# Corporate Governance in India

## Revised Clause 49 of Listing Agreement

## Preparing for Internal Control Reporting – Some aspects discussed



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**Our Ref: SSA/CIR/56-002** **April 7, 2005**
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# CORPORATE GOVERNANCE IN INDIA –
## REVISED CLAUSE 49 OF LISTING AGREEMENT

## PREPARING FOR INTERNAL CONTROL REPORTING – SOME ASPECTS DISCUSSED

### 1.0 Corporate Governance – An overview

Ideals of Corporate governance primarily need transparency, full disclosure, fairness to all stakeholders and effective monitoring of the state of corporate affairs. The basic philosophy of corporate governance is to achieve business excellence and enhance shareholder value, while keeping in view the need to balance the interests of all stakeholders.

The real genesis of the corporate governance lies in the business scams and failures. The junk bond fiasco in USA and the failure of Maxwell, BCCI and Polypeck in UK resulted in the Treadway Committee in USA and the Cadbury Committee in UK on corporate governance. A number of committees were set up to look into various aspects of corporate governance, which included Sir Adrain Cadbury Committee (1992), Greenbury Committee (1995), Hampel Committee (1998), Blue Ribbon Committee (1999), OECD Principles of Corporate Governance (1999) etc. across the globe.

The most stringent enactment passed in corporate governance developments across the globe is the Sarbanes Oxley Act in the US in July 2002 after the corporate collapses of Enron, Worldcom and Xerox to restore trust in the public securities market. Specifically, the US government enacted this law to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.

### 2.0 Corporate Governance – The Indian perspective

Corporate governance in India is evident from the various legal and regulatory frameworks and Committees set relating to corporate functioning comprising of the following:

- Companies Act, 1956
- Monopolies and Restrictive Trade Practices Act, 1969 (replaced by new Competition Law)
- Foreign Exchange Management Act, 2000
- Securities and Exchange Board of India Act, 1992

- Securities Contract Regulation Act, 1956
- The Depositories Act, 1996
- Arbitration and Conciliation Act, 1996
- SEBI Code on Corporate Governance
- CII Code of desirable corporate governance (19998)
- UTI code of governance (1999)
- Kumar Mangalam Birla Committee on Corporate Governance (2000)
- Naresh Chandra Committee (2002)
- N.R. Narayanamurthy Committee (SEBI-2003)

**One of the sweeping changes in Indian legislation was the introduction of clause 49 of the standard listing agreement by SEBI incorporating most of the suggestions of the Kumar Mangalam Birla Committee's report.**

The Enron debacle of 2001 involving the hand-in-glove relationship between the auditor and the corporate and the consequent enactment of the stringent Sarbanes Oxley Act in US led the Indian Government to appoint the Naresh Chandra Committee (2002) to examine and recommend amendments to the law involving the auditor-client relationship and the role of independent directors. The Companies Amendment Bill of 2005 placed before the Parliament includes many of the recommendations of the Naresh Chandra Committee.

**This was followed by the constitution of N.R. Narayanamurthy Committee by SEBI in 2002 to further analyze clause 49 of the standard listing agreement that has been amended with the recommendations of the committee's report.**

## 3.0 Recent amendments to Clause 49 of the Listing Agreement

SEBI has announced a complete revision of clause 49 in the listing agreement of stock exchanges vide circular dated October 29, 2004. This circular supersedes all other earlier circulars issued by SEBI on clause 49 of the Listing Agreement.

## 3.1 Applicability

The provisions of the revised clause 49 will be applicable to:

- All entities seeking listing for the first time at the time of seeking approval for listing.
- Existing listed entities having a paid up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company with effect from 1st April 2005.

