ISSN 2347 - 503X

Research Chronicler

International Multidisciplinary Research Journal

Vol III Issue I : January - 2015

Editor-In-Chief
Prof. K.N. Shelke

Research Chronicler

A Peer-Reviewed Refereed and Indexed International Multidisciplinary Research Journal

Volume III Issue I: January – 2015

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Corporate Governance Codes in India- A Critical Legal Analysis

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Abstract

Policy makers around the world have focused more on corporate governance reforms since financial crisis like Enron, WorldCom in USA. In particular, they have focused more to ensure corporate transparency, accountability and to secure investors confidence in corporate affairs. A good corporate governance regime is central to the efficient use of corporate capital and helps to ensure that corporations take into account the interests of a wide range of constituencies including the stakeholders, consumers and the communities in which they operate. Three major documents which lay down the principles of corporate governance such as Sarbanes-Oxley Act, 2002 of USA, Cadbury Committee Report of UK, OECD Guidelines, attained worldwide recognition. The Indian economy in the early 90's evolved from a closed Government controlled sector to an open liberalized nation. With the coming of transnational corporations, Foreign Direct investment and growth of indigenous industries, accountability and transparency attained great significance to protect investor interest. The growing number of financial crisis and corporate scandals such as UTI scam, Harshad Mehta scam, Ketan Parekh scam, Satyam and the 2G-spectrum scam in India, lead to the development of legislative measures to ensure transparency, accountability and fairness in corporate affairs. The present paper focuses on the development of Corporate Governance practices in India, the impact of international legal instruments by reviewing report of various committees such as Kumar Mangalum Birla Committee, Narayan Murthy Committee and analyzing the legislative reform process dealing with Corporate Governance in India.

Key Words: Corporate Governance, Corporate accountability, Satyam Scam, Sarbanes-Oxley Act, Cadbury Committee, Kumar Mangalum Birla Committee and Narayan Murthy Committee.

"Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."

1. Meaning and Definition of Corporate Governance:

The concept of governance is not a new concept. It is as old as human civilization. Governance refers to "all the processes of governing, whether undertaken by a government, market, or network, whether over a family, tribe, formal or informal organization, and whether through laws, norms, power, or language." Good governance is the basic foundation of sustainable development and equitable

distribution of a country's resources. It ensures accountability, transparency and fairness in governance which are the basic foundations for stability and prosperity. The term Corporate Governance refers to a system by which the business corporations are operated, directed, regulated and controlled. It defines and governs the relationships between the different constituencies of a corporation such as the shareholders, stakeholders, and directors, managers including the consumers, community and the environment in which it operates. "Corporate governance is not just corporate management; it is something much broader to include a fair, efficient and transparent administration to meet certain well-defined objectives. It is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs. The OECD principles of corporate governance state "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined." OECD defines corporate governance as "Procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making." The most simplest and common definition of corporate governance is provided by the Cadbury Report (U.K.) "Corporate Governance is the system by which businesses are directed and controlled".

The concept of corporate governance emerged in the wake up economic reforms characterized by liberalization and deregulation. With the increasing number of MNCs, FIIs and Joint Venture Companies, Mergers and Acquisitions, the significance of transparency and accountability of corporate affairs have also increased tremendously. Companies have been force to access international financial markets and as a result they are facing greater competition as before. Corporations cannot survive or earn profit for a long period without the contribution of all its stakeholders which includes community and environment at large. The management of a company needs to act as trustees of the shareholders at large and prevent asymmetry benefits between various sections of the shareholders especially between the equity owners and the minority group of shareholders. The main objective of corporate governance is to govern and manage the relationships between top management and other stakeholders as well as building checks and balance to ensure that the senior executives pursue strategies that are in accordance with the corporate mission. Therefore Corporate Governance calls for three major factors: (a)

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Transparency in decision –making, (b) Accountability which follows from transparency because responsibilities could be fixed easily for actions taken or not taken, and (c) The accountability for safeguarding the interests of the stakeholders and the investors in the organization.

