control standards.

The Board must adopt an audit standard to implement the internal control review required by section 404(b). This standard must require the auditor evaluate whether the internal control structure and procedures include records that accurately and fairly reflect the transactions of the issuer, provide reasonable assurance that the transactions are recorded in a manner that will permit the preparation of financial statements in accordance with GAAP, and a description of any material weaknesses in the internal controls.

Section 102(a): Mandatory Registration

Section 102(f): Registration And Annual Fees.

Section 109(d): Funding; Annual Accounting Support Fee For The Board.

In order to audit a public company, a public accounting firm must register with the Board. The Board shall collect "a registration fee" and "an annual fee" from each registered public accounting firm, in amounts that are "sufficient" to recover the costs of processing and reviewing applications and annual reports.

The Board shall also establish by rule a reasonable "annual accounting support fee" as may be necessary or appropriate to maintain the Board. This fee will be assessed on issuers only.

Section 104: Inspections of Registered Public Accounting Firms

Annual quality reviews (inspections) must be conducted for firms that audit more than 100 issues, all others must be conducted every 3 years. The SEC and/or the Board may order a special inspection of any firm at any time.

Section 105(b)(5): Investigation And Disciplinary Proceedings; Investigations; Use Of Documents.

Section 105(c)(2): Investigations And Disciplinary Proceedings; Disciplinary Procedures; Public Hearings.

Section 105(c)(4): Investigations And Disciplinary Proceedings; Sanctions.

Section 105(d): Investigations And Disciplinary Proceedings; Reporting of Sanctions.

All documents and information prepared or received by the Board shall be "confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery other legal process) in any proceeding in any Federal or State court or administrative agency, unless and until presented in connection with a public proceeding or [otherwise] released" in connection with a disciplinary action. However, all such documents and information can be made available to the SEC, the U.S. Attorney General, and other federal and appropriate state agencies.

Disciplinary hearings will be closed unless the Board orders that they be public, for good cause, and with the consent of the parties.

Sanctions can be imposed by the Board of a firm if it fails to reasonably supervise any associated person with regard to auditing or quality control standards, or otherwise.

No sanctions report will be made available to the public unless and until stays pending appeal have been lifted.

Section 106: Foreign Public Accounting Firms.

The bill would subject foreign accounting firms who audit a U.S. company to registrations with the Board. This would include foreign firms that perform some audit work, such as in a foreign subsidiary of a U.S. company, that is relied on by the primary auditor.

Section 107(a): Commission Oversight Of The Board; General Oversight Responsibility.

Section 107(b): Rules Of The Board.

Section 107(d): Censure Of The Board And Other Sanctions.

The SEC shall have "oversight and enforcement authority over the Board." The SEC can, by rule or order, give the Board additional responsibilities. The SEC may require the

Board to keep certain records, and it has the power to inspect the Board itself, in the same manner as it can with regard to SROs such as the NASD.

The Board, in its rulemaking process, is to be treated "as if the Board were a 'registered securities association'"-that is, a self-regulatory organization. The Board is required to file proposed rules and proposed rule changes with the SEC. The SEC may approve, reject, or amend such rules.

The Board must notify the SEC of pending investigations involving potential violations of the securities laws, and coordinate its investigation with the SEC Division of Enforcement as necessary to protect an ongoing SEC investigation.

The SEC may, by order, "censure or impose limitations upon the activities, functions, and operations of the Board" if it finds that the Board has violated the Act or the securities laws, or if the Board has failed to ensure the compliance of accounting firms with applicable rules without reasonable justification.

Section 107(c): Commission Review Of Disciplinary Action Taken By The Board.

The Board must notify the SEC when it imposes "any final sanction" on any accounting firm or associated person. The Board's findings and sanctions are subject to review by the SEC.

The SEC may enhance, modify, cancel, reduce, or require remission of such sanction.

Section 108: Accounting Standards.

The SEC is authorized to "recognize, as 'generally accepted'... any accounting principles" that are established by a standard-setting body that meets the bill's criteria, which include requirements that the body:
(1) be a private entity;
(2) be governed by a board of trustees (or equivalent body), the majority of whom are not or have not been associated persons with a public accounting firm for the past 2 years;

(3) be funded in a manner similar to the Board;
(4) have adopted procedures to ensure prompt consideration of changes to accounting principles by a majority vote;
(5) consider, when adopting standards, the need to keep them current and the extent to which international convergence of standards is necessary or appropriate.

Section 201: Services Outside The Scope Of Practice Of Auditors; Prohibited Activities.

It shall be "unlawful" for a registered public accounting firm to provide any non-audit service to an issuer contemporaneously with the audit, including: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; (9) any other service that the Board determines, by regulation, is impermissible. The Board may, on a case-by-case basis, exempt from these prohibitions any person, issuer, public accounting firm, or transaction, subject to review by the Commission.