**SEBI has further extended the date for ensuring compliance with the revised clause 49 up to December 31,2005 vide circular no. SEBI/CFD/DIL/CG/1/2005/29/3 dated March 29,2005.**

## 3.2 Reporting requirements

All listed Companies to whom this clause would be applicable, shall submit **a quarterly compliance report to the stock exchanges within 15 days from the close of the quarter.** This report shall be **signed by the Compliance Officer or the Chief Executive Officer** of the company.
**As the revised clause will be effective from 01.01.2006, the first report to be submitted by the Companies would be for the quarter ended March 31, 2006, which will fall due on April 15, 2006.**

## 3.3 Significant amendments to Clause 49

- Sea Change in the definition of Independent director I (A)
- Non-executive / Independent directors fees require approval of shareholders I (B)
- Board shall be responsible for compliance with laws and regulations I (C) (iii)
- Code of conduct to be laid for Board and senior management – declaration signed by CEO affirming compliance to be incorporated in the Annual report I (D)
- 2/3rd of the members of Audit Committee to be independent directors II (A)
- Audit Committee meetings – every quarter within a gap of 4 months between two meetings II (B)
- Members of audit committee to be financially literate and at least one member shall have accounting or financial management expertise II (A)
- Review of quarterly financial statements before submission to the Board for approval by Audit Committee II (D)
- Reviewing performance of statutory and internal auditors II (D)
- Mandatory review of certain information by the Audit Committee
- Independent Director to be on Board of material non-listed Indian subsidiary and additional role of Audit Committee and Board III
- Increased disclosures for related party transactions IV (A)
- Disclosures of proceeds from public, rights, preferential etc. issues – annual statement of funds utilized other than stated in offer document / prospectus / notice to be certified by the statutory auditor. IV (C)
- Disclosures on Risk Management Framework IV (C )
- The CEO / CFO of every applicable company would be required to certify the financial statements on true and fair view of the company's affairs, compliance with applicable laws and regulations, fraudulent, illegal or violation of company's code of conduct transactions, responsibility for establishing and maintaining internal controls and evaluation of the effectiveness of the internal control systems of the company.

For this purpose, internal control reporting and monitoring is very important and crucial. We have attempted to discuss some critical aspects relating to the requirement of internal control reporting to be certified by the CEO / CFO in this paper.

## 4.0 Requirement for CEO / CFO certification

SEBI has added a new requirement of CEO / CFO certification as an amendment to the clause 49 of the Listing Agreement.

**The CEO / CFO shall certify in the quarterly compliance report to the stock exchanges that –**

**4.1** They have reviewed the financial statements and the cash flow statement and that to the best of their knowledge and belief:

- These statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading.
- 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.

**4.2** 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.

**4.3 They accept responsibility for establishing and maintaining internal controls and that they have evaluated the effectiveness of the internal control systems of the company and they have disclosed to the auditors and the Audit Committee, deficiencies in the design of 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.**

**4.4** That they have indicated to the auditors and the Audit Committee -

- **Significant changes in internal control during the year.**
- Significant changes in the accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and
- 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.

## 5.0 Preparing for Internal Control Reporting –

### 5.1 Significance of evaluation of internal controls beyond reporting

A heavy responsibility has been cast on the CEOs and CFOs of companies. This calls for developing strategies and actions to manage their reporting obligations that will enhance public trust. Many companies view this as a painful and costly requirement with little benefit other than compliance. **However, benefits of going beyond mere compliance are huge, provided companies rejuvenate their internal control systems.**

With accelerated reporting deadlines and a risk of increased regulation, a more comprehensive approach to requirements for internal control reporting can achieve a return on investment well beyond mere compliance.

Since most companies already have some form of internal controls in place, they may be able to leverage existing systems, processes and resources when developing a more formalized process. In addition to providing a basis for the management's reporting, a comprehensive evaluation of internal control also might result in:

- Reducing the cost of accounting processes.
- Identifying existing control procedures that are redundant, inefficient or cost ineffective.
- Identifying areas or processes where controls need to be strengthened or redesigned.
- Identifying duplicative procedures and systems that are not necessary.
- Simplifying systems.
- Increasing productivity.
- Improving the effectiveness of the design or operation of controls.

### 5.2 Stages of Internal control reporting

The whole process of internal control reporting can be phased out in the following stages:

- Starting with a framework of Internal Control.
- Planning the evaluation of internal controls.
- Evaluation of effectiveness of internal controls at the entity Level.
- Evaluation of effectiveness of internal controls at the process, transaction or application level.
- Evaluation of overall effectiveness of entity-wide controls
- Identification of matters for Improvement and actions for improvement.
- Establishing Monitoring Systems.

We have dealt with each of the above stages in brief in the paper.

