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THE POSITION OF INDIAN COMPANIES IN THE QUEST FOR CORPORATE GOVERNANCE

Dr. M.M. Sulphey*

Prof. Rajesh Janardhanan†

Abstract

Corporate Governance (CG) defined as 'doing everything better to improve relations between companies and their share holders; to improve the quality of outside directors; to encourage people to think of long term relations; information needs of all stakeholders are met and to ensure that executive management is monitored properly in the interest of shareholders' has became a matter of top priority, interest and urgency recently. This has become all the more important in the aftermath of incidents like Enron's collapse, the Asian financial crises and certain other large number of accounting scandals the world over. In India, the Satyam episode has outlined the need and importance of CG. It will make closer scrutiny of the governance of the corporations and aims at the prevention of such scandals. CG also provides a detailed and structured system of disclosure about the company and this in turn will enable the investors to obtain and understand information in an accurate and reliable manner so as to make better investment decisions.

INTRODUCTION

CG has been defined in various ways. For example Denis & McConnell (2002) defined CG as 'an arrangement of a set of internal and external mechanisms designed and adopted to ensure that self interested managers act to maximize the value of the company to its shareholders'. Organisation for Economic Co-operation and Development (OECD) defines it as:

> 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. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.

Presenting a similar view, the Guidelines on Corporate Governance for Central Public Sector Enterprises (2007) put forth by the Government of India defines CG as:

> 'Corporate Governance involves a set of relationships between a company's management, its Board, its shareholders and other stakeholders. Corporate governance provides a principled process and structure through which the objectives of the company, the means of attaining the objectives and systems of monitoring performance are also set. Corporate governance is a set of accepted principles by management of the inalienable rights of the shareholders as a true owner of the corporation and of their own rule as

* **Professor, TKM Institute of Management, Kollam, Kerala**
† Asst. **Professor, TKM Institute of Management, Kollam, Kerala**

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trustees on behalf of the shareholders. It is about commitment to values, ethical business conduct, transparency and makes a distinction between personal and corporate funds in the management of a company'.

A review of literature showed that there are different views about CG. Bhagat, Bolton and Romano (2008), states that 'it is an area where a flexible regulatory regime allowing ample variation across firms is particularly desirable as there is considerable variation in the relation between different governance indices and different measures of performance'. CG practices have been found to vary across institutions and environments (Gordon & Roe, 2004; Zattoni & Cuomo, 2008), as well as nations (Aoki, 2001; Gordon & Roe, 2004). The principal characteristics of effective corporate governance are transparency (disclosure of relevant financial and operational information and internal process of management oversight and control), protection and enforceability of the rights and prerogatives of all shareholders and directors and checking into directors capability of independently approving of corporations strategy, major business plans and decisions, monitoring managements performance and integrity and replacing management when necessary.

Need for Corporate Governance

Now a day's CG has become an important topic for almost all people including academicians, institutional investors, policymakers, etc. This is because of late we have seen many instances of fraud and misuse in the corporate world. Elsewhere, we see CG reforms being enacted with a sense of urgency. Isaksson and Kirkpatrick (2009) states that CG is one that enables us to know how firms operate, their motives and principles, their reporting lines, to which they are accountable to, the way profits are managed, remunerations paid, etc. Dwelling in detail about the need for CG, Bebchuck and Hamdani, (2009) opines that there is a general belief that the quality of CG and investor protection can affect the performance of firms as well as the economies. Further, at the firm level there is all possibility that inadequate investor protection may reduce firm value and increase firms' cost of capital. In the macro level, inadequate investor protection may impede stock market development and undermine the financial growth.

The history of CG can be traced to the corporate mismanagement and unethical practices during the period of Great Depression of 1930s that resulted in the establishment of the Securities Exchange Commission (SEC) in 1934. This led to regulatory reforms defining corporate ownership and control. Later during 1970s, a series of business scandals led to unveiling and pervasive unethical practices in US Corporations. SEC investigations revealed widespread illegal contracting practices, insider trading, deceptive advertising and savings and loan scandals. The lawyers Alton Harris and Andrea Kreamer note that over 500 publically held US firms, including 117 of the then Fortune 500 companies were charged by the SEC and confessed to corporate misconduct.

