Corporate governance: Changing regulatory scenario and the role of the independent director
Foreword

The regulatory environment in India around corporate governance is changing rapidly and those entrusted with governance, i.e., the Board of Directors and the Audit Committee are being made responsible for the prevention and detection of fraud. The government has recently undertaken various measures to replace the Companies Act 1956 with a more stringent Companies Bill 2011 to clearly outline the duties and responsibilities of independent directors. In the wake of this, Ernst & Young’s Fraud Investigation and Dispute Services practice has come up with this thought leadership to understand the current perspective of directors, general counsels and law firms on this crucial subject.

The current legislation framework does not differentiate between independent directors and executive directors as it fails to distinguish between their liabilities. The real question is, since independent directors only play a supervisory role, should they be penalized only in the event of a discrepancy that directly relates to their responsibilities? Therefore, the need of the hour is for the legislature to draw a line between IDs and EDs by defining their roles and responsibilities, and demarcating their liabilities.

For directors of organizations with operations spread across multiple countries, the risk of non-compliance increases significantly as these organizations have to mandatorily comply with global legislations such as the US Foreign Corrupt Practices Act and the UK Bribery Act, 2010 as well.

For this report, we gathered insight from some of the eminent personalities in this field to gain their perspective on the liability of independent directors. The professionals with whom we conducted in-depth interviews include:

- M.L.Bhakta, Senior Partner, Kanga & Co
- Vivian Robinson QC, Partner, McGuireWoods London LLP
- Balaji Rao, Founder and Managing Director, at Indic Capital Advisors
- Siddharth Hariani, Partner, Phoenix Legal
- John Smart, Partner, Fraud Investigation & Dispute Services, Ernst & Young LLP

We take this opportunity to thank each one of them for their precious time and insights. Our report would not have the same value without their support.

We hope you find this report relevant and insightful.

Arpinder Singh
Partner and National Director
Fraud Investigation & Dispute Services (FIDS)
Ernst & Young Pvt. Ltd.
Independent directors and corporate governance

The concept of the institution of independent directors (ID) is simple. They are expected to be independent from the management and act as the trustees of shareholders. This implies that they are obligated to be fully aware of and question the conduct of organizations on relevant issues. After the break out of some of the largest corporate scams in the country in recent times and the subsequent increase in the number of resignations by IDs, there is a heightened focus on their role and responsibilities as custodians of stakeholders’ interests. The proposed Companies Bill, 2011, the Corporate Governance Voluntary Guidelines 2009 and General Circular No. 08/2011 issued by Ministry of Corporate Affairs have further stepped up their interest in this subject.

Who is an independent director?

According to SEBI\(^1\), the expression “independent director” refers to a non-executive director of a company who apart from receiving the director’s remuneration, does not have any material pecuniary relationships or transaction with the company, its promoters, directors, senior management, holding company or its subsidiaries and associates, which may impact his/her independence.

The IDs must not be related to the promoters or individuals occupying management positions at the board level or one level below the board or have been an executive in the company in the preceding three financial years. They must not have been a partner or an executive or involved with the statutory audit firm associated with the company or a legal or consulting firm with a material association with the company at any time in the preceding three years. They must not be a material supplier or service provider or customer or a lessor or lessee or a substantial shareholder of the company.

While the law defines who an ID is, there is a lack of clarity in terms of defining the role and liability. As a result, there is a huge expectation gap between what IDs do and what stakeholders expect them to do. Some of the questions such as “Should the IDs inform regulators about decisions taken at a board meeting, which are not appropriate?” still remain debatable.

Independent directors on the board

The appointment and functioning of IDs is the part of a larger scheme to bring about more accountability into the working of organizations. The fundamental purpose for the appointment of IDs is to ensure impartiality. However, in many organizations, the criteria for selecting IDs continues to be adhoc and individuals typically known to the promoters are often appointed as IDs on board to ensure minimum interference by them. A new trend is the practice of having celebrities on boards to add the glamour quotient to organizations. However, such directors may not know much about the business.

