CORPORATE GOVERNANCE

RECOMMENDATIONS FOR VOLUNTARY ADOPTION

REPORT OF THE
CII TASK FORCE ON CORPORATE GOVERNANCE

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November 2009

Confederation of Indian Industry

Foreword

For over a decade, the Confederation of Indian Industry (CII) has been at the forefront of the corporate governance movement in India. In April 1998, it released a Task Force report entitled "*Desirable Corporate Governance: A Code*", which outlined a series of voluntary recommendations regarding best-in-class practices of corporate governance for listed companies. It is worth noting that most of the CII Code was subsequently incorporated in SEBI's Kumar Mangalam Birla Committee Report and thereafter in Clause 49 of the Listing Agreement. Moreover, the CII Code was the first and probably a unique instance where an industry association took the lead in prescribing corporate governance standards for listed companies.

Corporate governance guidelines - both mandated and voluntary - have evolved since 1998, thanks to the efforts of several committees appointed by the Ministry of Corporate Affairs (MCA) and the SEBI. Indeed, it is fair to say that in terms of norms, guidelines and standards set for the board of directors, financial and non-financial disclosures and information to be shared by the management to stakeholders and the wider public, Indian corporate governance standards rank among the best in the world. And CII is privileged to be a part of this movement.

Unfortunately, history tells us that even the best standards cannot prevent instances of major corporate misconduct. This has been true in the US - Enron, Worldcom, Tyco and, more recently gross miss-selling of collateralised debt obligations; in the UK; in France; in Germany; in Italy; in Japan; in South Korea; and many other OECD nations. The Satyam-Maytas Infra-Maytas Properties scandal that has rocked India since 16th December 2008 is another example of a massive fraud.

Satyam is a one-off incident - especially considering the size of the malfeasance. The overwhelming majority of corporate India is well run, well regulated and does business in a sound and legal manner. However, the Satyam episode has prompted a relook at our corporate governance norms and how industry can go a step further through some voluntary measures.

With this in mind, the CII set up a Task Force under Mr Naresh Chandra in February 2009 to recommend ways of further improving corporate governance standards and practices both in letter and spirit.

The recommendations of the Naresh Chandra Task Force evolved over a series of meetings. The leitmotif of the report is to enunciate additional principles that can improve corporate governance in spirit and in practice. The report enumerates a set of voluntary recommendations with an objective to establish higher standards of probity and corporate governance in the country.

The recommendations outlined in this report are aimed at listed companies and wholly owned subsidiaries of listed companies.

Another comment is in order. Large, highly visible and publicised corporate scandals often provoke legislative and regulatory actions. CII advocates caution against over-regulating. It needs to be recognised that while the super-structure of corporate governance is built on laws and regulations, these cannot be anything more than a basic framework. Much of best-in-class corporate governance is voluntary - of companies taking conscious decisions of going beyond the mere letter of law. The spirit of this Task Force Report is to encourage better practices through voluntary adoption - based on a firm conviction that good corporate governance not only comes from within but also generates significantly greater reputational and stakeholder value when perceived to go beyond the rubric of law.

Therefore, it is only natural that this report should focus on recommendations, which are being placed before corporate India for adopting voluntarily. It is the belief of CII that Indian Industry would respond spontaneously and help set standards, which would define global benchmarks in the medium term.

Venu Srinivasan
President, CII (2009-10)

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CII Task Force on Corporate Governance

Members of the Task Force

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6. Mr Deepak M Satwalekar, Independent Director
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The CII Task Force Report

Introduction

Good corporate governance involves a commitment of a company to run its businesses in a legal, ethical and transparent manner - a dedication that must come from the very top and permeate throughout the organisation. That being so, much of what constitutes good corporate governance has to be voluntary. Law and regulations can, at best, define the basic framework - boundary conditions that cannot be crossed. CII has always held the view that while law may need to be strengthened when occasions so demand, there are fundamental limits to using legislative and regulatory instruments to enforce better corporate governance.

The thrust of this report, therefore, is to suggest certain voluntary recommendations for industry to adopt.

The report is structured according to the different elements of corporate governance:

- The Board of Directors
    - Non-executive and independent directors
    - Committees of the board
    - Significant related party transactions
- Auditors
    - Independence of Auditors
    - Rotation of Audit Partners
- Regulatory Agencies
    - Legal and regulatory standards
    - Effective and credible enforcement
- External Institutions
    - Institutional investors
    - The Press

The Board of Directors

1. Appointment of independent directors

An active, well-informed and independent Board is necessary to ensure highest standards of corporate governance. Getting the right people is crucial; as is the process of seeking, vetting and appointing such people.