### 5.3 Starting with a framework of Internal Control

- **Need to start from the basics – adopt a proper framework for Internal Control**

  Some companies already have documentation of their procedures and control mechanisms, including accounting policy and procedure manuals, information systems manuals and job descriptions.

  Also, internal auditors often have documentation of internal controls and procedures and have tested whether selected controls are functioning as designed.

  Further, the statutory auditors also will have evaluated controls in some areas in regards to their reporting requirements of CARO under the Companies Act, 1956. However, the focus of a financial statement audit is to give an opinion on the annual financial statements – not to report on the system of internal control. Statutory audit procedures are designed to be performed most effectively and efficiently in order to conclude as to the fairness of amounts and disclosures presented in the financial statements. Therefore, it is unlikely that the auditors' working papers will contain documentation of controls adequate to meet the needs of management for internal control reporting.

Thus, while a great deal of documentation relating to systems and controls may be available, companies may not have completed comprehensive documentation sufficient to support internal control reporting.

- **Formation of a framework for Internal Control**

  The Committee of Sponsoring Organization (COSO) formed in US provides for an effective model for establishing an internal control framework.

  According to COSO, Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

  - Effectiveness and efficiency of operations
  - Reliability of financial reporting
  - Compliance with applicable laws and regulations

  There are five interrelated components in the COSO internal control framework, which are presented as a pyramid, as follows:

  - **Control Environment** – It contains informal and often intangible soft controls ethics, integrity, management operating style as well as hard / formal controls such as organization structure, assignment of authority and responsibility, policies and practices etc.
  - **Risk Assessment –** According to COSO, effective risk assessment requires predefinition of objectives, identification of risks to achieving objectives, judgment of which risks are critical and determination of actions to mitigate risks. The Enterprise Risk Assessment model may be adopted by organizations.
  - **Control Activities –** The mechanisms management establishes to ensure their directives are carried out, including the activities identified to mitigate risks are control activities which comprises of risk control matrix that analyses activity / process / function level objectives, risks and controls
  - **Information and Communication –** Pertinent information must be identified, captured and communicated in a form and timeframe at all levels. Effective communication of information should occur, flowing down, across, up, inside and outside the organization.
  - **Monitoring –** Involves day-to-day oversight by managers, periodic reviews etc. and assessment of the quality of the performance of the framework, identifying deficiencies and taking corrective action.

### 5.4 Planning the evaluation of internal controls

The company should form a cross functional team of senior management of major business segments, finance and accounts personnel, IT head etc. The team should develop a plan of action, which should include

- Organization – defining responsibilities for various team members.
- Background information – documentation of business operations (locations, units, subsidiaries, joint ventures etc.), copies of polices, procedures, manuals etc.
- Scope and time of review – factors in control environment to be reviewed, significant processes / activities to be considered, flowcharting of the processes and the relevant risks and controls, planned timetable for completion.
- Problem areas for early attention - processes that are suspected of containing significant deficiencies or material weaknesses, new processes or activities etc.
- Documentation and reports

## 5.5 Evaluation of internal control at entity level

Entity-level controls are controls to monitor operations and oversee the control environment and risk assessment process at the overall corporate level as well as at the individual locations / business units. Such controls have a pervasive impact on controls at the process, transaction or application level and provide management with a mechanism to assist in overseeing and maintaining a sound internal control system.

The entity level controls can be broadly summarized into:

- Review of methods of assigning authorities and responsibilities in the organizational structure.
- Methods of monitoring decentralized operations.
- Assigning and monitoring responsibilities for information systems.
- Establishing and monitoring policies and procedures throughout the organization.
- Degree of segregation of duties among employees and IT applications.
- Establishment and communication of entity-level objectives, supported by strategic plans and complemented by process / application level.
- Establishment of risk assessment process.
- Setting mechanisms to anticipate, identify and react to changes that may have a significant effect on the entity. E.g. Disaster Recovery Plan, Whistler Blowers Policy etc.
- Setting of mechanisms to anticipate, identify and react to events that affect process / application level objectives.
- Processes to identify significant regulatory changes.
- Formation of information system, which provides management with accurate and timely information on entity's performance.
- Adequacy of communication across the organization to enable employees to discharge their responsibilities.
- Planning and reporting systems to identify variances from planned performance and corrective action on the same.
- Procedures for Information security and access.

