Critical Issues in Corporate Governance—

A comparative study of Committee Recommendations and Companies Act on Independence of Auditors and Independence of Directors

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There are various aspects which can be separately noted from the different Corporate Governance codes in India and outside. But after the U.S. corporate scams followed by the introduction of the Sarbanes-Oxley (SOX) Act there and subsequently followed by the formation of two separate committees in India on CG respectively under the chairmanship of Naresh Chandra (NCC) (2002) and Narayana Murthy (NHC) (2003) within a gap of a few months exposed two vital areas of Corporate Governance (CG) — Independence of Auditors and Independence of Directors. Section 292A of the Companies Amendment Act, 2002 has introduced the provision for setting up Audit Committee. The Bill of 2003 has proposed amendment to the existing Section 292A dealing with audit committees. The Bill has also incorporated stipulations more or less in line of the NCC or NMC for an independent director in Section 252A. As spelt out by the NMC itself, "…corporate governance is about ethical conduct in business. Corporate Governance is beyond the realm of law. It stems from the culture and mindset of management and cannot be regulated by legislation alone", too many legal provisions and their intricacies would make the real objective worthless.

The present remuneration structure vis-à-vis the professional competence of the directors, their busy schedule and specific knowledge of the subject often build hindrances in active participation of the members with sincerity. Actually, imposition and carrying out of penalties in case of auditor's fault are far more important which are very much missing in all the related regulations.

Among the various components of the Board, the executive directors' efficiency is beyond question and the non-executive promoter directors' involvement and dedication are also above doubt. But as there is a general belief about the external non-promoter non-executive directors that they are little less- involved about the company, the effectiveness of keeping independent directors in a board will remain a question.

Finally, it can be concluded that the areas of independence of auditors and directors are really important issues. But there should be necessary

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legal backing of the recommendations of different committees and regulations should also be made realistic and practical setting aside the limitations pointed out in criticism.

The Background

The last decade of corporate literature has experienced a significant amount of contribution on Corporate Governance (CG), which started from Sir Adrian Cadbury Committee's report and continued in Hampel Committee's report, King's Committee report, Greenbury Committee's report, the Combined Code of the London Stock Exchange, the OECD Code on Corporate Governance, the Blue Ribbon Committee's report, the CII guidelines (in India) and SEBI-appointed K.M. Birla Committee recommendations (in India). All this literature emanated due to identification of some specific problem areas of corporate management practices all-round the world and attempts from various corners to solve these problems. In India, the Companies Amendment Acts, the SEBI Act, Prudential Norms for NBFCs amended by the RBI (2000) and Guidance Note on Certification of Corporate Governance issued by the Institute of Chartered Accountants of India (2001) have attempted to take care of such situation. Actually K. M. Birla Committee's report was given due legal backing in the country by the SEBI in introducing clause 49 of the standard listing agreement, incorporating most of the suggestions of the Committee, to be compiled with by all the listed companies in stipulated phases. The Enron debacle of 2001 involving the hand-in-glove relationship between the auditor and the corporate client, the scam involving the fall of corporate giants in the U.S. like WorldCom, Qwest, Global Crossing, Xerox and the consequent enactment of the stringent Sarbanes Oxley Act in the U.S. were some important factors which led the Indian govt. to wake up and in the year 2002 The Naresh Chandra Committee was appointed to examine and recommend *(inter-alia)* drastic amendments to the law involving the auditor-client relationship and the role of the independent directors. In 2002 SEBI analyzed the statistics of compliance with clause 49 by the listed companies and constituted the Narayana Murthy Committee. In the meantime the Companies Amendment Bill of 2003, which was placed in the Parliament in May 2003, included many of the recommendations of the Naresh Chandra Committee.

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The Country

The country's economic condition of which a significant contribution is from the corporate bodies has not at all been satisfactory over the last few decades. Fiscal deficit is mounting, corporate scams repeating with a good number of companies regularly vanishing every year with huge amount of public money, non-performing assets of the banks are alarmingly high and most importantly, the securities market has experienced a scam in 2002 after the Harshad Mehta scam exploded in 1992, the basic nature of these scams being the same. However, the amendments in the Companies Act and clause 49 of the listing agreement, the basic purpose of which was to restrict the scams, have been in vogue during this time. Krishna Kumar (2003) exposed a truly sad picture of corporate India with reference to various dimensions of performance. According to his observations, out of a total of 2151 companies of the pre-liberalization period, 1686 (i.e.79%) were making profit in the year 1991, whereas ten years later, in the year 2001, only 1000 (i.e. 46%) among them were making profit. Thus 54% of the actual number of pre-reform corporate leaders were not in good shape. In terms of number of companies the overall profit performance of the corporate leaders has come down from 79% in 1991 to 38% in 2001. Of the balance, overall 25% were loss making, 2% in no profit no loss condition and 35% were in 'non reporting' category.