Good Boards have a Nomination Committee typically comprising entirely of independent directors (or where independent directors constitute the majority), with the Committee chairman being an independent director. The Board as a whole decides the skill sets that are needed going forward, keeping in mind the present and the desired composition; and the specialised oversight needs of the company in the foreseeable future. The Nomination Committee then takes up the task of seeking such directors - either through its own network of contacts or by a formal search process with the help of external consultants. The shortlist, along with the CVs, is then discussed in the full Board, and the final candidate(s) is/are recommended to the Chairman of the Board. The Chairman, then, gets in touch with the selected people and invites them to join the Board as additional directors - after which their appointment is sought to be ratified by shareholders in the next shareholders' meeting.

Recommendation 1: Nomination Committee

The Task Force believes that having a well functioning Nomination Committee will play a significant role in giving investors substantial comfort about the process of Board-level appointments. It, therefore, recommends that listed companies should have a Nomination Committee, comprising a majority of independent directors, including its chairman. This Committee's task should be to:

- Search for, evaluate, shortlist and recommend appropriate independent directors and NEDs, subject to the broad directions of the full Board; and
- Design processes for evaluating the effectiveness of individual directors as well as the Board as a whole.

The Nomination Committee should also be the body that evaluates and recommends the appointment of executive directors.

A separate section in the chapter on corporate governance in the annual reports of listed companies could outline the work done by the Nomination Committee during the year under consideration.

2. Duties, liabilities and remuneration of independent directors

The Task Force felt that there must be some formality in the appointment of NEDs and independent directors that goes beyond the ratification by the shareholders. It thus makes the following recommendation.

Recommendation 2: Letter of Appointment to Directors

- The Task Force recommends that listed companies should issue formal letters of appointment to NEDs and independent directors - just as it does in appointing employees and executive directors. The letter should:

- Specify the expectation of the Board from the appointed director;
- The Board-level committee(s) in which the director is expected to serve and its tasks;
- The fiduciary duties that come with such an appointment;
- The term of the appointment;
- The Code of Business Ethics that the company expects its directors and employees to follow;
- The list of actions that a director cannot do in the company;
- The liabilities that accompany such a fiduciary position, including whether the concerned director is covered by any Directors and Officers (D&O) insurance; and
- The remuneration, including sitting fees and stock options, if any.[1]

The letter stating the terms and conditions of appointment of any NED or independent director should form a part of the disclosure to shareholders at the time of the ratification of his/her appointment or re-appointment to the Board.

The Companies Act, 1956, prescribes the ceiling on remunerations that can be paid to NEDs and independent directors, including stock options, restricted stocks, sitting fees and commissions on net profit, if any, subject to approval of shareholders. Currently, NEDs, including independent directors, may be paid compensation within the limit of 1% of the company's stand-alone net profits for the year (or 3% in case it does not have any whole-time director). While such remunerations are eventually approved by shareholders, the task is usually delegated to the Board. Since propriety demands that the NEDs and independent directors recuse from discussions regarding their remunerations, in practice the remunerations are actually approved by the promoters or management.

The Task Force felt that linking the remuneration of NEDs and independent directors to the net profit of the stand-alone company has problems. Well oiled,

[1] More on this is in Recommendation 3.

well-running constantly profitable companies typically need less intensive Board oversight than start-ups, companies that are in financial and/or operational distress, or those that are in the beginning of a turnaround. These need best-in-class directors who will give considerably more time in debating strategy, closely monitoring progress and ensuring that systems are put in place for profitable growth. Here lies the difficulty! Such companies are either loss-making or do not make sufficient profits to be able to pay for the proven talents of real experts on the Board. And yet, their requirement for such expertise is the greatest. This is why there is a need to amend the current law which only allows for remuneration from net profits for such companies.

Recommendation 3: Fixed Contractual Remuneration

The Task Force recommends that the Companies Act, 1956, be amended so that companies have the option of giving a fixed contractual remuneration to NEDs and independent directors, which is not linked to the net profit or lack of it. Therefore, companies should be given the option to choose between:

a. Paying a fixed contractual remuneration to its NEDs and IDs, subject to an appropriate ceiling depending on the size of the company; or
b. Continuing with the existing practice of paying out upto 1% (or 3%) of the net profits of the stand alone entity as defined in the Companies Act, 1956.

For any company, the choice should be uniform for all NEDs and independent directors, i.e. some cannot be paid a commission of profits while others are paid a fixed amount.

If the option chosen is (a) above, then the NEDs and independent directors will not be eligible for any commission on profits.

The current limits and constraints on sitting fees and stock options or restricted stock may remain unchanged.

If stock options are granted as a form of payment to NEDs and independent directors, then these must be held by the concerned director until one year of his exit from the Board.