It will not be unlawful to provide other non-audit services if they are pre-approved by the audit committee in the following manner. The bill allows an accounting firm to "engage in any non-audit service, including tax services," that is not listed above, only if the activity is pre-approved by the audit committee of the issuer. The audit committee will disclose to investors in periodic reports its decision to pre-approve non-audit services. Statutory insurance company regulatory audits are treated as an audit service, and thus do not require pre-approval.

The pre-approval requirement is waived with respect to the provision of non-audit services for an issuer if the aggregate amount of all such non-audit services provided to the issuer constitutes less than 5 % of the total amount of revenues paid by the issuer to its auditor (calculated on the basis of revenues paid by the issuer during the fiscal year when the non-audit services are performed), such services were not recognized by the issuer at the time of the engagement to be non-audit services; and such services are promptly brought to the attention of the audit committee and approved prior to completion of the audit.

The authority to pre-approve services can be delegated to 1 or more members of the audit committee, but any decision by the delegate must be presented to the full audit committee.

Section 203: Audit Partner Rotation.

The lead audit or coordinating partner and the reviewing partner must rotate off of the audit every 5 years.

Section 204: Auditor Reports to Audit Committees.

The accounting firm must report to the audit committee all "critical accounting policies and practices to be used…all alternative treatments of financial information within [GAAP] that have been discussed with management…ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.

Section 206: Conflicts of Interest.

The CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company's audit firm during the 1-year period proceeding the audit.

Section 207: Study of Mandatory Rotation of Registered Public Accountants.

The GAO will do a study on the potential effects of requiring the mandatory rotation of audit firms.

Section 209: Consideration by Appropriate State Regulatory Authorities.

State regulators are directed to make an independent determination as to whether the Boards standards shall be applied to small and mid-size non-registered accounting firms.

Section 301: Public Company Audit Committees.

Each member of the audit committee shall be a member of the board of directors of the issuer, and shall otherwise be independent.

"Independent" is defined as not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof.

The SEC may make exemptions for certain individuals on a case-by-case basis.

The audit committee of an issuer shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer.

The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the issuer regarding accounting, internal controls, and auditing.

Each audit committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties.

Each issuer shall provide appropriate funding to the audit committee.

Section 302: Corporate Responsibility For Financial Reports.

The CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer." A violation of this section must be knowing and intentional to give rise to liability.

Section 303: Improper Influence on Conduct of Audits

It shall be unlawful for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading.

Section 304: Forfeiture Of Certain Bonuses And Profits.

Section 305: Officer And Director Bars And Penalties; Equitable Relief.

If an issuer is required to prepare a restatement due to "material noncompliance" with financial reporting requirements, the chief executive officer and the chief financial officer shall "reimburse the issuer for any bonus or other incentive-based or equity-based compensation received" during the twelve months following the issuance or filing of the non-compliant document and "any profits realized from the sale of securities of the issuer" during that period.

In any action brought by the SEC for violation of the securities laws, federal courts are authorized to "grant any equitable relief that may be appropriate or necessary for the benefit of investors."

Section 305: Officer And Director Bars And Penalties.

The SEC may issue an order to prohibit, conditionally or unconditionally, permanently or temporarily, any person who has violated section 10(b) of the 1934 Act from acting as an officer or director of an issuer if the SEC has found that such person's conduct "demonstrates unfitness" to serve as an officer or director of any such issuer.

Section 306: Insider Trades During Pension Fund Black-Out Periods Prohibited.

Prohibits the purchase or sale of stock by officers and directors and other insiders during blackout periods. Any profits resulting from sales in violation of this section "shall inure to and be recoverable by the issuer." If the issuer fails to bring suit or prosecute diligently, a suit to recover such profit may be instituted by "the owner of any security of the issuer."

Section 401(a): Disclosures In Periodic Reports; Disclosures Required.

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

"Each annual and quarterly financial report . . . shall disclose all material off-balance sheet transactions" and "other relationships" with "unconsolidated entities" that may have a material current or future effect on the financial condition of the issuer.

The SEC shall issue rules providing that pro forma financial information must be presented so as not to "contain an untrue statement" or omit to state a material fact necessary in order to make the pro forma financial information not misleading.

Section 401 (c): Study and Report on Special Purpose Entities.

SEC shall study off-balance sheet disclosures to determine a) extent of off-balance sheet transactions (including assets, liabilities, leases, losses and the use of special purpose entities); and b) whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion and make a report containing recommendations to the Congress.

Section 402(a): Prohibition on Personal Loans to Executives.

Generally, it will be unlawful for an issuer to extend credit to any director or executive officer. Consumer credit companies may make home improvement and consumer credit loans and issue credit cards to its directors and executive officers if it is done in the ordinary course of business on the same terms and conditions made to the general public.

