Analysis of Corporate Discipline and Internal controls in India (With a background of global developments)

Mukta Bansal*

Introductions

Most of the Public Companies (hereinafter referred to as "Corporates") are build upon the capital accumulated from a large investor base in domestic and international markets. Hence the management and the Board of Directors ("BoD" or "Board") must assume the responsibility of being trustees to the investors and safeguard their interests. In an age, where capital is flowing globally, as quick as information, a Corporate that does not promote an ethical and efficient oversight of its future, endangers its very survival in the present "accountable" world. Due to this, the relation between a Corporate's management, its BoD and external disclosure system has become quite crucial. The vital part of external disclosure is financial reporting and disclosures, which should present a true and fair view of working of the concern. Much emphasis has come from various sectors on truthfulness and fairness on the financial reports, but unfortunately few factors strengthening it have been ignored so far. As rightly viewed and incorporated worldwide, a sound disclosure system requires vigilant audit committee, independent directors (who at all times are accountable to share holders), upgraded accounting standards, disclosure and treatment of related party transactions and more stringent regulations on auditors etc.

Despite of such a handsome package of controls and guidelines, United States of America (USA) saw Enron Corporation scam, Qwest, Global Crossing and World Com Inc. scandals that shattered the investor confidence, tumbled the stock markets, busted the auditing firm Arthur Andersen, and destroyed the credibility of the Chartered Accountancy profession.

It also eroded the faith in capitalism worldwide. Common people began to distrust the CEOs on news and business magazine covers. New revelations showed that CEOs/ management had not just inflated profits but made bullish pronouncements gypping shareholders and employees while selling their own stocks.

Fortune magazine in its September 2002 issue listed the 25 "greediest executives" who made the most money through stock sales between January 1999-May 2002. Most of them cashed on the boom-time peak while their company stocks dropped or crashed subsequently. They were helped by Wall Street analysts who put out "buy" recommendations on junk stocks.

Through all this exposure of corporate sleaze, Indian business maintained a stoic silence. It suggested that Indian business houses did not indulge in creative accounting or stock fixing, were fair to their stockholders, and adhered to rules of Corporate Governance.

These notions were destroyed by Xerox Corporations' revelations of $700,000 payoffs by its Indian subsidiary. The Tata Finance-A.F.Ferguson controversy also muddied the waters although the Tata Group had sacked Tata Finance Managing Director last year for irregularities and had ordered insider-trading investigations against another director.

The accountability and responsibilities on the part of BoD and top management towards shareholders in India is quite thin. An example is the resignation of three Global Trust Bank (GTB) directors including the head of its audit committee(before its merger with oriental bank). None of them felt that they owed it to GTB stakeholders to explain their exit from Board. Instead shareholders had to draw inferences from media and elsewhere.

In United States the scandals triggered another face of reforms in corporate discipline, accounting practices and disclosures – this time more comprehensive than ever before. In July 2002, less than a year from the date when Enron filed for bankruptcy, the Sarbanes and Oxley Act (popularly called "SOX") was enacted. The Act brought with it fundamental changes in virtually every area of corporate discipline and particularly in auditor's independence, conflicts of interest, corporate responsibility, and enhanced financial disclosures

* *Assistant Professor, Commerce, Shayamlal College (M) University of Delhi*

and severe penalties, both financial and personal imprisonment for willful default by managers and auditors.

In India we are still searching to evolve a fair system of corporate discipline. Though, strengthening and empowering Department of Company Affairs (DCA) (there is more fear of DCA now than at any time before - DCA is also going through Xerox books in India with fine tooth comb rather than letting it go with a nominal fine), upgradation of accounting standards and rotation of company auditors (ICAI notification is still awaited) are progressive and bold steps in this direction but that is just the tip of the iceberg. There has been complacency on the part of corporates with regards to the recommendations from SEBI on corporate discipline. As such, with the recommendations of committees on corporate governance and SEBI's positive intervention, listed companies in India need to follow very stringent guidelines on corporate governance. These are ranked among some of the best in the world. Unfortunately there exists a wide gap between the prescription and practice.

