

# Audit Committee—the New Super Powerhouse



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## ABSTRACT

The Companies Act 2013 and the revised (2014) Code of Corporate Governance issued by the Securities and Exchange Board of India (SEBI) has made the Audit Committee responsible for protecting the minority interest and to support the board of directors in effectively performing its oversight and executive functions. Regulators have empowered the Audit Committee to enable it to function effectively. The current Audit Committee practices have to

change. The question is will they change? This article discusses the new provisions and raises some issues that need attention of both academics and practitioners of corporate governance.

Board of directors (hereafter Board) is primarily an oversight body that oversees the management of the company. Its role has changed over the years. Investors and regulators expect the Board to intervene in the operations of the company rather than just acting as an approving authority. The level of intervention depends on the confidence of the Board on the CEO. The level of intervention by the Board increases when the company goes through difficult situations. Regulators often specify specific responsibilities of the Board. For example, section 134 of the Companies Act 2013 requires that the Board's report shall include Director's Responsibility Statement, which shall state:

- (a) In the preparation of the annual accounts, the applicable accounting standards had been followed along with proper explanation relating to material departures;
- (b) The directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;
- (c) The directors had taken proper and sufficient care for the maintenance of adequate accounting records in

- accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
- (d) The directors had prepared the annual accounts on a going concern basis; and
  - (e) The directors, in the case of a listed company, had laid down internal financial controls to be followed by the company and that such internal financial controls are adequate and were operating effectively.
  - (f) The directors had devised proper systems to ensure compliance with the provisions of all applicable laws and that such systems were adequate and operating effectively.

## Internal Financial Control

Internal financial control is a usually defined very broadly. The Companies Act 2013 states that the term 'internal financial controls' means the policies and procedures adopted by the company for ensuring:

- The orderly and efficient conduct of its business, including adherence to company's policies,
- The safeguarding of its assets,
- The prevention and detection of frauds and errors,
- The accuracy and completeness of the accounting records, and
- The timely preparation of reliable financial information

Safeguarding of assets includes safeguarding of assets from theft, fraud, wastes arising from inefficiency and loss due to bad decisions, including poor strategy or poor execution of a good strategy.

The Audit Committee supports the Board in discharging most of the above responsibilities.

## Independent Audit Committee

Across the globe, the Audit Committee of the Board has emerged as an important institution in the corporate governance system. India is no exception. Companies Act 2013 (hereafter Act) requires that the Board of the following classes of companies to constitute an Audit Committee:

- Every listed company
- All public companies with a paid up capital of ten crore rupees or more (as existed on the date of last audited financial statements)
- All public companies having turnover of one hundred crore rupees or more (as existed on the date of last audited financial statements)
- All public companies, having in aggregate, outstanding loans or borrowings or debenture or deposits exceeding fifty crore rupees (as existed on the date of last audited financial statements)

The Act requires that:

- The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority; and
- Majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statement.

Clause 49 of the Equity Listing Agreement (hereafter 'Code of Corporate Governance') requires that:

- The Audit Committee shall have minimum three directors as members. Two-thirds of the members of Audit Committee shall be independent directors.
- All members of Audit Committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
- The Chairman of the Audit Committee shall be an independent director.

Effectiveness of the Audit Committee depends on its independence from the management. Therefore, regulators require that the majority of the members of the Committee should be independent directors. Code of Corporate Governance requires that the chairperson of the Committee should be an independent director. Compliance with the regulatory provisions does not make the Audit Committee independent if independent directors are not independent. There is a view that none of the directors can be independent because an individual cannot be appointed as a director without the blessings of the incumbent management. In a company, which is controlled by a shareholder group (e.g. a family business), no individual can get elected as a director without the support of the controlling shareholder group because directors are elected by ordinary resolution, that is, by simple majority. Theoretically, if the voting right of the controlling shareholder group is less than fifty percent, an individual can be elected without the support of the controlling shareholder. But that does not happen in practice, because many retail investors and institutional investors abstain from voting in the annual general meeting (AGM).

#### **Role of The Audit Committee**

The Board decides the terms of reference of the Audit Committee. The Act stipulates that, at the minimum, the Committee shall carry out the following functions:

- Recommend appointment, remuneration and terms of appointment of auditors of the company;
- Review and monitor the auditor's independence and performance, and effectiveness of audit process;
- Examine the financial statement and the auditor's report thereon;
- Approve or modify Related Party Transactions;
- Scrutinise inter-corporate loans and investments;
- Value undertakings or assets of the company, wherever it is necessary;
- Evaluate internal financial controls and risk management systems;
- Monitor the end use of funds raised through public offers and related matters.

Code of Corporate Governance, which is applicable to listed companies only, stipulates the following additional tasks for the Audit Committee:

- Oversee the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible;
- Approve payment to statutory auditors for any other services rendered by the statutory auditors;
- Review, with the management, the annual financial statements and auditor's report thereon before submission to the board for approval;
- Review, with the management, the quarterly financial statements before submission to the board for approval;
- Review, with the management, performance of statutory and internal auditors, adequacy of the internal control systems;
- Review the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit;
- Discuss with internal auditors of any significant findings and follow up there on;
- Review the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board;
- Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern;
- Look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividends) and creditors;
- Review the functioning of the Whistle Blower mechanism;
- Approve appointment of CFO
- Review Management discussion and analysis of financial condition and results of operations;
- Review statement of significant related party transactions (as defined by the Audit Committee), submitted by management;
- Review Management letters / letters of internal control weaknesses issued by the statutory auditors;
- Review Internal audit reports relating to internal control weaknesses; and
- Review the appointment, removal and terms of remuneration of the Chief internal auditor.

