SUSHANT UNIVERSITY ORGANIZED INTERNATIONAL CONFERENCE ON
"ADVANCES IN MULTIDISCIPLINARY RESEARCH AND INNVOATION" ICAMRI-2023
ON 28-29TH OCTOBER 2023
INTERNATIONAL ADVANCE JOURNAL OF ENGINEERING, SCIENCE AND MANAGEMENT (IAJESM)
July-December 2023, Submitted in October 2023, iajesm2014@gmail.com, ISSN -2393-8048
Multidisciplinary Indexed/Peer Reviewed Journal. SJIF Impact Factor 2023 =6.753

Awakening of Corporate Governance In India

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ABSTRACT

The paper titled "Awakening of Corporate Governance in India" explores the transformative changes brought about by the Companies Act of 2013 in the Indian corporate landscape. This research critically assesses the legal underpinnings of this significant legislation and its implications within the framework of corporate governance, while considering the unique socio-economic and cultural context of India (Bharat).

The Companies Act of 2013 introduced groundbreaking features and reforms, which this paper meticulously examines. This paper recognizes the dynamic nature of corporate governance in India and the intricate interplay between legal reforms, theoretical frameworks, and practical corporate practices.

AWAKENING OF CORPORATE GOVERNANCE IN INDIA (BHARAT)

"Business management is about maintaining the balance between personal and public goals, as well as financial and social goals. The purpose of management is to promote the efficient use of resources and ensure accountability for resource management. The aim is to protect the interests of people, business and society as much as possible." - Sir Adrian Cadbury[1]

Unveiling the Corporate Governance Revolution: The Companies Act of 2013 in India:

The new Companies Act 2013 has created a new buzz in the business world; while many people are happy with the goals they set, whereas others find it too much difficult to bear. The purpose of this article is to provide a critical assessment of the features introduced by the new Act while evaluating the key legislation in the context of the corporate governance regime adopted in India.

Companies in India have always been governed by laws created in the shadow of British precedents; The first is as a group, the second is a simple law. In fact, the first corporation that set its foot in India and the first corporation recognized so by the Crown to have monopoly of trade relations with India[2] was none other than East India Company in the year 1600 A.D. Over the years and until the year 2014, the companies in India were being governed by the Companies Act, 1956 which was a replica of its English counterpart.[3] The new enactment, though made in the accordance of the New Companies Act, 2006 of UK, marks the significant differences considering the specific characteristics of India.

The main focus of the new Act is to ensure healthy corporate governance and this has been done by strengthening its two pillars- transparency and accountability. This paper shall segregate the various features into these two categories to testify this focus. Ahead of the new bill, the focus was on listed companies whose management is strictly regulated by the Securities and Exchange Board of India (SEBI) through listing agreements and various regulations. But the new Act promises a stricter regime even for public companies, whether listed or not. Some regulations even cover private companies that are considered partnerships according to the previous Law and are not subject to legislation and other conditions to be announced. Certain exemptions were recently granted to private companies[4] after receiving strong displeasure from the business community. Despite such modification, the law, overall, has become grave towards companies, irrespective of their kind.

The need for a new law came with the kick start of the millennium wherein the world witnessed the fall of giant corporations[5] which promised nothing but prosperity before. India itself suffered from Satyam fiasco[6] to wake up from its slumber and the result was the delivery of this new enactment. While the JI Irani Committee report was published in 2005 and the Companies Bill was introduced in 2009, it is only after the comments of the parliamentary committee that the Companies Act was introduced in 2013 and entered into force (in part) in 2014.

FEATURES INTRODUCED FOR CORPORATE GOVERNANCE IN THE COMPANIES ACT

Following is the discussion on the various features introduced in the area of Corporate Governance under two umbrellas- **Transparency and Accountability**: The following is a summary of the features introduced under the patronage in the field of Corporate Governance - Transparency and Accountability:

Transparency:

1. **Increased Disclosures**:

Disclosures are the best way to build investor confidence in a company. While public disclosures help attracting more investors and provide information to stakeholders, the disclosure at the level of the company to shareholders helps retaining their confidence and long-term investment. These timely disclosures also discourage fraudulent practices, though may not prevent[7]. The new Act provides for public disclosures of their CSR policy[8], remuneration policy[9], vigil mechanism policy[10], etc while disclosure of remuneration ratio (of directors and employees)[11], remuneration for directors[12] and key managerial personnel and interest of directors in transactions[13] are mandatorily to be disclosed to the shareholders of public companies. These help reduce business information asymmetry while ensuring effective business management. It must be noted that not only the Companies Act but also the SEBI Act made the list longer for the disclosures[14]. Recently SEBI introduced regulations[15] which contain several disclosures required to be made when the company approaches the public for capital. These disclosures are in some cases to the SEBI only and in others, to the prospective investors (thereby to the public at large).