Objective

Present study analyses few factors which may help bridge the gap between the recommendations by the advisory committees like the Kumarmangalam Birla Committee (2000), Naresh Chandra committee (2002), N.R. Naryanmurthy committee (2003), which have been published to keep India's corporates at par on the world stage. The key issues being analysed are

- Management's responsibility to stake-holders
- Internal controls review and effectiveness in Indian Corporates
- Enactment of laws and regulations
- Transparency and accuracy of reporting to Shareholders
- Need for an integrated regulatory agency

Background

As already mentioned, SOX Act 2002 came with more stringent provisions on auditing, financial reporting, corporate disclosure and structure of BoD, than any other previous law in US history. There is ample space in Indian scenario, which can be filled by inputs from various bills and codes published worldwide.

Top management being the whole and sole of the company's performance in future is to be held responsible for adequate disclosures. Section 906 of SOX Act 2002 levy hefty fines and even imprisonment for neglect of duty. This is in order to prevent the CEO/ CFO/ the top management from duping the shareholders and raking the mullah immorally. In India though there has been a recommendation (recommendation no. 2.10) in the Naresh Chandra committee report which requires all the listed companies as well as public companies with paid up capital and accumulated reserves higher than Rs. 10 Crores or a turnover exceeding Rs 50 Crores to have a certification by the CEO (either the Executive Chairman or the Managing Director) and the CFO (Whole-time Finance Director or otherwise) which should state the fairness and accuracy of the financial reports to the best of their knowledge and belief. But this recommendation does not impose any concrete responsibility/ penalty on CEO and CFO, to ensure that the financial reporting is accurate, whereby they go an extra mile to ensure the adequacy of internal controls and financial reporting process to eliminate any discrepancies in the financial accounts. In absence of this it remains only a mere ritual. Therefore it can be analysed whether more stringent penalties and fines on CEO's and CFO's are desirable in Indian scenario as well to prevent top management from jeopardizing the future of the Corporate.

From the very beginning, internal controls their efficiency and effectiveness, has not been given its due importance. Quite, surprisingly, various recommendations did not prefer to go into the intricacies of the internal control implementation despite this being the backbone of the accuracy, fairness and efficiency in the Corporate system. The "Combined Code" on Corporate Governance (2003) published in UK dedicated its major part to elaborate the importance of internal controls and risk management, and how to maintain and review effectiveness of internal control. It also requires Board's statement on efficiency of internal control. Further the Section 404 of SOX Act 2002, also emphasize the need for having an adequate internal control structure. It requires the CEO and CFO of the listed companies to give a declaration that they have ensured they have ensured an adequate internal control structure throughout the year. This assertion also needs to be approved by the auditors of the company.

However in Indian scenario, internal control has been recommended only as one of the functions of audit committees so far. Kumarmangalam Birla committee stated that the audit committee should review with management, external and internal auditors, and the adequacy of the internal control system. N.R Murthy committee on corporate governance 2003 stated that audit committee should review the management letters/ letters of internal controls weaknesses, issued by statutory/ internal auditors mandatorily. However, none of these held either the Audit Committee or the Top Management accountable for formation, implementation and review of internal controls. In the present study the importance of internal controls, its knowledge and accountability on BoD and Management is analysed.

Since 1997, many committees have been organized and they issued valuable recommendations, but the practice of Corporate Governance is still not up to the mark. There appears a wide gap between prescription and practice. SEBI, after a survey in 2003 observed that the analyses of financial statements of companies and the report on Corporate Governance discloses that their quality is not uniform, whereas, compliance with the requirements in clause 49 of the Listing Agreement is by and large satisfactory. This clearly suggests that few recommendations should be backed by legal framework. At the same time it raises a question that whether compliance is in 'form' or in 'substance'. Quite importantly the laws, rules, and regulations should not reduce Corporate Governance to mere ritual. But the kind of penalties and stringent provisions that should be binding on corporate management, BoD, and Auditors is worth analyzing. Hence the present study attempts to analyze the viability of enactment of laws and regulations for Corporate Discipline in India.

One of the key concerns for efficiency and fairness of corporate disclosures is transparency to Shareholders, be it Tata – A.F.Ferguson case, or the GTB fiasco, shareholders are compelled to draw inferences from the bits and pieces of information available from the media and elsewhere. Why top management and BoD do not feel the need to inform the shareholder on what's going wrong or why important position holders exit without submitting an explanation. Shouldn't there be a system of more transparency and better information system to ease of the pains of the stakeholders and boost their confidence in Corporates. The present study attempts to find out the need of such transparency in Indian corridors.

