# Current affairs noticeboard

## Reforms to corporate governance

**Table 1**

| **Committee Recommendations** | **Included in relevant section of *The Companies (Amendment) Bill 2003 (CAB)*** | **Concept paper (2004) (CP) and Concept Rules (CR)** |
|---|---|---|
| For larger companies, at least half of board to be independent (Recommendation 4.2)<br><br>Definition of independent director to be included in CAB | Section 118<br><br>Section 119 | Section 63 of CP<br><br>Section 2 (45) of CP |
| For larger companies, audit committees to only consist of independent directors, have a charter (Recommendation 4.8) and report annually on various matters (Recommendation 2.9). | Section 136 recommends that audit committee consist of not less than 2 independent members and not more than that prescribed by government. The functions and powers of the audit committee are to be prescribed. | Section 62 of CP<br><br>Clause 62 (1) of CR states the audit committees should consist of not less than 2 independent directors. The maximum number of independent directors must be between 2/3 and 3/4 of the total members of the committee.<br><br>Clause 62 (2) of CR outlines functions of audit committees |
| Directors to be trained as to their rights, responsibilities, duties and liabilities of a legal, recognised fiduciary (para 35) | Section 119 | Clause 63 (1) of CR |

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|---|---|---|
| Chief Financial Officers (CEOs) and Chief Executive Officers (CEOs) to approve accounts | Larger companies must appoint a Chief Accounts Officer (Section 99) | Section 88 of CP |

As stated in the previous edition of *Current Affairs Noticeboard,* the basis of tackling corporate excess in India is corporate governance systems. This may be seen as part of a worldwide trend for regulators relying on self-regulatory corporate governance systems to prevent and/or deter corporate excesses. Corporate governance systems are based upon having independent directors sitting on boards and audit committees. Thus, all documents involved in the reform process to date have included a requirement that a majority of directors sitting on boards be independent. Each document contains an improved definition of an independent director. Sarathy (2003) notes the reasoning behind requiring non-executive directors to be independent is based

> on the concept that independence of a director and thereby his objectivity and integrity is best established when he has no personal stake in the business and there is no room for temptation or pressures (p.88).

It has been noted in Australia that the independent directors may lack the skills to effectively deal with complex matters brought before the board. Also, similar to Australia, there is a fear in India that there are insufficient independent directors to fulfil the requirement that Indian boards have a majority of independent directors (rediff.com, 2003, p.1). The Naresh Chandra Committee sought to tackle these problems by recommending that directors be trained to understand their rights, responsibilities, duties and liabilities (para 35 of the Executive Summary). This recommendation was included in section of 119 of *The Companies (Amendment) Bill, 2003.* However, the recommendation as such was not included in the Concept Paper. However, the Concept Rules outline the attributes of an independent director that include being a graduate of a recognised university/institute relating to the main business activity of the company or other area necessary for the workings of a company and post-graduate experience of not less than 5 years (Clause 63 (1)(C)).

Worldwide, the chief corporate governance practice that relates to financial statement reliability is the audit committee. Thus, it is no surprise that the Naresh Chandra committee recommended that larger Indian companies establish audit committees. Note that the Naresh Chandra committee recommended that audit committees consist of only independent members, while *The Companies (Amendment) Bill 2003* and Concept Rules suggest that the independent directors be a majority of the committee's members. The presence of executive management on the audit committee raises the fear that these persons may intimate or persuade independent members not to further investigate issues of concern.

The Naresh Chandra Committee recommended that audit committees take over key functions as dealing with the appointment, re-appointment or removal of the auditor and the remuneration of the auditor (Recommendation 2.9). These functions would not be controlled by executive management who, if they undertook these functions, could cause auditor independence problems. The importance of audit independence is reinforced when the Committee also recommended a general requirement that the audit committee review the independence of the auditor (Recommendation 2.9). However, *The Companies (Amendment) Bill 2003* noted the functions of the audit committee were to be prescribed. These functions were outlined in the Concept Rules. The functions outlined made no mention of audit independence. The only specific areas noted in relation to a full audit was that the audit committee should have discussions with the auditor about internal control systems, the scope of the audit that included any observations of the auditor and ensure company's compliance to the internal control systems (Clause 62 (2) (c)). However, clause (f) of clause 62 of the Concept Rules gives the audit committee the right to investigate any matter referred to it by the Board. Hopefully this includes the independence of the auditors.

In Australia, recommendation 4.1 of the ASX Corporate Governance Council (2003) *Principles of Good Corporate Governance and Best Practice Recommendations* states the chief executive officer and chief financial officer should certify to the board of directors that company's financial condition and operational results present a true and fair view. The Naresh Chandra Committee also noted a requirement was included in the Sarbanes Oxley Act that the CEO and CFO is to certify 'to the SEC regarding the veracity of each annual report and quarterly report' and concluded this to be a good corporate governance practice (para. 17 of the Executive Summary). The committee thus recommended a similar requirement should be included for larger Indian companies arguing

> (t)he 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 (para.2.30).

Included in the matters that would be subject to certification by the CEO and CFO are that the 'internal controls … have been designed to ensure that all material information is periodically known to them; and have evaluated the effectiveness of internal controls of the company' (para 17 of the Executive Summary).

The rationale for requiring the CEO to certify the financial statement lies in the dominant position of the CEO in being able to influence matters that include how the company financial reports are prepared. Alan Greenspan, 2002, chairman of The Federal Reserve Board in United States stated:

> The CEO sets the business strategy of the organization and strongly influences the choice of the accounting practices that measure the ongoing degree of success or failure of that strategy. Outside auditors are generally chosen by the CEO or by an audit committee of CEO-chosen directors. Shareholders usually perfunctorily affirm such choices (p.1).

An advantage in having the CEO and CFO make a declaration about the financial statements is that these persons are the most senior in a company and they set the culture in the company that may expect manipulation of accounting results. The CEO and CFO would be more likely liable to ensure the culture not conducive to fraud would occur knowing they can be prosecuted for making a false declaration. Another advantage is that a declaration would make it easier for regulators to prosecute CEOs for publishing false accounting results. It seems prosecuting directors for publishing unreliable accounting data has been a problem in India. The following is attributed to a judge in the Andrea Pradesh High Court who 'said he found there was no case in the High Court where directors had been punished for not submitting proper accounts' (*The Hindu,* 9 September 2004).

In Australia, a survey by RSM Bird Cameron (2005) noted a significant number of CEOs felt they lacked the knowledge to certify that the annual financial statements are in accordance with the various statutory requirements (p.1). It is reasonable to conclude that CEO's in India would experience the same problems. Thus a proposed regulation was included in the *Companies (Amendment) Bill, 2003* and Concept Paper that for larger companies a Chief Accounts Officer be appointed. The Chief Accounts Officer would be responsible for the proper maintenance of books of accounts, preparation of annual accounts and compliance with provisions relating to the accounts of the company (Section 99). For the Chief Accounts Officer, the same responsibilities are noted in section 88 of the Concept Paper.

## References

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