2. Development of Corporate Governance - A Global Perspective:

Financial crises in USA and UK such as the collapse of Enron in 2001, WorldCom, and Maxwell groups pension funds scandal, has brought international attention on company failures and the role that strong corporate governance felt essential to prevent corporate frauds in order to protect interests of investors at large. Hence, a series of developments occurred in USA and UK with regard to Corporate Governance which had tremendous impact on all the countries across the world. Hence, before going to discuss the Indian Scenario of Corporate Governance, it's important to discuss the various international legal instruments dealing with corporate governance.

The Cadbury Committee Report on Corporate Governance (1992): The Cadbury Report, titled Financial Aspects of Corporate Governance, is a report issued by the Committee on the Financial Aspects of Corporate Governance chaired by Adrian Cadbury, was established in May 1991by the Financial Reporting Council, the London Stock Exchange and the accountancy profession. The final report was published in December 1992. The Report sets out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures. The major components of the Cadbury Code are:

- that there be a clear division of responsibilities at the top, primarily that the position of Chairman of the Board be separated from that of the Chief Executive, or that there be a strong independent element on the board;
- that the majority of the Board be comprised of outside directors;
- that remuneration committee for board members be made up in the majority of non-executive directors; and
- that the Board should appoint an Audit Committee including at least three non-executive directors.

In U.S.A, the Sarbanes Oxley Act 2002 was enacted to bring fundamental changes in every area of corporate governance and particularly in auditor independence, conflict of interest, corporate responsibility and complete financial disclosures of corporate affairs. Some of the important provisions of the Act explained below:

- Establishment of Public Company Accounting Oversight Board (PCAOB), consisting of five members and whom two will be certified public accountants. All accounting firms have to register with the board. The Board will make regular inspection and will send the report to SEC which will ultimately send to Congress.
- Audit Committee: The Act provides for improved audit committee who is responsible for appointment, fixing fees and oversight of the work of independent

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auditors. The public accounting firms should not perform any audit services for publically traded company. The Act also provides for mandatory rotation of lead audit or co-coordinating partner and the partner reviewing audit once every 5years.

- CEOs/CFs is required to certify the reports filed by the Securities Exchange Commission (SEC).
- The Act prohibits US and foreign companies with Securities traded from making or arranging third parties any type of personal loan to directors.
- The Act prohibits the auditors from providing non-audit services currently with audit financial review services.

OECD's Principles of Corporate Governance: Organization for Economic Co-Operation and Development (OECD) was one of the earliest non-governmental organizations to work on and spell out principles and the practice that should govern corporate in their goal to attain long-term shareholder value. OECD principles of Corporate Governance and Guidelines for Multinational Enterprises intends to assist governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries as well as provides guidelines and suggestions for stock exchanges, investors and corporations. The OECD principles in summery includes; (i) Rights of the shareholders (ii) Equitable treatment of shareholders (iii) Role of stakeholders in corporate governance (iv) Disclosure and transparency (v) Responsibilities of the Board.

3. Development of Corporate Governance - An Indian Perspective:

Indian Corporate Culture is characterized by a mix of traditional and modern corporate structures. The old system of family run business, dominant shareholders settings and political influences exist side-by-side with companies having diversified shareholding, plying significant role in global market, adopting international standards and making structural reforms to compete globally. The Indian corporate scenario more or less was stagnant till the 90's. The Pre-Liberalization scenario was depressing and characterizes as 'License or Quota Raj', as demand always exceeded supply due to government imposed quotas. The corporate culture developed around the managers flattering the bureaucrats and the ministers for license. Quality and price of product and services were not determined by market which resulted in low quality of product, cost-ineffective technology. In 90's, the economic liberalization followed by financial liberalization, deregulation and privatization brought a big change in the entire financial system and structure of the nation and made corporate governance very crucial. Number of cases relating to corporate scandals and malpractices, financial scams, was increased. Obscure companies quickly listed on the exchanges during the stock market boom of 1993-94, disappeared after siphoning off public funds and leaving the retail investors with illiquid stock. Almost 122 companies were vanished after coming out with an initial public offering (IPO) during April 1992 to March 1995. Then, it was Ketan Parekh, Harshad Mehta incidents and the UTI scam

