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Early Warning Signs And Red Flags For Independent Directors

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Amidst a global economic downturn, the Indian economy stands out as a more promising prospect. The Indian government has committed to improving the ease of doing business, promoting market integrity, and expanding corporate governance, which has boosted investor and stakeholder confidence. Achieving these objectives requires good governance and strong frameworks. Corporate governance is gaining momentum in India due to past failures, unethical practices, and insufficient disclosures.

In recent years, the frequency, intensity, and magnitude of corporate governance failures have increased. India has seen examples of entities with good and bad corporate governance, including Kingfisher Airlines, Jet Airways, Punjab National Bank, DHFL, PMC Bank, Infrastructure Leasing & Financial Services (IL&FS), Rotomac Bank Fraud, and Videocon-ICICI Bank.

The Companies Act 2013 has given Independent Directors more power and responsibility, making them responsible for any shortcomings in corporate governance. Independent Directors play an active role in various committees to ensure good governance and protect the interests of all stakeholders. This article, based on secondary data and the Company Auditor's Report Order (CARO), highlights the key areas where an Independent Director can play a proactive role in sensing early warning signs, detecting them in advance, taking preventive measures, and mitigating risks that may arise. In recent corporate frauds, analysing the roles of Independent Directors has revealed that they either did not play their role effectively, were not aware of the issues, or could not read the early warning signs properly.

SENSE	What are various early warning signs?
DETECT	How to find early warning signs well in advance?
PREVENT	What measures an ID should take before these turn up into frauds?
PROTECT	What steps, if taken can mitigate arising risks from early warning signs?

Major Early Warning Signs

1. Audited Financial Statements

As board members, Independent Directors (ID) should review the most recent audited financial statements. A solid understanding of how to read key transactions can help detect early warning signs. For instance, in Related Party Transactions (RPTs), the frequency and volume of transactions can indicate potential issues. If the volume of RPT transactions is high or if the company has sold goods to an RPT without receiving payment, these should be flagged as early warning signs and discussed at board meetings.

An ID who has a comprehensive understanding of financial statements, legal requirements, business operations, business models, and corporate governance can make a significant difference in detecting early warning signs.

IDs should also check if the auditor's report includes a qualified or modified opinion. It is crucial to ensure that Generally Accepted Accounting Principles (GAAP) are followed by the company. If there are any violations or concerns highlighted in the auditor's report, these should be considered early warning signs. The following transactions should be closely examined:

- Depreciation not charged appropriately
- Improper sales recording
- High volume of RPT transactions
- Interest on loans not provided
- Unsettled transactions
- Transactions conducted on a barter system, which is not permitted.

2. Examination of Fixed Assets Register:

Fixed assets are a significant investment for any company, and it's important to maintain an accurate fixed assets register. The register should provide sufficient details on the asset, including its classification, quantity, location, original cost, date of purchase, useful life, date of revaluation (if any), accumulated depreciation/amortization, and residual life. The proper recording and use of fixed assets in production are crucial. If fixed assets are not being recorded correctly and used for production, it may result in a loss for the company and should be considered an early warning sign.

3. Evaluation of Inventory Records:

As an ID, it's essential to review the company's inventory records. This includes conducting regular physical inventory verifications, ensuring proper record-keeping, and addressing any discrepancies found in the books of accounts. Any unresolved discrepancies in inventory records should be discussed in board meetings. It's also important to consider the auditor's comments regarding any inventory discrepancies to arrive at a final conclusion.

The frequency of physical inventory verifications depends on the nature and location of the inventory. Management determines the periodicity of these verifications considering these factors.

4. Loans given by the company to other parties:

- Check if the terms and conditions of the loan are fair and not harmful to the company's interests.
- Verify if the loans are backed by adequate investments, guarantees, or security.
- Monitor if the repayments and interest are received on time as per the schedule.

- If a loan is overdue for more than 90 days and no reasonable steps have been taken by the company, it is an early warning sign and should be brought up for discussion at Board meetings.

This information is also mentioned in the auditor's report, which should be reviewed for the following details:

- The number of overdue cases and whether a list of such cases has been prepared.
- The principal amount overdue.
- The interest overdue.
- The total amount overdue.
- The company's reminders to demand overdue amount.
- The management's representation on these dues.

5. Compliance with RBI directives for accepting deposits:

If the company has accepted any deposits, it is essential to ensure compliance with the Reserve Bank of India's directives or other relevant provisions of the Companies Act, 2013. Failure to comply is an early warning sign and should be discussed at Board meetings to address the issue.

