Investigating Corporate Governance Practices in to-be-listed Small and Medium Enterprises in Pune Region

Prepared by

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Sponsored by

National Foundation for Corporate Governance (NFCG)

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About National Foundation for Corporate Governance (NFCG)

With the goal of promoting better corporate governance practices in India, the Ministry of Corporate Affairs, Government of India, on 1st October 2003 set up National Foundation for Corporate Governance (NFCG) in partnership with Confederation of Indian Industry (CII), Institute of Company Secretaries of India (ICSI) and Institute of Chartered Accountants of India (ICAI). In the year 2010, stakeholders in NFCG have been expanded with the inclusion of ICAI and the National Stock Exchange.

Vision

Be A Catalyst In Making India The Best In Corporate Governance Practices.

Mission

1) To foster a culture for promoting good governance, voluntary compliance and facilitate effective participation of different stakeholders;

2) To create a framework of best practices, structure, processes and ethics;

3) To make significant difference to Indian Corporate Sector by raising the standard of corporate governance in India towards achieving stability and growth.

Stakeholders

Ministry of Corporate Affairs (MCA): MCA is primarily concerned with administration of the Companies Act, 1956, other allied Acts and rules & regulations framed there-under mainly for regulating the functioning of the corporate sector in accordance with law. The Ministry is also responsible for administering the Competition Act, 2002 which will eventually replace the Monopolies and Restrictive Trade Practices

Act, 1969 under which the Monopolies and Restrictive Trade Practices Commission (MRTPC) is functioning. Besides, it exercises supervision over the three professional bodies, namely, Institute of Chartered Accountants of India (ICAI), Institute of Company Secretaries of India (ICSI) and The Institute of Cost Accountants of India (ICAI) which are constituted under three separate Acts of the Parliament for proper and orderly growth of the professions concerned. The Ministry also has the responsibility of carrying out the functions of the Central Government relating to administration of Partnership Act, 1932, the Companies (Donations to National Funds) Act, 1951 and Societies Registration Act, 1980.

Confederation of Indian Industry (CII): CII is a non-government, not for profit, industry led and industry-managed organization, playing proactive role in India's development process. CII works to create and sustain an environment conductive to the growth of industry in India, parenting Industry through advisory and consultative processes. A facilitator, CII catalyses change by working closely with government on policy issues, enhancing efficiency, competitiveness and expanding business opportunities for industry through a range of specialized services and global linkages.

Institute of Chartered Accountants of India (ICAI): ICAI is a statutory body established under the Chartered Accountants Act, 1949 for the regulation of the profession of Chartered Accountancy in India. The Institute has achieved recognition as a premier accounting body for the contribution in the fields of education, professional development, maintenance of high accounting, auditing and ethical standards.

Institute of Company Secretaries of India (ICSI): ICSI is a premier national professional body constituted under the Company Secretaries of India Act, 1980 to develop and regulate the profession of Company Secretaries. The Institute is functioning to develop high caliber professionals ensuring good Corporate Governance and effective management, thus contributing to society at large.

The Institute of Cost Accountants of India: The Institute of Cost Accountants of India was established by an Act of Parliament, namely, the Cost and Works Accountant Act, 1959. The institute was formed with the objectives of promoting, regulating and developing the profession of Cost Accountancy and is under the administrative control of Ministry of Corporate Affairs. The Institute is a founder member of International Federation of Accountants (IFAC), Confederation of Asian and Pacific Accountants (CAPA) and South Asian Federation of Accountants (SAFA)."

National Stock Exchange of India Limited (NSE): operates a nation-wide, electronic market, offering trading in Capital Market, Derivatives Market and Currency Derivatives segments, including equities based ETF, Gold ETF, and Retail Government Securities etc. It accounts for nearly 74% in Equity market and more than 98% market share in equity derivatives segment. Today NSE network stretches to more than 1,500 locations in the country and supports more than 2, 30,000 terminals. With more than 10 asset classes in offering, NSE has taken many initiatives to strengthen the securities industry and has launched several new products like Mini Nifty, Long Dated Options, Cross Margining, Currency and Interest Rate Derivatives, and Mutual Fund Service System. Responding to the evolving market needs, NSE has also introduced services like DMA, FIX capabilities, co-location and mobile trading facilities for various categories of investors.

NSE is committed to operate a market ecosystem which is transparent and at the same time offers high levels of safety, integrity and corporate governance. NSE would continue to provide newer products and services to cater to the demands of the market participants and provide an efficient trading platform for the investors

About Symbiosis Institute of Management Studies (SIMS)

SIMS was set up in 1993 and in the year 2002, the Ministry of HRD, Govt. of India conferred on Symbiosis, the status of Deemed to be University. Symbiosis today comprises of 37 institutes imparting training in diverse disciplines. It has over 45,000 students who hail from all states of India and from 60 different countries.

SIMS is a constituent of the prestigious Symbiosis International Deemed University and is accredited by the National Assessment and Accreditation Council (of the UGC) in November 2008. It is an ISO 9001:2008 quality certified management institute and a top-tier provider of business education across the spectrum. SIMS is also an accredited "Centre for Corporate Governance" of the 'National Foundation of Corporate Governance' (established by Ministry of Corporate Affairs and CII).

Vision

Be the premier hub of management education for armed forces personnel and their dependents.

SIMS has been ranked 16th overall in all India ranking and 6th in the west zone by ‘The WEEK’ magazine in its November, 2012 issue. The rating score was computed taking into consideration broadly- the input value, value addition, learning ambience and brand value. The information was collected from various stakeholders like the corporate Human Resource Managers, current students, aspiring students etc. SIMS was adjudged 4 awards at 2nd Asia’s Best B-School Awards organised by CMO Council held at Suntec, Singapore on 21st -22nd July 2011. Asia’s Best B-School Awards in collaboration with CMO Asia & CMO Council, USA endeavours to pay a tribute to temples of learning & make a difference to the education fraternity. The event saw the participation of 29 countries including Australia, Hongkong, Singapore, UAE etc.

SIMS has been ranked 20th in the India's Best B School Survey 2012 conducted by Business World.

Executive Summary

The National Foundation for Corporate Governance (NFCG) vision is to be a catalyst in moulding best corporate governance practices in India. NFCG identified Symbiosis Institute of Management Studies (SIMS) as a partner institute to carry out projects pertaining to corporate governance. This project focuses on compliance of corporate governance practices in to be listed Small and Medium Scale Enterprises (SMEs).

The main objectives of the project are

1. To understand the nature of to be listed SMEs
2. To observe the corporate governance practices of the selected SMEs

The project was executed by SIMS in Pune region. The nature of the research was an exploratory research with paramount focus on primary data collected in form of interviews. In all 16 companies were selected that fulfilled the prerequisites for the study. Extensive interviews were carried by the investigators; Brig Rajiv Divekar (retd), Dr. Pravin Kumar and Mr. Rajagopal. The corporate governance compliance was checked on certain selected parameters. The following key parameters were used to create a check list

- Private Equity Fund Association
- Independent Directors
- Board Meetings
- Audit Committee
- Transparency and Disclosures
- Internal Audit

- Statutory Auditors
- Investment Bank / Merchant banker association
- Growth sustainability exercise
- Succession Planning
- Industry
- CEO category
- Professional CA CS association
- Employee participation in Governance

Our results show that all the companies the investigators interviewed were sincere in their efforts for compliance to meet listing standards. The investigators also observed minimal material deviation in the key corporate governance parameters.

Our recommendations are skewed towards improving barriers to SME which would eventually lead them to adopt more effective corporate governance practices and reduce their cost of raising capital. The basic observations show same set of rules governing both SMEs and large organizations for cost of borrowing, taxes, and IPR. There is a requirement to incentivize taxes for retention of earnings, subsidize employment and skills training, ease regulatory compliance for SMEs, and mandatory government procurement from listed SMEs.