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which triggered the government to take immediate measures to establish effective corporate governance in order to restore the credibility of the capital market and to facilitate the flow of finance. Varied opinions were articulated in India in response to wide ranging corporate scandals like violations of foreign exchange regulations, making clandestine payments to politicians, involvement in illegal activities and unethical deals by the top industrial houses. A series of reformative measures were taken by the Ministry of Corporate Affairs (MCA) with the collaboration of other financial agencies such as SEBI (Securities and Exchange Board of India) and CII (Confederation of Indian Industries) to develop corporate governance code in India. Before delving further on the subject the author has outlined the economic scenario through making a case analysis of 'Satyam Scam' which led to the development of Corporate Governance Code in India.

Corporate Frauds in India: A case study of Satyam Computer's Limited (Satyam Scam):

Satyam Scam has been the greatest scam in the history of corporate world of India. The case was highlighted by the media as "India's Enron". Thus, before going to understand the severity of the scam it is important to understand the factor that contributed to such a big scam. Satyam Computers Ltd was a rising-star in the Indian 'outsourced' IT services industry. The Company was formed in 1987 in Hyderabad by Mr. Ramalinga Raju, began with 20 employees and grew rapidly as a global business. It offered IT and business outsourcing services across various sectors. Satyam was an example of "India's growing success". In 2008, the 'World Council for Corporate Governance awarded with Golden Peacock Award' for Global Excellency in corporate accountability. On January 2009, Mr. Raju disclosed in a letter to Satyam Computers Ltd Board of Directors that he had been manipulating the company's accounting numbers for years. Mr. Raju revealed that he overstated assets on Satyam's balance sheet by $1.47 billion. Nearly $1.04 billion in bank loans and cash that the company claimed to own was non-existent. Satyam also underreported liabilities on its balance sheet. Satyam overstated income nearly over the course of several years in order to meet analyst expectations. For this purpose Mr. Raju had created 600 fake bank accounts to advance the fraud. The company's global head of internal audit created fake customers identities and fake invoices to perpetrate the fraud. The global head of internal audit also forged board resolution and illegally obtains loans for the company. It also appeared that the cash that the company raised through American Depository Receipts in US never made it to balance sheets. Satyam planned to acquire a 51% stake in Maytas Infrastructure Limited, a leading infrastructure development, construction and project management company, for $300 million, where Raju had 37% stake. On December 16, 2008, the Satyam board, including its five independent directors had approved the founder's proposal to buy the stake in Maytas Infra and all of Maytas Properties, which were owned by family members of Satyam's Chairman, Ramalinga Raju, as

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fully owned subsidiary for $1.6 billion. Without the approval of the shareholders, the directors went ahead with the management's decision. The decision of acquisition was, however, reversed twelve hours after investors sold Satyam's stock and threatened against the management, and then it was followed by the law-suits filed by the U.S contesting Maytas deal. The World Bank banned Satyam from conducting business for 8 years due to inappropriate payments to staff and inability to provide information sought on invoices. On January 7, 2009, Chairman of Satyam, Mr. Raju Ramalinga resigned from Satyam after notifying board member and SEBI that Satyama's accounts had been falsified.