2. Increased Reporting and use of electronic mode for reaching out to the members:

Reporting system has been improved through the new Companies Act. More registers are to be kept, most of which are accessible to the members. Notices and voting of general meetings and board meetings[16] can now be done through electronic means. This can ensure proper receipt of notices including easy tracking of whether notice was actually sent or not[17] and now e-voting is also allowed for members who can't find time to attend the general meetings. Also recognizing the current trend, the legislature has allowed the maintenance of books and accounts in electronic form[18].

Moreover, participation of directors through video conferencing will be counted towards the necessary quorum for board meetings[19], i.e., now directors can attend meetings no matter in what part of the world they are. This move aligns in regard to digitizing India and works well for the investors as with our current Prime Minister's agenda. Like the case of UK and USA[20] India witnesses the problem of passive and disinterested scattered investors, what differentiates India's condition from the latter countries is that those disinterested investors are minority investors. Majority shareholders in India are usually the promoters/families who are already participating actively in the affairs of the company. Therefore, while such concepts of e-voting and e-notice may work well in UK and may produce positive results, introduction of electronic means is not likely to encourage the passive investors in India to take part in the general meetings.

3. Increased role of Independent Directors-:

The role of the independent director [21] cannot be undermined in the sustenance of good corporate governance regime. The new enactment promises an active participation of these directors who can introduce objectivity in the board room by making their presence compulsory in certain committees of the board. Additionally, a new code of conduct[22] for the guidance also helps in ensuring an effective involvement of these directors. Apart from describing their role and functions, the code entrusts the independent directors with the task of bringing the stakeholders in the board room deliberations as factors for consideration. Similarly, 'minority protection' is also a sacred duty of these directors. In order to prevent the 'decision making' sans independent judgment, if the board calls meeting at a shorter notice than what is usually prescribed by the Act, the decision must be approved by an independent director.[23] Furthermore, independent directors must have separate meetings to discuss matters of the company but whether their decisions at such meetings are binding on the board is a subject matter open to debate. With regard to their liability, the independent directors are protected to a great extent because the criteria for imposing liability on them are limited to their knowledge, consent or connivance. Such a boundary encourages the independent directors to participate in the functioning of the company without the fear of being held responsible for decisions of which they were not aware.

While Independent directors are a common feature in UK too, the Indian scenario warrants the existence of the Independent director more than its UK counterpart on account of the minority shareholders' protection which is quintessential in Indian business houses which are dominated by families. As the board of directors are under the constant influence of these dominant promoters and therefore an outsiders' perspective will definitely help the board to work in the interest of the company and not for the benefit of the promoters due to this the position of Independent Directors gains significance.

A note must be taken of the current situation wherein the independent directors do not get actively involved in the decision making process. There should be mechanisms in place to ensure their presence on the board by making certain number of meetings to be attended by them as mandatory even if they do not sit in any Committee of the Board. Effectiveness of independent director can be seen more visibly if their attendance is encouraged/regulated.

4. Investment through not more than 2 layers :

Since corporate group structures are getting complex by every passing day, the law has prohibited investment in companies by group companies through more than two layers to be able to simplify the processes of tracking down the sources of capital of the recipient company[24]. However, this provision is not likely to be very helpful in keeping the group companies in check because these creatures are capable of building complicated structures which making it difficult to point out with clarity as to which company invested in whom. The word used is 'two layers' which generally means two vertical layers but when the investment flows through associate companies[25], it will not be captured by the aforesaid provision and there lies a loophole which must be plugged.

