

Discussion paper on proposals relating to amendments to the Listing Agreement

1. Background

SEBI Committee on Disclosures and Accounting Standards (SCODA) is the standing Committee of SEBI that advises on matters relating to disclosures and accounting standards. As part of a review of the extant norms relating to disclosure requirements and accounting standards for listed entities, the Committee has deliberated on certain issues, the details of which are elaborated as under.

- a. Requirement of professional qualifications/financial literacy for Chief Financial Officer (CFO)
- b. Rotation of Audit firms / partners
- c. Appointment of an external audit firm as internal auditor of the company
- d. Modification in formats of limited review report and statutory auditor's report
- e. Voluntary adoption of International Financial Reporting Standards (IFRS) by listed entities having subsidiaries
- f. Interim disclosure of balance sheet items by listed entities
- g. Timelines for submission of financial results by listed entities

2. Issues deliberated by SCODA and proposals

a. Requirement of professional qualifications/financial literacy for CFO

In terms of the present requirements of Clause 49 of the Listing Agreement pertaining to 'Corporate Governance', the CEO and CFO of the listed entity is required to certify that he has reviewed the financial statements and the cash flow statement for the year and that to the best of his knowledge and belief, these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading. The CEO and CFO is also required to certify that these statements together present a true and fair view of the listed entity's affairs and are in compliance with existing accounting standards, applicable laws and regulations. However, the present norms do not specify any kind of educational qualification requirements or a certification for the CEO or the CFO.

In the backdrop of the Satyam episode, SEBI Board had also desired that SEBI may examine whether the CFO of a listed entity, who certifies the financial statements, should be a chartered accountant so that in case of any irregularities committed in the financial statements, action may be taken by the professional institute i.e. Institute of Chartered Accountants of India. The Board had also desired that it be examined whether SEBI can prescribe certain professional accountability for CFOs.

Therefore, a proposal was taken to the SCODA to deliberate on the need to have certain minimum professional qualifications and the requirement of financial literacy for the CEO and CFO. While deliberating on the said proposal, the SCODA felt that the requirement of professional qualifications had its inherent advantages, as it would ensure that in case of any fraudulent / malpractices by the CEO/CFO, the respective institute which has accorded the professional certification can take suitable action like terminating the certificate to practice, suspension etc. On the other hand, the Committee also noted that various companies operating in different sectors/industries might require professionals with varied specialized expertise and so, it may not be possible to specify one particular qualification for companies in all industries.

After deliberations on the issue, the SCODA was of the view that it may not be appropriate for SEBI to specify a particular professional qualification for CEO, as the companies prefer CEOs having relevant industry experience. As regards such requirements for the CFO, the SCODA was of the view that the objective that the CFO has adequate financial expertise to review and certify the financial statements could be achieved by ensuring that the appointment of CFO is approved by the Audit Committee, which while doing so shall be required to assess the qualifications, experience & background, etc. of the candidate. Accordingly, the SCODA recommended that the appointment of CFO for all listed companies shall be approved by the Audit Committee of the listed entity. The objective behind the said recommendation is to cast on the Audit Committee, the responsibility to ensure that the CFO has the necessary accounting or related financial management expertise and he possesses experience in financial or accounting or any other comparable experience or background which results in the individual's financial sophistication.

Views of the public are solicited on the aforesaid issue.

b. Rotation of Audit firms / partners

The quality of financials reported by companies and the true and fair view of the financial statements submitted by listed entities to the stock exchanges have, of late, come into sharp focus. In this context, it was felt relevant to discuss the need for independence of the statutory auditors with respect to the listed entity.

Although technically, the statutory auditors are appointed after approval by the shareholders, in practice, the shareholders merely approve a set of names that are proposed/ nominated by the Board of Directors and the promoters, who may be a part of the Board. The Board of Directors and the promoters may ensure that the firm they wish to appoint is approved in the meeting, in view of the sheer strength of their voting powers. A longer association between a particular audit firm and a listed entity may lead to complacency and defeat the true sense of independence of the auditors. Mandatory rotation of statutory auditors could break such a continued long-term association of an audit firm with the management of the listed entity.