#### **Engagement With Auditors**

The Audit Committee should engage with auditors intensively. The management has motivation to manage earnings. Earnings management achieves twin objectives. First it enhances the management compensation by increasing the bonus and by artificially enhancing the value of ESOP. Second, by delaying the bad news

management avoids active intervention of the Board and shareholders. The Audit Committee cannot directly detect earnings management. It has to depend on auditors. The quality of corporate financial report depends on accounting standards and the auditors' independence. It is the responsibility of the Audit Committee to protect the auditors' independence and to ensure that appropriate accounting principles and methods are applied in the preparation and presentation of financial statements.

Unfortunately most audit committees interact with the auditors only when they make presentations before the Audit Committee. Audit committee members ask typical and routine questions. Audit committee members also routinely approve management's proposal regarding the appointment and remuneration of auditors and appointment of auditors for other services. This makes the auditors vulnerable to the pulls and pressures of the management. In fact, the current practice exposes the members of the audit committee to the risk of being charged for not applying due diligence in discharging their responsibilities.

#### **Engagement With the Internal Auditor**

The Board is responsible to ensure that the internal financial control is adequate and operating effectively. This requires specialised knowledge and skills. Therefore, the Board depends on the Audit Committee, which is expected to have those specialised knowledge and skills. The Audit Committee cannot directly detect management misfeasance and management override of internal financial control. It depends on the assurance service that is provided by the internal audit function. Internal audit also provides assurance that the risk management system is adequate and effective. The internal auditor is the 'eyes and ears' of the audit committee, and its 'go-to man'. However, in India, in most organisations the internal auditor is yet to get the place in the organisation that it deserves. It exposes the Audit Committee to huge risks. This is the failure of the Audit Committee.

#### **Inter-corporate Loans and Investments**

The Audit Committee is required to scrutinise inter-corporate loans and investments. This is a challenging task, particularly in Group companies. This requires balancing the protection of minority interest of the company and advantages of internal banking within the Group. The Audit Committee cannot evaluate the proposals from the perspective of a banker or outside financier. It has to develop a different perspective keeping in mind that internal banking is a normal practice and usually financing is provided to Group companies, which is passing through difficult time and is unable to borrow from the market.

#### **Related Party Transactions**

Companies enter into related party transactions for various reasons. Many of those transactions benefit investors and optimise use of resources. For example purchase and sale between two related parties reduce

transaction costs. Related party transactions are also abused to expropriate the wealth of shareholders. It is the responsibility of the Audit Committee to protect shareholders from abusive related party transactions. The audit committee is required to approve those transactions. This is a challenging task. The audit committee has to collect required market information to develop a perspective on whether the related party transaction is abusive or beneficial to shareholders. It has to bring independent judgement in deciding the issue.

#### **Vigilance Mechanism**

An adequate and effective vigilance mechanism (also called whistle blower mechanism) is essential for managing fraud risk. It also provides an assurance to the Board and the management that the 'tone at the top' has percolated down and the standard of conduct is understood by all the employees and adhered to by them. Regulators require the Audit Committee to administer the vigil mechanism.

#### **Super Power House**

Tasks assigned to the Audit Committee are onerous. It should be empowered and adequate resources are to be provided to it to enable it to perform those tasks effectively. Organisational functions that support the Audit Committee should be independent of the management. Regulators have taken note of the same. The Act requires that the Audit Committee should decide the scope and mechanisms of internal audit. The Code of Corporate Governance requires that the Audit Committee to approve the appointment of the CFO. It also requires extensive engagement with both the statutory auditors and the internal auditor.

Regulators have empowered the Audit Committee to enable it to play its role effectively. The Companies Act 2013 stipulates that the Audit Committee shall have authority to investigate into any matter in relation to the items that are within its terms of reference. It has the power to obtain professional advice from external sources and has full access to information contained in the records of the company. The Act requires that the Board's report shall disclose the composition of an Audit Committee. The Board's report has to disclose where it had not accepted any recommendation of the Audit Committee and the reasons therefor.

Audit Committee has emerged as a new super powerhouse in the context of corporate governance, because of the responsibilities assigned to it are difficult and sensitive, and it is empowered to take independent decisions. Audit Committee is constituted of independent directors. There is a danger that the Audit Committee may become a separate power centre within the Board and develop an acrimonious relationship with the management. It is undesirable. Therefore, only those with leadership qualities should be appointed as Audit Committee members. Technical skills are not enough to handle sensitive and difficult issues.

**Conclusions**

Audit Committee has emerged as a super powerhouse, which has the responsibility to protect minority interest. It derives power from laws and regulations and also from the Board. At present, the Audit Committee does not function the way it is expected to function. The most important reason for the same is that independent directors are not independent of the management. Another

important reason is that independent directors do not devote the time and efforts that are required to do justice to the tasks assigned to the Audit Committee. An unresolved issue is whether Audit Committee members should be compensated adequately (at market rate) for their efforts. The danger is that compensation at that level might impair independence.

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