In addition the investigators feel the need to train CEOs and promoters to infuse best corporate governance practices in to be listed SMEs.

Chapter 1 gives an introduction to Micro Small and Medium Enterprises followed by Chapter 2 which highlights the corporate governance regulatory framework in India. In chapter 3 the investigators discuss the method of research and selection of key parameters. Chapter 4 the investigators discuss the observations of the study followed by recommendation in chapter 5.

Date: 12th November 2013

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Dr Pravin Kumar Bhoyar

Chapter 1 – *Micro, Small and Medium Scale Enterprises*

The definition of Micro, Small and Medium Scale Enterprise (MSME) varies from country to country. However the common parameters used for defining MSMEs at international level includes; number of employees, total net assets, sales and investment level. The European Union version of definition for MSMEs according to total number of employers is as follows

Number of Employees	Definition
0	Self employed
2-9	Micro business
10-49	Small business
50-249	Medium business

The Micro, Small and Medium Enterprises (MSME) Development Act of 2006, (India) attempts to define MSMEs for manufacturing and service sector according to plant & machinery and equipment investments respectively[1]. Accordingly MSMEs are defined as follows

Category	Manufacturing Sector	Service Sector
Micro	Rs. 25 lakh	Rs. 10 lakh
Small	Rs. 5 crore	Rs. 2 crore
Medium	Rs. 10 crore	Rs. 5 crore

[1] Investment limits in plant and machinery are considered for manufacturing units where as investment limits in equipments are considered for the service sector

Contribution and growth of MSMEs in India

There is a significant contribution of the MSMEs towards economy and employment. In terms of value, the sector accounts for about 45 per cent of the manufacturing output and 40 percent of the total exports of India. The MSME sector employs about 42 million persons in over 13 million units throughout the country. There are more than 6000 products, ranging from traditional to high-tech items, which are being manufactured by the Indian MSMEs[2]. The number of MSMEs has increased steadily in India from 67.87 lakhs in 1990-91 to 133.68 lakhs in 2007-08. Similarly, number of persons employed in MSEs has risen from 158.34 lakhs in 1990-91 to 322.28 lakhs in 2007-08. However, much of the labour absorption has taken place in the unorganized/ informal enterprises. The contribution of the MSE sector to overall industrial production has declined marginally from 39.74% in 1999-2000 to 38.57% in 2006-07. The contribution of the MSE sector to the gross domestic product (GDP) has increased from 5.86% in 1999-2000 to 5.94% in 2006-07. The exports from the small scale industry has increased from Rs. 9,664 crore in 1990-91 to Rs. 1,50,242 crore in 2005-06. Exports from SMEs majorly fall in eight product groups, (Readymade garments, Engineering goods, Electronic and computer software, Chemicals and allied products, Basic chemicals, pharmaceuticals and cosmetics, Processed foods, Finished leather and leather products and Plastic products) accounting for over 90 per cent of total value of exports[2].

Evolution of MSMEs in India

During the 2nd and 3rd Five Year Plans, India focused on industrialization which was capital intensive in nature and thus could not solve the problem of unemployment.. The Karve Committee Report (1955) highlighted the need to protect SMEs in India.

[2] Ghatak, S. (2010). Micro, Small and Medium Enterprises (MSMEs) in India: An Appraisal.

Reservation of items for exclusive manufacture in SSI sector statutorily provided for in the Industries (Development and Regulation) Act, 1951, has been one of the important policy measures for promoting this sector[2]. The perception of SMEs as infant and unorganized sector has changed post liberalization. Currently 21 items are reserved for exclusive manufacturing in the MSE sector. These include bread, pickles, wooden furniture, wax candles, exercise books and registers, safety matches, incense sticks, fireworks, and stainless steel and aluminium utensils[2]. The phased deletion of products from the list of items reserved for the exclusive manufacture by micro and small enterprises is being continued. In October 2008, the government deleted 14 items from this list[2].

Challenges for MSMEs in India

Ghatak[2] highlighted the following issues in the MSME sector (a) liberalisation of the investment regime during the 1990s, favouring foreign direct investment (FDI); (b) the formation of the World Trade Organisation (WTO) in 1995, and (c) domestic economic reforms.

Credit Issues

The Challenge of Employment in India: An Informal Economy Perspective *(NCEUS, 2009)* shows that between August 2007 and 2008, credit for credit cards , service sectors, real estate and construction was raised much higher than credit for agriculture, and MSMEs. The availability of credit to small and micro enterprises as percentage of net bank credit (NBC) of the Scheduled Commercial Banks (SCB) has declined from 15.5 per cent in 1996-97 to 6.6 per cent in 2007-08[2]. Banks' credit to micro enterprises (investment up to Rs 25 lakh in plant and machinery) declined from 4.2 percent in 2002-03 to 2.8 percent in 2007-08. The lower segment of micro enterprises (with investment up to Rs 5 lakh in plant and machinery) has experienced a decline from 2.2 per cent to 1.6 percent in the same period. The proportion of net bank credit flows to the small scale sector has been falling in recent years (from 16 per cent in early 1990s to 8 per cent in 2006–2007)[2].

The following reasons are mentioned by Ghatak[2] for banks unwilling to lend money to MSMEs and the other challenges faced by MSMEs

• High administrative costs of small-scale lending;

• Asymmetric information;

• High risk perception; and

• Lack of collateral.

Key challenges

a. Accessing adequate and timely financing on competitive terms, particularly longer tenure loans.

b. Credit access and liquidity constraints

c. Lack of credit access due to legal and regulatory framework

d. Inability of lenders to assess risks associated with SMEs

e. Unavailability of skilled manpower and R&D facilities

Chapter 2 – *Corporate Governance in India-Regulatory Framework*

Evolution of Corporate Governance in India

Poor governance and lack of transparency was attributed to the Asian crisis. This set a trigger for inculcating good corporate governance practices in India. The key differentiator in running a business in Asia was the ownership model. Majority of the companies were family run businesses. Such family run businesses were biased towards other family members resulting in funnelling of corporate gains. India has far surpassed other Asian countries in terms of corporate governance. The Companies Act 1956 has been the foundation of Corporate Governance and Accounting Systems in India. Since liberalization wide-ranging changes were brought about in the laws and regulations relating to the financial markets. The single most important development has been the establishment of Securities and Exchange Board of India (SEBI) in 1992. SEBI has played a crucial role in establishing the basic minimum compliance norms for corporate governance by listed companies[3].

The CII trigger

The initial corporate governance framework was initiated by CII in 1996. A National Task Force was set up under the Chairmanship of Rahul Bajaj, past President of CII and presently Chairman of the Bajaj Group. The Task force made a number of recommendations relating to board constitution, role of non-executive directors, role of audit committees and others. The committee submitted its Code in 1998.

[3] NFCG report, Corporate Governance Practices and Financial Performance of Selected Family Managed Medium Sized Listed Companies in India

SEBI and Kumar Mangalam Birla Committee

In 1999, SEBI set up a committee under the Chairmanship of Kumaramangalam Birla, to suggest suitable recommendations for the Listing Agreement of Companies with their Stock Exchanges to improve the existing standards of Corporate Governance in the listed companies[1]. The committee emphasized on composition of the Board of directors, disclosure laws and share transfers. The committee found that accountability, transparency and equal treatment of all stakeholders are the key elements of corporate governance and hence create a code of governance considering then market conditions. The Code was accepted in 2000 by SEBI and incorporated into a new Clause 49, which was inserted into the Listing Agreement of Companies with their Stock Exchange.