Aftermath: The Indian stock market fell dramatically upon disclosure of the Satyam scandal. Indian authorities started investigation and pursued criminal and civil litigations against people involved with Satyam. Indian authorities arrested Mr. Raju, his brother Ramu Raju, its former managing director, Srinivas Vdlamani, the company's head of internal audit and its CFO on criminal charges. Global audit firm, PricewaterhouseCoopers (PwC) audited Satyam's books from June 2000 to until the discovery of the fraud in 2009. Hence, criminal charges brought against the CFO and the auditors. The Institute of Charted Accountant of India ruled that The CFO and the auditors were guilty of professional misconduct. Hence, Pricewaterhouse Coopers came under intense scrutiny and license was revoked. There were also several civil charges filed in the United States against Satyam by the holders of its ADRs. Investigations by the Crime Investigation Department of the State Police and Central agencies have established that the fraud took place long back from 1999. This could happen because of lack of vigilance on the part of the regulatory authorities such as SEBI as a market watch dog, hence along with the promoters, the auditors, bankers and SEBI found responsible for such a big corporate fraud. The Independent board members of Satyam, the Institutional Investors' community, the SEBI, and the external auditor, none of them was able to detect the malfeasance. The factors that contributed to such a big accounting fraud are lack of transparency, excessive interest in maintaining stock prices, audit failure, weak role of independent directors and audit committee and lack of an effective whistle-blower policy. The Indian Government on one hand had started investigations against 'Satyam' and on the other hand took all the required steps to bring stability and confidence back to the company to ensure the sale of the company within 100-days framework. By mid- March several companies in the field of IT had gain confidence on Satyam's operations to participate in the auction process for Satyam and finally Tech Mahindra, bought the auction $1.13 per share, on April 13th 2009, the Stock got stabilized as a part of Tech Mahindra. Undoubtedly, the government of India successfully took prompt actions to protect the interest of the investors and safeguard nation's image across the world.

Lesson learned from Satyam: The Satyam Scam was not an accounting or auditing failure, it was a The Satyam Ltd. had grossly violated all the rules of corporate

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governance. The 'Satyam Scam' highlighted the key factors of the poor practice of corporate governance in India. It reinforced the policy makers to bring reform in the existing corporate governance codes, especially with regard to strengthening the role of Independent directors, appointment of audit committee, need to increase the disclosure of pledged securities by the promoters and controlling shareholders, and adoption of International Financial Accounting Reporting Standards (IFARS) complying with international standards on corporate governance in order to compete in the global market. The Indian Corporate sector as well as the policy makers has realized that better corporate governance adds considerable value to their operational performance and ensures a long-term trust between the companies and the investors.

4. Recommendations of Various Committees on Corporate Governance in India - A Legal Perspective:

Since 1990, with liberalization and increased number of corporate frauds, a series of committees formed with a view to bring reform in corporate governance practices in India. Hence, to understand the legal developments relating to corporate governance it is important to discuss the recommendations of various committees in a sequential order in the context of the then Indian as well as global market scenario.

In 1996, Confederation of Indian Industry (CII) took the first initiative on Corporate Governance and set up a task force under Rahul Baja, a reputed industrialist, to draft guidelines and code of corporate governance. The objective was to develop and promote a code for corporate governance to be adopted and followed by Indian companies, be it a private company or a public sector or financial institution, all which is a corporate entity. In 1998, CII released the Corporate Governance Code called "Desirable Corporate Governance Code" and was first to criticize nominee directors and suggested dilution of government stake in companies. The code was prepared with the view that Indian companies had to adopt the best of corporate practices if they were to access domestic as well as foreign capital at competitive rates. The code agreed that there was no unique way of understanding corporate governance. Different structures established in different countries might not be pertinent to local conditions. With increased exposure to global markets it became imperative on corporations to focus on transparency and adopt full disclosure mechanisms apart from consistently directing themselves towards amelioration of shareholder value. The code initially focused on the public listed companies. In the next three years, almost 30 large listed companies accounting for 25% of India's market capitalization voluntarily adopted the CII code. To survive international competition Indian companies have to attract low cost capital from across the globe. For this Indian companies have to gear up themselves to meet the increasingly demanding standards of international disclosures and corporate governance.

The Securities and Exchange Board of India (SEBI) appointed a committee on corporate governance on May 1999, under the Chairmanship of Kumar Mangalum Birla

