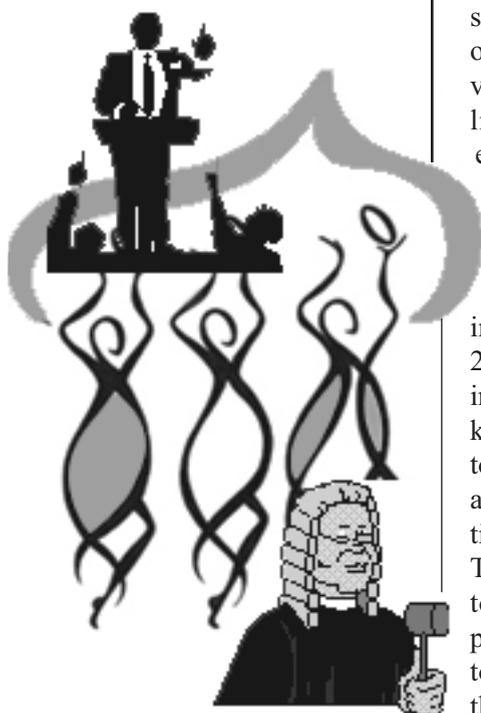


Though there are many measures to put corporate governance in place and practice, an important tool essential for the success is the efficacy and effective functioning of the audit committee. The audit committee is now looked upon as a distinct culture for corporate governance and excellence and has received a wide publicity.



The Audit Committee: A global perspective

—*P.T.Giridharan*

The Charter for Audit Committee as a part and parcel of corporate governance framework is taking rapid strides in the arena of corporate affairs by way of different prescriptions emanating from recommendations of the reports of various committees, statutes and listing requirements. What emerged and envisaged, as a concept of self-regulation, is gradually becoming a compulsory requirement for the listed entity. Mishaps that happened in major US corporate affairs in 2002 were taken as forewarning in the global context and the market regulators were quick enough to contemplate many new ideas and stipulations to the perspectives and reality of the situations. Though there are many measures to put corporate governance in place and practice, an important tool essential for the success is the efficacy and effective functioning of the audit committee.

The audit committee has been given the mandate to 'review' the financial functioning and affairs of an entity.

The audit committee is now looked upon as a distinct culture for corporate governance and excellence and has received a wide publicity. The concept as such is not something new and it has been in existence for over half a century. As early in 1940, the Audit committee came into formation with the support of the Securities Exchange Commission and New York Stock Exchange.

In 1970s the concept gained considerable popularity all over the world. As per the requirement of NYSE since 1978, each company listed on the stock exchange should establish an Audit committee. In UK, the recommendations of the Hampel Committee Report recognised the establishment of Audit committee.

The major report and recommendations of the Audit committee came from the Blue Ribbon Committee on improving the effectiveness of Corporate Audit Committee in 1998.

The author is Deputy Director, Board of Studies of ICAI. He can be reached at giridharan@icai.org

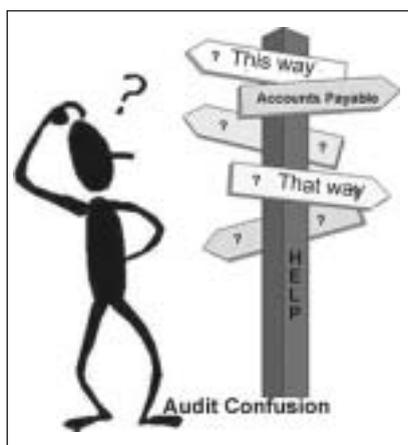
It is also worthwhile observing the attempt and approaches recently adopted in Europe and other parts of globe so as to draw references and comparisons in current Indian context:

United Kingdom: In UK, apart from the recommendations of Cadbury Committee and Hampel Committee, which set the tune for the agenda of the committee, Sir Robert Smith Group recommendations submitted in January 2003 are also under active consideration. The role of the audit committee as specified by them broadly relates to monitoring of the integrity of the financial statements of the company; reviewing reporting judgments, internal audit and control system; monitoring and reviewing external auditor's independence and objectivity; board's approach in relation to the appointment of external auditor and engagement of external auditor in relation to supply of non-audit services etc. The recommendations of Sir Robert Smith were further endorsed by another committee (Derek Higgs), which submitted its report in January 2003, on the review of the role and effectiveness of non-executive directors.

European Union: In the European Union, a high-level group of Company Law experts presented a report in November 2002, which recommended that a company should comply on company law and corporate governance on a "comply or explain" basis.