The Sox Act 2002 call for an integrated regulatory agency – Public Company Oversight and Accounting Board (PCAOB) to oversee the audit of listed companies in order to protect investor and public interest in matters relating to the preparation of the financial statements. It is recommended to be a non-profit body corporate and agency or establishment of the US government. Naresh Chandra committee in its report thoroughly analysed the need of such agency and came to the conclusion that PCAOB was not desirable at that time in India due to the following reasons:

- First, the powers that are sought to be vested in the PCAOB of the United States under the SOX Act are today, in India distributed across a plethora of regulatory agencies — the DCA, SEBI, RBI, ICAI, ICSI, ICWAI, the power to proceed under the Information Technology Act, 2000, and residual powers under the Code of Civil Procedure and the Code of Criminal Procedure.
- Secondly, if there were to be an Indian version of the PCAOB, then such powers would need to be withdrawn from the existing regulatory agencies and concentrated in the proposed public oversight board. Without these powers, the board would be yet another toothless agency — maintained pro forma without any significant operational content.
- Thirdly, it was argued that the need of the hour was reform of auditing oversight functions — but that such reforms did not necessarily entail circumscribing the powers of existing institutions to create yet another one. Instead, it was necessary to empower the organisations that are on the ground and, if need be, provide additional safeguards to ensure that they can expeditiously achieve their objectives.

But can so many institutions in which all such powers are segregated, build up synergy and carry out the desired work of PCAOB??

The recent developments pose a doubt on the same. A good example is the GTB fiasco. After PriceWaterhouse filed a heavily qualified report for GTB for financial year ending March 2003, GTB pretended to be not annoyed; its annual report said " it will apply to RBI for reappointing PWC as Auditors" but as the annual general meeting approached, the newspapers reported that the management may replace PWC as statutory auditors and the RBI cleared the newly appointed auditors even ahead of the AGM (later in the year, RBI was announcing moratorium on account of GTB failure). This particular incidence does not show weaknesses of RBI but the pitfalls in the whole system instead. Hence suggesting the need of a board, which can actually oversee the whole affairs of the corporates and has power to make a difference in corporate financial India. This paper also analyses the need and relevance for such a board and its merits and demerits.

To analyze the above, the present study is split into two parts:

Part one consists of two chapters: First Chapter looks into the history of Corporate Governance globally and Chapter Two throws light on the various committee reports which have been published on Corporate Governance in India until now.

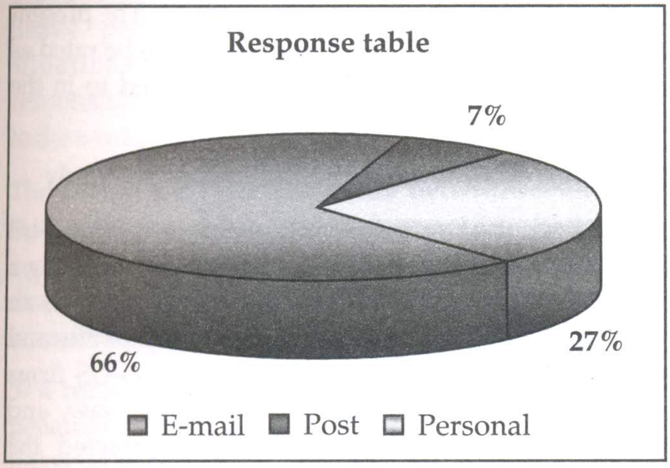
Part two comprises of three chapters: First Chapter compares the Global Corporate Governance postulates and the developments in the Indian scenario. Second chapter explains the methodology on the basis of which the analyses has been carried out and results of the Study. Chapter three chalks out the recommendations of research and the limitations of the present Study.

Research methodology

A survey was conducted in the Indian Market during the period of May 2004 to July 2004, with the help of a Questionnaire. The responses were obtained through personal, postal and electronic modes. The corporate discipline survey questionnaire was sent to over 200 participants across various Industry sectors and all parts of India.

While there was a moderate response rate from a few sectors, this does not necessarily reflect the level of interest in corporate governance issues. Many individuals communicated that they receive a large no. of surveys and therefore as a matter of policy do not respond to any. Further in a few cases, the employees had restrictions stemming from their Company regulations and hence expressed their inability to respond to the questionnaire.

In modern techno world as anticipated majority of responses came via e-mails. In aggregate 30 responses were received amounting to a 15% response rate. Out of these 20 were received on e-mails, 8 personally and 2 by post.