These governance failures led to investor dissatisfaction and made the public and the regulators to think about improving the governance of corporations. Consequent to this there were demands to raise the baseline of mandatory disclosure and compliance by corporations. These concerns have triggered a shift away fro 'soft law' practice of comply or explain to 'hard law' requirement of mandatory disclosures and compliance with standardized governance practices strictly supervised by the regulators. The result was a number of good governance codes across the globe by various committees, commissions, stock exchanges, investors associations etc. Some of the serious initiatives came in the from of the Tread way Commission and the SEC Blue Ribbon Commission in the U.S.A, the Cadbury Committee in the U.K, the Vienot Committee in France, and the Peters Report in the Netherlands. All these committees and commissions had a common view – that good governance required effective board

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functioning through informed independent directors, empowered board sub committees and improved board transparency to management function.

The legislations that were passed thereafter seemed to have failed to address the responsibilities relating to capable behavior and levels of disclosure for corporations. This is evident from the scandals at Enron, WorldCom, Qwest, TYCO etc. during the early 2000s. It may be seen that significant accounting irregularities were committed by overstating the profits by billions of dollars, off-of the book partnerships, etc. due to greed, arrogance and utter disregard for law, at the cost of shareholders and investor confidence. The loss in global capital inflow by 2009 is estimated to be more than $7 trillion in the capital market as per the report of NCAER-"Growth Trade and Economic Management- 2009"

In India, the Satyam scandal is one worth considering knowing how the shareholders lost their confidence because of irregularities in the accounting disclosures. Satyam's balance sheet of 2008 contained inflated figures for cash and bank balances of Rs 5,040 crores as against Rs. 5,361 crore reflected in the books. The malpractices in the disclosures reveals a non-existed accrued interest to the extent of Rs. 376 crores, an understated liability of Rs. 1,230 crores on account of funds, and an overstated debtors' position of Rs.490 crores. It must be noted that Satyam was the 2008 winner of the coveted Golden Peacock Award for Corporate Governance (World Council for Corporate Governance – UK). It was stripped from them in the aftermath of the scandal, under Risk Management and Compliance Issues.

These scandals point toward the need to look at CG in an entirely new dimension. Firms with sound CG mechanism are most likely to disclose more information in the annual reports. On the other hand poor CG and especially the lack of transparency of corporate financial reporting are said to be the root cause of the East Asian financial crisis that happened in the mid nineties (Rahman, 1998; and Johnson, Boone, Breach, & Friedman, 2000). This is true for many other financial crises that have struck the world at varying times and dimensions. Dwelling on the need for disclosure in CG, Mitton (2002) views that adequate disclosure is its integral part. OECD (2009) in its report opined that 'the current financial crisis could be attributed, in large part, to failures and weaknesses in corporate governance arrangements'. All these factors point out towards the indispensible requirement of CG in the current scenario.

Theoretical Aspects of CG

In the US the main focus of corporate law as well as CG systems is referred to as an 'agency problem' wherein an organizational concern arises when the owners of a corporation - the shareholders are not the managers who are in control (Bhagat, Bolton & Romano, 2008). Further elaborating they states that:

> 'Managers may not work as diligently as they could because the increase in firm value that their hard work produces is shared with stockholders (in proportion to stockholders' equity investments), while managers bear the full cost of their greater exertion. Corporate law seeks to mitigate the agency problem by providing an organizing framework to facilitate and support mechanisms of firms' corporate governance by which managers are incentivized and constrained to act in the shareholders' interest. The most elemental components of a corporate governance system are the board of directors, shareholder meetings and voting, and executive compensation'.

