Issues Calling for Clarification in Clause 49

The revised Clause 49 has come in force with effect from 1st January 2006. Now, the consequence of non-compliance of Clause 49 is 'de-listing'. But there are certain issues in Clause 49 that require clarification, as they are open to interpretation. This article highlights the issues where a harmonious and holistic view is called for.

The process of filing of the compliance reports and certificates on corporate governance with the respective stock Exchanges, as per the new requirements under Clause 49, is still on. The new set of reports and certificates are an eye-opener to the regulatory agencies, particularly when it comes to scrutiny as to how far corporates have complied with various aspects of new requirements. These requirements include composition of independent directors, powers, role and review of information by the audit committee, variety of financial transparency and disclosures, and the qualitativeness of compliance reports and certification by the Board, CEO/CFO and statutory auditors.

The revised Clause 49 finally came into force w.e.f 1st January 2006 and now the ultimate consequence of non-compliance of Clause 49 is 'de-listing'. However, there are certain issues in Clause 49, which require clarification, as they are open to interpretation. There are similar subject matters in the Clause 49 as well as in the Companies Act, 1956 where the companies and professionals should harmonise to facilitate easy understanding and compliance. The issues on which harmonious and holistic views are called for are as follows:

Independent Directors in Board – Clause 49 I (A) (i) & (ii)

(i) The Board of Directors of the company shall have an optimum combination of executive and non-executive directors with not less than 50% of the Board of Directors comprising non-executive directors.

(ii) Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise independent directors and in case he is an executive director, at least half of the Board should comprise independent directors.

The questions that arise out of this clause are:

- What is the 'optimum' combination of executive and non-executive directors?
- Who are executive and non-executive directors?
- Who shall decide whether a particular director is an independent director?

The word 'optimum' literally means ideal. The ideality of the situation depends upon whether the Chairman of the Board is a non-executive director or is an executive director. The terms 'executive' and 'non-executive' directors have not been defined and it has to be understood in the normal sense i.e. directors who are looking after day-to-day affairs are executive directors. Besides, in arriving at the above optimum number, as the case may be, it should be clarified whether the fraction contained, if any, should be rounded off. Reference may be drawn to a similar situation contained in the Companies Act, 1956 where under section 256, it is stated: "…if the number is not three or a multiple of three, then the number nearest to one-third shall retire from office." Similar wordings can be inserted in Clause 49.

The ICAI Guidance Note provides that since the

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words used in the clause is 'not less than' and 'at least', the fraction if any should be rounded off.

Definition of the Term 'Promoter'

(iii) For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who:

(b) is not related to promoters or persons occupying management positions at the board level or at one level below the board;

The clause for determining independent director refers to the term 'promoters'. The clause does not provide any explanation of the said term. Also the term 'promoter' has not been defined in the Companies Act, 1956. However, the term 'promoter' has been defined differently in the different rules/regulations framed by the SEBI. One has to use his objective judgement in the context of Clause 49 and arrive at a decision.

The ICAI Guidance Note provides that it is ultimately the Board, which would determine as to who is an independent director.

Compliance Reports of All Laws – Clause 49 I (C) (iii)

(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.

The clause states that the Board shall review compliance reports of all laws applicable to the company and take steps to rectify instances of non-compliance. This is a huge area and in a mega-sized company, almost all laws would fall within the purview of the company and the Board should exercise utmost care and caution to review and rectify situations where there are non-compliances, if any.

On the auditor's part, the ICAI Guidance Note provides that the auditor would take into consideration AAS 21 which deals with Consideration of Laws and Regulations in an Audit of Financial Statements. The scope of auditor in such a situation would be much focused as compared to the Board's responsibility for compliance of all laws.