Respondent Demographics

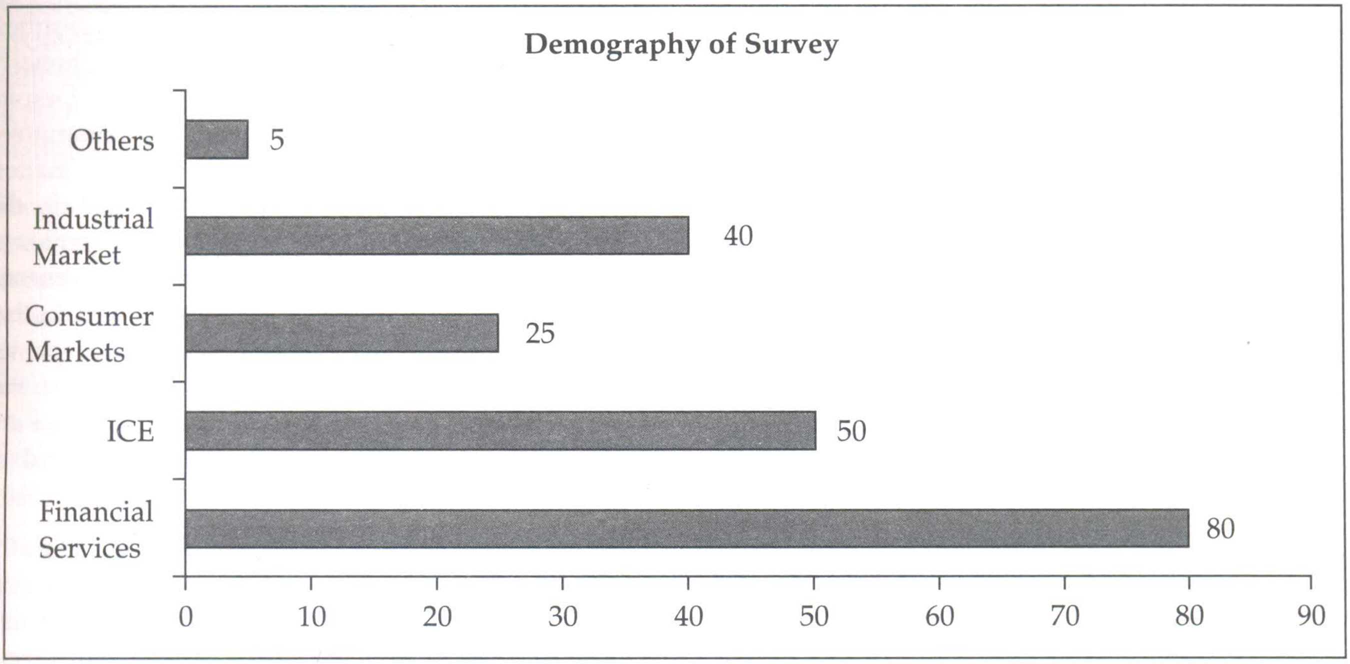
For the purpose of survey the participants were categorized from industries such as Financial Services, Information Communication and Entertainment, Industrial Market, Consumer Markets and Others.

Judgement Sampling

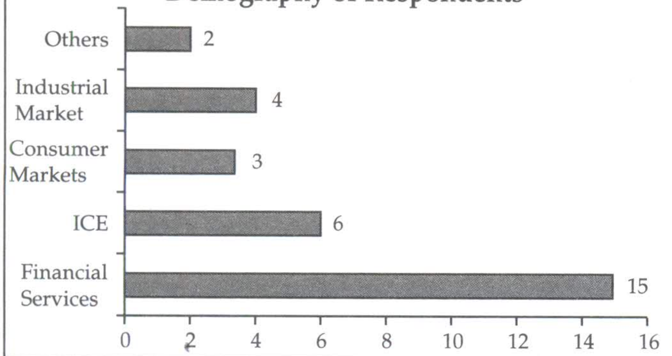
Judgment sampling has been used for identifying the items of the population which are to be included in the sample.

