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Audit Committee and Corporate Governance

9.1 Introduction

Corporate Governance is the system by which companies are directed and governed by the management in the best interests of the stakeholders and others ensuring better management, greater transparency and timely financial reporting. The Board of Directors are responsible for governance of their companies.

9.2 Definition of Corporate Governance

The word 'Corporate' is associated by legal enactment for the transaction of a business. Similarly, the word 'Governance' means exercise of authority, direction or control. Thus, the concept of 'Corporate Governance' is the system by which the management of a business entity directs and controls the activities in the best interest of the stakeholder.

As per N. R Narayana Murthy, Chairman, Committee on Corporate Governance, SEBI, Mumbai, February 8, 2003

"Corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company."

9.2.1 Issues of Corporate Governance - Clause 49 of the listing agreement covers SEBI guidelines regarding Corporate Governance. Issues addressed in Clause 49 regarding Corporate Governance are:

- (i) Board's Director including its composition and compensation;
- (ii) Provisions regarding Board's Committee including composition and functioning of Audit Committee which is an important pillar of the Corporate Governance;
- (iii) Management of subsidiary companies;
- (iv) Disclosures of important issues regarding related party transactions accounting policies, principle of risk management, accounting for proceeds from public issues, right issues, preferential issues, etc;
- (v) Content of management discussion and analysis;
- (vi) Information to shareholders;
- (vii) CEO/ CFO certification;

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(viii) Report of Corporate Governance and compliance certificate. (Refer to Appendix –I for text of the SEBI Circulars)

9.3 Management's Responsibility

Managements' responsibility for conducting its business implicitly requires it to take reasonable steps to ensure the implementation of the requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement. Under the terms of the Listing Agreement, a company is statutorily bound to implement the requirements of Clause 49 of the Listing Agreement. This flows from provision of Section 21 of the Securities Contracts (Regulation) Act, 1956. Section 23 of SCRA, 1956 provides for stringent penalties for non-compliance of Section 21 of the said Act.

9.4 Audit Committee under Clause 49

The summarised requirements of Corporate Governance under clause 49 of the listing Agreement is discussed below.

9.4.1 Qualified and Independent Audit Committee [Clause 49 (II) (A)] - As per the SEBI circular a qualified and independent audit committee shall be set up taking into account the following norms:

- (i) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors
- (ii) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
- (iii) The Chairman of the Audit Committee shall be an independent director
- (iv) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries
- (v) The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee
- (vi) The Company Secretary shall act as the secretary to the committee.

The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

9.4.2 Meeting of Audit Committee [Clause 49 (II) (B)] - The audit committee should meet at least four times in a year and not more than four months shall lapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

9.4.3 Powers of Audit Committee [Clause 49 (II) (C)] - The audit committee shall have powers, which should include the following:

- (1) To investigate any activity within its terms of reference.
- (2) To seek information from any employee.
- (3) To obtain outside legal or other professional advice.
- (4) To secure attendance of outsiders with relevant expertise.

Further it may be noted that the four powers as mentioned above are only illustrative and not exhaustive.

The auditor should check whether the terms of reference of the audit committee have been suitably framed mentioning the above powers. It is mandatory for the above-mentioned four powers to be vested in the Audit Committee. The Board may delegate/vest further powers to the committee.

9.4.4 Role of Audit Committee [Clause 49 (II) (D)] - The role of the audit committee shall include the following:

- (a) Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
- (b) Recommending the appointment and removal of external auditors, fixation of audit fee and also approval for payment of any other services.
- (c) Reviewing with management the annual financial statements before submission to the Board, focusing primarily on:
 - (i) Any changes in accounting policies / and practices;
 - (ii) Major accounting entries based on exercise of judgments by management;
 - (iii) Qualification in draft audit report;
 - (iv) Significant adjustments arising out of audit;
 - (v) The going concern assumption;
 - (vi) Compliance with accounting standards;
 - (vii) Compliance with stock exchanges and legal requirement concerning financial statements.
 - (viii) Any related party transactions.
- (d) Reviewing with the management, external and internal auditors, the adequacy of internal control system.

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- (e) Reviewing the adequacy of internal audit function, if any including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.
- (f) Discussion with internal auditors any significant findings and follow-up thereon.
- (g) Reviewing the findings of any internal investigation by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the Board.
- (h) Discussion with external auditors before the audit commences, nature and scope of audit as well as have post audit discussion to ascertain any area of concern.
- (i) Reviewing the company's financial and risk management policies.
- (j) To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividend) and creditors.
- (k) Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

The term "related party transactions" shall have the same meaning as contained in the Accounting Standard 18, Related Party Transactions, issued by the Institute of Chartered Accountants of India.