The below material is taken from the NFCG report titled, "Corporate Governance Practices and Financial Performance of Selected Family Managed Medium Sized Listed Companies in India".

Clause 49 of the Listing Agreement

The provisions of this Clause are applicable to all entities seeking listing approval and having a paid up capital of Rs. 3.0 crore and above or a net worth of Rs. 25 crore or more at any time in the history of the company. The provisions contained in Clause 49, took effect in phases between 2000 and 2003 as described later in this chapter.

RBI Advisory Group headed by Dr. R H Patil

The recommendations of this Group which were submitted to SEBI in 2001, covered some more codes and principles of private sector companies including consolidation of accounts incorporating performance of subsidiaries, criteria of independent directors and disclosures.

N R Narayan Murthy Committee

In 2002, SEBI constituted another committee under the Chairmanship of N R Narayan Murthy the then Chief Mentor of Infosys Technologies Ltd., to further streamline the provisions of Clause 49. Based on the recommendations of the Committee SEBI revised some sections of the Clause in August 2003 and later once again after further deliberations in December 2003.

In October 2004, SEBI published a revised Clause 49, relating to corporate governance, which set forth a schedule for newly listed companies and those already listed to comply with the revisions. Major changes in the Clause included amendments /additions to provisions relating definition of independent directors, strengthening the responsibility of Audit Committees and requiring Boards to adopt a formal Code of Conduct. Later the date for compliance with these new provisions was extended to December 2005, since a large number of companies were unprepared to fully implement the changes.

In January 2006, SEBI issued some further clarifications on Clause 49 which included:

1. The maximum time gap between board meetings of listed companies to be increased from three to four months.

2. Sitting fees paid to non-executive directors would not require the previous approval of shareholders

3. Certifications of internal controls and internal control systems by CEOs and CFOs would cover financial reporting only. The revised Clause 49, came into effect on January 13, 2006.

Further amendments were made in some of the provisions of the Clause in July 2007 which dealt with quarterly reporting. SEBI made it optional for companies to either present an unaudited or audited quarterly result and year to date financial results to Stock Exchanges within one month from the end of each quarter. If the option is to present unaudited results then the results will be subject to limited review and the report will have to be submitted to SEs within two months from the end of the quarter.

Provisions under Clause 49 of the Listing Agreement

In its final form the Clause 49 of the Listing Agreement covered the following provisions regarding corporate governance by listed companies.

Mandatory Provisions

I. Board of Directors: Composition of the Board, Definition of Independent directors and proportion of Independent Directors in the total board strength, Compensation of non-executive directors and disclosures, Board meetings, Information to be made available to the Board, membership of Board level committees by the directors and Code of Conduct

II. Audit Committee: Its constitution, its meetings, role, powers and review of information ,

III. Subsidiary companies: Number of subsidiaries, review of financial statements of the subsidiaries by the holding company, transactions of the listed holding company with the subsidiaries and other related disclosures.

IV. Disclosures: These include a series of mandatory disclosures like basis of Related Party Transactions, Accounting treatment, Risk management,Utilization of proceeds of public issues, Remuneration of Directors, Management Discussion and Analysis Report in the company's Annual Report, setting up of Shareholders/Investors Grievances committee and other items to be reported to the shareholders.

V. CEO/CFO Certification: This certification relates to the review of financial statements and cash flow statements by the CFO, compliance with existing accounting standards, laws and regulations, responsibility for maintaining internal controls, etc.

VI. Separate Section in the Company's Annual Report on Corporate Governance.

VII. Compliance certificate from Auditors or practicing Company Secretaries

Non-mandatory Requirements

These included provisions regarding the following :

I. Tenure of Independent directors

II. Constitution of the Remuneration Committee

III. Declaration of Half-yearly Financial Performance including summary of significant events to be sent to shareholders' residences

IV. Progression towards a regime of Unqualified Financial Statements

V. Training of Board members in the business model and risk profile of business parameters of the company including their responsibilities.

VI. Evaluation of Non-executive Board members

VII. Whistle Blower Policy

To curb the recurrence of accounting scandals like the one at Satyam Computers, a panel of experts was set up at SEBI. This panel recommended:

i) Rotation of Audit Partners

ii) Selection of CFO by the company's Audit Committee

iii) Standardization of disclosure of earnings

iv) Streamlining the submission of financial results.

SEBI has amended the listing agreement to include the above recommendations. Since then SEBI issued several circulars relating to amendments regarding applicability and enforcement of corporate governance provisions.

Corporate Governance Voluntary Guidelines -2009

During India Corporate Week in December 2009, the Ministry of Corporate Affairs brought out a set of Voluntary Guidelines for improvement of corporate governance practices by the listed companies. The objective of the guidelines was to encourage the use of better governance practices through voluntary adoption. The Guidelines issued a series of recommendations elaborating the various mandatory and non-mandatory provisions of Clause 49 of the Listing Agreement and suggested that the companies could adopt them on a voluntary basis in order to further improve their governance practices. The major recommendations referred to:

I. Board of Directors : Appointment of Directors, Separation of offices of Chairman and CEO, Nomination Committee and maximum limit of directorships in public limited and private companies that are either holding or subsidiary companies of public companies.

II. Independent Directors: Attributes of Independent Directors and their certification of Independence, Tenure of Independent Directors (not more than six years).

III. Remuneration of Directors: Guiding principles relating to Remuneration of Directors including Non-Executive and Independent Directors suggested, which should link corporate and individual performance. Incentive schemes to be designed around appropriate performance benchmarks with rewards for materially improved company performance. Suitable balance between fixed and variable remuneration. Performance related component of remuneration to form significant proportion of the package. Remuneration policy for Board members and key executives to be announced

IV. Remuneration of Non-Executive and Independent Directors: Non-executive directors to be paid a fixed contractual remuneration subject to an appropriate ceiling and an appropriate percent of net profits of the company. Uniform remuneration for all Non-Executive Directors. Independent Directors to be paid adequate sitting fees depending on criteria of Net worth and Turnover. No stock options for Independent Directors so as not to compromise their independence.

V. Responsibilities of Remuneration Committee and Procedures relating to Annual Evaluation of Performance of Directors.

VI. Training of Directors: Through suitable methods to enrich their skills.

VII. Risk Management : Board to affirm and report the framework and oversee the system every six months.

VIII. Board Evaluation: Performance of Directors and Committees thereof to be evaluated.

IX. Audit Committee of the Board: More elaborations on the Powers, Role and Responsibilities of the Audit Committee

X. Appointment of Internal Auditors: Internal auditor should not be an employee of the company to ensure credibility and independence of the audit process.

XI. Certification of Independence from Auditors: Affirmation of arm's length relationship with the auditors

XII. Rotation of Audit Partners and Audit Firms: Audit partners every three years and Audit Firm every five years.

XIII. Secretarial Audit.

XIV. Institution of Mechanism for Whistle Blowing.

These guidelines are expected to serve as a benchmark for the corporate sector and would also help the sector in achieving the highest governance standards. Adoption of the guidelines would also translate into much higher level of stakeholder confidence which is crucial to ensure long term sustainability and value generation by businesses. These guidelines were very detailed and not all companies are known to have fully adopted these guidelines.

National Voluntary Guidelines for Social, Environmental and

Economic Responsibilities of Business – July, 2011

These form a refinement over the earlier 'Corporate Social Responsibility Voluntary Guidelines, 2009 and are designed for all businesses irrespective of size, sector or location.