5. Consolidation of group accounts:

With a view to curb abuse of the concept of separate legal personality, the legislators have tightened their reigns on group companies who are now required to make consolidated books of accounts not only with their subsidiary companies but also with their associate companies and joint ventures[26]. This is a marked difference from the approach taken under the erstwhile statute wherein the financial statements of the subsidiary companies were only required to be 'attached'[27]. However, now the holding company must consolidate and lay before the General Meeting, the financial statements in order to show the entire group as a 'single economic entity' instead of just attaching the accounts. Through this consolidation, the government, concerned authorities and the members of a particular company (which is part of the group company) can see the larger picture to assess whether as a group, the entity is thriving or not. It will also put checks on tax evasion and abuse of the concept of 'separate legal personality'[28]. In fact, a company can also voluntarily revise the financial statements[29] and Board report[30] if it wishes and the presence of this provision prevents the directors from claiming oversight later on.

6. Audit Committee: Though audit committee was added to the Companies Act, 1956 in the year 2000 itself [31], it has gained strength through the new Act which has widened the scope of the committee by conferring on it certain additional functions including performance evaluation and monitoring the independence of the statutory auditor as well as the policy of internal financial controls and risk management.[32] The significance of the audit committee lies in its independence and objectivity the consequence of which is its constitution which prescribes that majority of the members of the committee should be independent directors[33] and most members should possess the ability to read and understand financial statements[34].

7. Nomination & Remuneration Committee:

The nomination and remuneration committee was introduced under the 2013 Act[35] to guarantee openness in the process of granting benefits to the directors while maintaining a balance between the interest of the company and the shareholders of the company[36]. A chief feature of this committee is its twofold functions- to recommend names for directorship alongwith their remuneration; and to evaluate the performance of the directors. The committeealso has an added responsibility of disclosing ratio of the pay for an average employee to that of a director which keeps a healthy tab on exorbitant pay package to the directors. This committee is also responsible for recommending appointments and remuneration of the key managerial personnel. This committee holds great importance with regard to executive remuneration but there is nothing to suggest that this committee's recommendation will be final and binding[37]. The board of directors has the ultimate say over these recommendations which may make the entire exercise futile at times.

8. Vigil Mechanism:

Under the new Act, an added measure taken to make certain, the transparent discharge of functions is the introduction of the whistleblower policy by every listed company38 and certain other companies[39] wherein mechanism has to be in place to ensure smooth and confidential path for directors and employees to blow whistle on the fraudulent or suspicious activities of the company. However, it seems that the activities which can be reported by such person are confined to the area of accounts and audit since the authority in this matter is the Chairperson of the Audit Committee.[40] Legitimacy of the complaints is maintained by empowering the Audit committee to take 'suitable action' against the person making frivolous complaints[41]. What would be a suitable action remains a grey area. It is undoubtedly a noble endeavor which should be encouraged by the legislature and which unfortunately hasn't received its due attention in the provision so far.

Accountability

1. Corporate Social Responsibility (CSR):

While every company has a social responsibility, the onus of mandatorily delivering their responsibility towards the society has been cast on the companies with large turnover.[42] These companies are imposed with a duty to 'spend' 2 % of their profits of the last three financial years towards social causes, an illustrative list for which is provided in Schedule VII. Several developed countries look upto India for its recognition of society as a legitimate stakeholder. This new feat signifies a drastic change in the policy of the government as well. Government wants the corporations to utilize their creative and managerial expertise for the benefit of the society[43]. Though the endeavor is commendable, the Act treats charity as CSR which is evident from the list which in turn is meant to be the guiding light for companies. This confusion leads to a confined approach towards CSR; different from the one India should take in the 21st century. Instead of asking the companies to do CSR in their areas of expertise, donating to promote gender equality or Prime Minister's Relief Fund[44] will only make them perceive CSR as charity; and not a responsibility towards the society wherein they must contribute through what they do best.

2. Duties of directors towards other stakeholders:

Not only does the new Companies Act codify the common law duties of the directors, it also puts an onus on the directors to take into consideration the interests of the stakeholders other than shareholders45 while taking business and management decisions of the company. In the

Board Report too, the directors are required to mention the extent of conservation of energy.46 This provision along with the duties of the independent director47 marks a steep incline towards the stakeholder theory which had so far only found place in academic discussions in India.

One finds such codification redundant because these duties have already been so well established by common law that codifying them will only cause confusion because while the duties have been recognized, their exceptions have not been codified. Does that mean that the duties are different from the ones which are established through cases in common law? While the answer is probably 'no', the codification hardly does any good to such a situation.