If the company has set up an audit committee as per section 292A of the Companies Act, the company agrees that the said audit committee shall have such additional functions / features as is contained in the Listing Agreement.

9.5 Functions of the Audit Committee

The Audit Committee performs various important functions like investigating the matters referred by board, discuss about internal control system etc. The sub-section 6 & 7 of Section 292A are reproduced hereunder which specify the functions of the audit committee:

- (6) The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.
- (7) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.

9.6 Review of Information by Audit Committee

The Audit Committee shall mandatorily review the following information as per Clause 49 II (E):

1. Management discussion and analysis of financial condition and results of operations;

2. Statement of significant related party transactions (as defined by the audit committee), submitted by management;
3. Management letters / letters of internal control weaknesses issued by the statutory auditors;
4. Internal audit reports relating to internal control weaknesses; and
5. The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

The auditor should ascertain from the minutes book of the audit committee and other sources like agenda papers, etc. whether the audit Committee has reviewed the above-mentioned information. The auditor should ascertain whether as a part of directors' report or as an addition thereto, a management discussion and analysis report forms part of the annual report to the shareholders. Under the old Clause 49, this was specifically mandated, but now not spelt out clearly. The auditor should further ascertain whether the management discussion and analysis includes discussion on the matters stipulated in this sub-clause.

Where certain deficiencies or adverse findings are noted by the audit committee, the auditor will be required to see that these have been suitably dealt with by the management in the Report on Corporate Governance.

The auditor should ascertain that the information reviewed by the Audit Committee is consistent with the reporting in the financial statements including those drawn up giving segment wise break-up for compliance of AS 17 (Segment Reporting).

9.7 Audit Committee under Section 292 A of the Companies Act, 1956

All companies listed on a stock exchange in India have to set-up in Audit Committee in Compliance with clause 49 of the Listing Agreement. This is in addition to the creation of Audit Committee under section 292 A of the Companies Act, 1956, the main features of which as per the provision is outlined below:

Section 292 A of the Companies Act, 1956 provides:

- (1) Every public company having paid-up capital of not less than five crores of rupees shall constitute a committee of the Board known as "Audit Committee" which shall consist of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors.
- (2) Every Audit Committee constituted under sub-section (1) shall act in accordance with terms of reference to be specified in writing by the Board.
- (3) The members of the Audit Committee shall elect a chairman from amongst themselves.
- (4) The annual report of the company shall disclose the composition of the Audit Committee.
- (5) The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.

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- (6) The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.
- (7) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.
- (8) The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.
- (9) If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefore and communicate such reasons to the shareholders.
- (10) The chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.
- (11) If a default is made in complying with the provisions of this section, the company, and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees, or with both."

9.8 Audit Committee - A Comparative

An Audit Committee is basically a committee formed with the Board of Director's of the company who are entrusted with the authority to oversee or supervise the process of financial reporting of the enterprise including issues related to audit function and review of financial policies, risk management policies etc. Introduction of such Committee under clause 49 of the listing agreement and section 292 A of the Companies Act, 1956 in respect of specified companies in India has brought about a marked change in the financial reporting process as auditors now have an opportunity to bring forth audit - related issues to the attention of BOD, mainly composed of non-executive or independent director for ensuring effective Corporate Governance.

The comparative chart showing the requirements under clause 49 and Section 292A is tabulated herein below:

<i>Clause 49 of the Listing Agreement</i>	<i>Section 292A of the Companies Act, 1956</i>
1(a) All companies seeking listing for the first time, at the time of seeking in principle approval for such listing and (b) All existing listed companies with a paid-up capital of ` 3 Crores and above or net worth of ` 25 crores or more at any time in the history of the company are required to set up an audit committee.	1. Every public company having paid-up capital of not less than five crores of rupees shall constitute an audit committee immediately on the enactment of Companies (Amendment) Act, 2000, i.e. with effect from 13th December, 2000.

2. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.	2. The audit committee shall have minimum three directors of which two-third of the total number of such directors shall be directors other than managing or whole-time directors.
3. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.	3. No such reference is contained in the Companies Act, 1956.
4. The Chairman of the audit committee shall be an "independent" director and shall be present at Annual General Meeting to answer queries of the shareholders.	4. The members of the audit committee shall elect a chairman from amongst themselves. The Chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.
5. A representative of the external auditor, when required shall be present as an invitee for the meetings of the audit committee. The audit committee may invite such of the executives to be present at the meetings of the committee. The Finance Director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee.	5. The Auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the audit committee but shall not have the right to vote.
6. The Company Secretary shall act as Secretary to the audit committee.	6. No such reference is contained in the Companies Act, 1956.

