
FINANCIAL REPORTING UNDER CORPORATE GOVERNANCE

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Financial reporting is the process of communicating information relevant to investors, creditors and other stake holders in a true and fair manner. Financial reporting frauds have often led to the failure of big business corporations. As a result, corporate governance in financial reporting has attained significant importance. The Companies Act, SEBI regulations and listing agreement with Stock Exchanges were amended to ensure that the financial reporting information is more accurate, transparent and reliable. Provisions have also been incorporated to check the internal functions and to ensure adequacy and reliability of reporting. The study also mentions some of the areas of concern that still remain. The discussion ends by underlining the need for Indian corporates to adopt global standards in financial reporting.

Introduction

The cardinal principle of financial reporting is that the reports presented should be true and fair. It should aim at the highest level of disclosures and ensure integrity and transparency through greater flow of information.

It is now recognized that one of the most important functions of Corporate Governance is to ensure the quality of the financial reporting process. Transparent management, a carefully articulated decision-making process that ensures the integrity of financial reporting, and finally instilling the confidence necessary for proper functioning of the corporation, are the key aspects of Corporate Governance. Corporate governance thus lays down the frame work for creating long term trust between company and its stake holders and aims at maximizing long term shareholder value.

Corporate Governance has received increasing emphasis and attention mainly due to the financial reporting frauds such as Enron, World .com etc. The objective of Corporate Governance as already mentioned, is to maximize long term shareholder value. As the shareholders are the residual claimants in a well performing financial and capital market, whatever maximizes the shareholder value must necessarily maximize corporate prosperity and best satisfy the claims of all the stakeholders viz.

creditors, employees, shareholders and the State.

Weaknesses in Governance and poor quality of financial reporting may lead to manipulations, financial reporting fraud and weakness in internal controls. Therefore, Corporate Governance emphasizes the need to improve the financial reporting process by enacting reforms to improve the effectiveness of the audit committee, timing, content, and the manner of financial reporting etc. Sarbanes and Oxley Act of USA and Clause 49 of the listing agreement in our country are examples. It also emphasizes the need to make the Board of Directors and the management accountable for ensuring the integrity of financial reports.

The corporate form of business organizations took roots in India in the late 18th century and early 19th century and was mainly dependent on a handful of British and Indian business families. During this period the Managing Agents were multi-tasking the various roles of entrepreneurs, financiers, and managers. They played a significant role in the management of companies for more than a century and also misused the system through interlocking of directorship and related party transactions, siphoning off funds through commissions to sole buying and selling agencies, manipulating inter-corporate loans and advances etc. (Balasubramanian, 1993, Balasubramanian, 2006). Hence the Managing Agency system had to be abolished in

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1969 through an amendment in the Companies Act.

Till the liberalization of the 1990's corporates were under the burden of bureaucratic excesses and were regulated by means of Companies Act, Controller of Capital Issues, MRTP Act, Foreign Exchange and Regulation Act, Industrial Development and Regulation Act etc. Industries were protected and not subject to external threat. Hence financial reporting was mainly aimed at satisfying legislative and bureaucratic requirements. Further, development financing became the prime objective of the banking sector after nationalization. As a result companies relied on debt rather than equity for their financial requirements. The State owned Financial Institutions also did not bother to monitor corporate performance, as there was political pressure on them for sanctioning loans.

Dubious practices of Indian business reached a peak in mid 1990s encouraged by an environment that was virtually free of government control. Preferential issues, price rigging, exorbitant pricing of new issues, accounting jugglery, delay in project implementation etc., were all commonplace. Companies such as Usha Rectifier, Bindal Agro, MS Shoes, CRB Capital Markets, Prudential Capital Markets, Real Value Appliances, as well as companies owned by Modi, Singania, Thapar and other groups were accused of scandals and fleecing investors. Harshad Metha became the biggest price manipulator on stock exchanges in 1992 (Joshi, 2003). All these scandals and dubious practices compelled the regulatory authorities to act, leading to the evolution of Corporate Governance system in the country. It is interesting to note that in India, despite a long corporate history, the phrase 'corporate governance' remained unknown until 1993. It came to the fore due to the spate of corporate scams and fraudulent practices during the first phase of economic liberalization and thereafter in successive recurrence.