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with a view to promoting and raising standards of corporate governance. The Committee's terms of reference were: (a) to suggest suitable amendments to the Listing Agreement executed by the stock exchanges with the companies and any other measures to improve corporate governance standards in the listed companies relating to full disclosure of corporate affairs, responsibility of independent and outside directors, (b) to draft code of best corporate practice, (c) to suggest safeguards to institute within the companies to deal with insider trading. The Committee submitted its report to SEBI and it is considered indeed a landmark development with regard to evolution of corporate governance in India. The code was approved by SEBI in early 2000. Based on the recommendations a new clause 49 was incorporated to the Listing Agreement to ensure corporate governance in listed companies, as currently in effect includes: (a) Board of Directors in listed companies must have minimum number of independent directors, where the chairman is an executive or promoter or a senior official then one-half the board should comprise independent directors. In other cases independent directors should constitute at least one- third of the board size. (b) Listed companies must have Audit Committee of the board with a minimum three of directors, two-third of whom must be independent. In addition the role and responsibilities of the audit are to be specified in detail. (c) Listed companies must periodically make various disclosures regarding financial and other matters to ensure transparency. (d) CEO and CFO certification of internal controls of listed companies is must. (e)Annual Report of the listed companies must carry status report about compliance with corporate governance norms. The recommendations of Kumar Mangalum Birla Committee Report were implemented through Clause 49 of Listing Agreement by SEBI. Both Mumbai and National Stock Exchange submitted a consolidated quarterly Report to SEBI for the quarter ended with 30th September 2002. It was observed that 1,848 and 741 companies were required to compliance with the requirements of the code, of these compliance Reports were submitted in respect of 1026 and 595 companies. The status of compliance with respect to corporate governance was found to be satisfactory by SEBI; however an analysis of the financial statements of companies and the Reports on corporate governance discloses that their quality is not uniform.

With the collapse of Enron in 2001 and the enactment of the Sarbanes- Oxley Act in July 2002 the Department of Company Affairs (DCA) formed a committee to evaluate corporate governance norms especially the composition and role of audit committee and independent directors, under the chairmanship of Naresh Chandra. The major recommendations of the Naresh Chandra Committee are: (a) the auditor-company relationship, (b) disqualification of audit assignments, (c) list of prohibited non-auditor services, (d) appointment of auditors, (e) certification of annual audit report by CEO/CFO, appointment of independent directors, (f) Exempting no-executive directors from certain liabilities, (h) setting up disciplinary mechanism for auditors, (i) establishment of corporate

serious fraud office. The Naresh Chandra Committee Report on 'Corporate Audit and Governance' takes forward the Kumar Mangalum Birla Committee Report.

In late 2002, the SEBI in response to rapidly growing international standards formed a committee under the chairmanship of N.R. Narayan Murthy of the Infosys Technologies Ltd. The Committee was constituted to review the performance of corporate governance and to determine the role of companies in responding market rumor and other price sensitive information in the market, in order to enhance the transparency and integrity of the market. The Narayan Murthy Committee came out with two sets of recommendations, mandatory and non-mandatory. Clause 49 of the Listing Agreement was revised on the basis of these recommendations to bring it in line with Sarbanes-Oxley Act of USA. The mandatory recommendations focused on strengthening the responsibilities of audit committees, improving quality of financial disclosures including those pertaining to related parties transaction and proceeds from initial public offering, requiring corporate executive bodies to asses and disclose business risks in the annual reports of the company, calling upon the board to formal codes of conduct; the position of nominee directors and improve disclosure relating to compensation to non-executive directors and shareholders. The non-mandatory recommendations included; moving to a regime where corporate financial statements are not qualified; instituting a system training of board members and evaluation of performance of board members. Like Birla Committee, Murthy Committee examined a range of corporate governance issues such as corporate boards and audit committees, disclosure to shareholders, focused mainly on the role and structure of corporate boards and strengthening the role of independent director in the then existing Clause-49. While the report of the Murthy Committee did not explicitly cite the Anglo-American models of governance, it was clearly a reaction to the events in the United States, particularly given the time of the report, which followed just a few months after the enactment of the Sarbanes Oxley Act. India's corporate governance reform efforts did not come to an end with the adoption of Clause 49. With the Satyam Scam in 2009, Ministry of Corporate Affairs (MCA) released Voluntary guidelines for Corporate Governance. These guidelines addressed key factors of corporate governance including independence of board, role of audit committee, auditors, secretarial audits, and institution of mechanisms to encourage whistle blowing.