The following additional requirements are stipulated as per Clause 49 of the Listing Agreement on which Section 292A (relating to audit committee) is silent:

- (i) The audit committee may invite such of the executives, as it considers appropriate (and particularly head of the finance function) to be present at the meeting of the committee, but on occasions, it may also meet without the presence of any executives of the company.
- (ii) The company secretary shall act as secretary to the committee.
- (iii) The audit committee shall meet at least four times in a year. The gap between two meetings should not be more than four months.
- (iv) The quorum of the audit committee shall be two members or one-third of the members of the audit committee whichever is higher and minimum of two independent directors be present.
- (v) The powers and role of the audit committee are elaborately contained in Clause 49 II (C) & (D).

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- (vi) All members of the audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

The following additional requirements are stipulated as per Section 292A the Companies Act, 1956 (relating to audit committee) on which Clause 49 of the Listing Agreement is silent:

- (i) The audit committee constituted shall act in accordance with terms of reference to be specified in writing by the Board.
- (ii) The recommendations of the audit committee on any matter relating to financial management, including the audit report, shall be binding on the Board.
- (iii) If the Board does not accept the recommendations of the audit committee, it shall record the reasons thereof and communicate such reasons to the shareholders.

The auditor should ascertain from the minutes book of the Board meetings whether a qualified and independent audit committee is set up which comprises of minimum three members. The auditor should ascertain whether two-thirds of the members of audit committee are independent directors and whether all members of audit committee are financially literate and at least one member has accounting or related financial management expertise. The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

The auditor should have met at least four times in a year and not more than 4 months have elapsed between two meetings.

The auditor should ascertain from the minute book of the audit committee whether quorum i.e. two ascertain from the minute book of the audit committee whether the audit committee members or one-third of the members of the audit committee, whichever is higher with a minimum of two independent directors was present in every meeting of the audit committee.

The auditor should ascertain whether the Chairman of the Audit Committee is an independent director. The expression "independent director" has been discussed in Clause 49 (I) (A) (iii).

The auditor should ascertain from the annual general meeting (herein after referred to as AGM) attendance book and minutes book whether the chairman of the audit committee was present at such meeting to answer shareholders' queries. In case the Chairman has not been present at the AGM, auditor should ensure that this is suitably disclosed. The AGM of the financial year which is under audit would be held subsequent to the auditor submitting the certificate of compliance of conditions of corporate governance and hence, the requirement would be to verify this condition with reference to the last AGM held.

The auditor should ascertain whether there is a practice of inviting the executives (and particularly the head of the finance function) in the audit committee meetings and he should further ascertain from the minutes book of the audit committee whether such executives did attend the audit committee meetings. His presence at such audit committee meetings (pursuant to Section 292A) would be required only when he has been invited to, duly given notice of such meeting

The auditor should ascertain from the minutes book of the audit committee, whether the finance director, head of internal audit representative of the statutory auditor when required was present as invitee in the meetings of the audit committee.

9.9 Role of Auditor in Audit Committee and Certification of Compliance of Conditions of Corporate Governance

The amendment to Listing Agreement as well as the Companies Act, 1956 in respect of constitution of audit committee underline the importance of audit process and its contribution to the corporate governance process. Clause 49 stipulates that a representative of the statutory auditor, when required, shall be present as an invitee for the meetings of the audit committee. Section 292A of the Companies Act, 1956 stipulate that the auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.

The auditor would be informing the audit committee on various matters connected with the audit from time to time. He can contribute significantly in assisting and advising the audit committee as per the request of the audit committee, particularly in improving corporate governance, oversight of financial reporting process, implementation of accounting policies and practices, compliance with accounting standards, strengthening of the internal control systems in regard to financial reporting and reporting processes.

The auditor would be devoting substantial professional time in assisting the management and the audit committee to enable it to discharge its functions effectively and in certification of requirements of corporate governance.

The auditor has to keep in mind that his role is not to drive corporate governance directly by ensuring compliance of the requirements of corporate governance. It is the management responsibility for ensuring the same and in the process he would play a significant role in assisting the management for ensuring better standards of corporate governance.

