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Audit Committee and Corporate Governance

Question 1

Mr. 'U', a respectable Chartered Accountant of international repute was requested by one of the major corporates in India to join its Board and also as a Chairman of Audit Committee. He expressed his apprehensions that he is not having the requisite experience. Mr. 'U' seeks your view on the responsibility of Audit Committee vis-a-vis the review of Financial Statements.

(4 Marks, May, 2014)

Answer

Responsibility of Audit Committee vis a vis review of Financial Statements: The responsibility of the audit committee while reviewing the annual financial statements with management before submission to the Board, focuses primarily on-

(i) Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (c) of sub-section 3 of section 134 of the Companies Act, 2013.

(ii) Changes, if any, in accounting policies and practices and reasons for the same.

(iii) Major accounting entries involving estimates based on the exercise of judgment by management.

(iv) Significant adjustments made in the financial statements arising out of audit findings.

(v) Compliance with listing and other legal requirements relating to financial statements.

(vi) Disclosure of any related party transactions.

(vii) Qualifications in the draft audit report.

Question 2

Dishonest Limited, a company incorporated in India has six members in its Audit Committee. Due to recessionary conditions in India the revenue of the company is going down and there is slow down in other activities of the company. Therefore, it was expected that there would not be significant work for members of the Audit Committee. Considering the overall recession in the company and the economy, the members of the Committee decided unanimously to meet once in a year only on March 31, 2013. They reviewed monthly information system of the

Company and found no errors. As an auditor of Dishonest Limited would you consider the decision taken by the Audit Committee is in line with the Clause 49 of the (SEBI) Listing Agreement? (4 Marks, November, 2013)

Answer

Holding of Meeting and Review Requirements as per Clause 49 of the (SEBI) Listing Agreement: One of the requirement as stipulated under Clause 49 [Clause 49 (III) (B)] (on which Section 177 of the Companies Act, 2013 relating to audit committee, is silent) is – The Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

In this case, Dishonest Limited is a company incorporated in India and have 6 members in it's Audit Committee. Contention of audit committee members to meet only once due to recessionary conditions in India, at the year end is not in line with the requirement of clause 49 of the (SEBI) Listing Agreement.

Besides, there is a mandatory review requirement as per Clause 49 (III) (E), according to which the Audit Committee shall mandatorily review the following information:

(i) Management discussion and analysis of financial condition and results of operations;

(ii) Statement of significant related party transactions (as defined by the Audit Committee), submitted by management;

(iii) Management letters / letters of internal control weaknesses issued by the statutory auditors;

(iv) Internal audit reports relating to internal control weaknesses; and

(v) The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

In the instant situation, though, the Audit Committee has reviewed monthly information system, but, failed to comply with the above requirements mentioned at point no. (i) to (v) of Clause 49 (III) (E) of Listing Agreement.

Question 3

Write a short note on Content of Management Discussion and Analysis. (4 Marks, November, 2013)

Answer

Content of Management Discussion and Analysis:

(1) As part of the directors' report or as an addition thereto, a Management Discussion and Analysis report should form part of the Annual Report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:

   (i) Industry structure and developments.

(ii) Opportunities and Threats.

(iii) Segment–wise or product-wise performance.

(iv) Outlook

(v) Risks and concerns.

(vi) Internal control systems and their adequacy.

(vii) Discussion on financial performance with respect to operational performance.

(viii) Material developments in Human Resources/Industrial Relations front, including number of people employed.

(2) Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its core management team excluding the Board of Directors). This would also include all members of management one level below the executive directors including all functional heads.

(3) The Code of Conduct for the Board of Directors and the senior management shall be disclosed on the website of the company.

Question 4

State the "Mandatory Review" areas of the audit committee. *(4 Marks, May, 2012)*

Answer

Mandatory Review Areas of the Audit Committee: The Audit Committee shall mandatorily review the following information as per Clause 49 of the Listing Agreement-

(i) Management discussion and analysis of financial condition and results of operations;

(ii) Statement of significant related party transactions (as defined by the Audit Committee), submitted by management;

(iii) Management letters / letters of internal control weaknesses issued by the statutory auditors;

(iv) Internal audit reports relating to internal control weaknesses; and

(v) The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

Question 5

State the main features of the Qualified and Independent Audit Committee set up under clause 49 of the listing agreement. *(8 Marks, November, 2008)*

Answer

Features of Qualified and Independent Audit Committee: The main features of a qualified and independent audit committee to be set up under clause 49 of listing agreement are as follows-

(1) The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors.

(2) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

Explanation (i): The term "financially literate" means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation (ii): A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(3) The Chairman of the Audit Committee shall be an independent director;

(4) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries;

(5) The Audit Committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee;

(6) The Company Secretary shall act as the secretary to the committee.

Question 6

Elaborate under Clause 49 of the Listing Agreement, who is an Independent Director.

(6 Marks, May, 2008)

Answer

Clause 49 of the Listing Agreement on Independent Director: As per Clause 49 of the listing agreement, an Independent Director shall mean a non-executive director, other than a nominee director of the company:

(1) who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;

(2) (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;

(ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;

(3) apart from receiving director's remuneration, has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;

(4) none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

(5) who, neither himself nor any of his relatives —

(i) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;

(ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of —

(A) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or

(B) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent or more of the gross turnover of such firm;

(iii) holds together with his relatives two per cent or more of the total voting power of the company; or

(iv) is a Chief Executive or director, by whatever name called, of any non-profit organisation that receives twenty-five per cent or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent or more of the total voting power of the company;

(v) is a material supplier, service provider or customer or a lessor or lessee of the company;

(6) who is not less than 21 years of age.

Question 7

Write a short note on Corporate Governance. *(4 Marks, November, 2004)*

Answer

Corporate Governance: Corporate governance is the system by which companies are directed and controlled by the management in the best interest of the shareholders and others ensuring greater transparency and better and timely financial reporting. The Board of Directors

are responsible for governance of their companies. A number of reports and codes of corporate governance have been published internationally.

The Securities and Exchange Board of India (SEBI) had set up a Committee under the Chairmanship of Shri Kumar Manglam Birla to formulate the code of corporate governance. The Securities and Exchange Board of India (SEBI) with the objective to align its provisions to the recently notified provisions of the Companies Act, 2013, ('the Act') has specifically reviewed clause 49 of the Listing Agreement, to adopt leading industry practices on corporate governance and to make the corporate governance framework more effective. The revised clause 49 on corporate governance shall be applicable to all listed companies with effect from 1st October 2014, except for the clause relating to the constitution of a Risk Management Committee which shall apply to the top 100 listed companies by market capitalisation, as at the end of the immediate previous financial year.

Various clauses deal with composition of board, setting-up of audit committee including scope thereof, remuneration of directors, meetings of Board, contents of management discussions and analysis report, etc.

Clause 49 also prescribes that there shall be a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted, should be specifically highlighted. Further, the entity is required to obtain a certificate from the statutory auditor of the entity as regards compliance of conditions of corporate governance as stipulated in that clause.

A monitoring cell set up by SEBI, will assess compliance by companies with the requirements of clause 49 and report noncompliances to SEBI within 60 days from the end of each quarter. This shows the strong intent of SEBI to not only bring in regulations, but also put in place a monitoring mechanism.

Note: SEBI has revised Clause 49 vide its Circular dated April 17, 2014 with effect from 1 October 2014.

Question 8

Explain the Constitution and functions of Audit Committee under Section 292A of the Companies Act, 1956. *(8 Marks, May, 2004)*

Answer

This question is redundant in view of the provisions of the Companies Act, 2013.