3. Variation in prospectus:

Unlike the Companies Act, 1956, the new Companies Act prescribes a 'special resolution' to be passed along with publication in the newspapers when the objects for which the capital was raised by the company are altered or the contract mentioned in the prospectus is varied.48 In addition to such special resolution and large scale publicity, the minority shareholders are protected by a provision for exit option49 to the dissenting shareholders wherein the promoters must give them an offer to purchase their shares at a fair price. This is a welcome measure for safeguarding the minority interests.

4. Stakeholder Relationship Committee:

A new committee of the board of directors that must be formed by certain companies50 is Stakeholders' Relationship Committee.51The name of this committee is however misleading because when one reads the provision, he realizes that the committee is only established to resolve the grievances of the 'security holders' and not all stakeholders. The aforesaid committee will try to provide a platform for grievances wherein the number of security holders is large in numbers. The intent of the provision seems to be self- regulation once again which seems to be goal of the legislators while drafting the new law on governance of companies.

5. Risk Management and internal financial controls:

A noteworthy introduction of 'risk management' as part of the duties of the Audit Committee has been made which warrants discussion. The Audit Committee is responsible for checking the risk management systems and the efficacy of the internal financial controls. This check comes in the aftermath of the accounting scams of Enron, Worldcom and Satyam and encourages companies to have in place internal mechanisms to keep a check on risky ventures and accounting processes. Independent directors are also entrusted with the duty to bring objectivity in the aforesaid processes and the Directors' Responsibility Statement should also provide assurance on the efficiency of these controls.[52]

6. Penalty for Key Managerial Personnel (KMP):

It is a known fact that board of directors is not the sole repository of all the management powers of the company. Through business practices (or through provisions in articles of association), some significant portion of this power has been allocated to certain top-notch officials of the company who are not directors of such company. These officials may be the Chief Executive Officers, Chief Financial Officers, Company Secretaries, etc. In order to regulate these officials also who are wielding considerable amount of powers while remaining out of the duty net of the common law which only captures the directors, the new law has imposed liability on such officers of the company. For instance, now the KMPs must also disclose their interests in the notice which is being sent for the general meeting alongwith the directors53or otherwise must disgorge profits made on account of such non-disclosures.54 For the same reason, KMPs are also not permitted to indulge in forward trading of the securities of the company55 and they can be held liable for non-filing of accounts with the Registrar of Companies.56 All these provisions did not capture KMPs before but the new Act ensures stronger surveillance of such discharge of functions, irrespective of who performs them.

7. Ambit of Related Party Transactions widened:

Related party transaction, though not new to the Act, has definitely turned heads due to its definition of 'related party'57 which now captures many more persons58 who could have escaped liability under the previous Act. Such widening of the ambit of the definition warrants an applaud on account of its ability to capture possible abuses.

8. Increased role, duty and independence of auditor:

In order to ensure independence of auditor, various steps have been taken in the new Act including a limitation on the number of years for which they can be appointed. Corresponding to the fact in a listed company an individual cannot be appointed as the auditor for more than 5 years and a firm cannot be appointed as the auditor for more than two consecutive terms of 5 years each[59.] A very effective check that has been attached to the appointment of statutory auditors is the ratification that must be made at every annual general meeting without which auditor cannot continue.60 It allows the members to deliberate on the continuation of the auditor's services every year. Prohibition on certain services also ensures a higher degree of independence of the statutory auditor.

9. Class Action introduced as a remedy:

Class action is famously practiced as a remedy against the company and the management in USA but now has been recognized as a remedy for the members in the new Companies Act, 2013.Apart from the members, this remedy is also available to the deposit holders. This remedy not only covers prevention of certain acts which will be prejudicial to the interests of the company but also confers the right to claim damages and compensation61 which was missing from the Companies Act for a very long time. This also helps in differentiating this remedy from the others which are at the disposal of the shareholders of the company.