Section 403: Disclosures Of Transactions Involving Management And Principal Stockholders.

Directors, officers, and 10% owner must report designated transactions by the end of the second business day following the day on which the transaction was executed.

Section 404: Management Assessment Of Internal Controls.

Requires each annual report of an issuer to contain an "internal control report", which shall:

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Each issuer's auditor shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this section shall be in accordance with standards for attestation engagements issued or adopted by the Board. An attestation engagement shall not be the subject of a separate engagement.

The language in the report of the Committee which accompanies the bill to explain the legislative intent states, "--- the Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees."

Directs the SEC to require each issuer to disclose whether it has adopted a code of ethics for its senior financial officers and the contents of that code.

Directs the SEC to revise its regulations concerning prompt disclosure on Form 8-K to require immediate disclosure "of any change in, or waiver of," an issuer's code of ethics.

Section 407: Disclosure of Audit Committee Financial Expert.

The SEC shall issue rules to require issuers to disclose whether at least 1 member of its audit committee is a "financial expert."

Section 409: Real Time Disclosure.

Issuers must disclose information on material changes in the financial condition or operations of the issuer on a rapid and current basis.

Section 501: Treatment of Securities Analysts by Registered securities Associations.

National Securities Exchanges and registered securities associations must adopt conflict of interest rules for research analysts who recommend equities in research reports.

Section 601: SEC Resources and Authority.

SEC appropriations for 2003 are increased to $776,000,000. $98 million of the funds shall be used to hire an additional 200 employees to provide enhanced oversight of auditors and audit services required by the Federal securities laws.

Section 602(a): Appearance and Practice Before the Commission.

The SEC may censure any person, or temporarily bar or deny any person the right to appear or practice before the SEC if the person does not possess the requisite qualifications to represent others, lacks character or integrity, or has willfully violated Federal securities laws.

Section 602(c): Study and Report.

SEC is to conduct a study of "securities professionals" (public accountants, public accounting firms, investment bankers, investment advisors, brokers, dealers, attorneys) who have been found to have aided and abetted a violation of Federal securities laws.

Section 602(d): Rules of Professional Responsibility for Attorneys.

The SEC shall establish rules setting minimum standards for professional conduct for attorneys practicing before it.

Section 701: GAO Study and Report Regarding Consolidation of Public Accounting Firms.

The GAO shall conduct a study regarding the consolidation of public accounting firms since 1989, including the present and future impact of the consolidation, and the solutions to any problems discovered.

Title VIII: Corporate and Criminal Fraud Accountability Act of 2002.

It is a felony to "knowingly" destroy or create documents to "impede, obstruct or influence" any existing or contemplated federal investigation.

Auditors are required to maintain "all audit or review work papers" for five years.

The statute of limitations on securities fraud claims is extended to the earlier of five years from the fraud, or two years after the fraud was discovered, from three years and one year, respectively.

Employees of issuers and accounting firms are extended "whistleblower protection" that would prohibit the employer from taking certain actions against employees who lawfully disclose private employer information to, among others, parties in a judicial proceeding involving a fraud claim. Whistle blowers are also granted a remedy of special damages and attorney's fees.

A new crime for securities fraud that has penalties of fines and up to 10 years imprisonment.

Title IX: White Collar Crime Penalty Enhancements

Maximum penalty for mail and wire fraud increased from 5 to 10 years.

Creates a crime for tampering with a record or otherwise impeding any official proceeding.

SEC given authority to seek court freeze of extraordinary payments to directors, offices, partners, controlling persons, agents of employees.

US Sentencing Commission to review sentencing guidelines for securities and accounting fraud.

SEC may prohibit anyone convicted of securities fraud from being an officer or director of any publicly traded company.

Financial Statements filed with the SEC must be certified by the CEO and CFO. The certification must state that the financial statements and disclosures fully comply with provisions of the Securities Exchange Act and that they fairly present, in all material respects, the operations and financial condition of the issuer. Maximum penalties for wilful and knowing violations of this section are a fine of not more than $500,000 and/or imprisonment of up to 5 years.

Section 1001: Sense of Congress Regarding Corporate Tax Returns

It is the sense of Congress that the Federal income tax return of a corporation should be signed by the chief executive officer of such corporation.

Section 1102: Tampering With a Record or Otherwise Impeding an Official Proceeding

Makes it a crime for any person to corruptly alter, destroy, mutilate, or conceal any document with the intent to impair the object's integrity or availability for use in an official proceeding or to otherwise obstruct, influence or impede any official proceeding is liable for up to 20 years in prison and a fine.

Section 1103: Temporary Freeze Authority

The SEC is authorized to freeze the payment of an extraordinary payment to any director, officer, partner, controlling person, agent, or employee of a company during an investigation of possible violations of securities laws.