Taking a similar view Ho, Tower & Barako (2008), states that this agency theory has led to an issue of 'information asymmetry' between the managers and shareholders. In this peculiar relationship, management who act as the agents acquires information about the present and the future performance of the firm, which may be far more superior to the information

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acquired by shareholders who are the principals. As such there is all possibility that the management may take undue advantage so as to engage in activities that may enhance their personal goals.

Cohen, Krishnamoorthy, & Wright, (2008) providing a comprehensive view of CG explored three widely recognized additional theoretical perspectives: resource dependence, managerial hegemony, and institutional theory. They have detailed all the above three theories, which were based on Cohen, Krishnamoorthy, & Wright, (2007); Kosnik, (1987) and Powell (1991) respectively. According to them:

> Resource dependence is a theory developed in the strategic management literature, and focuses on the contribution of governance mechanisms as a vehicle to help a firm achieve or further its strategic objectives. The managerial hegemony perspective is based in the strategy literature and in contrast to the agency theory paradigm; it views the board and its attendant committees as being under the control of management and existing merely to fulfil regulatory requirements. A third source of theory is institutional theory, developed in the sociology of organizations and organizational behaviour literatures. Institutional theory suggests that it is necessary to understand the substance of the interactions between different governance parties and how these parties use at times symbolic gestures and activities to maintain their form to all relevant parties.

Paredes (2005) states about two models of CG, viz. a market oriented one and a mandatory corporate law. The market-oriented model does not rely on any mandatory law to protect shareholders. It depends on a host of other formal and informal mechanisms, which ranges from aspects like incentive-based compensation and hostile takeovers, to holding managers and directors accountable. This cannot be applied overnight. The next approach depends on a mandatory model of corporate law in which state, as against the marketplace plays a pivotal role in protecting shareholders. This is done by framing mandatory rules that define shareholders rights.

In India the Securities and Exchange Board of India (SEBI) has formulated certain guidelines for CG by the listed companies, through the listing agreement. Clause 49 (provided as Annexure) was introduced in 2000 by SEBI after lobbying by large firms, and subsequent to a governance code being proposed by a leading industry group. This guideline now applies to all the listed Indian public companies. The present study has compared the disclosures in the Annual Report of the 50 NIFTY companies for the year 200-09 with the benchmark Clause 49 of listing agreement.

Need for the Study

CG focuses on some structures and mechanisms that ensure the proper maintenance of certain internal control and structures for the Board of Directors, creation of independent committees, rules of discourses of information to share holders & creditors, transparency of operations, and an impeccable process of decision making & control of management (Fernando, 2006). Not many studies have been undertaken in India regarding the disclosures with respect to CG among the Indian corporates. The present study is an attempt in this direction.

Methodology

The present study made use of secondary data to find out the position of CG and its disclosure among Indian companies. In the study a comparison was made with respect to the disclosures regarding CG of all the 50 companies included in the NIFTY. The Annual Reports pertaining to

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the year 2008-09 of the 50 companies listed in NIFTY were used for the study. The Clause 49 of Listing Agreement of Stock Exchanges introduced by SEBI was taken as benchmark and the disclosures regarding CG in the Annual Reports were compared with the same.

The rationales behind using the NIFTY companies for the study are the following:

1. NSE is the third largest stock exchange in the world, and the largest in the country, in terms of volume. It has presence in 1,486 with a membership of over 1000.
2. The turnover of NSE during 2007-2008 was US $ million 4,234,134 compared to that of US $ million 456,173 for BSE (www.nseindia.com).
3. Further, NSE has played a catalytic role in reforming the Indian securities market in terms of microstructure, market practices and trading volumes. During the year 2007-08, it accounted for over 90 % of total trading value (debt, derivatives and equity) in the stock exchanges and 69% in equities and more than 98% in derivatives.

The findings are presented in the following sections.

Findings

The analyses and the details pertaining to the disclosures of CG as against the Clause 49 of Listing Agreement of Stock Exchange are provided in Table 1. The analysis regarding the disclosures of CG has revealed some interesting pattern. The data is now presented as per the respective sub-headings.