Therefore, a proposal was taken to the SCODA as to whether there is a need to specifically lay down norms regarding mandatory rotation of audit firms or mandatory rotation of the partners of an audit firm. After deliberations, the SCODA was of the view that mandatory rotation of firms may not be practical by all companies. The Committee, accordingly, recommended as under:-

- SEBI may mandate that the partner of the audit firm signing the audited accounts of a listed entity be mandatorily rotated every five years.
- The Audit Committee shall be responsible for ensuring independence of the audit firm and its partners.

The objective behind the above recommendation seeks to ensure that the statutory auditors are independent from management. It would also break any continued long-term association of an audit partner with the management of a particular listed entity.

Views of the public are solicited on the aforesaid issue.

c. Role of internal auditor of the company

Clause 49 of the listing agreement requires the audit committee to review with the management, the performance of statutory and internal auditors, and the adequacy of the internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage, frequency of internal audit. The Audit Committee is also required to review the internal audit reports relating to internal control weaknesses and discuss the significant findings of the audit with the internal auditors and follow up there on.

The present norms also specify that the appointment, removal and terms of remuneration of the Chief internal auditor are subject to review by the Audit Committee.

The recently witnessed accounting irregularities at Satyam Computer Services Ltd., re-iterates the need for having greater internal checks and controls in an organisation. However, the mere existence of robust internal checks and controls may not suffice the purpose of having an internal review mechanism. It is also pertinent that such an internal control mechanism is able to discharge its responsibility independently without any restrictions from or fear of the management. It must also be able to evaluate the business processes and procedures rationally and assess the adequacy and effectiveness of the internal controls to ensure optimal levels of productivity.

In order to ensure that such internal control systems are truly independent and carry out their function without any influence from the management, it was proposed by SEBI to the SCODA that in the case of listed companies, the function of internal audit may be mandatorily carried out by an external audit firm.

The SCODA deliberated on the proposal and discussed the advantages and disadvantages in the same. The Committee agreed that commissioning the internal audit in-house may ensure that the internal auditor has a detailed insight on the business of the organisation. However, it was also felt that such a practice would be more convenient for larger organizations with offices spread across various locations who can also afford to appoint a fulltime in house internal auditor. On the other hand, it was noted that an external audit firm being an internal auditor would ensure greater independence of the internal audit function.

After deliberations on the proposal, the Committee was of the view that the current mechanism laid down under Clause 49 of the Listing Agreement wherein Audit Committee is given the responsibility to review the performance of internal auditor was sufficient and provides adequate checks and balances as far as internal control mechanisms are concerned. Therefore, the Committee recommended that it would not be prudent to mandate that the internal audit function may be carried out by an external audit firm.

Views of the public are solicited on the aforesaid issue.

d. Modification in formats of limited review report and statutory auditor's report

Clause 41 of the Listing Agreement provides for periodical disclosures to be made by the listed entities regarding financial results. Annexures to Clause 41 provide for the formats for submission of (a) periodical financial results by listed entities, (b)

limited review reports by the statutory auditors and (c) statutory auditors' reports wherein he expresses an unqualified opinion on the financial results.

SEBI vide circular dated February 3, 2009 provided for certain periodical disclosures to be made by listed entities regarding the details of promoters and promoter group shareholding, including the details of pledged/encumbered promoters' shareholding, as additional line items (Item Nos. 17 and 18 of the format) alongwith the periodical disclosures of financial results provided as annexures to Clause 41.

Certain concerns were raised as to whether inclusion of such disclosures alongwith the financial results may lead investors to presume that information about pledge by promoters /promoter group is also reviewed and certified by the auditors. The SCODA discussed the modifications that are required to the limited review report and the statutory auditor's report that have been provided as annexures to Clause 41 of the Listing Agreement. After deliberations, the SCODA recommended that the following may be added at an appropriate place in the limited review report and in the statutory auditor's report:-

"except for disclosures in item No. 17 and 18 namely, 'Public Shareholding' and 'Promoter and Promoter Group Shareholding' which have been traced from disclosures made by the management."