Need for Good Governance in Financial Reporting

The lifeline of the market is information, and any factor which prevents, restricts or distorts the flow of adequate and relevant information contributes to imperfections in the market. It is also recognized that there is a strong positive co-relation between greater transparency and accurate valuation of securities. Hence, in recent years, there has been an increasing sense of urgency surrounding the need for responsible financial reporting. At the same time, the demands on the flexibility of financial reporting have also become increasingly intense with the growing sophistication of financial instruments to manage risks. The recent turmoil in foreign markets has further heightened the need for sound financial reporting.

To source external capital, the company not only has to have a global perspective but also must follow internationally accepted

practices with regard to Financial Reporting. One of the established international practices that an Indian corporate has to follow is recasting its financial statements (prepared as per Indian GAAP) in accordance with US GAAP. As the global financial markets are fast integrating and Indian corporates are exploring the foreign markets for raising funds, it is no longer possible to follow two yardsticks for disclosure of financial and accounting information, one for domestic investors and another for foreign investors. Indian Accounting Standards can no longer afford to remain isolated from worldwide trends. They must be able to provide a fair and transparent system of information flow from the business organisations to the users of such information, taking into account that the user has an ever-increasing need for information.

In the liberalized scenario the growing awareness of Corporate Governance and the experience in the early stages of liberalization brought numerous changes in financial reporting. The Companies (Amendment) Act, 1999 inserted a new section 210A providing for the constitution of a National Advisory Committee on Accounting Standards to advise the Central Government on the formulation and laying down of accounting policies and accounting standards for adoption by companies or class of companies. (Department of Company Affairs, 1997)

With a view to ensure greater transparency and accountability, a new section 292A has been incorporated requiring every public company having a paid up capital of Rupees Five Crores or more to constitute an Audit Committee. The Committee is required to have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and a review of the half yearly and annual financial statements before submission thereof to the Board, and also to ensure compliance of internal control systems. Companies are also required to include in their Director's Report, a statement of its director's responsibility.

SEBI, the Capital market regulator, on its part, gradually came out with Rules governing the functioning of Stock exchanges, brokers, merchant bankers etc. It has modified the listing agreement incorporating stronger disclosure norms for initial public offers, declaration of un-audited quarterly results, mandatory appointment of a Compliance Officer, and more disclosures in the Directors Report.

Major changes brought in the Financial Reporting

In the following section we propose to make a brief analysis of the major changes that have been brought about in the financial reporting process in the wake of the introduction of Corporate Governance in India.

a) Accounting standards in Financial Reporting

Accounting Standards are written policy documents issued by the government or expert institutes or other regulatory body covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transaction in the financial statements. It aims at standardizing the diverse accounting policies and practices with a view to reduce to a considerable extent, or eliminate altogether, the wide variations in the accounting treatments used to prepare and present financial statements.

Before the amendment in the Companies Act, in 1999, compliance with the Accounting Standards by every company in the preparation of Profit and Loss account and Balance Sheet was binding only to the Members of the Institute of Chartered Accountants of India. Therefore, the financial reporting varied from company to company depending on the extent to which the Accounting Standards were adopted by the companies voluntarily. Therefore, in order to prescribe and review the Accounting Standards, Section 210A of the Companies Act (after the Amendment Act of 1999) provided for the constitution of a National Advisory Committee on Accounting Standards. The Central Government prescribes the Accounting Standards to be followed by companies in India on the basis of the recommendation by this National Advisory Committee. This new section has helped to standardize the accounting policies followed by the companies by making them comparable and improving the reliability of Financial Statements. It helps the users of the financial statements viz. the investors, employees, lenders, suppliers etc. to analyze, interpret and take decisions in a uniform manner. The details about the prevailing Accounting Standards, the enterprises to which it is applicable and the date from which it is mandatory, are given in the Annexure.