This is also recommended by the Combined Code of the UK. It is a good practice that will forever eradicate all suspicions of insider trading of vested stocks.

Some argue that since an NED or an independent director is primarily a fiduciary of the shareholders, and since the variable cash flow rights of shareholders depend upon the profitability of the company, why should these fiduciaries be given a fixed compensation at all? The argument is flawed on three counts. First, the fiduciaries and overseers appointed by the shareholders should be looking at maximising long term enterprise value, just as the management. If management can get fixed contractual payments approved by shareholders, so too can NEDs and independent directors. Second, even when a company does not make a profit, it can pay dividends from reserves. So, shareholders may get some cash return on equity even in the absence of profits; NEDs and independent directors cannot. Third, it is very difficult to get first rate NEDs and independent directors to give up a sizeable chunk of their time to serve on boards that make no profits and, hence, pay no commission.[2]

Whether it is from net profits or as a fixed contractual payment, the structure of remuneration to NEDs and independent directors needs to be transparent, well specified and made available to shareholders in the annual report of the company. As the Combined Code of the UK states, "Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role." To be sure, this can neither be legislated nor completely specified. However, there are best practices in transparently setting remuneration guidelines - one of which is given below.

Recommendation 4: Structure of Compensation to NEDs

The Task Force recommends that listed companies use the following template in structuring their remuneration to NEDs and independent directors

- Fixed component: This should be relatively low, so as to align NEDs and independent directors to a greater share of variable pay. Typically, these are not more than 30% of the total cash remuneration package.
- Variable Component: Based on attendance of Board and Committee meetings (at least 70% of all meetings should be an eligibility pre-condition)
- Additional payment for being the chairman of the Board, especially if he/she is a non-executive chairman
- Additional payment for being the chairman of the Audit Committee
- Additional payment for being the chairman of other committees of the Board
- Additional payment for being members of Board committees: Audit, Shareholder Grievance, Remuneration, Nomination, etc.

The Task Force also recommends that if such a structure (or any structure) of remuneration is adopted by the Board, it should be disclosed to the shareholders in the annual report of the company.

3. Remuneration Committee of the Board

All over the developed world, a major source of shareholder grievance has been the levels, structures and payouts of executive compensation. Although Indian senior executive pay has been significantly lower than those who occupy top slots in the Fortune 500 companies — even when calculated in terms of purchasing power parity — there is a case for creating a sound Board-level process for approving

[2] Paying a fixed contractual amount is, indeed, the practice in most OECD countries, such as the USA, UK, Australia, France, Germany, Italy, Spain, the Netherlands, the Scandinavian countries, and others.

remunerations to executive directors and for those who are one level below the Board. The basic principle is best stated in the Combined Code of the UK: "There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration."

Recommendation 5: Remuneration Committee

The Task Force recommends that listed companies should have a Remuneration Committee of the Board.

- The Remuneration Committee should comprise at least three members, majority of whom should be independent directors.
- It should have delegated responsibility for setting the remuneration for all executive directors and the executive chairman, including any compensation payments, such as retiral benefits or stock options. It should also recommend and monitor the level and structure of pay for senior management, i.e. one level below the Board.
- The Remuneration Committee should make available its terms of reference, its role, the authority delegated to it by the Board, and what it has done for the year under review to the shareholders in a separate section of the chapter on corporate governance in the annual report.

4. Audit Committee of the Board

In its present form, Clause 49 of the Listing Agreement contains detailed mandatory provisions for the Audit Committee of the Board. Even so, it has one flaw that needs immediate remedy. In the earlier version of Clause 49, only NEDs could be members of the Audit Committee. The revised Clause 49 omitted this requirement. Under the present dispensation, two-thirds of the members of the Audit Committee must be independent directors as must the chairman, but the rest may be either NEDs or executive directors. This is clearly a mistake, and runs counter to a fundamental operating principle of good corporate governance, namely that the Audit Committee must comprise entirely of non-executive directors with independent directors forming the majority.

Another counter-view that the Task Force also considered was that the presence of executive directors on the audit committee needs to be appreciated since they are well versed with the internal working of the company and bring first hand information to the table which helps an objective and meaningful analysis of the discussions by the Committee.

The Task Force, however, suggests that for bolstering the independence of the internal as well as the external auditors and ensuring a free and frank discussion with the audit committee, it is important that the Audit Committee must necessarily constitute of NEDs. The executive directors can be invited to attend the audit committee meetings to provide the necessary clarifications.

Recommendation 6: Audit Committee Constitution

Listed companies should have at least a three-member Audit Committee comprising entirely of non-executive directors with independent directors constituting the majority.