The above disclosure recommended by the SCODA would clarify that the details regarding disclosure of pledged shares have not been verified by the auditor and have been drawn from the disclosures made by promoters/promoter group of the listed entity. Verification of details of pledged/encumbered shares of the promoters/promoter group may not be within the scope of the statutory auditors of listed entities wherein the opinion is given by them on the financial results.

Views of the public are solicited on the aforesaid issue.

e. Voluntary adoption of International Financial Reporting Standards (IFRS) by listed entities having subsidiaries

With increasing globalization trends witnessed in the Indian economy, more particularly in the corporate sector, there is a felt need to align the financial reporting standards for Indian companies with internationally accepted reporting standards that have been specified for this purpose. In an era of trans-national companies and businesses, it is essential to have uniform financial reporting standards to enable global comparison of financials of companies across various industries and sectors. This is also critical from the perspective of stakeholders, whether in India or overseas.

Ministry of Corporate Affairs has recognized this need to harmonize the financial reporting standards for Indian companies with the IFRS and have tentatively announced that the Indian financial reporting standards be converged with IFRS from the accounting periods commencing on or after 1st April, 2011 for all public interest entities.

In order to be prepared by the above timeline, it was felt necessary to give sufficient lead time to listed entities for coming to terms with IFRS requirements so that any glitches in the processes are identified at an early stage and suitably ironed out. Accordingly, voluntary adoption of IFRS by listed entities for consolidated accounts

was discussed by the SCODA as a possible first step towards phased implementation of IFRS for listed entities. An issue that came up for debate in this context was whether all listed entities should be permitted to present consolidated accounts in IFRS or only those entities that have foreign subsidiaries should be permitted to do so.

During the deliberations, the following two alternative views emerged in this regard:-

- i. Only those listed entities which have overseas subsidiaries contributing to a major portion, say at least 50% of the total revenue of the consolidated entity, should be given the option to voluntarily adopt IFRS, the logic being that the financials of the overseas subsidiaries are often prepared in IFRS and requiring them to recast accounts in Indian GAAP for purposes of consolidation may be retrograde, especially when India is contemplating migration to IFRS by 2011. Therefore, it was suggested that such listed entities may be given an option to submit their consolidated financial results in IFRS on a voluntary basis, subject to the condition that they submit reconciliation as per IFRS 1 and IAS 34.
- ii. Restricting the aforesaid option to submit consolidated financial results in IFRS to only those listed entities with overseas subsidiaries may not be viewed as fair and the option may be extended to all listed entities having subsidiaries, especially if the objective of voluntary adoption is to enable entities to prepare themselves for mandatory convergence with IFRS by 2011.

Views of the public are solicited on the aforesaid issue.

f. Interim disclosure of balance sheet by listed entities

Presently, all registered companies in India are required, inter-alia, under section 210 of the Companies Act, 1956 to lay down before its share holders, during its annual general meeting, a balance sheet, providing a statement of assets and liabilities of the company as at the end of the financial year. In terms of the above requirement, the shareholders of a company have access to the statement of assets and liabilities of the company and its solvency position on an annual basis. Clause 31 of the Listing Agreement requires listed entities to forward copies of their balance sheets to the stock exchanges. However, neither the Companies Act nor the Listing Agreement requires companies to submit interim disclosures of balance sheet items on quarterly or half-yearly basis.

Internationally, it has been observed that most of the jurisdictions have disclosure of balance sheet items on an interim basis.

In the wake of the recent global financial crisis and subsequent cases of global corporations going bust, the issue of solvency and not merely the profitability of entities come to the forefront from the shareholders' perspective. It was felt that a more frequent disclosure of the asset-liability position of companies would assist the shareholders in assessing the financial health of the companies, thereby helping them in making informed investment decisions. Accordingly, the SCODA reviewed the frequency of submission of balance sheet items by listed entities to stock exchanges. After deliberations, the SCODA recommended that the audited figures of the major heads of the balance sheet prepared in accordance with Schedule VI to the Companies Act or its equivalent in other statutes may be disclosed by listed entities on a half-yearly basis.