Board of Directors

It is observed that, of the four aspects provided under this heading, details have been provided in the Report on CG by all the 50 companies only in the first two aspects. In the other two aspects, viz. particulars regarding 'Other provisions as to Board and Committees' and 'Code of Conduct', three and six companies respectively have not provided any details.

Audit Committee

Of the five aspects provided under this head in the guidelines, it is found that disclosures were provided by 47 companies each in the first two aspects, viz. 'Qualified & independent Audit Committee' and 'Meeting of Audit Committee'. Three companies made only negligible particulars about these aspects in their report on CG. Under the head 'Power of Audit Committee' it was observed that only 38 of the companies provided particulars in the Report. Eight companies did not provide any particulars and four provided only negligible particulars. In 'Role of Audit Committee', while full particulars were provided by 39 companies, seven did not provide any mention about this, and four of them provided only minimum particulars. The aspect 'Review of Information by Audit Committee' was better than the above two, as 42 companies have provided particulars under this. Three provided only negligible information and five companies did not provide any information at all.

Menon (2009), citing the example of Satyam episode has opined that auditor independence is a matter of worry, and is a problem in any large audit failures. The worrying issue is auditor independence, which has proven to be a problem in any large audit failures. Conducting a detailed review of the major steps taken recently he state that 'if an auditor is not independent from the client, then he/she may fail to exert sufficient effort to detect a problem, or even after having discovered a problem, may fail to report it'. The Birla Committee (as cited in Afsharipour, 2009), had recognized the importance of audit committees and made many specific recommendations regarding the function and constitution of board audit committees. These recommendations have been provided with an idea of having transparency in operations and the providing of required information to the share holders. In the case of the 50 NIFTY companies studied not all companies have provided the relevant

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particulars pertaining to the Audit Committee in their CG Reports, which do not augur well for CG.

Subsidiary Companies

Under this head, it was found that only 33 of the companies provided full details regarding their Subsidiary companies. While one company provided negligible data it was observer that 16 companies did not provide any data at all about their respective subsidiary companies.

Disclosures

Under the head 'Disclosures' there are seven various aspects. All these aspects have been provided based on the recommendations of various committees so that there is transparency in all the matters provided to the share holders (Afsharipour, 2009). The analysis, done in the present study, provided a mixed bag with many of the companies ignoring this aspect. For example, while as many as 23 companies did not make any statement regarding proceeds from public/rights/ preferential issues, etc.; four provided only negligible data. Similarly, only 29 made disclosure about accounting treatment with six of them providing inadequate data. On the higher side 46 companies provided full data regarding the remuneration to Directors, with two each not providing any data or negligible data. To provide a fair comparison, the data are presented in Table 2.

Taking into consideration the fact that the 50 companies studied are considered the prime movers in the Indian Corporate world, the above table which presents a mixed bag seems to provide not so better a picture about Corporate Disclosures.

Non Mandatory Requirements

The analysis of particulars pertaining to Non Mandatory Requirements also provided a picture worth studying in detail. The two main aspects pertaining to the Board provided under this head are 'Training of Board Members' and Mechanism for Evaluating Non-Executive Board Members'. It was surprising to note that only less than 50 per cent of the companies have provided details in their CG Report regarding these two aspects. Further, only 30 of the companies studied were having a 'Whistle Blower Policy'. According to Afsharipour (2009), the Narayana Murthy Committee had provided special mention about this and had even stated that whistle blowers must have access to the audit committee, without first having to inform their supervisors, and that companies should annually affirm that they have not denied access to the audit committee or unfairly treated whistle-blowers generally. It is worth noting that while 14 of the companies were not at all having a policy; six companies were either vague or provided only minimal data regarding this aspect. It seems that, in general, the Non Mandatory Requirements have been treated by Indian Corporate in a 'non mandatory' manner.