The target respondents were classified in four categories and the persons most likely to respond were contacted:

- Top management – 'C' Level or the Board
- Senior management like Vice President/ Financial Controller / Company Secretary etc.
- Middle Management: Managers/Senior managers / Senior consultants
- Operational Management: Team Leads/ Assistant Managers / Junior Management



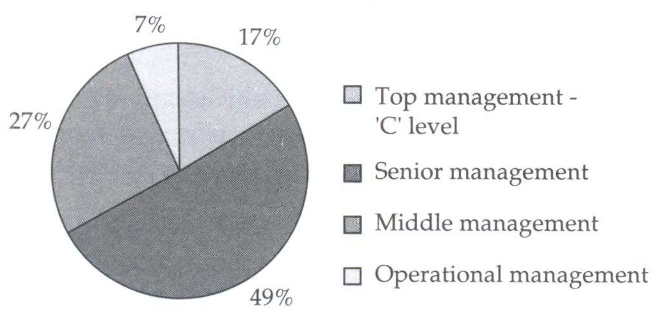
Demography of Respondents



Schedule of Questionnaire sent and received

Management classification	Requested	Received
Providing extra discount	92	13.0
Consumer shift	202	28.7
Decline in sales	180	25.5
Economic slump	150	21.3
Increase in operational cost	31	4.4
In crease in price by suppliers	31	4.4
others	19	2.7

Respondent's Profile



Contents of Questionnaire

Category	No. of questions
Management's responsibility to stake-holders	3
Internal controls review and effectiveness in Indian Corporates	5
Enactment of laws and regulations	5
Transparency and accuracy of reporting to Shareholders	5
Need for an integrated regulatory agency	3

About the questionnaire

The questionnaire had 21 questions which were classified under 5 objectives of the study as follows:

The no. of questions were deliberately kept low in order to achive a high rate of response. The present study got about 15% response which can be rated as good. The questionnaire can be referred to in the Appendix 1 of the Study.

Recommendations and conclusions of the Study

After a slew of scandals in corporate sector US lawmakers have reacted most vigorously, passing a tough new corporate reform bill that establishes an oversight board for auditors of public companies and criminalizes securities fraud. Many non-US firms also find themselves bound by the new law, and jitters about corporate frauds have affected the markets worldwide – government reviews into corporate discipline are underway in UK, Germany, European Commission and elsewhere.

Various studies in India itself have shown that the corporate discipline is one of the current priorities. No one needs the disputes for transparency, honesty and accuracy on part of corporations. Despite various recommendations by various committees and active intervention of SEBI in this matter, corporate discipline seems a mere ritual on the organization's part. There are a few companies in India which are pursuing corporate governance actively, unfortunately not because of the Indian regulations but because their parent companies abroad. GE, Hewlett Packard, IBM, Pepsi, Coke and General Motors fall in this category. Still there are certain factors which have changed the world of corporate discipline abroad and if implemented in India, can make a sea change in its Industry.

In the present study few such factors were selected and a small survey was carried out among Indian Industry. The responses were diverse and have a direct relation to the corporate that they were employed with and the designations that they were working bearing.

The foremost factor and a big question is that how far the senior management assumes its responsibilities towards shareholders? Whether some stringent provisions should be introduced which include heavy penalties or imprisonment in extreme situations, to hold the senior management responsible for the adequate and accurate disclosure to the world.

The survey suggested that the penalties should be instituted for inadequate/ inaccurate disclosures and a few respondents suggested that if inaccurate disclosure was intentional then even imprisonment is justified.

57% respondents are in favour of imposing criminal penalties while another 33% wants to impose further financial penalties.

Interestingly, respondents holding top positions (CEO/ CFO) were mostly against the idea of imprisonment. As a shareholder mostly respondents felt that before investing they check the credibility of Board of directors and management with the return on security. Ironically, Auditor's Report was to be referred lastly reflecting the shaken confidence in Auditor's.

The SoX awareness of Indian corporate executives was quite high, but most of them did not knew all the important provisions and the right perspective of the law. Second factor analyzed in the present study is importance and awareness of internal controls, and their implementation, review and effectiveness in Indian corporate arena. Only 3% of the respondents feel that there are adequate internal controls in the Indian Corporates.

Survey reflected that most of the respondents agree that adequate internal controls are a must for effective functioning of any company and consider internal controls as an integral part of corporate governance but unfortunately its need and importance has been sidelined uptill now.

The structure of internal controls in Indian corporates is at a premature stage, there are no well defined parameters, or regulations/ enactments etc. and it still needs a lot of improvement, hence most of the respondents feel that there should be some policy measure to institute a robust internal controls structure in Indian corporates, on the lines of UK's Combined Code. 90% of respondents feel that financial reporting controls can help in early detection of fraud.

50% of the respondents feel that all the three sets of controls are equally important, however 37% feel that the financial reporting controls are more important than others.