5. Separation of the offices of the Chairman and the Chief Executive Officer (CEO)

The Task Force deliberated at length on whether it is desirable to separate the offices of the Chairman of a publicly listed company from that of the CEO. While it was observed that there is no obvious causality between such a separation and better corporate governance or performance, it was nevertheless true that there is a growing trend internationally of separating the offices of the Chairman and the CEO.[3] It is the dominant practice in the UK; increasingly so throughout continental Europe; and even the USA — which has had a long tradition of having the same person as Chairman and CEO — is increasingly moving towards a separation of offices.

This trend towards separation of the role of Chairman and the CEO has never been mandated by the legislation or regulation — which is exactly as it should be. Instead it has been driven either voluntarily or by major long-term institutional investors such as pension funds.

The Task Force felt that the situation is different in India. Most Indian listed companies are controlled by promoters, often holding over 50 per cent of the voting stock. Indeed, many in corporate India feel that the separation is not desirable — that the dominant, risk taking shareholder being both the Chairman and Chief Executive of a company gives a greater notion of commitment than otherwise.

A view running counter to the argument was also presented for consideration of the Task Force quoting absence of evidence supporting that separation of the two offices improves corporate performance or promotes good corporate governance practices. Further, separating Chairman & CEO provides no guarantee of better leadership and can add to a layer of potential conflict.

[3] The Chairman and CEO roles are separate in 65% of the Fortune 500 – this figure is significantly skewed by the US, which accounts for 152 of the 500, and where only 36% of companies have separate roles. Companies from countries other than the US that contribute significantly to the Fortune 500 have generally high rates of CEO-Chairman separation (usually upwards of 80%). Company size (revenue) does correlate with role separation trends, and is predominantly skewed by the number of companies from a particular country (especially US).
2 of the 7 Indian companies in the Fortune 500 have separate CEOs and Chairmen.

After extensive deliberation on the subject, on balance, the Task Force expressed its preference for separating the two offices.

Recommendation 7: Separation of Offices of Chairman & Chief Executive Officer

The Task Force recognised the ground realities of India. Keeping these in mind, it has recommended, wherever possible, to separate the office of the Chairman from that of the CEO.

6. Attending Board and Committee Meetings through Tele-conferencing and video conferencing

E-presence of a director would ensure larger participation at Board/Committee meetings and shall also step up the frequency of such meetings as well as the interaction of Board members, while at the same time bringing down the cost of holding physical meetings. The Companies Bill, 2009 has also proposed participation of Directors in board meetings through electronic means. Even prior to the adoption of the Companies Bill, in a meeting in relation to matters which do not require a physical meeting, directors ought to be able to participate through e-presence (where they would otherwise not be able to attend). The decisions may be subsequently recorded as a circular resolution signed by the directors physically present and those participating through audio or video-conferencing.

Recommendation 8: Board Meetings through Tele-conferencing

If a director cannot be physically present but wants to participate in the proceedings of the board and its committees, then a minuted and signed proceeding of a tele-conference or video conference should constitute proof of his or her participation. Accordingly, this should be treated as presence in the meeting(s). However, minutes of all such meetings or the decisions taken thereat, recorded as circular resolutions, should be signed and confirmed by the director/s who has/have attended the meeting through video conferencing.

7. Executive Sessions of the Independent Directors

While the independent directors are kept updated of all business-related issues and new initiatives by the management, it is imperative that the independent directors have executive sessions (as their internal discussion and debating process to evolve a consensus among independent directors). Having such interactions without the presence of any of the non-independent directors would promote open discussions among independent directors and also assist in independent appraisal of corporate performance, strategic issues, determining a “smell test” for “grey” or “border line” proposals.

Recommendation 9: Executive Sessions

To empower independent directors to serve as a more effective check on management, the independent directors could meet at regularly scheduled executive sessions without management and before the Board or Committee meetings discuss the agenda.

The Task Force also recommends separate executive sessions of the Audit Committee with both internal and external Auditors as well as the Management.

8. *The role of the board and shareholders in related party transactions*

The Audit Committee members, at a meeting held prior to the Board Meeting in which related party transaction shall be discussed, should be given access to the contract / terms of all proposed related party transactions, before they are entered into. In the event of the Company proposing to enter into or amending an existing related-party transaction which is not in the ordinary course of business or not on “arms length’ basis, the management shall present it to the Audit Committee. The Committee should discuss all related party transactions which are not in the ordinary course of business or not on “arms length” basis and, in approving or rejecting the transactions shall consider all relevant facts and circumstances including (i) risks, costs and benefits to the Company (ii) impact on a director's independence, if such related party contract concerns an independent director (iii) availability of other sources /unrelated third parties for comparable services or products - and shall approve only those transactions that are in the best interests of the Company.

