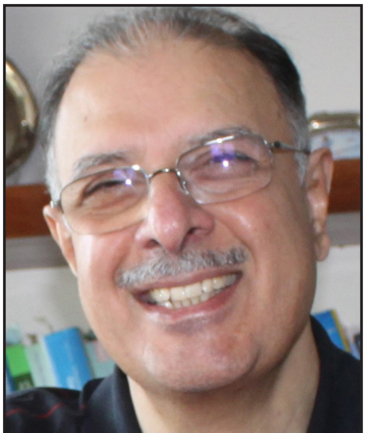
Audit Committee Concepts



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When I first chaired an audit committee nearly a quarter century ago, such committees were new in India and we, these committees' members, were learning as we went. Clause 49 of the standard Stock Exchange Listing Agreement had just been introduced along with section 292A in the Companies Act, 1956. The requirements then were simple with a focus on the financial statements and on controls for the management of risk. In these 23 years much change has taken place - section 217 of the Companies Act 2013 combined with the LODR, and a few good practices has taken the number of tasks an audit committee is expected to perform to nearly 50. These taks may appear to be a random grab-bag but some reflection indicates a few clear concepts driving the activities of these committees. These are:

A. An audit committee is a caucus of independent functionaries.

Apart from its members, an audit committee contains, in non-member roles, several independent and quasi-independent functionaries. These include the statutory auditor, the valuation expert (if necessary), the legal advisor (if there is one), the company secretary, the internal auditor, the head of risk management the company's legal head and the compliance officer if there is one. The list includes employees of the company who need to be quasi-independent, i.e., in their inputs to the committee they need to be free of any influence of either the senior management or of the controlling shareholder. The committee must take special care to protect the employee participants from pressures because potential influencers are in a stronger position than they are with external participants.

No doubt, committee meetings also generally have in attendance the company's CFO and CEO or other senior managers, as required, the latter especially when risks and controls are on the agenda. While they are expected to be honest in their interactions with the committee, the raison d'être of audit committee is to assess the reliability of representations made by management to various stakeholders including the board of directors. Therefore, the managers cannot be independent of the matters before the audit committee.

Inexplicable, the law and SEBI have left a huge loophole open – they do not forbid executive directors to be members of these committees, indeed in unlisted companies they could even be the chairs. In PSU's it is virtually the norm for Finance Directors to be members of audit committees.

B. An audit committee works through "agents".

Unlike any other committee of the board an audit committee is expected to do a fair amount of original work. Section 177 of the Companies Act requires an audit committee to undertake an "**examination**" of the financial statements. An examination is an activity that requires a level of diligence that is far greater than a review. The section requires an "**evaluation**" of internal controls. This too expects a high level of involvement. The involvement is high because the work of the committee goes into the detailed processes and reports that it is evaluating or examining. There are several other activities that a committee must undertake – approving related party transactions, valuing assets, scrutinizing inter-corporate loans and investments, monitoring the end use of funds raised from the public, review schemes of arrangement, etc. The LODR uses a variety of verbs to describe a long list of committee responsibilities - review, recommend, approve, oversee, scrutinise, evaluate, discuss, look into, carry out.

How can a body that functions only through meetings perform this plethora of diverse and detailed tasks that require several different special areas of expertise? The law provides the answer – the appointment under the aegis of the committee of specialists. External auditors to audit the financial statements, internal auditors to evaluate the internal controls for managing risks, valuers for valuations of assets are specifically identified. In addition, committees employ the expertise of the company secretary or compliance officer to assist them in evaluating controls for legal compliance and for compiling and presenting comprehensive and reliable data for related party transactions.

Because these functionaries undertake tasks on behalf of the committee or are critical to the committee discharging its responsibilities, the committee must consider them equivalent to its "agents". This is because any failure on their part could expose the committee to a failure in discharging its own responsibilities. The two principal reasons that the "agents" may fail in their work are lacking the necessary competence or being influenced to improperly endorse a matter. Therefore, the committee must take special care to ensure that its "agents" are independent and competent. They must possess these attributes both, when appointed as well as throughout the engagement. Where the law provides for a functionary to be licensed, the committee must not depend merely on the license. It needs to ensure that the party understands the business of the company well, can comprehend any non-routine transactions (e.g., forex, commodity hedging) and is familiar with special regulations that may apply to the business. The entity should have good quality control, knowledge management, training and assignment execution processes. As for independence from management and controlling shareholder influence, it is not sufficient for the entity to meet the required professional or legal requirements. The committee must satisfy itself that in fact independence exists and is maintained throughout the assignment. For the latter purpose the chair of the committee must invest heavily in building a bond of trust between himself or herself and the independent entities. How this is to be done is a topic for another article.

C. The committee must take responsibility for the work of its "agents".

Most committees accept the outcome of their "agents'" work without any further diligence. They believe that having appointed an expert, they have no further responsibility and are entitled to rely in toto on their work. I have in the previous paragraphs summarised the law's and regulator's expectations of audit committees. Those are not limited to appointing external and internal auditors and other "agents". I use the term "agents" advisedly – a principal is responsible for its agent's work. Therefore, committees must be diligent in engaging with their "agents" and in assessing the outcome of their work. There are a few broad guides for this:

- At the start of the work – is the plan of work reasonable, are the resources to be deployed adequate in quantity and knowledge, what inputs will be used and how reliable are they expected to be, what areas of work need special emphasis, what could go wrong, are timelines reasonable?
- During execution – how are significant challenges being resolved, are there new developments that need to be informed to the "agent", could the assignment fail to meet the committee's expectations?
- At the work's conclusion – has the assignment been completed as expected, is its outcome as expected, what are the risks that may not have been identified, what are the major assumptions, estimates and judgments the "agent" used for the work and does the committee concur with them, was the "agent" constrained in any manner (including influencing)? Section 134(5) of the Companies Act has a good list of items that need to be addressed both when discussing the financial statements as also determining the work an internal auditor must do.

If a committee is diligent and its "agent" fails in a matter that diligence would not bring to the surface, the committee can claim to be not culpable. But if a committee has unquestioningly accepted an agent's work, as the principal, it would be as liable as the agent for the failure.

Conclusion

An audit committee would be effective if it bore in mind the above basic concepts. In brief:

- It should have good judgment independent of the management and controlling shareholders as also of its "agents".
- The committee must focus on the substance of its work and on what is presented to it rather than make a formal ritual of its agenda.
- The committee must take responsibility for its "agent's" work by ensuring their competence and their independence.
- The committee must be diligent in whatever it does.

Boards of directors may have no option but to trust the managers; it is their audit committees that verify what these managers tell the board.