It recommended that the role of a majority of independent non-executive directors in the supervision of the audit of company's accounts and the audit committee

Despite arguments for and against the responsibility of auditors in ensuring his participation in audit committee meetings, recent changes in Companies Act, 1956 and amendments in listing requirements have led to more challenges and as a result public expectation on the role of auditors has grown manifold.



should comprise non-executive or supervisory directors who are mostly independent.

United States: The Sarbanes Oxley Act, 2002 provides for the role and composition of the audit committee. Currently the Securities Exchange Commission (SEC) Rules require: —

- A declaration of independence stating whether the audit committee members are independent under new standards established by NYSE, NASDAQ and AMEX.

- An Audit committee Charter at least once in every three years
- An Audit Committee Report

Ireland: The Review Group on Auditing incorporated into Companies (Audit and Accountancy) Amendment Bill, 2001 the provisions for audit committee requiring, a charter, a report, a list of functions to be discharged etc. The Bill provided, besides other matters for written Terms of Reference (TOR) covering auditor appointment, monitoring his performance, quality of work of auditors etc.

France: The Bouton Report on "Promoting better corporate governance in listed companies" issued in September 2002 specified diversified role and responsibility for audit committee and operating procedures. Besides mentioning that the two-thirds of members should be independent directors, it recommended that the committee should interview auditors, Chief Financial Officer (CFO), heads of accounting and treasury departments.

Canada: The Canada Business Corporations Act requires that the audit committee should be composed of unrelated directors and all the members will be required to be financially literate with at least one having accounting or financial related expertise.

Australia: The Corporations Act does not require Australian companies to establish audit committees. However, it will be mandatory for top 500 listed companies. The ASX listing rules lacks such a mandatory requirement,

Indian Experience In The Concept Of Audit Committee

The concept of audit committee initially gained its importance as a measure of self-discipline, adopted by certain large companies, which availed term loans from public financial institutions. In the banking sector, pursuant to Joint Parliamentary Committee's report (1993), the RBI issued necessary instructions for the constitution of Audit committee. The concept was further advocated strongly by the High Level Expert Working Group on the Companies Act, 1956. Thereafter, the importance gained its place and became mandatory in the Companies Act, 1956 by an amendment brought into force by the Companies (Amendment) Act, 2000 [vide Section 292A]. The maiden attempt on amendment to the listing requirements relating to compliance of conditions of corporate governance followed after the report of Kumarmanagalm Birla Committee constituted by the Securities and Exchange Board of India [SEBI] in the year 2000. The Birla Committee Report on Corporate Governance recommended for a constitu-



tion of Independent Audit committee in case of listed companies of a certain size. The recommendations of the committee were brought into force through Clause 49 of the listing requirements.

Subsequently, the clause 49 to the listing requirements was amended from time to time based on the reports of committee constituted by the Securities and Exchange Board of India.

The initiative of the SEBI following Narayana Murthy Committee on Corporate Governance has given new dimensions to the code, compliance of conditions by the entity relating to corporate governance. The revised clause 49 is now at the centre stage, adding new dimensions to the disclosure and reporting requirements on corporate governance by the corporate as well new responsibilities for Chartered Accountants, Company Secretaries and Chief Financial Officer (CFO's) and Chief Executive Officers (CEO's). SEBI is presently reviewing the revised clause after having invited comments and suggestions.

however, the company must give an explanation as to how the situation is alternatively handled.

Primitive Style

In the early days, the audit committee was required to undertake primarily three functions:

- (1) Review Annual Accounts and Audited Statements and submit them to the Board with its comments and recommendations.
 - (2) Review the findings/reports of the internal auditors and statutory auditors, and
 - (3) Maintain an appropriate interface with the management in regard to internal control vis-à-vis accounts and audit functions.
- But today, because of increasing



complexity of business situations and regulatory requirements and as a result of more public pressure on disclosures and transparency requirements, the function of Audit committee has assumed a dynamic, diversified and demanding role and responsibilities.

