More must be done to prevent false disclosures

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The statements made by a company (whether private, listed, or unlisted) in its financial disclosures form the backbone of corporate governance. These disclosures provide valuable insights into the financial health of a corporation, and give existing shareholders, creditors and prospective investors a clear idea about its performance and its position in the market.

The listing agreement and the Companies Act, 1956, require financial disclosures to be made by companies on a regular basis. This article describes some of the existing provisions aimed at preventing false statements in financial disclosures by a listed company, and also considers issues and problems in enforcement.

Clause 41 of the listing agreement describes the method by which financial results should be prepared and submitted. It gives companies the option to furnish audited or unaudited quarterly and year-to-date financial results to the stock exchange within one month from the end of each quarter.

Where unaudited accounts are furnished, the clause imposes certain other conditions; audited accounts must be accompanied by the audit report. Further, the managing director and the other key employees are supposed to sign off on the financial statements to confirm their authenticity. Clearly, several checks and balances are contained in the various sub-provisions of the listing agreement, as well as other applicable laws.

In addition, the act stipulates that the books of account must reflect a "true and fair view" of the state of the company at the end of each financial year. Though the expression "true and fair view" has not been defined in the act, it is interpreted to mean that the financial statements should not give a misleading impression. It is also important that the information laid out in financial reports meets commonly accepted accounting standards. Failure to comply with these requirements exposes the company managing director, and other key employees responsible for the non-compliance, to the risk of monetary and penal sanctions.

To discourage corporate managers from abusing or falsifying companies' accounts, Indian legislators have included sanctions under various provisions of the Indian Penal Code. Sanctions for cheating, criminal breach of trust, and fraud include fines and imprisonment, which may be imposed in combination.

The Satyam scandal has attracted global attention on account of its magnitude. Unfortunately, it is fair to assume that there are several similar, and potentially explosive instances of fiscal falsification waiting to be discovered. Statutory provisions to combat fraud are in abundance; the measures outlined above are only a small part of what the law provides in this regard. In India, the key issue is not a lack of law, but a lack of enforcement. Why is this the case?

Firstly, systematic corporate governance is a recent phenomenon in India, its framework having been established only a decade ago. The recommendations of the Securities and Exchange Board of India's Kumar Mangalam Birla Committee on Corporate Governance, released in December 1999, formed the basis for Clause 49 of the listing agreement, which is the cornerstone of corporate governance for listed companies.

A second factor is the prevailing and profound lack of coordination between key government departments and regulators. The Irani Report, on which the new Companies Act will be based, puts it succinctly: "Sometimes, various agencies pursue action in their respective domains without regard to the comprehensive picture. This results in overlap of jurisdiction or regulatory gaps. There is a need to bring about coordination in the role and action of various regulatory agencies to enable effective investor protection."

Thirdly, the mindset of the whole corporate community in relation to independence and rigour in financial reporting needs to undergo a dramatic change. Without this change no enforcement will be effective. Legislators can enact more laws, and company promoters, shareholders and boards can establish as many monitoring committees as they want, but without a significant shift in the attitude of the corporate managers who are responsible for financial reporting, all such measures will be in vain.

A fourth factor is that most unlisted companies are closely held family enterprises that do not see the need for transparency; as a result, honest disclosures are uncommon. Friendships between senior company officers and the auditors give leverage for manipulation, and that is true even for listed companies.

Finally, minority shareholders should be given more "teeth" under the law. Pursuant to Clause 32 of the listing agreement, minority shareholders have a right to a copy of the complete and full balance sheet, profit and loss account and the directors' report. While they do have a judicial remedy in the event of mismanagement or falsification of fiscal statements, the burden of proof is prohibitively onerous.

Overall it is clear that the need of the hour in corporate governance is for transparency, effective monitoring, an overhaul of implementation mechanics, controls over shareholder actions and a speedier judicial system.

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