(b) Director's responsibility statements

In the year 2000, a new Sub Section 2AA was added to Section 217 of the Indian Companies Act to include Director's Responsibility Statement in the Director's Report attached with the Balance sheet. Through this statement the Directors of the Company confirm the following:

- i) That the Company has followed the applicable accounting standards in the preparation of annual accounts and, if there is any departure, proper explanation has been given.
- ii) That they have selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the Company at the end of the financial year, and of the profit and loss account of the company for that period.

- iii) That they have taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Companies Act, 1956 for the safeguarding of the assets of the company and for prevention and detection of fraud and other irregularities.
- iv) That the directors have prepared the annual accounts on a going concern basis.

The responsibility statements provide some express declarations regarding the commitment of the directors on the financial statements and confirm the responsibility of the Board in safeguarding the public fund and the organizational assets. The directors declare and undertake complete responsibility for the integrity and reliability of the financial statements. This provides sufficient confidence to the users of the financial statements.

(c) Auditor's report

The Auditor's Report accompanying the financial statement must contain a statement that the Profit and Loss account and Balance Sheet, in their opinion, has complied with the Accounting Standards prescribed in the Companies Act, 1956. The intention is to obtain a comment from an independent professional regarding the compliance of the prescribed Accounting Standards. Any adverse comments or observations made by the auditors on the functioning of the Company are to be shown in bold italics so as to get the attention of the readers. These changes were brought in by the Companies Amendment Act, 1998 and 2000 respectively.

Compliance of Companies (Auditor's Report) Order, 2003 replacing the Manufacturing and other Companies (Auditor's Report) Order, 1988 has brought in significant changes by including matters like default in repayment of dues to financial institutions, utilization of loan amount only for the purpose for which it has been taken, details of preferential allotments, fraud either on or by the Company etc. in the Auditor's report attached to the financial statements. This was made applicable for Companies and professionals since January 1, 2004. (Notification No. GSR 480(E) dated June 12, 2003 General Circular No. 32 of 2003 dated November 10, 2003).

The above changes have been made to evaluate the activities of the Companies by an independent professional viz., the company's statutory auditors, and to report them to the readers of the financial statements. It also acts as a control on the management to utilize the funds of the company for the purpose for which it was raised. Prior to the change of the Auditors Report Order, 2003 the auditors were not required to comment on the raising and utilization of the financial resources of the company.

(d) Amendments in the listing agreement

The listing agreement with stock exchanges covers external financial reporting as well as internal reporting to ensure required disclosures at the appropriate time, and is required to be complied with only by the listed companies.

As per **Clause 32** of the Listing Agreement, companies are required to give Cash Flow Statement along with Balance Sheet and Profit and Loss Account and it should be prepared in accordance with the Accounting Standard on Cash flow (AS-3) (Circular No. SMD-I(N)/JJ/223/95 dated June 26, 1995). It is mandatory for companies to publish consolidated Financial Statements in its Annual Report in addition to the individual financial statements, disclose loans/ advances and investments in its own shares, its subsidiaries, associates etc. and related party disclosures. This provides additional information to the users of the financial statement. This shows the flow of incoming and outgoing cash and assesses the ability of the enterprise to generate cash, and to utilize the cash. It is also a tool for assessing the liquidity and solvency of the enterprise.

Clause 41 requires the listed companies to furnish within 15 minutes after the conclusion of the Board Meeting the unaudited financial results to the Stock Exchange, where its shares are listed, in the prescribed format and to publish the same in news papers within 48 hours of the conclusion of the Board Meeting or Committee of Directors which *considers* the results. Since the quarter ending 30th September 2001 companies are required to publish segment-wise revenue results and capital employed along with the quarterly results. From the quarter ending June 30, 2003, the quarterly results are subject to 'Limited Review' by the Auditors of the company and a copy of the review report has to be given to the stock exchanges within two months from the close of the quarter. If the Net Profit or Loss after tax and exceptional or extraordinary items varies by 10% or more from the respective unaudited quarterly results as determined after the limited review by the Auditors, the company has to send a statement, approved by the Board of Directors, explaining the reasons to the stock exchange, along with the review report. In the case of the last quarter in the financial year, if the company is publishing the yearly audited financial result in the prescribed format within 3 months from the end of the financial year, it need not publish the unaudited financial results of the last quarter.