Audit Assurance

Audit is an assurance to all those who have a financial interest in the company and the dimensions of audit, reporting requirements have undergone vast changes. The most direct method of ensuring that companies are accountable for their actions is through better transparency, openness, and disclosure and by compliance of accounting

standards, principles and practices. The legal framework, in which auditors operate, however, is not sufficiently designed in certain respects to provide the objectivity which shareholders and the public expect from auditors in carrying out their due diligence and attestation functions. A further drawback is the lack of knowledge and understanding amongst the shareholders and public, of the nature and extent of auditor's role. The difference between what auditors do achieve and what is thought to be achieved or should achieve is the "expectation gap". An essential step addressing the issue is to clearly lay down the respective responsibilities of directors and auditors in preparation and reporting on the financial statements of companies

in order to narrow down the expectation gap. A moot question may arise in the backdrop of the above situation is that whether an auditor is primarily responsible for ensuring compliance of corporate governance? Though a direct answer to this question cannot be so emphatic and affirmative, the reports on various aspects of Corporate Governance, in major portion, have highlighted the importance of financial statements, disclosures, transparency, responsibilities and accountability on the part of board as well as auditors. The auditor's role is to report whether the financial statements give a true and fair view (not full and fair view) and provide a reasonable assurance that these statements are free from material mis-statements. His role is not to prepare the financial statements, nor to provide absolute assurance that figures in the financial statements is correct, nor to provide a guarantee that the company will be a *going concern*.

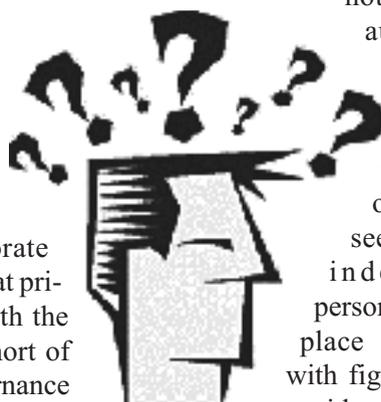
Despite the arguments for and against the responsibility of auditors in ensuring his participation at the meetings of audit committee, recent changes in Companies Act, 1956 and the amendments in listing requirements have thrown open more challenges and as a result the public expectation on the role of auditors has grown manifold.

How far an auditor is responsible?

This is a vital question. If at all he is wholly responsible, it requires a justification by way of a special position and role framed under the relevant statutes. The auditors do not have an executive role in Corporate Governance. It may be so, that primary responsibility vests with the Board. If the Board falls short of standards of corporate governance then the question arises who shall be able to identify, whistle-blow and rectify the deficiency? The

basic statutory duty of the auditors is to report to the shareholders whether accounts have been properly prepared to give a true and fair view and are in consistence with standard accounting policies and practices.

The prime responsibility for lapses if any, does not logically come within the scope and role of auditors unless there is prima-facie material evidence before him. However, given the statement, it is not that the auditor can become devoid of his responsibilities. In order to be seen as an independent person, he should place such facts with figures before consideration of the audit committee, which in his preliminary opinion might adversely affect the functioning of the com-



Current Issues and Ideal Approach

At present the scope and functions of the audit committee as per section 292A of the Companies Act, 1956 and as per the clause 49 of the Listing requirements are being addressed for harmonization. Yet basically and in generality, the scope and functions of the audit committee revolve around the following:

- (a) Discussions with the auditors periodically on internal control systems, scope of audit, observations of auditors and review of half-yearly and annual financial statements;
- (b) Investigate into any matter as specified in section 292A or referred to it by the Board as per the Terms of Reference;
- (c) Oversight of the financial reporting process and to ensure that statement is correct, sufficient and credible;
- (d) Recommending appointment and removal of external auditor, fixation of audit fee and for approval for any other service;
- (e) Reviewing the annual financial statements before submission to the Board;
- (f) Reviewing with management, external and internal auditors, the adequacy of internal control systems and functions;
- (g) Reviewing the findings of any internal investigation by the internal auditors;
- (h) Reviewing company's financial and risk management policies;
- (i) To look for reasons for substantial defaults in the payment to the depositors, debenture-holders, shareholders and creditors.

pany as a going concern and leave the judgment to the wisdom of the audit committee, who may otherwise take cognizance and report if necessary to further consider-

ation of the Board. It is in this connection that the role of auditors in participative and deliberative discussion with the audit committee may be advantageously taken by him to rest assure that what is otherwise not seen as seemingly independent is only apparent and not real.

Audit Expectation Gap

Another issue in the growing expectation gap on the role of auditors is that whether the prime responsibility for the prevention and detection of fraud is of the auditors or the fiduciary responsibility of the Board. These are not easy questions/problems, which can be answered in one way. The solution to the problem lies in the support systems that the company has created by way of internal control and systems, constitution of independent audit committee etc. To place a duty on the auditors to detect fraud(s) is unwarranted because he will never be in a position to guarantee that no such fraud has taken place. Whenever a fraud is expected by him, which are in collusion with the top management and no material evidence is possible, it may not be realistic nor logistic for the auditors to place or bring to the attention of the shareholders, of such instances.