The appointment of IDs has become a matter of mere legal compliance. What is really missing in the boards of directors today is the inclusion of IDs who are business managers and act akin to CEOs by playing a general management role, clearly indicating what is right and wrong. In order to appoint directors who are capable of carrying out their duties

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1 “Definition of the independent director,” SEBI – Amendments to Clause 49 of the Listing agreement, 31 October 2003
without any conflict of interest in their judgment, organizations need to follow some specific guidelines agreed upon by the board of directors before appointing the IDs.

**Raising a flag to even out the long-standing ambiguity between the roles of independent and executive directors**

**Indian scenario**

The Companies Act 1956 does not make an obvious distinction between the accountability of an ID and an ED. On careful analysis, it may be noted that IDs are included in the definition of an “officer in default” under Section 5. Although IDs are equally liable for both financial and criminal penalties, the act gives a small degree of immunity to IDs as against EDs.

The immunity may be available for IDs on a case-to-case basis. An example in this order is that of the Negotiable Instruments Act, if the IDs can prove that an offence was committed without their knowledge or that they have exercised all due diligence to prevent the commission of such offences.

**Global scenario**

Under the UK Bribery Act 2010, in a specific provision, i.e., Section 14, senior officers or directors in a company who commit a general bribery offence will also be liable for the purposes of the act. This will therefore include ED, NED, management, company secretary, among others.

In the US, there is no distinction between directors. All directors can be potentially liable whenever a company makes a materially misleading public statement or omission. Also, the Securities and Exchange Commission (SEC) can initiate enforcement action against them on the grounds of failure to properly discharge their duties. Beyond the direct financial liability, IDs are more apprehensive about the time, cost, lost opportunity and the reputation at stake once any legal action is initiated against them.

**Independent directors’ liability – undefined**

According to Ernst & Young’s Eleventh Global Fraud Survey, 92% of the directors in India are concerned about their personal liability. This may be because their personal assets are at risk and their hard-earned reputation is at stake in the corporate world. IDs cannot be held liable for cases pertaining to, for instance, bounced cheques. They are only responsible for matters that ought to come to the board of an organization. However, issues such as promoters giving bribes to expedite registration never reach board members and it is difficult for directors to ascertain such information.

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**Fig.1: Directors’ concern about potential liability**

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<th>India</th>
<th>Middle East and Africa</th>
<th>Global</th>
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<tr>
<td>Not at all concerned</td>
<td>28</td>
<td>33</td>
<td>33</td>
</tr>
<tr>
<td>Fairly concerned</td>
<td>64</td>
<td>54</td>
<td>43</td>
</tr>
<tr>
<td>Very concerned</td>
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Q. How concerned, if at all, would you say your board of directors is about their personal liability for the actions carried out by the company? Base: Respondents in India (50), the Middle East and Africa (152), globally (1,409) Source: Ernst & Young’s Eleventh Global Fraud Survey
Corporate governance: Changing regulatory scenario and the role of the independent director

“Owing to the limited role that they play in the day-to-day running of a company, under the current framework, only the Ministry of Corporate Affairs recognizes that no liability must be attached to independent directors for a breach that is outside the purview of their knowledge. However, the position of an independent director is not all hunky-dory since acts of negligence on their part may not go unpunished. Hence, prudence must be the watchword for independent directors”

Siddharth Hariani
Partner, Phoenix Legal

The downfall of one of the largest multibillion dollar energy companies in the US was triggered when the company’s executives started evading income taxes. Questions were raised as to how a company of this stature could be in such an irreversible predicament. Even though these issues were brought to the direct attention of the CEO by a whistleblower, he did not take personal responsibility to investigate the matter, which led to further errors. As the CEO of the company, managing ethics and code of conduct were concerns that directly fell in his area of responsibility. However, the CEO relied heavily on the company’s CFO to manage these issues. Due to the negligence of the CEO, the CFO managed to inflate profits and improperly hide debts.

The Court found that the directors had not participated in the misrepresentation involved; they simply failed to detect it. Nonetheless, the directors were ordered to make payments out of their personal assets for failing to detect fraud. The fact that this liability resulted in awards being paid out of personal pockets has made it even more difficult than before to recruit qualified independent directors to serve on the board of directors and is therefore in conflict with the purpose and policy of the Sarbanes-Oxley Act.