The Task Force also noted that the J J Irani Committee had considered that, any contract by an independent director or his firm, which exceeds 10% of the director’s or the firm’s turnover renders such director dependent and shall be presumed to affect the independence of such a director.

Recommendation 10: Related Party Transactions

Audit Committee, being an independent Committee, should pre-approve all related party transactions which are not in the ordinary course of business or not on "arms length basis" or any amendment of such related party transactions. All other related party transactions should be placed before the Committee for its reference.

The Role of Auditors

9. Auditor – Company Relationship

The report of the Naresh Chandra Committee on Corporate Audit and Governance had suggested that auditors should refrain from providing non-audit services to their audit clients and had recommended an explicit list of prohibited non-audit services. The Task Force, noted that the recommendation was endorsed by the Ministry of Corporate Affairs and has also been proposed under the Companies Bill, 2009. The Task Force concurred with the recommendation that legislation should expressly prohibit auditors from rendering certain services to their audit clients. Audit firms should have to mandatorily disclose network agreements between audit firms and non-audit companies, pecuniary interests exceeding 2% between the audit firm and its affiliate non-audit service firm or company and measures of Chinese walls and data protection/confidentiality that are in place between them. The Task Force noted the existing practice in this regard. And found it to be sufficient.

10. Independence of Auditors

In order to build capacity, consulting firms undertake audit assignments through their associate/affiliates organisations. However, such affiliations could lead to too much revenue dependence on a particular client causing potential threats to auditor independence. While a blanket ban cannot be imposed on such business relationships, in case more than 10% of consolidated revenue of a firm or its network affiliate emanates from a single client, with whom there is also an audit engagement, the auditor should not be construed as independent of its client. However, to help newer and smaller audit firms, this requirement should not be applicable to audit firms for the first five years from the date of commencement of their activities, and for those whose total revenues are less than Rs.15 lakhs per year.

Recommendation 11: Auditors' Revenues from the Audit Client

No more than 10% of the revenues of an audit firm singly or taken together with its subsidiaries, associates or affiliated entities, should come from a single corporate client or group with whom there is also an audit engagement.

11. Certificate of Independence

The Task Force considered the requirement of ensuring Independence of Auditors throughout the period of engagement as recommended by the Naresh Chandra Committee on Corporate Audit and Governance and recommended the practice of seeking a Certificate of Independence from the Auditors before appointment / re-appointment. The Audit Committee must prescribe a specific form for disclosures concerning the auditor, any network relationship agreements rendering non-audit service firms or companies or group entities and any pecuniary interest between members or firms inter-se exceeding 2% of the network or the capital or the profit ratio, whichever is lower.

Recommendation 12: Certificate of Independence

Every company must obtain a certificate from the auditor certifying the firm's independence and arm's length relationship with the client company. The Certificate of Independence should certify that the firm, together with its consulting and specialised services affiliates, subsidiaries and associated companies or network or group entities have not / has not undertaken any prohibited non-audit assignments for the company and are independent vis-à-vis the client company, by reason of revenues earned and the independence test are observed.

12. Audit Partner Rotation

The Task Force considered the on-going debate on the requirement of rotation of auditor versus rotation of audit partner after a specified period of time. The view that audit firms should be changed after 9 or 10 years was discussed. In line with international practice, the Task Force considered it expedient to recommend mandatory rotation of audit partners after two terms of three years each. This would help discourage creation of any affinity between auditors and controlling shareholders or promoters or the management and may help to prevent "capture" of the audit process by corporate insiders. An initial experience of the impact of rotation of the audit partner should be studied. If this measure does not improve or prevent "capture of audit process by corporate insiders", then the alternative of rotation of auditors after nine years should be made mandatory.

Recommendation 13: Rotation of Audit Partners

The partners handling the audit assignment of a listed company should be rotated after every six years. The partners and at least 50% of the audit engagement team responsible for the audit should be rotated every six years, but this should be staggered so that on any given day there isn't a change in partner and engagement manager.

A cooling off period of 3 years should elapse before a partner can resume the same audit assignment.

13. Auditor Liability

The liability of the auditor for dereliction of duty needs to be prescribed for listed companies. This should not be limited to the signing partner only but the audit firm and / or any network affiliates providing non-audit services to the company, which have resulted in dereliction of duty should also be held liable.

Recommendation 14: Auditor's Liability

The firm, as a statutory auditor or internal auditor, has to confidentially disclose its networth to the listed company appointing it. Each member of the audit firm is liable to an unlimited extent unless they have formed a limited liability partnership firm or company for professional services as permitted to be incorporated by the relevant professional disciplinary body (ICAI). Even in the case of a limited liability firm undertaking audit in the future, under the new law, the individual auditor responsible for dereliction of duty shall have unlimited liability and the firm and its partners shall have liability limited to the extent of their paid-in capital and free or undistributed reserves.