Despite these wide-ranging developments on corporate governance, the core problem which becomes increasingly appearing in India is the accountability of promoters and dominant share holders. The Anglo-Saxon Model of corporate governance on which corporate governance rules and regulations are based on, to some extend has its limitations in its applicability in Indian environment. For instance, in USA and U.K the central governance issues is essentially that of disciplining management that has ceased to be effectively accountable to the owners who are disappeared shareholders. Whereas in India, the main issue is that of disciplining the dominant shareholders, who

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is the principle block-holder and of protecting the interest of the minority shareholders and other stakeholders. In this context, relying on the independent directors, who are appointed by controlling shareholders, the role of independent board directors, audit committee likely to prove weak in safeguarding the interest of minority shareholders and full disclosure of corporate affairs. Hence, the reform process continued with the review and redrafting of the Companies Act, 1956, which resulted in the enactment of the Companies Act 2013. The Companies Act, 1956 has proven outmoded in terms of controlling corporate frauds, accounting scandals in India. The Companies Act, 2013 sets higher standard of corporate governance with strong internal controls and Risk Management frameworks and, Increased Reporting Frameworks. The highlights of the New Act in this regard discussed below:

- In director's responsibility statement, the directors in listed companies need to state that they have laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and operating effectively, preventing and dictating fraud and other irregularities, adequacy of policies and procedure in adherence to company's policies.
- The concept of Independent director introduced for the first time in Companies Act and laid down the duties, code of conduct and performance evaluation mechanism for independent directors. At least 1/3rd of the total number of Directors on the Board of the listed companies shall be Independent Directors.
- Prescribed class of companies to have whole-time Key Managerial Personnel; Chief Finance officer to be whole time KMP and whole-time Director is included in the definition of KMP.
- For listed and prescribed companies Audit Committee, Stakeholder relationship Committee, Corporate Social Responsibility Committee, Nomination and Remuneration Committee, made mandatory. Nomination Committee shall identify persons who are qualified to be directors and who can be appointed in senior management; recommended to the BOD policy relating to remuneration, KMP, other employees on the basis of appropriate performance benchmark and, also responsible for evaluation of every director of BOD.
- Secretarial Audit made mandatory for listed and prescribed classes of companies. Approval of Central Government required for certain managerial remuneration.
- Mandatory audit rotation for listed and prescribed classes of companies. Individual auditors will be compulsorily rotated in every five years and the audit firm will be rotated in every 10years.This step has taken that auditor do not increase familiarity and reduce their independence by continuing to audit a company for a long period of time.
- A cooling period of 5 years also prescribed before reappointment of

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auditors who complete one term. The New Companies Act also enhances the accountability of the auditors by placing on auditors the onus of reporting fraud noticed by them. Internal audit for prescribed classes of companies made mandatory. Restriction placed on specific non-audit services by an auditor to ensure independence and accountability of the auditor.

- Related party transaction to be disclosed in the Director's Report along with the justification thereof. Approval of BOD for related party transaction made mandatory and approval of shareholders requires through special resolution for companies having prescribed paid up capital or transaction exceeds the prescribed amount.
- No Company shall directly or indirectly advance any loan or guarantee or provide security in connection with such loan to any director or related person.
- Director or KMP to refrain from forward dealing /buy options in shares or debentures of company/ holding company/ subsidiary/ associate.
- Members or Depositories may notify the Tribunal, if company conduct is prejudice to their interest and can filed 'Class Action Suit' for fraudulent, unlawful or wrongful act or improper or misleading statement, on Company or Directors, Auditor/Audit firm.

Conclusion:

With financial market reforms in 90's, a series of efforts have been made by the Government of India as well as by the Indian Corporate sector to develop effective Corporate Governance Code in India. It is well understood by the Indian Corporate sector that Corporations can not earn profit and survive in a long-run without having effective corporate governance mechanisms. Drawing heavily from Anglo-Saxon Model of Corporate Governance, the policy makers have realized that the Indian corporate culture is quite different from European Corporate culture, hence there is need to develop Corporate Governance principles and regulations suitable to Indian Corporate Climate. In this regard the last decade can be considered as the decade of corporate governance in India. India has advanced significantly in adopting better governance standards in the last decade. Its standing in the world with regard to development of effective corporate governance mechanisms is quite high. Now Corporate Governance became an essential part of Indian Corporate culture.

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