The Guidelines have nine basic principles:

I. Businesses should conduct and govern themselves with Ethics, Transparency and Accountability

II. Businesses should provide goods and services that are safe and contribute to sustainability throughout their life cycles

III. Businesses should promote the wellbeing of all employees

IV. Businesses should respect the interests of and be responsible towards all stakeholders, especially those disadvantaged, vulnerable and marginalized

V. Businesses should respect and promote human rights

VI. Businesses should respect, protect and make efforts to restore the environment

VII. Businesses when influencing public and regulatory policy should do so in a responsible manner

VIII. Businesses should support inclusive growth and equitable development

IX. Businesses should engage with and provide value to their customers and consumers in a responsible manner

The Companies Act 1956

The Companies Act, 1956 provides the legal framework for corporate entities in India. The Act has made provisions for some aspects of corporate governance which include number, role, powers, duties and liabilities of directors and restrictions placed on them. Other provisions include number and frequency of board meetings, rights of minority shareholders, maintenance of books of accounts and development of accounting standards, audit obligations and report of auditors. Since 1956, as many as 24 amendments have been made in the Act providing statutory provisions relating to corporate governance.

Several major amendments had been proposed in the Companies (Amendment Bill) 2003. But their consideration has been held back in anticipation of a comprehensive review of the Company Law through a Consultative process. In view of the changes in the national and international economic environment and the expansion and growth of our economy the Central Govt. had decided to repeal the Companies Act 1956 and enact a new legislation to provide for renewed provisions to enable an accelerated growth of the economy. As a first step of the review a Concept Paper on Company law was drawn and put up on the electronic media for opinions and suggestions from all interested parties. The need was to bring about harmony between SEBI's Clause 49 provisions and those of corporate governance in the Company's Act.

J J Irani Committee

As a number of suggestions were received from various bodies on the Concept Paper, it was felt that these proposals should be evaluated by an expert committee. Hence in December 2004, a Committee was constituted under the chairmanship of Dr. J J Irani the then Director of Tata Sons. The objectives of the Committee were to address the changes in the national and international scenario facing listed companies, enable internationally accepted best practices and provide adequate flexibility for timely evolution of legal reforms in response to the changing business models. The report of the Committee was submitted in May, 2005.

The Companies Bill, 2008

On October 23, 2008, the Minister for Corporate Affairs, introduced the new Companies Bill, 2008 into the parliament. It was subsequently referred to the Department related Parliamentary Standing Committee on Finance for examination and report. The Bill sought to enable the corporate sector in India to operate in a regulatory environment of best international practices that foster entrepreneurship, investment and growth. A number of other improvements were proposed in the new bill including board meetings to be conducted through video conferencing and recognizing votes cast through e-mail.

Before the report could be submitted by the parliamentary committee the Loksabha was dissolved and the Bill lapsed. It was later reintroduced without any change in August, 2009. It was again referred to the Parliamentary Standing Committee on Finance for examination and report. The Committee gave its Report on Aug. 31, 2010. During the period Central Government had received several suggestions from various stakeholders for amendments in the Bill. The Parliamentary Committee had also made a large number of recommendations in its Report. In view of the large number of amendments proposed in the Companies Bill, the Central Government decided to withdraw the Companies Bill 2009 and introduce a freshBill the companies Amendment Bill 2011, incorporating all the recommendations.

The Companies Amendment Bill, 2011

After over six years, since the J J Irani Committee Report was submitted, the Companies Amendment Bill was tabled in the Parliament on Dec. 14, 2011. The Bill was vetted by Parliament's Standing Committee on Finance headed by former finance minister, Yashwant Sinha. The amendments in the Bill are aimed at strengthening governance in companies and enhancing transparency. The new Bill seeks to ensure greater board independence, higher levels of accountability through additional disclosure norms, facilitate raising of capital, protection of minority shareholders and setting up of a CSR Committee.

In brief the following amendments have been recommended:

I. Corporate Social Responsibility expenditure to be two percent of profit of last three years. A mandatory CSR committee.

II. Independent Directors to be appointed from a notified data bank containing names, addresses and qualifications of persons who are eligible. They can be appointed for two consecutive terms of five years each. A cooling off period of three years to be maintained before reappointment.

III. A Code of Conduct for Independent directors

IV. Independent Directors to give a declaration of independence every year.

V. No stock option for independent directors.

VI. An individual auditor can be appointed for one term of five years and an audit firm for two terms of five years. A cooling off period of five years before reappointment. Auditors are not to provide non-audit services

VII. An audit partner and his team may be changed every year by the company.

VIII. Incoming Audit Firm and Outgoing Audit Firm should not have common partners.

IX. An auditor should not hold any securities in the company or its subsidiaries or have any business interest with the company or be indebted to it or have a relative who is a director in the company.

X. Secretarial Audit – a practicing company secretary to report to the Board that the company has complied with all the requirements under the Companies Act as well as other laws applicable to the company.

XI. Companies to provide an exit option to minority shareholders who may disagree with the firm's decision to acquire a firm do a corporate or loan restructuring or diversify into unrelated business area.

Apart from reducing the number of sections drastically the Bill has also prescribed 33 new concepts and definitions. We have briefly discussed below the proposed amendments pertaining to Corporate Governance.

Preliminary

Some of the new definitions introduced refer to One Person Company, An Associate Company, Small Company, Employee Stock Option, Promoter, Related Party, Turnover, Chief Executive Officer, Chief Financial Officer, and Global Depository Receipt.

Matters relating to Incorporation of a Company

Declaration by the Director: Within this list of amendments, the major one is the declaration by a director in a prescribed form that the subscribers have paid the value of shares agreed to be paid by them and a confirmation that the company has filed a verification of its Registered Office with the Registrar.

Exit Option for Minority Shareholders: A company which has raised money from public through a prospectus and has an unutilized amount out of the money so raised, shall not change its objects unless a special resolution is passed and other requirements of advertisements are complied with. The company has to give an exit opportunity to dissenting shareholders and other investors if they are not agreeable with the company's diversification plans, acquisition of another firm, or a corporate or loan restructuring plan or proposals for transfer or sale of the existing business. The provision attempts to address typical issues in Indian companies where promoters holding majority of the shareholding generally ignore the voice of minority shareholders in some of their major corporate decisions. This amendment is now expected to give a greater say to the minority shareholders in the company's business plans, many of which presently have the freedom and flexibility to buy, sell or merge and demerge businesses.

This is a minority investor friendly move but may prove to be cumbersome for the companies. The minority investors who wish to exit would not be simply selling their shares in the open market but could demand a specific option more on the lines of a buyback or a delisting offer. Companies going through financial pressures and intending to sell their assets to raise funds may not be able to offer exit options to dissenting minority shareholders. Again if this is done the prevailing norm of 25 percent public holding of equity for listed companies may be difficult to comply with given the exit options.

Prospectus and Allotment of Securities

The Bill governs the issue of all types of securities. Under the Companies Act, 1956, only shares and debentures were covered. The Bill has included provisions which apply to public offer, private placement or issue by way of bonus or rights issue.

Share Capital and Debentures

Certain provisions have been included which relate to further issue of shares for increasing the subscribed paid up capital, voting power of preference shareholders, issue of bonus shares, buyback of shares, offer of shares to employees by way of ESOPs, etc. The scope of the section relating to transfer and transmission of securities has also been widened to include all types of securities. All these provisions will help the regulators in monitoring the entire paid up share capital of the company and also assess the number of shares held by various categories of shareholders and their voting power.

Management and Administration

Additional Information to be provided in the Annual Returns: The annual returns of the company have been elaborated to include additional information like particulars of its holdings and subsidiary and associate companies. It should also include changes in the number of shares held by promoters and top ten shareholders of the company and matters relating to certification of compliances, disclosures, remuneration of directors and key managerial personnel. In case of companies with prescribed paid up capital and turnover, certification of annual return by a practicing company secretary has been made mandatory. These provisions will bring in greater transparency relating to shareholding by promoters and majority shareholders. Disclosures relating to key financial outflows of the company would help in monitoring them more effectively.