The above recommendation of the SCODA seeks to disclose the solvency position of listed entities to the shareholders on a half-yearly basis which would be in the larger interest of the shareholders.

Views of the public are solicited on the aforesaid issue.

g. Timelines for Submission of financial results by listed entities

Presently, listed entities can submit either audited or un-audited quarterly and year to date financial results within one month from the end of each quarter (other than the last quarter). If the entity opts to submit un-audited financial results, the same shall be subject to a limited review by the auditors and a copy of the limited review report shall also be submitted within two months from the end of the quarter.

As regards the last quarter, listed entities can either submit un-audited results for the quarter within one month from the end of the quarter or submit audited results for the entire financial year within three months from the end of the financial year. If the company opts to submit un-audited results for the last quarter, the same shall be subject to a limited review by the auditors, a copy of which shall also be submitted within two months from the end of the quarter. It shall also submit audited financial results for the entire financial year, as soon as they are approved by the Board.

If a listed entity has subsidiaries, in addition to submitting stand-alone quarterly and year to date financial results within one month from the end of the quarter, they may also submit consolidated quarterly and year to date financial results within two months from end of quarter. Further, in addition to submitting annual audited financial results on a stand-alone basis, listed entities are also required to submit consolidated annual audited financial results to the stock exchanges. As regards publishing the financial results, listed entities that have submitted consolidated financial results in addition to standalone financial results, are required to publish only consolidated financial results in the newspapers.

In the light of the various options given to listed entities as mentioned above, it was seen that several categories of financial results in respect of a particular period for an entity were disseminated in public domain which tends to confuse the investors at large. Further, at the end of the last quarter, listed entities have been given an option to either submit un-audited last quarter financial results within one month from the end of the last quarter. Hence, if a company opts to submit annual audited results in lieu of last quarter financial results, there is no information available in public domain about its financials for about five months or more, which could make the shares of the company more prone to insider trading.

In view of the above, SCODA reviewed the extant requirements relating to submission and publishing of financial results by listed entities. After deliberations, the SCODA made the following recommendations:-

- i. Listed entities shall be required to submit their (a) quarterly and year to date audited stand-alone financial results or (b) quarterly and year to date un-audited stand-alone financial results accompanied by limited review report of the auditor, within 45 days from the end of the quarter. This shall be applicable for all quarters other than the last quarter.
- ii. Listed entities which have subsidiaries, may, along with the quarterly and year to date stand-alone financial results as mentioned at (i) above, also submit

consolidated audited quarterly and year to date financial results or un-audited quarterly and year to date financial results accompanied by limited review report, as the case may be, within 45 days from the end of the quarter. This shall be applicable for all quarters other than the last quarter.

- iii. Listed entities having subsidiaries which submit consolidated quarterly and year to date financial results in addition to stand-alone results shall continue to publish only consolidated financial results. However, the following items shall also be additionally published on a stand-alone basis, as a foot note:- (a) Turnover (b) Profit before tax (c) Profit after tax.
- iv. Listed entities which opt to submit their annual audited results on a stand-alone basis in lieu of the last quarter un-audited financial results subject to limited review report by the auditors shall submit the annual audited results within 60 days from the end of the financial year.
- v. Listed entities having subsidiaries shall, in addition to submission of stand-alone annual audited financial results as mentioned at (iv) above, submit their consolidated annual audited financial results within 60 days from the end of the financial year.
- vi. Listed entities that do not opt to submit their annual audited financials results within 60 days from end of financial year as mentioned at (iv) and (v) above shall submit their last quarter un-audited financial results accompanied by limited review within 45 days from the end of the quarter.

The above recommendations seek to streamline the submission of financial results by listed entities by making it uniform and to reduce the timeline for submission of the same to the stock exchanges.

Views of the public are solicited on the aforesaid issue.

3. Public comments

As part of the consultative decision making process followed by SEBI in policy formulation, the above proposals are placed on SEBI website for public comments. Comments, if any, on the same may be e-mailed on or before September 25, 2009 to aparnat@sebi.gov.in.