9.9.1 Auditor's Responsibility - The Auditor's responsibility in certifying compliance of requirements of corporate governance relate to verification and certification of factual implementation of requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement. Such verification and certification is neither an audit nor an expression of opinion on financial statements of the company.

The certificate from the Auditor as regards compliance of requirements of corporate governance is neither an assurance as to the future viability of the company nor the efficiency or effectiveness with which the management has conducted the affairs of the company.

9.9.2 General Principles of Audit - The Standards are set out in Standards on Auditing (hereinafter referred to as SA) would be applicable in performance of certification of requirements of corporate governance by the Auditor, to the extent relevant.

As in the case of other professional assignments, in certification of compliance of requirements of corporate governance, the Auditor should comply with the "Code of Ethics" issued by the Institute of Chartered Accountants of India.

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The Auditor should conduct verification of compliance of requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement in accordance with this Guidance Note.

9.9.3 Documentation - The auditor should document matters, which are important in providing evidence to support the certificate of factual findings in accordance with SA 230 on "Audit Documentation".

9.9.4 Management Representations - The auditor should consider obtaining management representations on conditions of Corporate Governance in accordance with SA 580, "Written Representations".

9.9.5 Verification regarding composition of Board -

(i) The auditor should ascertain throughout the reporting period whether the Board of Directors comprises not less than 50% of the directors who are non-executive directors. The minutes of the Board of Directors' should be verified to ascertain whether a director is an executive director or a non-executive director.

(ii) The auditor should also verify that where the Chairman of the Board is a non-executive director, at least 1/3rd of the Board should comprise of independent directors. In case the Chairman is an executive director, at least half of the Board should comprise of independent directors. In determining the number of requisite independent directors and/or non-executive directors, the fraction, if any, in number of one-half or one-third as the case may be should be rounded off. Since the terms in this clause refer to 'not less than' and 'at least', it would be appropriate to compute the number by rounding off any fraction to the next integer. For example, in a Board headed by non-executive Chairman and comprising of six other directors (i.e., seven directors) the independent directors should be three or more.

(iii) Annual Declaration by directors to the Board of Directors may be examined for this purpose. If Board of Directors has followed any particular procedure(s) to ascertain independence of directors, the auditor should examine the same. Effect of changes in the composition of the Board and/or its Chairman and its impact on compliance throughout the reporting period may also be looked into.

(iv) It may be noted that a independent non-executive director apart from receiving remuneration should not have any material pecuniary relationship or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director.

Also, such independent director should not be a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director and should not also be a substantial shareholder of the company. In determining 'not a substantial shareholder', he should not own 2% or more of the block of voting shares.

9.9.6 Remuneration of Directors [Clause 49 IV (E)] – Disclosure requirements regarding directors remuneration are stated below:

(i) All pecuniary relationship or transactions of the non-executive directors vis-à-vis the company shall be disclosed in the Annual Report.

- (ii) Further the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the Annual Report:
 - (a) All elements of remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc.
 - (b) Details of fixed component and performance linked incentives, along with the performance criteria.
 - (c) Service contracts, notice period, severance fees.
 - (d) Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.
- (iii) The company shall publish its criteria of making payments to non-executive directors in its annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.
- (iv) The company shall disclose the number of shares and convertible instruments held by non-executive directors in the annual report.
- (v) Non-executive directors shall be required to disclose their shareholding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.

9.9.7 All fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of shareholders in limits for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

Provided that the requirement of obtaining prior approval of shareholders in general meeting shall not apply to payment of sitting fees to non-executive directors, if made within the limits prescribed under the Companies Act, 1956 for payment of sitting fees without approval of the Central Government.

In this context the auditor may note - That no approval from the Central Government is required so long as the remuneration is within the limits prescribed in Schedule XIII to the Companies Act, 1956.

Should ascertain from the minutes of the Board of Directors' meeting, shareholders' meetings, relevant agenda papers, notices, explanatory statements etc., whether remuneration of non-executive directors has been decided by the Board of directors and previous approval of the shareholders in general meeting have been obtained.

May note that in regard to sitting fees payable to non-executive directors, prior approval in general meeting will not be required if made within the limits prescribed under the Companies Act, 1956.

Should also verify whether the remuneration is in compliance with Section 198, 309, 314, 349 and 350 of the Companies Act, 1956 and whether the stock options that are granted to the non-executive directors are in accordance with SEBI (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999.

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Should further refer to the Articles of Association of the Company wherever applicable.

Should examine the report of the Board of directors on Corporate Governance to be included in the annual report of the company and ascertain whether the same contains the disclosures required of remuneration to non-executive directors. The auditor should correlate this data with that contained in the financial statements.