The Points of Comparison

There are various aspects which can be separately noted from the different CG codes in India and outside. But after the U.S. corporate scams followed by the introduction of SOX Act there and subsequently followed by the formation of last two committees in India on CG respectively under the chairmanship of Naresh Chandra (2002) and Narayana Murthy (2003) within a gap of a few months exposed two vital areas of CG —

— Independence of auditors and Independence of directors. This paper, therefore, will attempt to highlight the comparative outlook of these committees on one hand on these issues and the Companies Amendment Bill (2003) on the other for drawing a conclusion from them.

Independence of Auditors and Independence of Directors – why so important in a Corporate Governance model?

The external auditors owe a statutory duty to the shareholders of a company about the truth and fairness of the accounts prepared by the company officials. They also owe similar duty in respect of the statement of profit and loss and the statement of assets and liabilities, which are the natural outcomes of these accounts. The auditors' independence is therefore quite necessary for shareholders' reliance upon their report. At the time of doing the audit work, which is conducted during a reasonably long time, the auditors come into close contact with the internal auditors and also with different sections of company officials. Besides, to continue for getting audit assignments in the present company and its group and associated companies and to continue getting various non-audit consultancy work in the same company and other related companies (since the fees for such consultancy work far exceeds the auditor's remuneration), the auditors often want to maintain a cordial relationship with the company administration. Besides different kinds of illegal earnings also allure them towards disobeyance of their professional duties and to lose the professional independence significantly.

Proper and well functioning corporate governance system exists when the three main groups responsible for financial reporting i.e., the board, the management including the internal auditor and the outside auditors, form the three-legged stool that supports responsible financial disclosure as well as active and participating oversight. Corporate Governance in a corporate set up focuses on the accountability of the management (agent) towards its shareholders (principal) and the former is expected to discharge its function to the best interest of its principal and other stakeholders. The need to ensure this accountability has helped to emerge the role of the third parties, the auditor. Financial reporting and its authenticity play an important role in the overall accountability. The audit committee has an important role to play in the process, since audit committee is a subgroup of the full board and monitors this process. The members of the board can only take some strategic decisions applying their skill, intelligence and judgment, irrespective of the agency-related problem, for the maximum welfare of the shareholders if they are financially independent. Independence of directors is therefore quite necessary and such independence along with independence of auditors only can assure about the fullest protection.

Independence of Auditors – Comparative views

Naresh Chandra Committee's (NCC) Report, 2002

On 21st August 2002, DCA under the Ministry of Finance and Company Affairs appointed this High Level Committee to examine the various Corporate Governance issues. The committee subsequently submitted its report. The important recommendations relating to audit are given as follows:

- 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 by this committee.
- However, this will not apply to (i) unlisted public companies which have not 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, (ii) unlisted subsidiaries of listed companies.
- A "nominee director" cannot be a member of audit committee.
- Before agreeing to be appointed, the audit firm must submit a certificate of independence to the audit committee or to the board of directors of the client company.
- The audit committee shall: (i) discuss the annual work programme with the auditor; (ii) review the independence of the audit firm; and (iii) recommend to the board, with reasons either the appointment / reappointment or removal of the external auditor, along with the annual audit remuneration.
- The Chairman of the Audit Committee must annually certify whether and to what extent each of the functions listed in the audit committee charter was discharged in the course of the year.
- This disclosure shall also give a succinct but accu-

rate 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, perception of risks and in the event of any qualification, why the audit committee accepted and recommended the financial statements with qualifications.

Narayana Murthy Committee's Report, 2003

To review the performance of CG in India and protect the investors beyond the mere systems and procedures, SEBI constituted this committee. The Committee submitted its report on 8th February 2003. The important recommendations relating to audit are given as follows:

1. Audit Committees of public listed companies should be required to review the following information mandatorily –
   - Financial Statements and draft Audit Report including quarterly and half yearly financial information
   - Management discussion and analysis of financial condition and results of operation
   - Reports relating to compliance with laws and to risk management
   - Management letters and letters of internal control weaknesses issued by statutory/internal auditors
   - Records of related party transactions
2. All members of the audit committee should be "financially literate" and at least one member should have accounting or related financial management expertise.

Companies Amendment Bill, 2003

Section 292A of the Companies Amendment Act, 2002 has introduced the provision for setting up Audit Committee. The important provisions of this section are given below:

- Every public company having paid up capital of not less than Rs. 5 crores shall constitute an Audit Committee.
- There should be at least three directors as members of such committee.
- At least two-third of the total members of the committee shall be non-executive directors.
- The members of the committee shall elect a chairman from amongst themselves.
- Every such committee shall act in accordance with the terms of reference to be specified in writing by the board.
- The Chairman of the committee shall attend the AGM to provide clarification on audit if any.
- The external and internal auditors and also the Executive Director (Finance) shall attend the meetings of the audit committee without any voting right.

The recommendations of the audit committee on any matter related to financial management including the audit report, shall be binding on the board.

The Bill of 2003 has added flexibility to the role and functions of the audit committee by empowering the Central Government to prescribe its functions from time to time.