This clause also requires the companies to provide information on:

- i) any event or transaction that is material to an understanding of the results including completion of expansion, diversification programs, strike, lockout, change in

management, change in capital structure etc.,

- ii) all material, non recurring or abnormal income or gain, and expenditure or loss, and the impact of any changes in accounting practices on the profit
- iii) the seasonal nature of activities in case the income is subject to material seasonal variations.
- iv) the effect of change in composition of the company including business combinations, acquisitions or disposal of subsidiaries and long term investments, restructuring and discontinuing operations
- v) disqualification, if any, by the auditors with respect to the audited accounts, along with the impact of such audit qualifications on the profit or loss. In case of audit qualifications in the previous accounting year explanation has to be given as to how the company addressed the qualifications and if the same is not addressed then the impact of that qualification.

This clause takes care of the price sensitive information and the interim reporting of the financial information to the stake holders. The format, time etc., are specified in the clause to ensure adequate financial information at the appropriate time. The segment-wise financial reporting helps in analyzing the companies' performance in each segment. Limited review of the quarterly financial results and reporting of the variation ensures accuracy of reporting. The reporting of all price sensitive information or information which has an impact on the results of the company helps the users to evaluate the results with reasonable accuracy. In the present scenario of globalised economical environment, this information will greatly help the investors to take an informed decision.

Clause 49 requires an independent audit committee to oversee the company's financial reporting process and disclose financial information to ensure that the financial statements are correct, sufficient and credible. It is mandatory for the audit committee to review:

- a) Management discussion and analysis of financial condition and results of operations
- b) Statement of significant related party transactions
- c) Internal control weaknesses pointed out by the statutory auditors
- d) Internal audit report relating to internal control weaknesses
- e) Quarterly and annual financial statements along with the management before submission to the Board for approval
- f) Details of related party transactions

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- g) Utilization of proceeds from public issue, right issue, preferential issue etc. and make necessary recommendations

The following disclosures about Directors should be made in the Annual Report:

- 1) All pecuniary relationship or transactions of the non-executive directors with the company
- 2) All elements of remuneration package of individual directors, details of fixed components and performance-linked incentives along with performance criteria, and stock option details if any.
- 3) Shareholding particulars of non executive directors

The directors are required to include the following in the Management Discussion and Analysis in a report attached with the annual report to the share holders:

- a) Industry structure and development
- b) Opportunities and threats
- c) Segment-wise and product-wise performance
- d) Future outlook
- e) Risks and concerns
- f) Internal control system and its adequacy
- g) Discussion of financial performance with respect to operational performance
- h) Material development in human resources

In short, clause 49 ensures not only the statutory requirement of financial reporting but also covers the process, to ensure the reliability, accuracy and adequacy of the financial information. It fixes a duty on the Audit Committee to review certain information like related party transaction, internal audit report, quarterly and annual financial results, utilization of the proceeds of public issue, rights issue etc. The Audit committee comprises of independent directors and their review enhances reliability of the financial information. Under this clause, all transactions with directors including their remuneration, shareholding etc. are to be disclosed. Therefore, the investors are in a position to know what benefits are available to the directors for managing the affairs of the company. The Management Discussion and Analysis in the annual report helps to evaluate the company, its strengths, weaknesses, opportunities, risks etc. The users of the financial information can use this information for a meaningful analysis.