Conclusion And Recommendations

CG is often described as one that has arisen as a result of separation of ownership and control of the companies. This is of immense importance in the current corporate scenario as good CG is being appreciated as a sound business strategy. Further, it works as an important facilitator to tap the domestic as well as international capital. India, being the fastest growing economy has a lot to do in the area of CG. The present study was done to find out the current patterns of CG among Indian Companies. Clause 49 of Listing Agreement of SEBI was taken as benchmark and the Report on CG in the Annual Report for the year 2008-09, with respect to the 50 NIFTY companies were studied.

The analysis of the Reports on CG revealed that certain companies have not provided the due importance and focus to the aspects provided in Clause 49. Some of them have provided only

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negligible details regarding this matter, and seem to have dealt with this issue in a casual manner. However, there are a number of companies (less than 10) that have provided the details pertaining to CG in a meticulous manner as prescribed in Clause 49, and can be considered models. There are also a few companies which have compared their CG with the international standards, which are worth commending and emulating. Since several international studies have found positive relationship between CG and corporate performance (Fernando, 2006), in terms of rise in share value, profitability, etc., Indian companies should also strive to achieve or even exceed the international standards. In general, the present study established that Indian corporate world have a long way to go to meet the international standards of CG. Further, this study studied only whether the disclosure has been made with respect to Clause 49. The quality of the disclosure has not been enquired into in this study. There is scope to do a detailed analysis in this area.

Sound governance is not something abstract, and it does not occur as a result of accidents or sudden outbreaks of altruism. It happens only when the leaders lead with integrity, when directors actually direct and when major organizations are held to the highest standards of accountability by vigilant stakeholders and informed individuals. In the USA, the Sarbanes – Oxley Act (SOX), the revised NYSE and NASDAQ listing rules have created more stringent standards for financial disclosures, committee and board nominations and audit policies. SOX 404 tests requires the company's CEO to annually assess internal controls and sign written statements, acknowledging responsibility in maintaining control over financial reporting. Any violations and false declaration can result in heavy penalties including imprisonment and fines up to $30 million. SOX focus more on substance than form which persists; move from rule based accounting to the setting up of objective oriented accounting standards; and reporting based on business opportunities, risks, strategies and plans; assessment of quality sustainability and variability of corporations cash flows and funds flow and earnings (including compensation comparison of CEO) through clarified reporting of audit committee. The FDI Confidence Index published by the Conference Board recommends that India must continue to improve its CG and financial infrastructure to actually realize its vast potential. Good governance requires a mindset within the corporate, which integrates the corporate code of ethics into the day to day activities of its managers and workers. To avoid the scandals in future and have good CG, the corporates can have better share holder surveillance and attempt the following:

- Select informed people with integrity and independence of mind for board positions.
- Board governance training should be given the due and adequate importance, including independent directors, with regular assessment of their performance.
- Peer evaluation for each member of the board by the nomination committee, where the Chairman of the board sits with each board member and discusses and suggests remedies and course-corrections should be done.
- Chairman's performance review should be handled by the lead independent director.
- Boards should adopt global standards for director independence, should disclose how each independent director meets the standards, and follow GAAP and IAS.
- The board members should interact with executives frequently to understand the operational issues.
- The independent board members should periodically review the performance of the company's CEO, the internal directors and the senior management.
- Senior management compensation should be determined by the board in a manner that is fair to all stakeholders.
- Effective and independent audit committee, preferably consisting of independent directors, should conduct independent examination of financial statements and ensure they are free of material misstatement.

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- The lead audit partner and the audit partner responsible for reviewing the company's audit must be rotated once in every three to five years.
- Audit committee should establish procedures for the treatment of complaints received through anonymous submission by employees or whistle blowers who must be protected.
- All related party transaction should be required to take prior approval of audit committee, the full board and the shareholders, if it is material.
- False certifications by the CEO& CFO should be subject to severe criminal penalties including fines and imprisonment, if willful and knowing.
- Steps should be taken to accelerate the disclosure of insider trading,
- State should play its role as a fair, diligent, transparent and accountable regulator for free markets

This work is concluded with a quotation from 'A Better India A Better World', written by Narayana Murthy of Infosys. We should have:

> "Good business leaders with integrity … good compensation structure that is market driven but fair which is recommended by the compensation committee and approved by the shareholders …. transparency and disclosure should be the motto." Corporate should aim to improve governance by enhancing power and competence of the board, striving to improve access to information for the shareholders and reduce the risk to shareholders arising out of various reasons.