10. Reduced interference of the Government:

It is well said that "that government is best which governs least" [62]. Following this, the legislators withdrew the powers conferred on the Central Government under the erstwhile statute and allocated these powers to the general meeting instead. After all, the general meeting is the other organ of the company and is perfectly capable of taking decisions for the company. Consequently, powers of increasing the remuneration beyond the maximum limit requires the approval of the general meeting[63] now and so does the increase in number of directors beyond the limit prescribed generally for the companies[64] via the new Act. For related party transactions too, the government has substituted the general meeting for approval in its stead.[65]

CONCLUSION

The new Companies Act promises a robust structure for corporations in India keeping in line with the 'ease of doing business' campaign of the current PM of the country. Be it fast track mergers of small companies or speedy registration processes or specialized tribunals and courts to resolve matters arising under the law, the legislators have indeed made efforts to smoothen the carpet for the domestic and foreign entrants.

The Committee[66] responsible for the introduction of the Act wanted to enunciate principles while leaving the details to the regulatory authorities. This makes the role of executives more important in the corporate world. However, since its partial enforcement in 2014, the perennial flow of rules, amendments, orders, circulars, notifications and clarifications has only added to the confusion instead of bringing about clarity. Business community wants certainty in the law which much to their dismay, hasn't been provided so far. Also, the rules made recently have started overriding the statute itself. For instance, can one create exception to the law in the Rules and will it hold water in the court of law? This question hangs before the Ministry which must stop manufacturing the law (not conferred to do so by the Constitution of India) and must endeavor to smoothen the law.

The law currently tightens its clutches on the public companies only. Though it is true that the public companies are the only ones which can raise capital from the public, the private companies, small companies and one person companies which borrow from banking companies[67] should also be subjected to such measures of transparency and accountability because ultimately, what banking companies have lent is public money and therefore the corporate debtors, irrespective of public or private, should imbibe the structure of corporate governance as stringently as public companies.

Moreover, one must not forget that corporate governance in India is a strong reflection of its UK counterpart, which doesn't cater to the India specific problems. A result of that is the hollow structure with no effective governance. It is interesting to note that Satyam was the recipient of the best governed company of the year[68] before it went down under and it had every mechanism in place that scholars of good corporate governance vouch for and yet, none of those tools could detect the mismanagement. The need of the hour is not a structure but effectiveness of the structure to prevent scams in the future since such setbacks not only adversely affect the securities market but also shake the confidence of the investors who invest their savings in the securities and because of whom the entire economy thrives. While the legislators have made sincere efforts to instill a system for good corporate governance in the Indian corporate world, it is only ethics which can make the corporations follow the spirit of the law instead of mere compliance oriented approach. The corporations must realize their responsibilities towards the stakeholders in order to become more responsible citizens of India and until then the legislators and executive will keep them under strict surveillance through the introduction of laws in the nature of the new Act.

REFERENCES

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2) V.Baladouni "Accounting in the Early Years of the East India Company", The Accounting Historians Journal, 1983
3) When UK became part of the European Union, changes were introduced in the UK Companies Act, 1985 to align the law with the Union and thence, there is a deviation in Indian and English Company Law in certain respects.
4) Ministry of Corporate Affairs Notification GSR 464(E) dated 5 June, 2015.
5) For example: Worldcom, Enron, Lehman Brothers, AIG, etc.
6) For details, See Satyam scam: All you need to know about India's biggest accounting fraud, Hindustan Times, 9 April, 2015 available at http://www.hindustantimes.com/business/satyam-scam-all-you-need-to-know-aboutindia-s-biggestaccounting-fraud/story-YTfHTZy9K6NvsW8PxIEEYL.html
7) For example, in the case of 'Worldcom' or 'Satyam Computers' wherein disclosures were made on regular basis but were not sufficient to detect the fraud.
8) Section 134(3)(o)
9) Section 178(3) read with 173(4).
10) Section 177(10)
11) Section 197(12)
12) Section 178 read with Section 197
13) Section 184 and Section 188
14) Since listed public companies can be freely traded on the stock exchanges, the chances of abuse as well as misuse of information by those 'in the know' at the expense of those who are not, is substantial. This is the general consequence of asymmetry of information
15) SEBI (Listing Obligations and Disclosure Requirements)Regulations, 2016.
16) Section 101 of the Companies Act, 2013
17) As per Section 101, notice must be received at least 21 days before the date of general meeting and deliberate omission to send notice is violation of the provision.
18) Section 120

19) Section 174
20) See generally Adolf Berle and Gardiner Means, "The Modern Corporation and Private Property", 1932, Transaction Publishers, Reprint 2009.
21) See S.149(6) for the definition of an independent director.
22) Schedule IV to the Companies Act.
23) Section 173
24) Section 186(1)(i)
25) Section 2(6) "defines 'associate company' means a "company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company".