CEO/CFO Certification - Clause 49 also provides for a certificate to be given by the CEO/CFO to the Board stating that they have reviewed the financial statements and the cash flow

statement for the year, and that these do not include any material untrue or misleading statement, that they have not omitted any material fact, and the financial statements presented together shows a true and fair value of the company's affairs and are in compliance with the existing Accounting Standards and applicable laws and regulations. He also certifies that the company has not entered into any transaction which is fraudulent, illegal or in violation of the company's code of conduct. This is an internal certification by the Chief Executive Officer and the Chief Financial Officer of the Company who are responsible to the Board. This certificate enhances the confidence of the Board of Directors with regard to the financial statements.

Corporate Governance Compliance Report

To ensure the compliance of the Corporate Governance provisions, it is mandatory to include a certificate from the auditors or from a practicing Company Secretary regarding compliance with all the mandatory regulations of Corporate Governance. This ensures an evaluation of the compliance of the Corporate Governance requirements by an independent professional so that the users of the financial statements can rely on the statements.

Filing of Financial Information on the Edifar Website (Electronic Data Information Filing and Retrieval System)

All listed Companies are required to file the quarterly and annual financial reports in the prescribed format among other things in the EDIFAR web site within one month from the end of the period to which the report relates. (SEBI Circular SMD/POLICY/Cir-13/02 dated June 20, 2002). This website is maintained by SEBI in public domain and is accessible to public. Any member of the public who requires information of the Companies can access this website for information.

The globalized capital markets give importance to high quality financial information relevant to investors, creditors and others for making investments, and business decisions. The legislative and regulatory requirements discussed above fixes responsibilities on the directors and executive management to present a balanced and understandable assessment of the company's position and prospects, maintain a sound system of internal control to safeguard company's assets, and to have a financial reporting system which will ensure the availability of authentic, reliable and adequate information at the appropriate time. Compliance of these requirements in its true spirit will certainly add sustainable business value.

Areas of concern.

Based on the experience in the early stages of liberalization, the

regulators, professional bodies and government authorities brought numerous changes in the financial reporting, especially in the listed companies. In spite of all this there are certain areas of concern.

Audit is the cornerstone of Financial Reporting and Corporate Governance. The directors are required to report on their stewardship by means of the Annual Report and financial statements. Audit provides an external and objective check on the way in which the financial statements are prepared and presented. However, there is no clarity regarding the respective responsibilities of Directors and Auditors for preparing and reporting the financial statements of Companies. For instance, if auditors connive with the directors and present misleading financial statements, the users will not have any means to know the correct position. Further, if any financial irregularity comes to the notice of the auditors, they do not have any alternative to report to statutory and regulatory authorities. Their only option is to mention it in the Auditors Report. There is no scope to recommend any penal or remedial action and it may turn out that ultimately no one may take any action.

Separation of listed and unlisted companies for reporting and presenting financial statements has provided more scope for manipulation. In the globalized business environment, companies are resorting to the de-listing route to avoid compliance of Governance requirements of reporting. Multinational private equity funds are entering the country to invest in shares especially in the unlisted category. Therefore companies exceeding a particular percentage of turnover, say Rs. 50 crores or total investment exceeding a particular limit, should follow uniform disclosures irrespective of its listing status.

While much of the responsibility and accountability is with the directors, the fact that is often overlooked is that the board, being non-executive in nature, can only have an oversight and surveillance role in most matters and that the executive management of the company is the primary source both for originating strategies and implementing them. Hence the importance of achieving corporate objectives within an appropriate and acceptable ethical and value based frame work has to be inculcated in all the parties concerned.

Corporates play a significant role in the economic development and well being of society. Companies are social institutions and their contribution to society should have a place in the financial statements, through mandatory provisions like reporting utilization of a percentage of turnover for social causes.

Though Accounting Standards in India have been upgraded there

is a need to bring about harmonization and synchronization of the Indian Accounting Standards with the global standards.

In the post liberalized scenario, the global financial markets are fast integrating and Indian corporates are exploring the foreign market for raising funds. It is not, therefore, possible to follow two yardsticks for disclosure of financial and accounting information, one for domestic investors and the other for foreign investors. Financial reporting by corporates in India can no longer afford to remain isolated from worldwide trends. There must be a fair and transparent system of information flow from the business organization to the users of such information, taking into account the ever-increasing need for information.