This case is an example of weak management due to the lack of enforcement in ethics and dependence vis-à-vis critical mainstream responsibilities of the top leadership.

Case study
Directors held responsible for failing to detect fraud
The appointment of IDs ensures an effective and balanced composition of the boards. It is widely recognized that the board of directors are the most significant instrument of compliance with corporate governance.

**Need for changes in the regulatory framework for IDs**

The corporate governance structure hinges on the IDs, who are supposed to bring objectivity to the oversight function of the board and improve its effectiveness. Members place high expectations on them to ensure that the company is run effectively. However, the problem is that an ID cannot play an effective role in isolation despite their commitment to ethical practices. They cannot stop a decision that is detrimental to the members individually, but if they act collectively, then they can act prudently before arriving at any such decision. IDs may not be in a position to stop fraud at the highest level, but with a high level of commitment and due-diligence, they may be well placed to identify signals that indicate that everything is not as it should be.

The need of the hour is for the legislature to draw a line between IDs and EDs by defining their roles and responsibilities, and demarcating their liabilities. Discretion lies with the enforcement authority to determine the extent of the liability that the IDs may incur.

“Private equity or institutional capital will predicate governance and the compliance at a global level and the best way to systemize the same would be to outsource it to a credible transnational firm of repute and integrity.”

Balaji Rao
Founder and Managing Director, Indic Capital Advisors

**Companies Bill 2011**

The government has proposed various measures to counter fraud risk in the Companies Bill 2011\(^2\), which is slated to replace the Companies Act 1956. This is in addition to many current regulations such as Clause 49 of the Listing Agreement and the Companies’ (Auditor’s Report) Order (CARO) 2003, which entrusts the responsibility of preventing corporate fraud with directors, CEOs, CFOs and auditors of a company. Other amendments proposed in this bill cover aspects such as a financial reporting body to better monitor corporate financial management, concept of “dormant companies” to facilitate inactive companies to have minimum compliance requirements and facilitate provisions to include corporate social responsibility (CSR).

The proposed bill suggests changes in the concept of IDs, their terms of tenure and code of conduct. These are some of the proposed amendments towards the scope of IDs:

- At least one third of the total number of directors of a public listed company will be IDs.
- IDs will be appointed by the company from a databank of IDs that is maintained by the Central Government. This data bank will be available online.
- Any resolution passed in the absence of an ID will be made final only on the ratification of such a resolution by at least one ID.
- The audit committee will consist of a minimum of three directors, the majority of whom must be IDs.
- Schedule IV of the Act prescribes the code of IDs, which specifies guidelines of professional conduct and elaborates on their role and function.

The Cabinet has approved the Companies Bill 2011 and it is now awaiting the Parliament’s approval. The Companies Bill, 2011 if approved, could serve to deter corporate crime and related offences by defining composition, roles, responsibilities, liabilities etc of the board and senior management.

**Corporate Governance Voluntary Guidelines 2009**

The “Corporate Governance Voluntary Guidelines 2009\(^3\)” is proposed for voluntary adoption by the corporate sector. The endeavor of the ministry through these guidelines is to administer the Companies Act and the activities of the corporate sector.

The guidelines recommend ways to further improve corporate governance standards and practices as well as focus on the independence of IDs. Some of the

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\(^2\) “Bill No. 121 of 2011,” The Companies Bill, 2011

\(^3\) “Corporate Governance Voluntary Guidelines 2009,” Ministry of Corporate Affairs, Government of India, December 2009
key provisions in the voluntary guidelines that serve to enhance and empower the institution of IDs include:

- To prevent any unfettered decision-making power with a single individual, there should be a clear demarcation of the roles and responsibilities of the Chairman of the Board and that of the Managing Director/CEO.
- Companies should have a nomination committee comprising a majority of independent directors and an independent chairman who will drive the selection of non-executive directors (NEDs).
- Corporations should obtain and post the Certificate of Independence on their company’s website, as well as on the website of the stock exchange.
- While appointing the ID, the formal letter of appointment specifying the roles and responsibilities of IDs and NEDs should be issued. The number of outside directorships should be limited to seven.
- An Individual can remain as an ID in a company for a maximum period of 6 years and a period of 3 years should elapse before she or he is inducted again in the same company in any capacity.
- IDs should have the autonomy to interact with the company’s management as and when they deem it important.
- IDs should have an independent office space, access to requisite information, additional resources and support by the company.
- Companies should provide reasonable and sufficient remuneration to attract, retain and motivate directors and should also ensure adequate sitting fees for IDs, depending on variable aspects such as net worth and turnover.