Independence of Directors – Comparative views

Naresh Chandra Committee's (NCC) Report, 2002

The concept of independent directors has been explained in recommendation no. 4.1 of the Naresh Chandra Committee Report. According to this recommendation, an independent director of a company is a non-executive director who:

- ☑ apart from receiving director's remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;
- ☑ is not related to promoters or management at the board level, or one level below the board (spouse and dependent parents, children or siblings);
- ☑ has not been an executive of the company in the last three years;
- ☑ is not a partner or an executive of the statutory auditing firm, the internal audit firm that is 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;
- ☑ is not a significant supplier, vendor or customer of the company;
- ☑ is not a substantial shareholder of the company, *i.e.* owning two percent or more of the block of voting shares;
- ☑ has not been a director, independent or otherwise

of the company for more than three terms of three year each (not exceeding nine years in any case);

- ☑ is not an employee, executive director or nominee of any bank, financial Institution, corporations or trustees of debenture and bondholder, who is normally called a "Nominee Director".

Narayana Murthy Committee's (NMC) Report, 2003

It lists more or less all the above eligibility criteria excluding the last two as stated by the NCC. Actually, the committee has recommended that there shall not be any nominee director. The shareholders have to make an appointment in case an institution or the Government (in case of public sector companies) wishes to appoint a director on the board.

Companies Amendment Bill, 2003

The Bill has incorporated the above stipulations more or less in line of the NCC or NMC for an independent director in Section 252A. Clause 119 of Section 252A has thus mentioned eleven negative attributes, which would render a person incapable of being treated as an independent director. Two new points of ineligibility in relation to the NCC and NMC recommendations have been proposed for any person, who is holder of any equity share of a company in which he is an independent director during his tenure as such a director and six months after he ceases to be an independent director and for a person who is a nominated director in any other company which has nominated a director in the company in which he is an independent director. In addition, the bill has recommended that an independent director needs to undergo training from the prescribed institute of the government.

Comparative Views – A Critique

As spelt out by the NMC itself, "…corporate governance is about ethical conduct in business. Corporate governance is beyond the realm of law. Following from this argument, the proposal of the maximum number of directors by the Companies (Amendment) Bill, 2003 to be fifteen cannot be justified with any reason.

In case of independence of auditors, a lot has been said on the formation and composition of the audit committee to make the functioning of the committee impartial. But functions like reviewing the independence of the audit firm from the viewpoint of restriction of some non-audit consultancy services of the auditors, discussion of the annual work programme with the auditor, etc. are lot more critical, which require active participation of the members with sincerity. The present remuneration structure vis-à-vis the professional competence of the directors, their busy schedule and specific knowledge of the subject often build hindrances in that active participation of the members with sincerity. Auditor's audit remuneration against the fees of non-audit services is also an important point of consideration. A time may come when the auditor firms will be seen to be interested in the non-audit assignments sacrificing the audit assignment if the law debars so. The provision of issuing "certification of independence" by the auditors, in that case would not matter much. The request of the ICAI to the DCA to drop that particular requirement from the NCC recommendations by highlighting the "faith in the continued independence of auditors" is worth mentioning in this context (The Hindu Business Line, April 10, 2003). Actually, imposition and carrying out of penalties in case of auditor's fault are far more important which are very much missing in all the related regulations. Only debarring from conducting audit activities if found guilty for a few years by the ICAI, as happened after the infamous securities scam of 1992 in India, would not serve the basic objective very much.

Regarding independence of directors, a few questions have been very rightly put forward by Israni (2003) to expose the lacunae of the concept. The questions are: (1) what role are the independent directors expected to perform? (2) are they supposed to be watchdogs or bloodhounds? (3) will the proposed provisions that the majority of the directors on the board should be independent directors create friction with the promoter directors? (4) will independent directors stop corporate scams? (5) are independent directors superior to promoter directors? (6) are they going to be super directors? Among the various components of the Board, the executive directors' efficiency is beyond question and the non-executive promoter directors' involvement and dedication are also above doubt. But as there is a general belief about the external non-promoter non-executive directors that they are little less-involved about the company (which may have emerged on the basis of an empirical fact that such directors do not attend the meetings of the board very regularly), the effectiveness of keeping independent directors in a board will remain a question. Further, if the points of disqualification of becoming an independent director are checked, it appears to be also a matter

of doubt whether all the companies will get adequate number of competent persons as such. Again, the proposed provision of training of independent directors from a prescribed institute also appears to be redundant for the experienced persons only who are expected to be selected. Presence of nominee directors is also required in the board for the obvious reason of keeping vigil of the nominating body. Now the recommendation of the NMC in this regard is one-sided and must not be acceptable for such institutions.

Finally, it can be concluded that no part of Corporate Governance should be transformed into a bunch of codes. The areas of independence of auditors and directors are really important issues. But there should be necessary legal backing of the recommendations of different committees and regulations should also be made realistic and practical setting aside the above limitations pointed out in criticism. ■