Accounts of Companies

Scope of Directors' Report Widened: The Bill recognizes that books of accounts may be kept in electronic form. Balance Sheet and Profit & Loss Account have been defined collectively as Financial Statements. Along with financial statements, consolidated financial statements of all subsidiaries and associate companies shall be prepared and laid before the AGM. This disclosure of consolidated financial statements will bring to light all transactions done by the listed company with its subsidiaries and give an opportunity to minority shareholders to question suspect dealings with the associate companies. The scope of the Directors' Report has been widened to include additional information like number of board meetings, policy of the company relating to appointment of directors and their remuneration, explanation or comments by the board on every qualification, reservation or remark or disclaimer made by the company secretary in the Secretarial Audit Report, particulars relating to loans, guarantees, investments, etc. The Directors' Responsibility Statement in case of a listed company should include additional statement relating to internal financial controls and Compliance of all applicable laws. These provisions have placed greater responsibility on the directors in the areas of loans and investments, appointment of directors and their remunerations, explanations with regard to audit qualifications, and commitment on internal controls and compliance with all types of regulations. Directors' Report and Directors' Responsibility Statement being part of the published annual report will make all the shareholders aware of the decisions taken by the board in these key areas of governance and any shortcoming can be challenged by the shareholders and investors.

Corporate Social Responsibility: Every company having a net worth of Rs. 500 crore or more or turnover of Rs. 1,000 crore or more or a net profit of Rs. 5.0 crore shall constitute a Corporate Social Responsibility Committee of the Board consisting of three or more directors (at least one being an independent director). The committee will

recommend the CSR policy of the Board. The Board of every such company must ensure that in every financial year the company spends at least two percent of the average net profit of the company made during the three immediately preceding financial years in pursuance of the CSR policy. Failure to do so needs to be reported with reasons thereof in the Directors' report. This move to make CSR compulsory for certain high net worth companies will ensure that this function of giving back to the Society is taken more seriously and made sustainable by the promoters and directors of the company . Earlier it was treated as a mere compulsion with some funds channelized in this direction. With the passing of the Bill there will be a commitment to ensure that a certain percentage of profits flow into CSR activities every year. This is an excellent provision in the direction of inclusive growth and social sector reforms.

Audit and Auditors

Rotation of Auditors and Audit firms: The Bill provides for compulsory rotation of individual auditors every five years and of audit firm every ten years for listed and certain other class of companies. A transition period of three years has been provided to comply with this provision.

Prescription of Auditing Standards: Central Govt. will prescribe the auditing standards as recommended by the Institute of Chartered Accountants in consultation with the National Financial Reporting Authority.

Responsibilities of Auditors: Auditors have to comply with auditing standards. Certain new provisions for disqualification of auditors have also been prescribed. Partner or partners of the audit firm and the firm shall be jointly and severally responsible for the liability, whether civil or criminal as provided in the Act or any other law. If any fraudulent practice civil or criminal, by the auditors is proved the Audit partner/partners and the firm are punishable. The prescriptions for Auditors and their compulsory rotation every five years together with compliance to auditing standards recommended by Institute of Chartered Accountants of India, will ensure complete transparency in the internal workings of companies in order to avoid any future Satyam like scams.

Appointment and Qualification of Directors

Appointment of Independent Directors (IDs): One of the major criticisms of the current policy of appointment of Independent Directors is that the promoters exert tremendous influence in determining and appointing Independent Directors. This issue has been addressed by making it mandatory for all listed and certain other class of companies to constitute a Nomination and Remuneration committee consisting of three or more Non- Executive Directors of which not less than half should be Independent

Directors. The Committee has to consider candidates for appointments as IDs and recommend them to the Board. The Bill also proposes the formation of a Databank of IDs from which suitable persons may be selected. This is expected to bring in greater objectivity in to the process of nomination of IDs and preclude the influence of promoters on them. The Bill prescribes that at least one-third of the directors on the Board should be IDs. This is a departure from the prevailing norms wherein half the directors had to be independent in case the company has an Executive Chairman or he is related to the promoter of the company. This represents a dilution from the existing position. The Bill also provides for at least one woman director on the Board.

The definition of an ID has been considerably tightened: The definition now includes positive attributes of independence namely that the Director should be a person of integrity and possess relevant expertise and experience in the opinion of the Board. Central govt. is also vested with powers to prescribe qualifications of IDs. Every ID is required to declare that he or she meets the criteria of independence. Participation of minority shareholders in the appointment of IDs has been kept non-mandatory.

Directorship in not more than 20 companies: The number of companies in which a person can be a director has been increased from 15 to 20. Of the 20, he cannot become a director in more than 10 companies.

Role and Functions: Section IV of the Bill lays down the code which sets out the role functions and duties of the IDs and also those relating to their appointment, resignation and evaluation. These prescriptions make the role of the IDs quite onerous and could enhance the level of monitoring of the listed companies which is so crucial for good governance practices.

Liability of the IDs: The Bill limits the liability of the ID only in respect of acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes and with his consent or connivance or where he had not acted diligently.

Remuneration: In a break from the earlier norms, an ID is entitled only to fees for attending meetings of the boards and possibly commissions within certain limits. The Bill expressly disallows IDs from obtaining stock options. Companies may find it difficult to get directors of the requisite caliber unless they are appropriately remunerated.

Tenure: To ensure that IDs maintain their independence, the term of their tenure has been prescribed. The initial term is prescribed as five years following which further appointment would require a special shareholder resolution. The total tenure shall not exceed two consecutive terms. All the provisions relating to IDs, their appointment procedures, their liabilities, tenure, role and functions are in the right direction and place greater responsibilities on the Ids which was very vital for ensuring greater board independence. Limiting the liabilities of IDs to acts which have occurred with his knowledge or in his presence, provides a safeguard mechanism for the ID who need not be held liable for all Board decisions, even those taken without his presence. Mandatory constitution of Nomination and Remuneration Committee, Stakeholders Relationship Committee and CSR Committee means that the IDs and Non-executive Directors would be more involved in the operations of the company and would have to take greater interest in the appointment of Directors and key management personnel. They will also have to be more engaged with all the stakeholders and resolve grievances of all security holders.

Audit Committee: Composition of the Audit Committee has been changed. The committee shall now comprise of three minimum directors, majority of them being Independent Directors. Majority of them should also be having the ability to read and understand financial statements.

Vigilance Mechanism : Every listed company and such other class of companies shall have a vigilance mechanism in the prescribed manner.

Stakeholders Relationship Committee: Every company which has more than 1000 shareholders, debenture holders or deposit holders shall constitute a Stakeholders Relationship committee consisting of a Chairman who is a non-executive Director and such others as may be decided by the Board.

Disclosure of Interest by a Director: This has been made mandatory and not discretionary as was there in the Companies Act of 1956. Even in case of a Private Company an interested director cannot vote or take part in the discussions relating to any matter in which he is interested.

Investments by a company: A Company, unless otherwise prescribed, shall not make investments through more than two layers of investment companies subject to certain exemptions.

Related Party Transactions: No approval of Central Govt. is required for entering into any elated party transactions. No approval of Central govt. is required for appointment of any director, or any other person to any office or place of profit in the company or its subsidiary.

Certain new Related Party Transactions are provided in the Bill which requires approval of the Board. The Bill provides for certain new matters which are to be transacted by the Directors at their Board meetings only.

Insider Trading: The Act already had a provision relating to prohibition on forward dealing in securities of the company by a director or key management personnel. The Bill now provides the provisions for prohibiting insider trading in the company. All these provisions are aimed at strengthening the supervision mechanism of the company by the regulators, strengthening the powers of the Board especially the Ids and above all prohibiting fraudulent transactions with related parties for which the Board is made responsible.