While it is expected that more and more corporate entities should make sincere efforts to consider the adoption of these guidelines, there may be genuine reasons for some companies for not being able to adopt them completely. However, over a period of time, the adoption of these guidelines will progressively converge toward a framework of best corporate governance standards and practices.

Case study
Need to clearly define the roles and responsibilities of IDs

A non-banking finance company (NBFC) defaulted on its public deposits worth around INR1 billion. Around three years earlier, an investment banker who was serving as an ID at the NBFC had resigned from his post. Police authorities pursued him, following the defaults under a provision within the Andhra Pradesh Protection of Depositors of Financial Establishments (APPDFE) Act 1999. The relevant provision of the act permitted the state government to punish “every person responsible for the management of the affairs of the financial establishment with the imprisonment for a term that may extend to 10 years along with fine.” State governments have been given the authority to arrest anybody involved in the management of companies, including past and present directors, executive and independent directors.

The investment banker’s lawyer argued that he could not be held liable for what had happened as he could not have caused or avoided the defaults since he had left the company in his erstwhile role as an ID three years ago. Due to the lack of any specific responsibilities outlined for IDs, the investment banker was exposed to circumstances where he had no involvement and was rendered susceptible to the law that did not provide any “real” basis of accusation.

MCA’s circular regarding “Prosecution of Directors”

The Ministry of Corporate Affairs has issued a circular clarifying the position of non-executive directors in March 2011. The circular specifically states that Registrar of Companies have to undertake due care while including a non-executive director as an “Officer in default”. It specifically states that an ID of a listed company would not be liable for any act which occurred without his knowledge or without his consent or connivance or where he has acted diligently in the Board process.

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4 “General Circular No. 08/2011”, Prosecution of Directors, Ministry of Corporate Affairs, 25 March 2011
Globally, with the evolving regulatory landscape, which makes them responsible for the prevention and detection of fraud, directors have begun exercising adequate oversight on the management of the risk of fraud. Non-compliance with these regulations or guidelines can have serious repercussions for directors, including their reputational loss and personal liabilities.

For directors of organizations with operations spread across multiple countries, the risk of non-compliance increases significantly as such organizations need to also comply with global legislations such as Foreign Corrupt Practices Act (USA) and the UK Bribery Act 2010.

The role of IDs in fraud prevention and detection has come under the direct scanner of regulators, members and other stakeholders due to the recent exposure of high-profile instances of fraud in India. In the last few months, we can clearly see IDs taking direct interest in reviewing the fraud risk management framework put in place by their organizations to mitigate the risk of fraud.

“A director of any company, whether an ED or a NED, should be careful in ensuring that the company has anti-corruption policies and procedures, which comply with the requirements of the UK Bribery Act 2010. Directors should also examine their directors and officers’ insurance policy to see whether the potential liability under this act is covered”

Vivian Robinson QC, Partner, McGuireWoods, London LLP

Recently, when an instance of fraud was reported in a large IT company, IDs on the boards of other companies insisted on conducting a forensic review of corresponding processes and transactions in their companies to ensure that similar issues do not exist in their company. Several multinational companies have started conducting a “Fraud Risk Diagnostic Review” at their Indian subsidiaries to understand the current state of fraud risk management at these entities. The trend is clearly a positive one by IDs, choosing to be proactive rather than assuming that no fraud can happen in the company.