14. Appointment of Auditors

The Task Force decided to propose the recommendation of the Naresh Chandra Committee relating to appointment of auditors for adoption by companies.

Recommendation 15: Appointment of Auditors

The Audit Committee of the board of directors shall be the first point of reference regarding the appointment of auditors. The Audit Committee should have regard to the entire profile of the audit firm, its responsible audit partner, his or her previous experience of handling audit for similar sized companies and the firm and the audit partner's assurance that the audit clerks and / or understudy chartered accountants or paralegals appointed for discharge of the task for the listed company shall have done a minimum number of years of study of Accounting Principles and have minimum prior experience as audit clerks.

To discharge the Audit Committee's duty, the Audit Committee shall:

- discuss the annual work programme and the depth and detailing of the audit plan to be undertaken by the auditor, with the auditor;
- examine and review the documentation and the certificate for proof of independence of the audit firm, and
- recommend to the board, with reasons, either the appointment/re-appointment or removal of the statutory auditor, along with the annual audit remuneration.

15. Qualifications Introduced by Statutory Auditors or Internal Auditors in their Audit Reports, Tax Audit Report or CARO Reports.

The Task Force discussed the issues of the extensive disclaimers which are being introduced time and again by firms of auditors, in relation to their certification following their audit function. The auditors have to discharge a significantly important responsibility concerning the accuracy of the accounts and the absence of any systemic fraud due to controls established in the listed company. It is important to provide regular audit information, thereby preventing clubbing of work towards the end of a quarter or near the end of the financial year and audit period before publishing the audited accounts; resulting in hurried and hasty clearance. The auditor has the role of a watchdog and ought not to escape liability for dereliction of duty to stakeholders by introducing qualifications in to their reports. The notes of accounts ought to facilitate the Audit Committee and analysts by their ease of conversion into financial terms having impact on the accounts presented.

The Task Force recommends that the ICAI appoint a committee with a significant membership of government directors and invite management professionals and lawyers having an understanding of accounts, to standardise the language of disclaimers or qualifications permissible to the audit firms. Anything beyond the scope of such permitted language should require the auditor to provide a sufficient explanation and should not create a new escape route for avoiding responsibility for discharging the audit function diligently, as the public relies upon them to do a thorough job.

Recommendation 16: Qualifications in Auditor's Report

ICAI should appoint a committee to standardise the language of disclaimers or qualifications permissible to audit firms. Anything beyond the scope of such permitted language should require the auditor to provide sufficient explanation.

16. Whistle Blowing Policy

Clause 49 has recommended that companies establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics. Even though companies have adopted and communicated the existence of a whistle-blowing policy, we have not seen any success on this front in corporate India. The Task Force pondered over what organisations can do to create an environment which helps employees to prevent undesirable practices. It was felt that adoption and encouragement of the policy should be made mandatory for all listed companies. This is bound to send a positive signal to employees that the management is willing and able to prevent any illegal activity and also ensure that there is a process by which the individuals can expose the problem to the appropriate authority who can take action. The employees would need to be oriented towards the company's ethics policy. HR Department can play an effective role in the process by assigning ombudsmen, providing special telephone numbers and email IDs. Since whistle-blowers need to be provided high degrees of protection, the Listing Agreement should consider providing statutory protection from dismissal or wrongful termination for acting as a whistle blower. There are adequate precedents in other jurisdictions for such laws and these could be examined. Fostering a culture which promotes and supports institutionalisation of whistle blowing policy shall deter corrupt practices and help in preventing corporate disgrace and debacles.

Recommendation 17: Institution of Mechanism for Whistle Blowing

The Task Force recommends institution of a mechanism for employees to report concerns about unethical behaviour, actual or suspected fraud, or violation of the company's code of conduct or ethics policy. It should also provide for adequate safeguards against victimization of employees who avail of the mechanism, and also allows direct access to the Chairperson of the audit committee in exceptional cases.

17. Risk Management Framework

The sources of risk, and their magnitude, have changed dramatically. Due to globalisation, changing risks and their global dimension, pose challenges not only to business and governments but also to society and economies. Inadequate risk evaluation for credit derivatives is identified as one of the causes for the global meltdown of 2008. The Task Force felt that the board must be provided with information on the most significant risks and how they are being managed to integrate risk management in decision making activity. A strategy must be instituted to deal with and manage or mitigate each of the identified risks with an objective of creating equilibrium between risk minimisation and risk optimisation. While the policy need not be made public for reasons that confidential information ought not to be published as would compromise competitiveness, the fact that the risk management strategy has been implemented and responsibility allocated, as certified by the CEO and countersigned by the Chairman of the Audit Committee, would act as a deterrent to those who may take unjustifiable risks with the objective of increasing compensations and incentives by short-term individual performance.