Since Clause 49 I (B) (i) refers to stock options that can be granted to non-executive directors, reference may be made to ICAI Guidance Note on Accounting for Employee Share-based Payments

Where application of this clause requires the value of ESOP to be determined, the services of expert may have to be utilized. In this regard, reference may be made to SA 620 dealing with "Using the Work of an Auditor's Expert"

9.9.8 Other provisions as to Board and Committees as per Clause 49 I (C) –

- (i) The board shall meet at least four times a year, with a maximum time gap of four months between any two meetings. (ii) A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

Explanation:

- 1. For the purpose of considering the limit of the committees on which a director can serve, all public limited companies, whether listed or not, shall be included and all other companies including private limited companies, foreign companies and companies under Section 25 of the Companies Act shall be excluded.
- 2. For the purpose of reckoning the limit under this sub-clause, Chairmanship/membership of the Audit Committee and the Shareholders' Grievance Committee alone shall be considered.
- (iii) The Board shall periodically review compliance reports of all laws applicable to the company, prepared by the company as well as steps taken by the company to rectify instances of non-compliances.

9.9.9 Section 285 of the Companies Act, 1956 requires that - "Board to meet at least once in every three calendar months- In the case of every company, a meeting of its Board of Directors shall be held at least once in every three months and at least four such meetings shall be held in every year.

Provided that the Central Government may, by notification in the Official Gazette, direct that the provisions of this section shall not apply in relation to any class of companies or shall apply in relation thereto subject to such exceptions, modifications or conditions as may be specified in the notification."

Clause 49 and Section 285 stipulate that the Board meeting shall be held at least four times a year. The further requirement of Clause 49 is that the maximum time gap between any two

meetings should not exceed four months. The requirement under the Companies Act, 1956 is that the Board meeting would be held at least once in every three months.

The auditor should ascertain from the minutes book of the Board meetings whether Board meetings were held at least four times a year, with a maximum time gap of four months between any two meetings. The auditor should also ascertain whether minimum information was made available to the Board.

The auditor should also ascertain that a director of the Company is not a member in more than ten committees or is acting as chairman of more than five committees across all companies in which he is a director. A suitable declaration from the management and/or director should be obtained to this effect. This information should be verified from the mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies as well as from the changes notified by every director when they take place. The Explanation (1) to Clause 49 (1) (C) (ii) clarifies that the limit of the committees on which a director can serve would comprise of all public limited companies, whether listed or not and excluding private limited companies, foreign companies and companies which are granted license under section 25 of the Companies Act, 1956. Further Explanation (2) clarifies that only two committees namely Audit Committee, and Shareholders' Grievance Committee shall be considered for the purpose of limit.

For the purpose of reviewing compliance reports of all laws applicable to the company, the said reports prepared by the company as well as steps taken by the company to rectify instances of non-compliances, the auditor should take into consideration SA 250, dealing with consideration of Laws and Regulations in an Audit of Financial Statements. It is the management's responsibility to ensure that company operations are conducted in accordance with Laws and Regulations. The responsibility for the prevention and detection of non-compliance rests with the management. The auditor's responsibility is limited to verification that management has taken suitable steps and has put in place policies and procedures to ensure compliance with laws and regulations and to detect deviation from such procedures.

9.9.10 Code of Conduct as per Clause 49 I (D) -

- (i) The Board shall lay down a code of conduct for all Board members and senior management of the company. The code of conduct shall be posted on the website of the company.
- (ii) All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The Annual Report of the company shall contain a declaration to this effect signed by the CEO.

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

The auditor should ascertain whether the Board of Directors of the company has laid down a code of conduct for all Board members and senior personnel of the company and obtain a copy of the same. He should also verify whether all Board members and senior management

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personnel have affirmed compliance with the code on an annual basis and whether the code has been posted on company's website.

9.9.11 Subsidiary Companies Clause 49 (III) -

- (i) At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of a material non listed Indian subsidiary company.
- (ii) The Audit Committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.
- (iii) The minutes of the Board meetings of the unlisted subsidiary company shall be placed at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

The term "material non-listed Indian subsidiary" shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth (i.e. paid up capital and free reserves) exceeds 20% of the consolidated turnover or net worth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.

The term "significant transaction or arrangement" shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the material unlisted subsidiary for the immediately preceding accounting year.

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

Clause 49 III (i) requires the appointment of at least one of the independent director of a holding company to be appointed as a director of a material non-listed Indian subsidiary company. The concept of "material" non-listed subsidiary is explained in Explanation 1 under the said clause.