Despite arguments for and against the responsibility of auditors in ensuring his participation in audit committee meetings, recent changes in Companies Act, 1956 and amendments in listing requirements have led to more challenges and as a result public expectation on the role of auditors has grown manifold.

Recent Dimensions to Audit Committee

Despite safe play methods, in the Indian context, the revised Clause 49 to the listing requirements has added new dimensions to the aspect of audit committee. Some of the issues, which are presently under debate in relation to the audit committee, are: -

Qualified and independent audit committee:

The revised clause states that all the members of the audit committee shall be non-executive

with the majority of them being independent. Here, it is not clear whether it is a simple majority or 3/4th as majority. Again that majority of the independent directors should be non-executive is apparently causing confusion when it is stated that independent directors shall mean non-executive directors. How suddenly a non-executive director can become devoid of his independence?

Reporting on Harmonious Consideration: In addition, it is stated that if the company has set up an audit committee pursuant to pro-

visions of the Companies Act, 1956, the company shall have such additional functions/features as is contained in the listing agreement. Though it

has been stated in the Master circular on the revised clause 49 that steps shall be taken to harmonise between the two laws namely section 292A of the Companies Act, 1956 dealing with the audit committee and clause 49, till such time, the company/auditor have to see that that conditions stated in the two laws are to be satisfied by way of principles of harmonisation.

Adding to the cause of fresh confusion, the Draft Companies Bill, 2004 in the form of Concept Paper on Company Law in section 62 prescribes that audit committee shall consist of not less than two independent directors and not more than such number of maximum independent directors as the Central Government may prescribe (at present as per section 292A it is three). Whether the independence of audit committee lies on the number of independent directors or the way it shall function is a moot point for discussion.

Further the audit committee shall mandatorily review besides other information such as reports relating to compliance with laws, to risk management, on related party transactions etc. Except relating to risk management, it is not clear that who shall prepare the report and submit on other aspects to the audit committee.

On the audit reports and audit qualifications, it is stated that in case the management has followed alternative treatment than that of



prescribed in accounting standards, it shall clearly explain such case in the footnote of the financial statements. This clause seems to be not consistent with the disclosure of contingent liabilities.

Who are Whistle-Blowers? On the whistle-blower policy, the proposed revised clause has given honours to the employee personnel to report such unethical practices adopted by the entity, of course with the safeguard for protection. Whether the auditor is also a whistle blower otherwise is matter of best judgment and assessment.

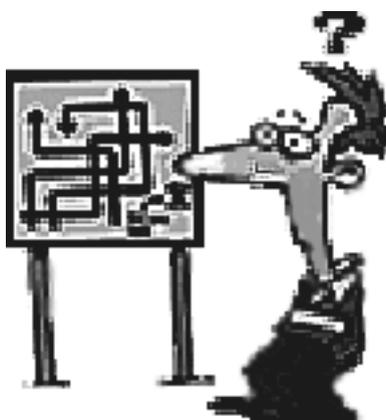
Is Holding and Subsidiary One entity? On subsidiary companies, the clause seems to have treated the holding and subsidiary as one entity/company, though in letter and spirit of the law, i.e. Companies Act, 1956, they are treated as separate entities. Only for accounting purposes under the SEBI Act, 1992, consolidation of accounts is made compulsory, yet for other purposes, can the clause provide:

- (a) that the composition of board be the same for both the companies;
- (b) that the audit committee of the holding company has powers to interfere with that of audit committee of the subsidiary;
- (c) whether the board minutes of the subsidiary are placed for review at the meetings of the board of the holding company;

The above matters have to be debated and discussed.

Disclosures in Plain English: On the disclosure of contingent liabilities, it is stated that the management shall provide a clear description in plain English of each material contingent liability and its risks accompanied by auditor's comments in clear words. What are plain English

Adding a fresh confusion, the Draft Companies Bill, 2004 in the form of Concept Paper on Company Law in section 62 prescribes that audit committee shall consist of not less than two independent directors and not more than such number of maximum independent directors as the Central Government may prescribe.



and clear words cannot be strictly applied in a technical matter.

On the disclosure of related party transaction, the revised clause 49 states that the AS 18 has to be taken into consideration. There is a mention of transaction not on arm's length basis, which is silent in AS 18. The auditor in such circumstances may draw inference to the provisions contained in the Income Tax Act, 1961.

Duty of Risk Management: As per the revised clause it is now the duty of the board/compliance officer to report on disclosures relating to risk management.

Utilisation of Funds: On the utilisation of proceeds from Initial Public Offerings (IPO's), it is stated that the independent auditor shall

certify the statement. This apparently as per SEBI, DIP Guidelines, 2000, is the duty cast upon the merchant bankers. It is also important to note that for the first time the clause uses the term 'independent auditor' but without any explanation.