Recommendation 18: Risk Management

The Board, its audit committee and its executive management must collectively identify the risks impacting the company's business and document their process of risk identification, risk minimisation, risk optimization as a part of a risk management policy or strategy. The Board should also affirm that it has put in place critical risk management framework across the company, which is overseen once every six months by the Board.

Role of Regulatory Agencies

18. The Legal and Regulatory Standards

Provisions under the existing and proposed company law pertaining to the requirement of independent directors, constitution of audit committee, definition of independent director, promoter, key managerial personnel should be aligned with the existing Listing Agreement and other SEBI legislations to achieve uniformity in corporate governance standards in the country. The Task Force recognises the varying degree of best in practice standards for SMEs, listed companies and unlisted public companies, which have significant impact on the economy. The Task Force suggests that regulations / prescriptions should be set under the Companies Law and its regulations from time to time and should be in-sync with SEBI, as far as listed companies are concerned. For that purpose, joint committees of SEBI and the Ministry of Corporate Affairs should be constituted so that uniform, agreed upon standards are prescribed for listed companies under both laws.

Recommendation 19: Harmonization of Corporate Governance Standards

The Task Force suggests that the Government and the SEBI as a market Regulator must concur in the corporate governance standards deemed desirable for listed companies to ensure good corporate governance.

19. The Capability of Regulatory Agencies - Ensuring Quality in Audit Process

Based on the recommendations of the Naresh Chandra Committee on Corporate Audit & Governance, an independent Quality Review Board (QRB) was set up, which could be entrusted to provide transparent and expeditious oversight. The Board was funded by ICAI and also depended on the Institute to provide infrastructural support. However, the ICAI QRB has not achieved the objectives for which it was established and the Task Force, thus considered it imperative that the QRB is made functional going forward to ensure quality in the audit process by a critical review of the intensity and integrity of auditors by peer auditors on an annual basis.

Recommendation 20: Audit Oversight Mechanism

In the interest of investors, the general public and the auditors, the Task Force recommends that the Government intervenes to strengthen the ICAI Quality Review Board and facilitate its functioning of ensuring the quality of the audit process through an oversight mechanism on the lines of Public Company Accounting Oversight Board (PCAOB) in the United States.

20. Effective and Credible Enforcement

Multiplicity of investigating agencies leads to delay in the overall judicial process and possible misinterpretation of information. Regulators under the Company Law, the Securities Laws and the Serious Fraud Investigation Office should have an inter-se cooperation agreement. In fact, the Naresh Chandra Committee Report on Corporate Audit and Governance (2002), set up by the then Department of Company Affairs, had recommended that there should be a Task Force constituted for each case under a designated team leader and in the interest of adequate control and efficiency, a Committee each, headed by the Cabinet Secretary should directly oversee the appointments to, and functioning of this office, and coordinate the work of concerned department and agencies. The mode of cooperation and the specification of inter-se duties, areas of investigation ought to be determined at the initiation of the investigation so as to avoid conflicting reports. The inter-regulator committee for instituting criminal and civil recovery proceedings should be supported by highly trained professionals so that serious frauds are controlled and adequate deterrence measures are put in place against defaulters. During the Harshad Mehta scandal, the Special Courts Act was empowered to consider both civil and criminal actions from the securities fraud transaction. A special bench of the Company Law Board or its successor, the National Company Law Tribunal should be invested with special powers for adjudication of civil recovery actions and for criminal offences and penalties to be levied thereunder. Such a bench should have time management processes for disclosure and pre-trial discovery admissions for determining the issues to be proved, leading of evidence on a day-to-day basis and a specified time line for rendering the judgement after a collaborative time-table between the court / NCLT / prosecutors and defence counsel is set at commencement after the charge sheet or the plaint is instituted. The bench should endeavour to dispose off matters concerning securities frauds or serious frauds within a time frame of 6 to 12 months from commencement.

Recommendation 21: Effective & Credible Enforcement

The Task Force recommends that instances of investigations of serious corporate fraud must be coordinated and jointly investigated. Joint investigations / interrogation by the regulators for example, the SFIO and the CBI should be conducted in tandem. On the lines of the recommendations of the Naresh Chandra Committee Report on Corporate Audit and Governance, a Task Force should be constituted for each case under a designated team leader and in the interest of adequate control and efficiency, a Committee each, headed by the Cabinet Secretary should directly oversee the appointments to, and functioning of this office, and coordinate the work of concerned department and agencies. Civil recovery for acts of misfeasance, malfeasance, nonfeasance and recovery from the wrongdoers and criminal offences and penalties and punishments should be adjudicated appropriately, without conflicting reports and opinions, and disposed off between 6 to 12 months.