Annexure

Status of Accounting Standards issued by ICAI

For the purpose of applicability of accounting standards, enterprises are classified into three categories:-

- **Level I Enterprises:** Enterprises which fall in any one or more of the following categories, *at any time* during the accounting period are classified as Level I enterprises:-
 - (i) Enterprises whose equity or debt securities are listed whether in India or outside India.
 - (ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the Board of Directors' resolution in this regard.
 - (iii) Banks including co-operative banks.
 - (iv) Financial Institutions
 - (v) Enterprises carrying on insurance business.
 - (vi) All commercial, industrial and business reporting enterprises, whose turnover (*not including /other income*) for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crores,.
 - (vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crores *at any time* during the accounting period.
 - (viii) Holding and subsidiary enterprises of any one of the above *at any time* during the accounting period.
- **Level II Enterprises:** Enterprises which are not Level I Enterprises but fall in any one or more of the following categories are classified as Level II enterprises:-
 - a) All commercial, industrial and business reporting enterprises, whose turnover (*not including /other*

income) for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs.40 lakhs but does not exceed Rs.50 crore.

- b) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs.1 crore but not in excess of

Rs.10 crores *at any time* during the accounting period.

- **Level III Enterprises:** Enterprises which are not covered under Level I and Level II are considered as Level III enterprises.

AS No.	Title of the Accounting Standard	Date from which mandatory (i.e. accounting periods commencing on or after)	Enterprises to which applicable
AS-1	Disclosure of Accounting Policies	1-4-1993	All
AS-2 (Revised)	Valuation of Inventories	1-4-1999	All
AS-3 (Revised)	Cash Flow Statement	1-4-2001	Level-I
AS-4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date	1-4-1998	All
AS-5 (Revised)	Net Profit or Loss for the period, Prior Period Items and changes in Accounting Policies	1-4-1996	All
AS-6 (Revised)	Depreciation Accounting	1-4-1995	All
AS-7 (Revised)	Construction contracts	1-4-2002	All
AS-8	Accounting for Research and Development	Withdrawn and included in AS-26	
AS-9	Revenue Recognition	1-4-1993	All
AS-10	Accounting for Fixed Assets	1-4-1993	All
AS-11 (Revised 2003)	The Effects of changes in Foreign Exchange Rates	1-4-2004	All
AS-12	Accounting for Government Grants	1-4-1994	All
AS-13	Accounting for Investments	1-4-1995	All
AS-14	Accounting for Amalgamations	1-4-1995	All
AS-15 (Revised 2005)	Employees Benefits	1-4-2006	All
AS-16	Borrowing costs	1-4-2000	All
AS-17	Segment Reporting	1-4-2001	Level-I
AS-18	Related Party Disclosures	1-4-2001	All
AS-19	Leases	1-4-2001	All
AS-20	Earning Per Share	1-4-2001	Level-I
AS-21	Consolidated Financial Statements	1-4-2001	Refer Note
AS-22	Accounting for Taxes on Income	1-4-2001	For Listed Companies
		1-4-2002	Other than Listed Companies
		1-4-2006	All
AS-23	Accounting for Investment in Associates in Consolidated Financial Statements	1-4-2002	Refer Note
AS-24	Discontinuing operations	1-4-2004	Level-I

AS-25	Interim Financial Reporting	1-4-2002	Level-I
AS-26	Intangible Assets	1-4-2003	All
AS-27	Financial Reporting of Interests in Joint Ventures	1-4-2002	Refer Note
AS-28	Impairment of Assets	1-4-2004	Level I
		1-4-2006	Level II
		1-4-2008	Level III
AS-29	Provisions, Contingent Liabilities and Contingent Assets	1-4-2004	All

Note- AS-21, AS-23 and AS-27 are required to be complied with by an enterprise if the enterprise prepares and presents consolidated financial statements, pursuant to the requirements of a statute or regulation or voluntarily. (See, Ghosh and Chandratre, 2007).

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