There have been many recommendations from Naresh Chandra, Kumar Mangalam and the Narayan Murthy committees in India on corporate governance. Most of the respondents feel that these committees have increased awareness in Corporate arena about corporate discipline. Only 27% of the respondents feel that various committees have created awareness and changes in management structure. While 37% feel that more provisions should be framed, 20% feel that these should be enforced more rigorously Large corporates have started responding positively to corporate discipline but medium and small companies need improvement. The recommendations suggest strict procedures and process of corporate discipline but the supporting enactments have been loose and without stringent enforcement. The recommendations should be transformed into regulations which should be backed by an adequate legal framework. The survey suggests that implementations of strict regulations should be continual and gradual adapting to the domestic market, rather than blindly following the west. The industry should be able to walk along, rather than tumbling down and crashing the bourses.

Other aspect covering the shareholders is transparency and accuracy of reporting to shareholders. With increased corporate fiascos, there is a need to find the causes. Survey suggests majority of people feel that financial reporting controls can help early detection of fraud. To bring greater transparency and establish shareholder confidence respondents suggested that comprehensive disclosures about fixed assets, periodical inspection and evaluation thereof, disclosures on the type of customers and quality of income, periodical risk assessment of business, professionalism of management and auditor's comments should help the same. Few of the above things have been taken care by ICAI in its accounting standards, but most of them have not been touched thus far.

Also transparency about a Company's Governance policies is critical. As long as investors and shareholders are given clear accessible information about these policies, the market can be allowed to do the rest, like assigning an appropriate risk premium to the Companies that have too few independent directors or an overly aggressive compensation policy, or cutting the cost of capital for the companies that adhere to conservative accounting policies. In the survey majority of respondents conveyed that in their opinion corporate governance have a positive impact on the stock price of the company. Also the awards for the best governance policies will help other cooperates to follow suit and be transparent about their policies. Very few companies are genuinely transparent, and this is an area where most organizations should do much more.

SoX 2002 recommends setting up of an independent regulatory agency – PCAOB (Public Company Accounting and Oversight Board) which would act as a single window to monitor the auditors and the corporate's internal controls in order to protect the interest of the investors. In India most of the regulatory powers are scattered and conflicting among Department of Company Affairs (DCA), SEBI, RBI, ICAI and the code of civil and criminal procedures

In the survey 77% of the the respondents feet that there is an immediate need of a single umbrella operator because of a lot of ambiguity in the existing enactments of various regulators. Some of the respondents also feel that such regulators should be independent and free from the political influence and manipulations.

Hence the present study after recognizing the increased awareness on corporate discipline suggests a few measures to strengthen it in India following few steps from the west which may have far reaching impact on Indian corporates. Few measures are immediate and few have to be continual and gradual. Together with the industry, the regulations shall make a conducive environment for investors who trust others for their hard earned money.

Limitations of the Study

- The study got fairly high response, i.e over 15% but in absolute terms the sample size of 30 may act as a constraint in interpreting the results of the survey.
- All industries were not covered as a part of the survey and some may have divergent views on the subject.
- The methodology used for sample selection was judgment based and hence could have an element of subjectivity involved.
- Present study has aimed only on a few important provisions on the subject. There can be many more related issues, which were not considered for the sake of brevity.

References

1. Report on Committee on financial aspects of Corporate Governance; The Code of Best Practice (Cadbury Code) – 1 December 1992
2. German Corporate Governance Code; May 21; 2003.

3. Report of Committee on Financial Aspects of Corporate Governance; Compliance with Code of Best Practices – 24 May 1995.
4. Committee on Corporate Governance; Final Report (Hampel Committee Report) – 28 Jan 1998.
5. Internal Control and Financial Reporting – Guidelines for Disclosure of listed companies registered in UK – December 1994.
6. Report of Committee set up by Confederation of Indian Industry (CII) on Corporate Governance; December 1995.
7. Report of the Committee appointed by Securities and Exchange Board of India (SEBI) on corporate governance under the chairmanship of Kumar Mangalam Birla, 2000.
8. Report of Committee approved by Department of Company Affairs (DCA) and Ministry of Finance and Company Affairs on Corporate Governance; under Chairmanship of Shri Naresh Chandra; 21 August 2002
9. Report of NR Narayanmurthy Committee, 8 February 2003
10. *Sarbanes and Oxley Act 2002 issued by 107th* congress of United States of America