In regard to taking note of the proceedings of the Board of the unlisted company, Clause 49 III (iii) requires the minutes of the Board of every unlisted subsidiary to be placed before the Board of the holding company. Apart from the above, the management of the holding company should periodically bring to the attention of the Board of Directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company. This applies only in regard to "significant transaction or arrangement" the meaning of which is given in Explanation 2 under the clause.

Reading the Explanation 2 in totality, it would be seen that the disclosure to the Board of the holding company would apply only where such significant transaction or arrangement are entered into by a company which is a material unlisted subsidiary as mentioned above.

It may further be noted that the plain reading of Explanation 2 would indicate that the least of total revenues, total expenses, total assets or total liabilities of the immediately preceding accounting year are to be considered as the basis for computing benchmark of 10% thereof.

However, the use of the words 'or' coupled with 'as the case may be' would support the more logical view that one has to apply the test comparing with like items. For example a capital expenditure has to be compared with aggregate capital expenditure for the year. When making the comparison of any transaction with 'total revenues', "total expenses" etc., one may take into consideration the total revenue or expenditure 'likely to' arise for the entire financial year and not necessarily the aggregate expenditure incurred.

Clause 49 III (ii) requires the audit committee of the listed holding company to review the financial statements and in particular, the investments made by the unlisted subsidiary company would apply all unlisted subsidiary companies. This is required in regard to all unlisted subsidiaries, without reference to materiality or place of incorporation etc. Where however the subsidiary of a listed company is itself a listed company, the Explanation 3 would apply.

9.9.12 Proceeds from public issues, rights issues, preferential issues etc Clause 49 IV (D) - When money is raised through an issue (public issues, rights issues, preferential issues etc.), it shall disclose to the Audit Committee, the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and place it before the audit committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.

The object of this sub-clause is to ensure that in case of diversion of funds from the proceeds of issues, it should be appropriately brought to the notice of audit committee for suitable action to be taken. Also, it is desirable that quarterly and yearly report on the same is placed before the audit committee for its review and action if any. It is to be noted that the disclosure under the sub-clause should continue to be made till such time the issue money is utilized in full and the statutory auditors certify the said statement. Further it may be noted that statement shall pertain only to the year in which money has been raised or till such time the money is fully spent whichever is later.

The following procedure may be noted in carrying out the aforesaid action on the uses and applications of funds from proceeds from public issues etc:

The quarterly report on the uses/application of funds shall be placed before the Audit Committee by the management.

Diversion of funds, if any shall be brought to the attention of the Audit Committee by the management

The management would then obtain the duly certified statement from the statutory auditors of the company and place it before the Audit Committee to enable the discontinuance of reporting thereafter.

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9.9.13 Content of Management Discussion and Analysis [Clause 49 IV (F)] -

- (i) As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:
 - (i) Industry structure and developments.
 - (ii) Opportunities and Threats.
 - (iii) Segment-wise or product-wise performance.
 - (iv) Outlook
 - (v) Risks and concerns.
 - (vi) Internal control systems and their adequacy.
 - (vii) Discussion on financial performance with respect to operational performance.
 - (viii) Material developments in Human Resources / Industrial Relations front, including number of people employed.
- (ii) Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding the Board of Directors). This would also include all members of management one level below the executive directors including all functional heads.

The above information presented by the Management is likely to include non-financial information, which may be outside the area of auditors' expertise. In such situations, the auditor may keep in mind the SA 315 relating to **Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment** and the fact that he is only required to review the compliance with Disclosure requirements and not verify the particular facts as disclosed by the management.

The auditor should ascertain that this information [i.e. segment-wise or product-wise performance (sub-clause (iii) as stated above) and considered as a part of Management Discussion and Analysis Report] is consistent with what is reported in financial statements complying with AS 17 (Segment Reporting) and also as per provisions of Section 211, 217(2AA) and 227 of the Companies Act, 1956.

9.9.14 Information to Shareholders [Clause 49 IV (G)] -

- (i) In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:
 - (a) A brief resume of the director;

- (b) Nature of his expertise in specific functional areas;
- (c) Names of companies in which the person also holds the directorship and the membership of Committees of the Board; and
- (d) Shareholding of non-executive directors as stated in Clause 49 (IV) (E) (v) above
- (ii) Quarterly results and presentations made by the company to analysts shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.
- (iii) A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This Committee shall be designated as 'Shareholders/ Investors Grievance Committee'.
- (iv) To expedite the process of share transfers, the Board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

The auditor should ascertain from the communications sent, whether in the case of appointment of a new director or re-appointment of a director the shareholders have been provided with the information stipulated in sub-clause (i) as mentioned above.