Responsibility of IDs for the prevention and detection of fraud

Case study
Law expects IDs to question the management’s decision

A recent order of the SEBI, held three independent directors liable for the inflation of account books and for failing to properly monitor financial reporting despite being on the audit committee of the relevant company. The SEBI order observes that:

“... [Aberrations] in financial figures would alert any person of ordinary prudence. The appropriate questions at the right time from the noticees would have unravelled the fraud being played by the company on the innocent investors. By failing to ask the right questions at the right point of time, I find that the noticees have failed in their duty of care as an independent director. They failed to review, as members of the audit committee, the internal control systems, which generated misleading financial statements. I find that the noticees were either too negligent to notice the aberrations in performance of the company and the fraud behind such aberrations or acted as shadow directors of the board / members of the audit committee. In either case, they facilitated the company to make false and misleading disclosures and thereby created artificial prices and volumes in the securities of PSTL in the market, to the detriment of innocent investors. I, therefore, conclude that the charge of disclosure of false and misleading statements, as alleged in the SCN against the noticees, is established. Thus, the noticees are guilty of violating...”

Reference: “SEBI report before the Securities and Exchange Board of India,” 23 August 2010
10 questions every director should ask:

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<th>1. Do we set and communicate the right “tone at the top”?</th>
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<td>Do we effectively assess our corruption risk?</td>
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<td>3.</td>
<td>Do we have effective standards, policies and processes to address these risks?</td>
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<td>4.</td>
<td>Do we adequately communicate and train directors on our anti-bribery and corruption policies and processes?</td>
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<td>5.</td>
<td>How do we know that our training is effective?</td>
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<td>6.</td>
<td>What incentives do we provide for compliance and penalties for non-compliance?</td>
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<td>7.</td>
<td>How do we monitor and audit to detect improper conduct?</td>
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<td>8.</td>
<td>Do our compliance officers have adequate clout, resources and independence?</td>
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<td>9.</td>
<td>How do we review the effectiveness of our compliance program?</td>
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<td>10.</td>
<td>When we find a problem, do we ensure that an independent and thorough investigation is carried out?</td>
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How can IDs protect themselves against liability due to fraud, bribery and corruption?

**Insuring against potential liability**

With the recent spate of scams, the directors and officers are concerned with a company's Directors and Officers (D&O) Liability Insurance program as it is their personal assets that are at risk along with their hard-earned reputation in the corporate world.

D&O Liability insurance coverage ensures adequate funding for any indemnification claim. Thus, companies with quality D&O insurance coverage are the ones that attract the best directors and officers. Most of the UK companies cover their directors with the D&O Liability Insurance Coverage.

In contrast, one of the leading industry stakeholders reportedly believes that directors should face consequences of their mistakes in the same way other shareholders do, although individual operating companies may still purchase such insurance.

To avoid such concerns and mitigate risks in general, IDs should ensure that their potential liability is insured. The vulnerability of independent directors is a real concern as they are being arrested for actions that are a result of no fault of theirs. However, in the Indian context, it may be argued that liability arises only on account of conduct or act or omission on part of the ID to fulfill certain obligations, and not by the mere fact of holding an officer responsible for actions taken by the company.

**Reaffirming the supervisory role of IDs**

Conducting due diligence
- Sharing the onus to manage goodwill and reputation concerns
- Evaluating the company’s risk parameters and gauging plausible risk scenarios to initiate corrective/preventive measures

Stepping up awareness
- Acquiring a better grasp on changing business scenarios
- Achieving proficiency on recent tools/techniques to prevent and detect fraud
- Avoiding direct involvement in a company’s day-to-day affairs
- Probing as and when the need arises and managing relevant interventions by asking questions and documenting the issues raised

Implementing good governance
- Ensuring compliance with the stipulated code of conduct
- Being well-aligned with the tone at the top
- Staying regularly updated with the company’s policies, procedures and compliance requirements
- Taking stock of compliance confirmation and certification
- Giving due cognizance to the whistleblower mechanism
- Bearing a proactive stance as the lead director
Dealing with complex issues of fraud, regulatory compliance and business disputes can distract you from your effort to achieve your company’s potential. Better management of fraud risk and compliance exposure has become a critical business necessity for companies today, regardless of the industry sectors in which they operate. With our more than 1,400 fraud investigation and dispute professionals across the globe, we assemble the right multi-disciplinary and culturally aligned teams to work with our clients and their legal advisors, to give them the benefit of our broad sector experience, deep knowledge of relevant subjects and pertinent insights from our work worldwide. This is how Ernst & Young makes a difference.

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