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Table 1:Patters of Disclosures Regarding Corporate Governance of the 50 NIFTY Companies

No	Details	Yes*	No@	Negligible Data#
	I Board of Directors			
I(A)	Composition of Board	50	0	0
I(B)	Non Executive Director's Compensation & disclosures	50	0	0
I(C)	Other provisions as to Board & Committees	47	3	0
I(D)	Code of Conduct	44	6	0
	II Audit Committee			
II(A)	Qualified and independent Audit Committee	47	3	0
II(B)	Meeting of Audit Committee	47	3	0
II(C)	Power of Audit Committee	38	8	4
II(D)	Role of Audit Committee	39	7	4
II(E)	Review of Information	42	5	3
	III Subsidiary Companies			
III	Subsidiary Companies	33	16	1
	IV Disclosures			
IV(A)	Basis of related party transactions	41	5	4
IV(B)	Disclosure of Accounting Treatment	29	15	6
IV(C)	Board Disclosures – Risk Management	39	7	4
IV(D)	Proceeds from public, rights issues, etc.	23	23	4
IV(E)	Remuneration of Directors	46	2	2
IV(F)	Management	34	12	4
IV(G)	Shareholders	41	5	4
	V CEO/CFO Certification			
V	CEO/CFO Certification	46	4	0
	VI Report on Corporate Governance			
VI	Report on Corporate Governance	38	12	0
	VII Compliance			
VII	Compliance	44	6	0
	Non –Mandatory Requirements			
1	The Board	33	10	7
2	Remuneration Committee	38	5	7
3	Shareholders Rights	33	10	7
4	Audit qualifications	35	6	7
5	Training of Board Members	21	22	7
6	Mechanism for evaluating non-executive Board Members	20	23	7
7	Whistle Blower Policy	30	14	6

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Table 2: Particulars Regarding 'Disclosures' – IV

No	Details	Yes	Per cent	No	Per cent	Negligible Data	Per cent
IV(A)	Related Party Transaction	41	82	5	10	4	8
IV(B)	Accounting Treatment	29	58	15	30	6	12
IV(C)	Board – Risk Management	39	78	7	14	4	8
IV(D)	Proceeds from Issues	23	46	23	46	4	8
IV(E)	Remuneration of Directors	46	92	2	4	2	4
IV(F)	Management	34	68	12	24	4	8
IV(G)	Share holders	41	82	5	10	4	8

ANNEXURE

The company agrees to comply with the following provisions:

I. Board of Directors

(A) Composition of Board

(B) Non executive directors' compensation and disclosures

(C) Other provisions as to Board and Committees

(D) Code of Conduct

II Audit Committee

(A) Qualified and Independent Audit Committee

(B) Meeting of Audit Committee

(C) Powers of Audit Committee

(D) Role of Audit Committee

(E) Review of information by Audit Committee

III. Subsidiary Companies

IV. Disclosures

(A) Basis of related party transactions

(B) Disclosure of Accounting Treatment

(C) Board Disclosures – Risk management

(D) Proceeds from public issues, rights issues, preferential issues etc.

(E) Remuneration of Directors

(F) Management

(G) Shareholders

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V. CEO/CFO certification

VI. Report on Corporate Governance

VII. Compliance

Non-Mandatory Requirements

(1) The Board

(2) Remuneration Committee

(3) Shareholder Rights

(4) Audit qualifications

(5) Training of Board Members

(6) Mechanism for evaluating non-executive Board Members

(7) Whistle Blower Policy

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