21. Confiscation of Shares

In case of securities fraud by a shareholder or other securities holder, the company should aide the regulators (i.e. Ministry of Corporate Affairs and SEBI) as decided by an inter-se agreement between the two to take actions such as freezing the shares, intimating the stock exchanges of the details of the relevant securities and in case of physical share certificates, confiscation and cancellation thereof; as fraud conveys no title. The power of confiscation and cancellation in relation to securities fraud, should extend to cancellation of such fraudulent securities even if it concerns creation of one or more (multiple) pledges subsequent to the first act of securities fraud.

Recommendation 22: Cancellation of Fraudulent Securities

A provision of confiscation and cancellation of securities of a person who perpetrates a securities fraud on the company or security holders ought to be prescribed for the protection of capital markets.

22. Personal Liability

In case any director or employee(s) of the company commits an offence with an intention to make personal monetary gains or profits, personal penalty should be imposed on such directors or the employees commensurate with the wrongful gains made in addition to disgorgement of wrongful gains. The Shardul Shroff Committee constituted by the Department of Corporate Affairs has provided for consequences of repeat offences and ad valorem fines and penalties based upon the magnitude of unlawful or unjust enrichment and gains from a fraudulent or illegal act under the Company Law. With mega frauds, the financial penalty of Rs.25 Crores prescribed under SEBI and Securities Laws are inadequate and an ad valorem rate based upon the extent of the securities fraud may be considered.

The collection of fines and penalties should be employed for restitution of those shareholders or the company which has been a victim of the fraud or the offence and should not be accumulated to government coffers. The deterrence aspect of a serious fraud must be significant and serious and the victims who suffer such frauds must enjoy the benefits of distribution of such fines and penalties after recovery of costs of the conduct of any trial to prove the offences or the recovery from the wrongdoer and the disgorgement of wrongful gains.

On the other hand, if a director is not informed or does not possess any knowledge of any non-compliance on part of the company, he should not be held liable, The Task Force drew a reference to the judgment in the case of Homi Phiroze Ranina Vs. The State of Maharashtra where it was held that " non-executive directors cannot be made to undergo the ordeal of a trial for offence of non-compliance with a statutory provision unless it can be established prima facie that they were liable for the failure on part of the company”

Recommendation 23: Liability of Directors & Employees

Personal penalties should be imposed on directors and employees who seek unjust enrichment and commit offence with such intentions. Such punishments should be commensurate with the wrongful act and be imposed in addition to disgorgement of wrongful gains. Further, non-executive directors cannot be made to undergo the ordeal of a trial for offence of non-compliance with a statutory provision unless it can be established prima facie that they were liable for the failure on part of the company.

The Role of External Institutions

23. Institutional Investors

Long term institutional shareholders, pension funds or infrastructure funds with significant holdings in securities of listed companies across all of the West but largely in the United States, are known to be powerful players in shaping corporate governance norms. Hedge funds and FIIs have a shorter term view but are equally concerned with observance of corporate governance norms and the protection of capital markets. Their role assumes more significance as dispersed shareholders have neither resources nor incentive to invest the significant resources required to effectively monitor and sometimes agitate against ineffective or even fraudulent boards and managements.

Recommendation 24: Shareholder Activism

Long term institutional investors, pension funds or infrastructure funds can help to develop a vibrant state of shareholder activism in the country. The oversight by such investors of corporate conduct can be facilitated through internal participation of their nominees as directors or external proceedings for preventing mis-management. Such institutional investors should establish model codes for proper exercise of their votes in the interest of the company and its minority shareholders, at general meetings, analyze and review corporate actions intended in their investee companies proactively and assume responsible roles in monitoring corporate governance and promoting good management of companies in which they invest.

24. The Press

Capacity building in the area of corporate governance, has assumed critical importance in India, given the renewed emphasis on the subject in the light of the recent events. Media has an important part to play in raising general awareness and understanding of corporate governance and potentially as a watch dog in the area of corporate governance. Being a significant stakeholder itself, the fourth estate should consider upgrading capacity to carry out analytical and investigative reporting in matters impacting best in practice standards of corporate governance as they can play the role of a responsible and an effective stakeholder in protecting capital markets or securities markets from injury from corporate fraud.

Recommendation 25: Media as a stakeholder

The Task Force recommends that media, especially in the financial analytics and reporting business should invest more in analytical, financial and legal rigour and enhance their capacity for analytical and investigative reporting.