Section 1105: SEC Authority to Prohibit Persons from Serving as Officers or Directors

The SEC may prohibit a person from serving as an officer or director of a public company if the person has committed securities fraud.

Appendix 4

List of Documents submitted to/considered by the Committee

S. No. **Name**

1. Memorandum of UTI.
2. Memorandum of Shri Seshasayee, M/s Ashok Leyland.
3. Draft Charter for Audit Committees submitted by ICAI.
4. Memorandum of Investors' Grievances Forum.
5. Suggestions made by Prof. N Balasubramanian, IIM Bangalore.
6. Suggestions made by Shri P N Shah, Former President, ICAI.
7. Suggestions made by Ms Sucheta Dalal, Journalist.
8. Presentation of J M Morgan Stanley.
9. Suggestions made by Shri Shardul Shroff, Advocate.
10. Paper presented by Principal Director, Commercial Audit, office of CAG.
11. Report of the Task Force on Corporate Excellence through Governance (Executive Summary).
12. Statistics regarding increasing work load on ROCs.
13. SEBI guidelines on Corporate Governance
14. Memorandum of Indian Bank Association.
15. Memorandum of ASSOCHAM.
16. Memorandum of Merchants' Chamber of Commerce, Calcutta.
17. Memorandum of PHD Chamber of Commerce and Industry.
18. IFAC code of ethics for professional accountants.
19. Comparatives position of the Sarbanes-Oxley Act, 2002 vis-à-vis Indian Legal Provisions.
20. European Commission's suggestion regarding Statutory Auditors' Independence.

21. Suggestion made by Shri P K Kaul, IAS (Retd.), former Cabinet Secretary.
22. Paper titled "comparison between the prohibited activities for auditors under the Indian, US and IFAC Regulations".
23. Suggestions made by Shri Bharat Doshi, M/s Mahindra & Mahindra.
24. Memorandum of RBI (without annexures, except Sl No. 33 below).
25. Memorandum of Institute of Directors.
26. Suggestions received from Shri T B Mohan Das Pai, M/s Infosys.
27. Memorandum of the Institute of Cost and Works Accountants.
28. Presentation made by Institute of Cost and Works Accountants.
29. Presentation made by the Institute of Company Secretaries.
30. Note on compliance audit submitted by Shri Krishnan.
31. Memorandum received from Tamilnadu Investors Association.
32. Suggestions made by Shri Kirit Somaiya, MP.
33. Report of Consultative Group of Directors, RBI, 2002 (Executive Summary).
34. Summary of the Ganguly Committee Report.
35. ICAI's comments on Sarbanes-Oxley Act of 2002.
36. Presentation made by ICAI.
37. ICAI's submission regarding disciplinary proceedings.
38. Memorandum of SEBI
39. Memorandum of IFCI Ltd.
40. Suggestions made by Shri A N Haksar, Chairman (Emeritus), ITC Ltd
41. Memorandum of FICCI.
42. Memorandum of CII.
43. Suggestions made by Shri Y. H. Malegam, Chartered Accountant.

While every care has been taken to make this list exhaustive, inadvertent omissions, if any, are deeply regretted.

List of Abbreviations

AGM	Annual General Meeting
ASSOCHAM	Associated Chamber of Commerce and Industry
BSE	Bombay Stock Exchange
CAG	Comptroller and Auditor-General

CBDT	Central Board of Direct Taxes
CBEC	Central Board of Excise & Customs
CCI	Comptroller of Capital Issues
CEO	Chief Executive Officer
CFE	Certified Fraud Examiner
CFO	Chief Financial Officer
CFS	Consolidated Financial Statement
CII	Confederation of Indian Industry
CPA	Certified Public Accountant
CRISIL	Credit Rating Information Services of India Ltd
CSFO	Corporate Serious Frauds Office
DCA	Department of Company Affairs
ESI	Employees State Insurance
FICCI	Federation of Indian Chamber of Commerce and Industry
GAAP	Generally Accepted Accounting Principles
ICAI	Institute of Chartered Accountants of India
ICRA	Investment Information & Credit Rating Agency
ICSI	Institute of Company Secretaries of India
ICWAI	Institute of Cost and Works Accountants of India
IEPC	Investor Education and Protection Committeek
IEPF	Investor Education and Protection Fund
IFAC	International Federation of Accountants
IIM	Indian Institute of Management
LIC	Life Insurance Corporation
MAOCARO	Manufacturing and Other Companies (Auditors' Report) Order
NACAS	National Advisory Committee on Accounting Standards
OECD	Organisation for Economic Cooperation and Development
PCAOB	Public Company Accounting Oversight Board
POB	Public Oversight Board
QRB	Quality Review Board
RBI	Reserve Bank of India
ROC	Registrar of Companies
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission
SOX	Sarbanes–Oxley Act
UTI	Unit Trust of India