Quarterly Compliance Report: On quarterly compliance report to the stock exchanges, as certified by the Chief Executive Officer (CEO)/Chief Financial Officer (CFO) it is not clear as to whether it is to be obtained and seen by the auditor for the purpose of preparing quarterly financial statements.

Thus in pursuit of furtherance and commitment to corporate governance, the revised clause has instilled many areas, which have to be complied by the company. The listing requirements have thrown many challenges and opportunities to the professionals, personnel in the company and the entity itself.

Audit Committee's independence

It is often believed that the committee is an extension and constitution by the Board itself and therefore it reports to the shareholders and works for the management. This myth lays the foundation for the independence, excellence and integrity of the committee as a constituent of the Board. The audit committee to remain in the seat, in order to preserve the unblemished reputation for its independence should not have any conflict of commercial interest in the company in which they form part of. The role of Audit committee is an important area to safeguard the interests of various stakeholders, however big or small. Its composition of independent

directors, active participation of institutional directors, their responsibility vis-à-vis the term of office of non-executive directors, meetings of the audit committee, its seriousness in participative discussions and deliberations, review of information obtained by it, and on audit reports and qualifications have been prescribed to set and place in the seat of independence.

The word “excellence” is difficult to define in terms of charter or standards and easier to define in terms of conditions.

As far as the committee is concerned, the laws and the listing requirements provide a broader perspective and it is the committee to keep afloat its own code of conduct and guidance for governance and excellence. Therefore, an independent audit committee can be of excellence in the context of its reporting requirements on the compliance of the conditions of Corporate Governance. The end result

The Revised Clause 49 is adding new dimensions to disclosure and reporting requirements on corporate governance by the corporate besides adding to the responsibilities of CAs.

of independence and excellence is the integrity of the committee by gaining the confidence of various interested parties.

Audit Committee for the future

Apart from the normal statutory disclosures whether there is a need for voluntarily disclosures by the committee, which may be useful to the prospective shareholders for deciding their investment in the company. In view of the growing expectation, a paradigm shift is necessary that the committee apart from the statutory disclosures should voluntarily disclose on such other matters as a part



of its observation or recommendations or opinion. The voluntary disclosures shall enhance the independence and excellence

of the committee.

Despite the scope, responsibilities and benefits that arise from Audit committee, which is a positive step towards an enhancement of credibility and integrity of financial statements, there are certain obstacles in the process. Though the formation of Audit Committee is a simple matter, but making it effective is more complex. The most important factor is the attitude of top management, selection of independent directors and such other members who should have the bent of mind, knowledge, inclination, understanding and expertise of the financial matters. ■

IMPORTANT ANNOUNCEMENT

For attention of students of Final Examination covered initially under erstwhile syllabus as per para 3 of Schedule “BB” to the Chartered Accountants Regulations, 1964 (two group scheme applicable after 1st January 1985) or para 3 of Schedule “B” to the Chartered Accountants Regulations, 1988.

In partial modification of the Announcement dated 18th July 2002, the Council of the Institute has decided, in terms of Regulation 38A(5) of the Chartered Accountants Regulations, 1988 with the approval of the Central Government to relax the time limit from existing May 2004 to the Final Examination to be held in November, 2006 for passing the remaining group of Final Examination to such students who had passed one of the groups of Final Examination under erstwhile syllabus as per para 3 of Schedule “BB” to the Chartered Accountants Regulations, 1964 (two group scheme applicable after 1st January 1985) or para 3 of Schedule “B” to the Chartered Accountants Regulations, 1988 in order to complete the requirements of passing the Final Examination.

Thereafter, the benefit of group exemption under the existing syllabus will not be available to such candidates and they shall be required to appear in both the groups in the syllabus, as in vogue, afresh in order to complete the Final Examination. It is also stated that the Central Government has also conveyed that no further extension to the aforesaid group exemption will be agreed to.

Accordingly, the students of Final Examination who had already passed one of the groups under erstwhile aforesaid syllabus are now required to appear in the remaining group of Final Examination to be held from November 2004 until November 2006 in order to complete the passing of Final Examination. In other words, if a student had passed Group First of Final Examination under the syllabus as specified above shall now be required to appear in Group Second and vice versa of Final Examination till and inclusive of Final Examination to be held in November 2006.

All concerned students are advised to note the above decision of the Council.

(G. SOMASEKHAR)
Joint Secretary (Exams)-CC