Audit Committee – Clause 49 II

There are differences between Clause 49 and the Companies Act, 1956 on matters relating to audit committee. Certain aspects relating to audit committee, its composition, powers, roles, etc. have been provided in the Companies Act, 1956 but not in Clause 49 and vice-versa. Therefore, listed companies have to fulfil the requirements on the subject distinctively under the Companies Act, 1956 as well as under Clause 49. One presumes that these distinctions are suitably addressed in the new Bill on the Company Law.

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One important aspect provided under Section 292A of the Companies Act, 1956, is that the recommendations of the audit committee are binding on the Board and if the Board does not accept the recommendations then they shall disclose reasons for the same. The Clause 49 is silent on this aspect though it states that there should be a duly qualified and independent audit committee. If one looks at the role, responsibilities and the task of review of information by the audit committee, the scope of Clause 49 is much larger compared to

the Section 292A in the Companies Act, 1956. Audit committee is an important aspect of corporate governance where harmonisation is required between the Companies Act, 1956 and the Clause 49.

Some of the other issues that arise in the context of conduct of the audit committee are:

- Whether an internal auditor is required to attend the meetings of audit committee only on notice duly given to him?
- Whether the Board, apart from the four powers mentioned in Clause 49 II (C), can delegate any other power to the audit committee?
- Whether the auditor would be reviewing the internal control system only with regard to financial aspects or would cover the entire internal control systems?

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.

Explanation 1: 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.

Explanation 2: 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.

Explanation 3: 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.

There are differences between Clause 49 and the Companies Act, 1956 on matters relating to audit committee. Certain aspects relating to audit committee, its composition, powers, roles, etc have been provided in the Companies Act, 1956 but not in Clause 49, and vice-versa.

The issues that arise in this context are:

- Whether foreign subsidiary company is also to be covered in sub-clause (ii) as above.
- In the same sub-clause ii (ii), the word 'material' has been used before the words 'unlisted subsidiary company' whereas sub-clause (i) refers to material non-listed Indian subsidiary company.
- In Explanation 2, for determining 'significant transaction or arrangement', the test of four parameters, has been given i.e. 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be. It should be clarified whether it is the highest of the four parameters that should be taken into account.
- Again in Explanation 2, the usage of the word 'likely' before the words 'to exceed

10% of...' needs to be clarified.

- Similarly, in Explanation 2, the word 'material' is appearing before the words 'unlisted subsidiary for the immediately preceding accounting year', whereas, in sub-clause (ii) of paragraph III, the word 'material' is not used before the words 'unlisted subsidiary company'. The issue is, whether clause (ii) and Explanation 2 should be read separately or in conjunction.

Disclosures – Clause 49 IV

(A) Basis of related party transactions

(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.

The questions that arise are:

- What is meant by 'ordinary' and 'normal' course of business as stated above in the said Clause?
- In sub-clause (iii) of the paragraph above, it is not clear which parties are to be covered under the word 'others', used before the words 'which are not on arm's length basis'.

(D) Proceeds from Public Issues, Rights Issues, Preferential Issues, etc.

When money is raised through an issue (public issues, rights issues, preferential issues, etc.), the audit committee has to be informed about the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc) on a quarterly basis as part of the company's quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilised 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.

Clause 49 is based on similar requirements as prescribed in Sarbanes Oxley Act, 2002 of US (SOX). The compliance of SOX in US is rigorous, robust and still being debated upon in view of its wider coverage and the responsibilities that it has cast on the corporates and the professionals. To that extent, Clause 49 is not real SOX as in US, but apparently an Indian SOX.

The questions that arise in this connection are:

- What is the time limit by which the disclosures have to be made?
- What shall be the position in case of companies having longer gestation period?

Conclusion

Clause 49 is based on similar requirements as prescribed in Sarbanes Oxley Act, 2002 of US (SOX). The compliance of SOX in US is rigorous, robust and still being debated upon in view of its wider coverage and the responsibilities that it has cast on the corporates and the professionals. To that extent, Clause 49 is not real SOX as in US, but apparently an Indian SOX. ❐