Appointment and Remuneration of Managerial Personnel

Managing Director/Whole Time Director/Manager: These appointments have to be approved by a General Meeting by special resolution instead of ordinary resolution. The Bill provides for provision related to Secretarial Audit in certain prescribed companies and also prescribes the functions of the Company Secretary. This ensures greater involvement of shareholders in key appointments on the Board and management.

Inspection, Inquiry and Investigation

Central govt. will set up a Serious Fraud Investigation Office (SFIO) for investigation of frauds relating to a company. The affairs of a Related Company can also be investigated by the inspector. If a fraud is reported Central govt. is empowered to file an application to the Tribunal for appropriate disgorgement of such assets, property or cash and for holding of such director, key management personnel, officer or other person liable personally without any limitation of liability. SIFO however can act if and when someone has lodged a complaint or someone has initiated an enquiry.

Corporate Governance Rating

Rating of practices of Corporate Governance and Value Creation for its Stakeholders is being carried out by leading Rating Agencies like CRISIL. This type of rating helps the companies greatly as an unbiased evaluation of the company's corporate governance practices is carried out by an outside and reputed agency and an appropriate Rating Certificate is given. The Company can use this certificate for raising finance from the market as well as from

Chapter 3 – *Methodology*

The primary objective of the study is to investigate the corporate governance practices in to be listed SMEs in Pune region who are in the process of preparation of listing of their shares in Stock Exchanges. The investigators adopted **exploratory research method** for the investigation with emphasis on primary data collected using questionnaire and interviews.

Being SME's and the transition from proprietary way of management to Governance regulations being a challenge particularly when regulations for listing of shares between upcoming SME's and large listed corporations are no different. Cost and quick conversion is known to be not possible and hence the scope of the study was only to review the steps taken, its adequacy, reason for resistance to certain regulations etc.

Scope is also limited to compliance of the present requirements of the listing agreement with Stock Exchanges and in particular clause 49 of the same. Clauses cited hereunder against each of the issues covered are only the major pointers of the clauses of the Listing agreement which to be listed companies are expected to meet on listing. The newly introduced Corporate Governance practices under the Companies Act 2013 is out of scope of this study as the visits to the units were made before the new law was enacted.

Sample Size and Distribution

The investigators set a sample size of 16 SMEs which satisfied the requirements for the study. Among the 16 companies, 12 companies were pertaining to manufacturing sector while 4 companies were representing real estate sector. IT and Services industries were also included as a category but the investigators did not find companies fitting the research criteria for the aforementioned sectors. The investigators have not mentioned the names of the companies confirming to the confidentiality request made by the target companies.

Parameters for Evaluation

The researchers identified the following parameters for analysis

Private Equity Fund Association

The need for better corporate governance practices have stemmed from the nature of source of capital. Globalization and cross border trade have opened a new channel for flow of capital. Private capital has today become an important source of funds for investment. Private Equity firms not only act as financial investors but also occasionally guide companies on operational matters like human resource management, diversification, business focus etc. The infusion of private equity would enhance the access to capital for the company. In addition the private equity players will be vigilant on the business moves and business evolution of the company.

The investigators categorized the PE fund into two categories for this study. 1. Short term PE fund, the duration of which was less than 3 years and 2. Long term PE fund, the duration of which was greater than 3 years.

Independent Directors [Clause 49(I) (B)]

The Listing Agreement, clause 49(I)(A)(i) strives for optimum combination of executive and non-executive directors, with at least half of the board comprising of nonexecutive directors. However the minimum number of independent director varies in accordance with chairman on board. In the event of the chairman holding an executive position in the company, at least one half of the board should consist of independent directors, and where the chairman is in a non-executive capacity, at least one third of the board should consist of independent directors (*Id.*, clause 49(I)(A)(ii)). Independent directors have become an integral part of corporate governance framework. Independent directors were introduced voluntarily as a measure of good governance in the United States (U.S.) in the 1950s before they were mandated by law. An independent director is defined as a non-executive director who: apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries (clause 49(I)(A)(iii)(a)). The governance reforms under the Kumar Mangalam Birla Committee highlighted the relationship between investor perception and corporate governance. A temporal frame of 2 days from 7 may 1999 witnessed a share price increase of 4 % of the firms who intended to inculcate corporate governance reforms (Varottil, U. (2010))[4]. This widely established the investor confidence on corporate governance which they perceived to limit the independence of the directors.

The investigators classified the number of independent directors into two categories for this study. 1. Number of independent directors was 2, and 2. Number of independent directors was more than 2.

Board Meetings [Annexure 1A of clause 49]

Directors are, however, required to ensure some minimum commitment towards boards on which they sit. Companies are required to have at least four board meetings a year (*Id.*, clause 49(I)(C)(i)). Apart from that, there may be meetings of various committees of the board that directors are required to attend if they are members of such committees. Towards that end, there are maximum limits as to the number of boards and committees on which independent directors can sit. An independent director cannot be a member of

[4] Varottil, U. (2010). Evolution and Effectiveness of Independent Directors in Indian Corporate Governance. *Hastings Business Law Journal*, *6*(2), 281.

more than 10 committees or act as chairman of more than 5 committees across all companies (*Id.*, clause 49(I)(C)(ii)). This is to ensure that the director is not so busy as to be unable to devote sufficient time and attention towards responsibilities in each company[2].

The investigators classified the number of board meeting into two categories for this study. 1. Number of board meetings conducted was 4 per year, and 2. Number of board meetings conducted was more than 4 per year.

Audit Committee [Clause 49(II)]

The Companies Act; Clause 49 (II) mandates formation of an audit committee with minimum three directors with independent directors forming the majority. The audit committee has the following responsibilities:

(i) Recommendation for appointment, remuneration and terms of appointment of auditors of the company

(ii) Review and monitor the auditor's independence and performance, and effectiveness of audit process

(iii) Examination of the financial statement and the auditors report

(iv) Approval or any subsequent modification of transactions of the company with related parties

(v) Scrutiny of inter-corporate loans and investments

(vi) Valuation of undertakings or assets of the company, wherever it is necessary

(vii) Evaluation of internal financial controls and risk management systems

(viii) Monitoring the end use of funds raised through public offers and related matters

The investigators noted the presence of audit committee in the target companies

Transparency and Disclosures [Clause 36 & 46]

Disclosures and Transparency require timely and accurate disclosures on all material matters relating to the corporation including financial performance, ownership and governance[3]. Foreign investors attach a great deal of importance to transparency in the balance sheets especially with regard to remunerations. Disclosure of remuneration of nonexecutive and independent directors is mandatory but some companies voluntarily disclose more details like the fixed component as well as the performance related component of the total remunerations, as suggested under Voluntary Guidelines issued by the Ministry of Corporate Affairs, Government of India (NFCG report)[5]. Disclosures in the annual reports, aimed at sharing more information with the shareholders and investors which reflects a higher degree of transparency in the balance sheets has also had a positive influence on the financial performance in terms of higher Market Capitalization and Tobin's Q (NFCG report)[3].

The investigators noted the presence of transparency and disclosure mechanisms in the target companies

Internal Audit [Clause 49(IV), Annexure IC to Cl.49, Clause 49(1)(d) sub clauses 6, 7, 8, & 9]

Internal audit mechanisms periodically check the efficacy of the governance system thereby leading to more transparency. Presence of internal audit boosts investors confidence (both foreign and domestic).

[5] Corporate Governance Practices and Financial Performance of Selected Family Managed Medium Sized listed Companies in India - By SPJIMR, 2012

The investigators noted the presence of internal audit mechanism in the target companies

In addition to aforementioned important parameters, the investigators also considered the following additional parameters to assess holistically the status of corporate governances in the target companies under study.