The auditor should see that the references contained in the above paragraph are complied therewith.

The Auditor should ascertain from the company's website whether information like quarterly results, presentation made by the entity to analyst have been put on company's website. In the alternative whether such information has been sent in a form so as to enable the Stock Exchange in which the company's securities are listed to enable such Stock Exchange to put it on its own website. The auditor should also ascertain whether the other information which are mandatorily required to be disclosed to the shareholders as per the Listing Agreement or as per the Companies Act, 1956 are put on company's web-site or alternatively sent in such form to enable the stock exchange on which the company's securities are listed to enable such stock exchange to put it on its own web-site.

The auditor should ascertain from the minute book of the Board meeting whether a Board committee namely Shareholders/ Investors Grievance Committee has been set up under the chairmanship of a non-executive director to specifically look into the redressing of shareholder and investors complaints like transfer of shares, non receipt of balance sheet, non receipt of declared dividends, etc. Further the auditor should also ascertain from the minute book of the Shareholders/ Investors Grievance Committee whether such committee is prima-facie functioning.

The auditor should also verify from the records of the Shareholders/ Investors Grievance Committee as well as from the certificate obtained by the company from SEBI and Stock Exchange(s), if any, as regards the investors grievances pending upto the date of certificate of compliance of conditions of corporate governance.

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The auditor should ascertain from the minute book of the Board meeting whether the company has delegated the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The auditor should also verify from the records maintained to ascertain whether the delegated authority has attended to share transfer formalities at least once in a fortnight. The auditor may verify whether any transfer request are pending for more than a fortnight and are not attended to in terms of this sub-paragraph.

9.9.15 CEO/CFO certification Clause 49 V - The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

- (a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:
 - (i) These statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;
 - (ii) These statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.
- (b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.
- (c) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of the internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.
- (d) They have indicated to the auditors and the Audit committee
 - (i) Significant changes in internal control over financial reporting during the year;
 - (ii) Significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
 - (iii) Instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting."

The amendments effected in Clause 49V(c) & (d) clearly bring out that

The responsibility entrusted to the CEO/CFO is in relation to establishing and maintaining internal controls for financial reporting.

The CEO/CFO certificate has to assert that they have evaluated the effectiveness of internal control systems of the company pertaining to financial reporting.

The CEO/CFO certificate will further state the manner in which deficiencies (if any) in the design or operation of such internal controls has been disclosed to the auditors and the audit committee.

The CEO/CFO certification will also state the steps they have taken or propose to take to rectify these deficiencies in the design or operation of such internal controls pertaining to financial reporting.

In the context of internal controls, the auditor should ensure that

The management has institutionalized an internal control framework with respect to financial reporting controls. The framework should be examined in the context of the documentation created for each significant process in terms of the related risk and mitigating control;

He has further examined whether the assessment process followed for evaluation of controls is reasonable and there is a process by which significant deficiencies as well as steps taken to correct them is communicated to the audit committee and to the auditors; and

He should also examine whether a process exists in the company whereby all significant changes in the accounting policies and in the system of internal controls are communicated to the audit committee and the auditors.

The auditor should examine the adequacy of the process followed for issuing the CEO/CFO certificate and should review the same in regard to matters stated in Para 9.52 above and the consideration of the same by the Audit Committee. For this purpose he should refer to the minutes of the Audit Committee.

In certain situations negative or adverse comment or exclusions/disclaimer contained in the CEO/CFO certificate, the auditor should take cognizance of the same as the circumstances require in the audit report and or the Certificate of Compliance of conditions of Corporate Governance.

9.10 Disclosures

The Report on Corporate Governance requires disclosure of certain transactions with related parties or transactions, which may not be 'arms length' transactions. The auditor is required to verify whether the management has placed periodically the information before the Audit Committee. The disclosures to be made is mentioned below

The transactions required to be disclosed by the management are as under -

- Transactions with related parties, entered into in the ordinary course of business are to be disclosed in summary form (Grouping them into broad categories of the transactions).
- Transactions with related parties which do not fall within the normal business transactions (and are therefore not covered in (a) above) are to be disclosed individually if such transactions are material transactions.
- Transactions with any party (related or otherwise), which are not considered as arm's length transactions, are to be disclosed individually if such transactions are material transactions.