Carefully read the auditor's report to note the following details:

- The nature of the deposits accepted.
- The terms and conditions of acceptance.
- Limits up to which deposits can be accepted.
- Maintenance of a register.
- General provisions regarding the repayment of deposits.

6. Compliance with Statutory Dues: It is important to ensure that the company has been consistently depositing its statutory dues within the stipulated time frame. These dues include provident fund, excise duty, income tax, sales tax, cess, and other similar payments. In case of non-compliance, the reasons for the same and the extent of arrears should be investigated. The auditor's report can be used as a reference to determine if this is an early warning sign or not. If it is, then it should be discussed in the board meeting.

7. Default in Loan Repayment: An investigation should be conducted to ascertain whether the company has defaulted in repaying its loans or borrowings from banks or financial institutions. If a default has occurred, the period and amount of default should be obtained from the management. It should also be determined whether the default occurred in the current financial year or in previous years and is still ongoing. The auditor's comments on this matter can help the ID to assess the seriousness of the situation. If it is deemed an early warning sign, it should be brought to the board's attention for discussion.

8. Fraud by the Company or its Employees: If any fraudulent activity is discovered to have been carried out by the company or its employees, the nature and extent of the fraud should be thoroughly investigated. If the amount involved is substantial, then it should be considered an early warning sign and brought to the attention of the management and board members. Fraudulent financial reporting can take various forms, such as intentional misstatement or omission of amounts or disclosures in financial statements, manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.

9. Compliance with Managerial Remuneration: The Independent Director should review the audit report on managerial remuneration under section 197 of schedule V to the Companies Act. The law prescribes a maximum ceiling of 11% of net profit for payment of managerial remuneration by a public company to its directors and managers. If the remuneration is not in accordance with the law, the Independent Director should carefully read the auditor's comments on the matter. Non-compliance with the prescribed limits should be considered an early warning sign and brought to the Board's attention for discussion.
10. Related Party Transactions: The Independent Director should carefully review the auditor's comments on Related Party Transactions (RPT). Non-compliance with the arm's length principle as defined in Standards of Accounting (SA), 550 should be considered an early warning sign and brought to the Board's attention for discussion. The following RPTs should be reviewed to ensure compliance with the arm's length principle: sale, purchase, or supply of any goods or material; sale or lease of any property; rendering of any services; and loans and advances. The Independent Director should also assess whether these transactions are usual or unusual and whether they align with the company's business line. The frequency, purpose, size, and volume of transactions should also be considered.
11. Non-Cash Transactions with Directors or Connected Persons: The Independent Director should review the auditor's comments on non-cash transactions between the company and its directors or connected persons. If these transactions do not comply with section 192 (1) of the CA 2013, the Independent Director should consider it an early warning sign and discuss it with the Board members.
12. As a board member, it's important to ensure that funds raised through Initial Public Offerings (IPOs), Further Public Offerings (FPOs), and debt instruments are being used for their intended purpose. Auditors' reports can help independent directors come to a conclusion on this matter. If the funds are not being utilized as intended, it may be a warning sign and the board should seek clarification from management.
13. Board members should also check whether any transactions not recorded in the books of account have been disclosed as income during the year in tax assessments. If so, it's important to verify whether the unrecorded income has been properly recorded in the books of account.
14. It's important to ensure that the company has adequate internal financial controls in place and that they are operating effectively. Independent directors can refer to the Ministry of Corporate Affairs notification on this subject. The Satyam Computers Scandal of 2009 highlighted the need for stronger regulatory and legal frameworks for boards of directors and auditors. If the company is not in compliance with these regulations, it may be a warning sign and the finance team and board members should discuss it.
15. Independent directors should also investigate whether there has been any resignation of statutory auditors during the year and whether the auditor has taken into consideration the concerns raised by the outgoing auditors. This can be a warning sign and should be discussed in detail.
16. Other important points to consider include the transfer of unspent funds to specified funds, the company's capability to meet its liabilities, the gap between fixed assets and production, and investments made into subsidiaries whose objectives are not aligned with the holding company (e.g. an IT company setting up a gold company).

Board members have limited time to discuss important matters, and it's not always possible to visit the company in person. However, key points from auditors' reports can help independent directors identify potential areas of concern where unusual activities may be taking place. Early detection of such activities can help the board implement proper control mechanisms.