"Explanation- For the purposes of this clause, 'significant influence' means control of at least twenty per cent of total share capital, or of business decisions under an agreement."

26) Section 129 read with Explanation to the Section.
27) Section 212(1) of the Companies Act, 1956
28) See for example Scottish Cooperative Wholesale Society Ltd. v. Meyer (1959) A.C. 324 HL and Adams v. Cape Industries Plc (1990) Ch.433 wherein the separate legal personality was abused by the parent company.
29) Section 135
30) Section 131
31) Through the Companies (Amendment) Act, 2000.
32) Section 177(4)
33) "The Audit Committee can have minimum of three directors. Audit Committee is required to be formed by listed public companies and certain other companies which are prescribed by the Ministry of Corporate Affairs".
34) Section 2(40) defines 'financial statement' and it includes Balance Sheet, Profit and Loss Account and Cash Flow Statement.
35) Section 178
36) "Following companies are required to have a Nomination and Remuneration Committee":

(i) "all public companies with a paid up capital of Rs.10 crore or more";
(ii) "all public companies having turnover of Rs.100 crore or more";
(iii) "all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding Rs.50 crore or more"

37) "If the committee recommends a name of a candidate which is rejected by the board, the committee can think it over but if again, it is not accepted by the board, that name will not reach the general meeting for nomination as a candidate for appointment of a director".
38) Section 177(9) and (10) read with Schedule IV "wherein Independent directors are entrusted with the duty to ascertain if the company has an effective vigil mechanism in place and to ensure that the whistleblowers are not prejudicially affected because of their revelations".
39) "Companies which accept deposits from the public; or companies which have borrowed money from banks and public financial institutions in excess of Rs.50 crore."
40) Section 177(10)
41) Rule 7of the Companies (Meetings of Board and its Powers) Rules, 2014.
42) Section 135(1) identifies the following companies mandatory for CSR:

(i) "company having net worth of Rs.500 crores or more, or"
(ii) "turnover of Rs.1,000 crores or more or"
(iii) "net profit of Rs.5 crores or more during any financial year".

43) General Circular no. 01/2016 dated 5 September, 2015 issued by MCA.
44) As mentioned in Clause (iii) and (ix) of the Schedule VII to the companies Act, 2013.
45) Section 166(2)

46) Section 134(3)(m)
47) See duties as mentioned in Schedule IV Clause III.
48) Section 27(1)
49) Section 27(2). Such exit price is to be determined as per the SEBI Regulations made in this regard.
50) Companies which have more than 1,000 shareholders, debenture-holders, deposit-holders & any other security holders at any point of time during a financial year.
51) Sections 178(5) and (6)
52) Section 134(5)
53) Section 102(1)(a)
54) Section 102(4) and Section 102(5) if the profits are not disgorged.
55) Section 194
56) Section 137(12). See also S.134 wherein the CEO, CFO or company secretary, as the case may be, must sign the financial statements and the penalty for non-compliance is imprisonment and a fine under Section 134(8).
57) Section 2(76) defines 'related party'.
58) For instance, KMP and his relatives are captured by the provision.
59) Section 139
60) Proviso to Section 139(1)
61) See Section 245(1)(g) of the Act.
62) Thomas Jefferson in his Retirement Papers, 1837.
63) Section 197(1) second proviso. in comparison with Section 309 (3) proviso of the Companies Act, 1956.
64) Section 149(1) in comparison with Section 259 of the Companies Act, 1956.
65) Section 188 (1) proviso
66) JJ Irani Committee Report, 2005.
67) It will also help to reduce the value of the non-performing assets of banks.
68) "It was the recipient of Golden Peacock Global Award for excellence in corporate governance in 2008 and of SAP Pinnacle Award 2008 under "Service – Ecosystem Expansion (Growth)". Satyam's founder had received Ernst & Young - Entrepreneur of the Year Award in 2007. Also, Satyam's internal audit team was awarded the 'Recognition of Commitment' award from The Institute of Internal Auditors, USA in 2007".