- *Statutory Auditors [Clause 49(1) (d) sub clauses 2, 3, 4, 6, & 10]*
- *Investment Bank / Merchant banker association [Clause 23, 24 (c), 24 (d) (ii)]*
- *Growth sustainability exercise [Clause 36]*
- *Succession Planning [Clause 36 r w responsibilities of board in Annexure 1A to clause 49 r w principle VI (D) (3) of OECD principles of Corporate Governance]*
- *Industry*
- *CEO category*
- *Professional CA CS association [Clause 47 and 49(v)]*
- *Employee participation in Governance*

Chapter 4 – *Observations*

CEO Category & Presence of CA/CS

The investigators observed that out of 16 companies, 12 companies had promoters as their CEO. On the other hand only 9 companies were found to have a professional CA/CS association

Expected: The CEO shall be one totally understanding the business and being SME normally is the promoter who started the business but expect certain important functions of the business be delegated to independent professionals who are experts in the subject.

Like: Marketing (for scaling the business), Production (for meeting marketing needs), Finance (for exploring all sources of finance, disclosures, internal controls etc) Legal and Company Secretarial for regulatory compliance requirements.

Association of CA and CS is to meet compliance and controls requirements and assist the Independent Directors and Audit committee in their due discharge of their responsibilities.

Actual: Though it was noted that except in a few cases the CEO job is retained by the promoters. However delegation of certain core functions like Finance, Marketing and Legal have been delegated to professionals by appointing them. In certain cases though CA or CS have not been taken in the company, professional CA or CS have been retained for rendering the services on the ground that full time appointment is not only expensive but full time work for such professionals have not yet arisen and may happen only after listing and reasonable scaling of the activity of the company.

Material Deviations: No material deviations have been noticed as the SME's are yet to be listed but have taken steps to meet requirements well in advance.

PE Fund

The investigators found that 4 companies out of 16 had long term PE funds (greater than 3 years) on the other hand 12 companies had short term PE fund (less than 3 years)

Expectations: PE funding is generally seen as a first step to listing of the shares. Their evaluations and association helps in inculcating the good and transparent governance practices required to meet the listing requirements on Corporate Governance.

Actual: PE funding had created an atmosphere of professionalism in the organization and at least in the approach of the promoter group. Their exit routes generally being through the listing process, steps to get the shares listed is also an agenda of the SME's as stipulated by the PE Funds. Though in certain cases where such stipulations do not exist also, better transparency and regular board meets and approvals process and documentations have improved.

Material deviations: No material deviations were noticed

Independent Directors [Clause 49(I) (B)]

The investigators found that 4 companies out of 16 had more than 2 independent directors. 12 out of 16 companies had 2 independent directors.

Expectations: To evaluate whether the SME's have come out of the old system of closed governance to actual participation in meetings along with the Independent Directors who are unrelated to the promoters.

Actual: Though on record Independent Directors have been taken, but are mostly technical or marketing personnel who are experts who could contribute in the growth of the business.

Material deviations: Complete details are unavailable to evaluate the independence of the Independence Director. However such appointments itself is a step towards better transparency and governance.

Board Meetings [Annexure 1A of clause 49]

The investigators found that all the 16 companies conducted 4 board meetings a year.

Expectations: To evaluate whether actual meeting of the members of the board happen and whether papers and transparency exist, deliberations and discussions happen on crucial issues and decisions are taken considering all aspects. Also to ensure whether board papers are prepared in advance and proper recording of the proceedings are done. Also to evaluate how many such meetings happen every year

Actual: From the information gathered and explanations given it was noted that due to the presence of PE Fund representatives and Independent Directors intake crucial decisions, actual meetings are held, sometimes even more than the statutory minimum of 4 meetings in a year happen, papers are distributed 7 days in advance to the members attending the board meet and proper recordings are made by way of minutes, as per law.

Material deviations: No material deviations have been noticed but scope to improve could not be ascertained.

Audit Committee [Clause 49(II)]

The investigators found that all 16 companies had established an audit committee.

Expectations: To evaluate whether Independent Director heads the Audit committee, all important financial statements like quarterly results etc. are first reviewed and then sent to the Board for their approval. Also whether the terms of reference for appointment of the Internal Auditors are reviewed and discussed at Audit Committee meetings.

Actual: Though the committee is formed complete functions of the Audit Committee of a listed company is not being followed, Improvements are being made to reduce the burden of the Board in taking the decisions. Interactions with Internal Auditor, CFO, CS, Professionals etc are seen happening by way of Governance improvements.

Material Deviations: Steps in the right direction have been taken though the scope is known to increase after listing of the shares.

Transparency and Disclosures [Clause 36 & 46]

The investigators found sufficient mechanisms for transparency and disclosures in 4 out of 16 companies. The remaining 12 companies need to do more for improving transparency and disclosure.

Expectations: Whether actual documentations and less of verbal discussions happen to reduce differences and helps participation in the organization. Proper communication channels are in place to communicate to the concerned. This is expected to improve Governance standards.

Actual: In most cases due to the implementation of the technology and computer setups and emails, transparency and disclosures are improving. More disclosures are to meet compliances. Scope to improve communications always exists, which are being addressed.

Material Deviations: No material deviations have been observed

Internal Audit [Clause 49(IV), Annexure IC to Cl.49, Clause 49(1)(d) sub clauses 6, 7, 8, & 9]

The investigators noticed an absence of internal audit system in 4 companies out of 16.

Expectations: Purpose was to evaluate whether competent personnel is conducting the Internal Audit. Also whether their terms of reference cover important control areas and exposure of weaknesses and their reports and suggestions are considered by competent personnel for implementation.

Actual: Though the Internal audits are conducted and sometimes by audit firms who charge less as the cost factor is also considered. Whether the purposes are achieved are not in full is unascertainable.

Material deviations: More of compliance than improving governance standards has been observed.

Statutory Auditors [Clause 49(1) (d) sub clauses 2, 3, 4, 6, & 10]

Expectations: To review whether in the expectation of going for listing whether the companies have even considered reputed Statutory Auditors including the big 4 firms.

Actual: In most cases no such changes were noticed. In some cases where PE fund investments have taken place, Auditors change has happened and in one case even from the big 4 is chosen.

Material deviations: Cost and benefit analysis do not permit such changes immediately and hence can only expected to improve after scaling and listing of the company shares.

Investment Bank / Merchant banker association [Clause 23, 24 (c), 24 (d) (ii)]

4 companies out of 16 reported Investment bank association.

Expectations: This aspect was to evaluate whether there is a scope for immediate listing of the company's shares and whether preparation to meet requirements of listing has started or not.

Actual: In most cases except a few, no association of the Investment / Merchant Banker has taken place. But all of the units are aware of such association before the listing and hence are getting prepared for such association.

Material Deviations: Too early to evaluate.

Growth sustainability exercise [Clause 36]

12 out of 16 companies were actively involved in growth sustainability excercises.

Expectations: This aspect was to evaluate whether the scope for scaling and sustainability for a long time exist in the organizations. Also to evaluate the capability of scaling beyond the funding part.

Actual: All the companies are start ups and / or of young age with lot of drive and competence of the promoters who understand the business. Scaling scope is seen mostly within the country but less on exports and international trade or services. Growth and sustainability scope exist.

Material Deviations: No deviations were observed

Industry

12 companies were from manufacturing industry and 4 companies were form real estate industry

Expectations: This was to evaluate whether any specific difficulty or hindrance for any specific sector of the business. Manufacturing, Real Estate, IT Services etc were in the survey list.