## 5.6 Evaluation of Internal control at the process, transaction or application level

- **Identification of significant locations or business units**

  The evaluation of internal controls at the process / transaction level will initiate with identification of significant locations or business units for which background work has already being done in the planning stage.

  In making this identification, it should evaluate factors such as the relative significance / contribution of the location / business unit and the risk involved. The extent to which the business processes and underlying controls for a given location / business unit occur in a central in a centralized environment should also be considered.

  The process of selecting locations and business units involves identifying:

- Individually important locations / business units encompassing a large portion of the company's operations and financial position.
- Locations / business units not individually important but with specific risks that make them important.
- Locations / business units when aggregated constituting significant portion of operations.

- **Identification of significant processes and evaluation of controls**

  After identifying the significant locations / business units, the management should identify the significant processes and activities of the locations / business units. The following aspects should be consider the following aspects:

  Understand the flow of transactions, including how the transactions are initiated, recorded, processed and reported at various levels.

  - Preparing flow-charts of sub-processes
  - List the risks associated with the processes
  - Rating of the risks and vulnerability, likelihood of occurrence, impact on business, ability of business to absorb risk.
  - Prepare checklists of desired controls vis-à-vis existing controls
  - Discussion of alternative control mechanisms
  - Consideration of application controls (IT controls)

### 5.7 Evaluation of the overall effectiveness of entity-wide controls

The determination of whether controls as designed are effective should be assessed considering whether the controls achieve given objectives / address the given risks.

Further, management should assess whether the controls are functioning as designed. This will involve performing a walk-through of a transaction / process to test the effectiveness of the controls.

### 5.8 Identification of matters for Improvement and actions for improvement

In a dynamic business environment, controls will require modification from time to time. Certain systems may require control enhancements to respond to emerging risks. Automating certain manual controls may improve both efficiency and compliance. Redundant controls or procedures may be found in some areas that are not essential.

The management should form a cost-benefit decision as to whether the costs to install and maintain a control that will reduce the risk would exceed the expected benefits. Further, cost-benefit analyses can be used to determine whether existing controls should be retained.

### 5.9 Establishing monitoring systems

The management should establish mechanisms to continually monitor and maintain the system of internal control and take corrective action in a timely manner, when required. The following aspects can be considered for monitoring the internal control systems:

- Establishing responsibility for issuing policies and procedures.
- Forming reporting structures at various levels.
- Internal Audit by an independent authority.
- Involvement of the Audit Committee.

## 6.0 Significance of Compliance for overseas operations / businesses

The major recommendations of the revisions to clause 49 of the listing agreement are adopted from the Sarbanes Oxley Act (SOX) of US. This is the most stringent legislation ever passed in the history of US legislation.

The law is intended to improve corporate governance, promote ethical business practices, enhance the transparency of financial statements and disclosures**,** improving internal controls**,** ensure that company executives are aware of material information emanating from their business, and hold management accountable for material information filed with the Securities and Exchange Commission (SEC) and released to investors.

**Indian companies proposing to go for listing in US stock exchanges or foreign companies having Indian counterparts squarely fall under the compliance requirements of SOX.**

**Similarity of clause 49 with SOX**

The concepts of independent director, some disclosure requirements and CEO / CFO certification of internal control reporting has been adopted from SOX.
**Sarbanes Oxley goes further to the extent of seeking documentation of the evaluation of the effectiveness of the internal controls. In addition, it requires the attestation of statutory auditors on the management's assessment of effectiveness of internal controls.**

**It may not be astonishing if the requirement of documentation of internal controls and attestation by statutory auditors will be introduced in Indian legislation also. It is just a matter of time. Hence, companies should be geared up with the compliance of clause 49 requirements for further requirements of SOX, if applicable.**

## 7.0 Conclusion – A new beginning

The compliance requirements of clause 49 should be looked upon by the management as a challenge for a new beginning resulting into simplification of systems, increased efficiency and optimum utilization of resources.

**Prepared by:**

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NOTE: - This note is not meant for circulation and is general in nature. In this note, we have attempted to summarise some of the significant aspects to be kept in mind by our Clients to ensure compliance for internal control reporting of clause 49 of the listing agreement as per SEBI guidelines. It may be noted that nothing contained in this note should be regarded as our opinion. We are not responsible for any liability arising from any statements or error contained in this circular.