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The auditor has to verify whether a transaction is a related party transaction as per AS 18 (Related Party Disclosures). As per AS 18, parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. For the purpose of carrying out verification, reference may be made to SA 550 (Related Parties).

Materiality depends on the size and nature of the item judged in the particular circumstances.

9.10.1 Basis of related party transactions Clause 49 IV (A) -

- (i) A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.
- (ii) Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.
- (iii) Details of material individual transactions with related parties or others, which are not on an arm's length basis should be placed before the audit committee, together with Management's justification for the same.

9.10.2 Disclosure of Accounting Treatment Clause 49 IV (B) - Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.

In this regard the auditor has to refer to Sections 211(3B), 217(2AA) and 227 of the Companies Act, 1956. Also the auditor should refer to the CEO/CFO certification given under Clause 49 (IV).

9.10.3 Board Disclosures – Risk management Clause 49 IV (C) - The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

9.11 Report on Corporate Governance

As per Clause 49 (VI) -

- (i) There shall be the separate section on Corporate Governance in the Annual Reports of Company, with a detailed compliance report on Corporate Governance. Non-Compliance of any Mandatory Requirement i.e., which is a part of the Listing Agreement with reasons thereof and the extent to which the Non-Mandatory requirements have been adopted should be specifically highlighted.
- (ii) The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter. The report shall be signed either by the Compliance Officer or the Chief Executive Officer of the company.

The auditor should ascertain whether the Board of directors have included in the annual report of the company, a separate section on corporate governance with a detailed compliance report on corporate governance. This would specifically highlight non-compliance of any mandatory requirement. (i.e. which is part of the Listing Agreement) with reasons thereof and also the extent to which the non-mandatory requirements have been adopted. The auditor should also verify whether the suggested list of items and list of non-mandatory requirements as per Clause 49 have been incorporated in such report.

Any data in the report on corporate governance should not be inconsistent with that contained in the financial statements.

9.12 Auditors' Certificate

As per the listing agreement of Clause 49 (VII) a company shall obtain a Certificate from the Auditor of the company regarding compliance of conditions of Corporate Governance and annex the Certificate with the Directors' Report which is sent annually to all the shareholders of the company. The same Certificate shall also be sent to the stock exchange along with annual returns filed by the company.

9.12.1 Adverse or Qualified Statement - Depending upon the facts and circumstances, some situations may require an adverse or qualified statement or a disclosure without necessarily making it a subject matter of qualification in the Auditors' Certificate, in respect of compliance of requirements of Corporate Governance for e.g.,

- (a) The number of non-executive directors is less than 50% of the strength of Board of directors.
- (b) A qualified and independent audit committee is not set up.
- (c) The chairman of the audit committee is not an independent director.
- (d) The audit committee does not meet four times a year.
- (e) The necessary powers in terms of Clause 49 II (D) of the Listing Agreement have not been vested by the Board in the audit committee.
- (f) The time gap between two Board meetings is more than four months.
- (g) A director is a member of more than ten committees across all companies in which he is a director.
- (h) The information of quarterly results is neither put on the company's website nor sent in a form so as to enable the Stock Exchange on which the entity's securities are listed to enable such Stock Exchange to put it on its own website.
- (i) The power of share transfer is not delegated to an officer or a committee or to the registrar and share transfer agents.

A Performa of the Certificate to be issued by the Auditors regarding compliance of conditions of Corporate Governance is shown below:

CERTIFICATE

To,

The Members of.....

(Name of the entity)

We have examined the compliance of conditions of Corporate Governance by (name of the entity) for the year ended on as stipulated in clause 49 of the listing Agreement of the said with stock Exchange (s).

The compliance of conditions of Corporate Governance is the responsibility of the management. Our examination was limited to procedures and implementation thereof, adopted by the company for ensuring the compliance of the conditions of the Corporate Governance. It is neither an audit nor an expression of opinion on the financial statement of the company.

In our opinion, and to the best of our information and according to the explanations given to us, subject to the following:

- 1)
- 2)

We certify that the company has complied with the conditions of Corporate Governance as stipulated in the above mentioned listing Agreement.

We state that no / investor grievance(s) is / are pending for a period exceeding one month against the company as per the records maintained by the shareholders / investors Grievance Committee.

We further state that such compliance is neither an assurance as to the future viability of the company nor the efficiency or effectiveness with which the management has conducted the affairs of the company.

For & on behalf of

XYZ & Co.

Chartered Accountants

(Partner / Proprietor)

Place.....

Date.....