Actual: Sector wise specific problems were not observed. In all cases the general observation is inability to satisfy the mismatch between cost of compliance and the benefit from such compliances by listing the shares.

Succession Planning [Clause 36 r w responsibilities of board in Annexure 1A to clause 49 r w principle VI (D) (3) of OECD principles of Corporate Governance]

4 out of 16 companies had given a thought for succession planning.

Expectations: This was to evaluate whether the organization has even thought of a succession plan of the CEO as it is material for sustainability and governance.

Actual: Majority of the organizations have never thought of such eventualities.

Material Deviations: There is scope for education and training of the promoters to understand the benefits from such planning process.

Over all the results show that all the companies the investigators interviewed were sincere in their efforts for compliance to meet listing standards. The investigators also observed minimal material deviation in the key corporate governance parameters.

Sr No	Parameters		SME 1	SME 2	SME 3	SME 4	SME 5	SME 6	SME 7	SME 8	SME 9	SME 10	SME 11	SME 12	SME 13	SME 14	SME 15	SME 16
1	CEO Category	1. Promoter 2. Non-Promoter	1	2	1	1	1	2	1	1	1	2	1	1	1	2	1	1
2	PE Fund	3. Short term (< 3 yrs) 4. Long term (> 3 yrs)	3	4	3	3	3	4	3	3	3	4	3	3	3	4	3	3
3	Independent Director	5. Equal to 2 6. More than 2	6	5	5	5	6	5	5	5	6	5	5	5	6	5	5	5
4	Number of Board Meetings per Year	7. Equal to 4 8. More than 4	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7	7
5	Audit Committee	9. Yes 10. No	9	9	9	9	9	9	9	9	9	9	9	9	9	9	9	9
6	Transparency & Disclosure	11. Sufficient 12. More improvements required	12	11	12	12	12	11	12	12	12	11	12	12	12	11	12	12
7	Internal Audit	13. Yes 14. No	13	13	14	13	13	13	14	13	13	13	14	13	13	13	14	13
8	Employee Participation	15. Yes 16. No	15	16	15	16	15	16	15	16	15	16	15	16	15	16	15	16

9	Big 4 Auditors Association	17. Yes 18.No	18	17	18	18	18	17	18	18	18	17	18	18	18	17	18	18
10	Investment Banker Association	19. Yes 20. No	19	20	20	20	19	20	20	20	19	20	20	20	19	20	20	20
11	Growth Sustainability Exercise	1. Yes 2. No	1	1	2	1	1	1	2	1	1	1	2	1	1	1	2	1
12	Industry Category	21. Manufacturing ; 22. Services; 23. Real Estate; 24. IT/ITES	21	21	21	23	21	21	21	23	21	21	21	23	21	21	21	23
13	Professional CA/CS Association	25. Yes 26. No	25	25	26	26	25	25	26	26	25	25	26	26	25	25	26	26
14	Related Party Transaction	27. Yes 28. No	28	28	27	28	28	28	27	28	28	28	27	28	28	28	27	28
15	Succession Planning	29. Yes 30. No	30	30	29	30	30	30	29	30	30	30	29	30	30	30	29	30

Chapter 5 – *Recommendations*

These recommendations are based on observations during the assessment of several SME's who are planning and / or in the process of getting their shares listed in SME exchange.

The following are the recommendations for improving the existing environment for SMEs

Cost of raising capital

The cost of raising capital for SME is high. This is a discouragement for any step towards listing by SME's. Hence they prefer borrowings as a tool to financing against capital raising. SEBI regulations including Merchant Bankers fees, issue procedures and cost of prospectus etc are so high a major expenditure goes away from the raised capital. No special concessions for SME's to reduce cost exist.

Incentives to get IPR to be provided

SME's are in the same level of getting IPR's with large organizations and is becoming a discouragement for their attempt to get IPR's which only will enable them to scale their operations. Special incentive and removal of regulatory hurdles to encourage more IPR's for SME's is necessary for their value creation and encouragement to raise capital by listing.

Tax incentive for retention of earnings needs to be extended

Tax burden for partnerships in retained earnings as compared to Corporate SME's are much less acting as a deterrent to convert to listed companies. Corporate Tax and dividend distributions tax taken together is high and a deterrent to development of SME's and their listing.

Employment generation and skill training provided by SME has to be subsidized

It is recognized that better skill development and training ground for youngsters are SME's and are always known for creating skilled employment. No special incentive for such contribution to national cause is recognized by way of incentive, which is necessary as an encouragement for SME's and their listing to capitalise on value created by such incentives.

Regulatory compliance need to be eased for SME

Even the recently introduced Companies Act 2013 do not list any incentive from strict regulatory hurdles for SME's as compared to a large listed company form Corporate Governance compliance requirements making costs prohibitive for SME's to only adhere to the compliance.

Compulsory Government. procurement from listed SME's need encouragement

Government procurement and / or large private sector procurement from SME's need encouragement by way of compulsory thresholds (%) to encourage large enterprises to outsource and build SMEs. Separate thresholds for listed and unlisted SMEs will further encourage listings.

Thin capitalization rules and interest cap will encourage SME listings

SME's generally reinvest their initial earnings back to the business and discourage distribution of dividends which is a deterrent to listing as retail shareholders do not participate in such investments . Long term value creation is less on the agenda of the retail investors. Interest cap for unlisted SME's / Partnerships say Interest as % of EBIT will encourage SME listings by raising capital, which may European countries have successfully done through thin capitalization rules.

CG exemption for SME shares need improvement over large companies

Presently Income Tax on Capital Gains of listed companies large or SME is same and no incentive exists for an investor to participate in SME capital. Special incentive for SME capital gains tax both short term and long terms is required.

MAT rules for SME's need to be different

Minimum Alternate Tax applicable for corporates apply equally for SME's which has to be different if the government is serious of promoting SME listings. Say exemption for first 5 years from listing etc will be encouraging.

All barriers for high cost of doing business to be brought down

Basic problem for SME's are their high cost of doing business and their lesser capacity to absorb compliance costs and deal with red tape. Any incentive which will result in reducing their cost of doing business will be an encouragement for many more SME's going for raising capital and rely less on borrowed capital. If compliance is a necessity and effective it has to be affordable or else the compliance will be in letter and not spirit and entire objective of such regulation get defeated.

Recommendations for enhancing Corporate Governance practices for to be listed SMEs

There is a need for in depth training programs for promoters and CEOs of the SMEs for them to have in depth knowledge to set parameters before selection of

1) Independent Directors,

2) Internal Audit, and

3) Merchant Bankers.

This will facilitate them in taking right decisions for better corporate governance practices after listing.

Annexure I - *Organizations associated with MSMEs*

Small Industries Development Organisation (SIDO),

Small Scale Industries Board (SSIB),

National Small Industries Corporation Ltd. (NSIC),

Confederation of Indian Industry (CII),

Federation of Indian Chamber of Commerce and Industry (FICCI),

PHD Chamber of Commerce and Industry (PHDCCI),

Associated Chamber of Commerce and Industry of India (ASSOCHAM),

Federation of Indian Exporters Organisation (FIEO),

World Association for Small and Medium Enterprises (WASME),

Federation of Associations of Small Industries of India (FASII),

Consortium of Women Entrepreneurs of India (CWEI),

Laghu Udyog Bharti (LUB), Indian Council of Small Industries (ICSI),

Indian Institute of Entrepreneurship (IIE),

National Institute of Small-Industry Extension Training (NISIET),

National Backward Caste Finance Development Corporation (NBCFDC),

National Institute for Entrepreneurship and Small Business Development (NIESBUD),

Small Entrepreneurs Promotion and Training Institute (SEPTI),

Small Industries Development Bank of India (SIDBI)