

Corporate Governance Through Audit Committees

The Audit Committee of the Board is today seen as a key fulcrum of any company. Being mandatory under Clause 49, the Audit Committee can be of great help to Board in implementing, monitoring and continuing good corporate governance practices to the benefit of the company and its stakeholders. This article offers an overview of the Audit Committee and its functions.

A Board's efficiency depends on the overall performance of its functions, Board composition and structure and the procedures followed by it. Ideally, in mid-sized to large-sized Boards, the Board of directors constitute sub-committees as part of the Board only to discuss certain issues at Board level in a much detailed and focused manner. Such functioning of Boards through committees result in enhanced quality of decisions taken with focused approach. Such committees assist the Board in discharging its responsibilities in a better manner. It is ideal for unitary Boards (Indian case) to work through committee management system. The boards function through various committees such as Audit Committee, Remuneration or Compensation Committee, Nomination Committee, Shareholders Committee, etc.

Types of Committees under Clause 49

Clause 49 prescribes only two committees as mandatory ones i.e.,

- (i) Audit Committee
- (ii) Shareholder's Grievance Committee.

Apart from these too, the Board may also set up a remuneration committee (a non mandatory requirement)

Audit Committee Statute in India

Section 292A of the Companies Act, 1956 (inserted w.e.f. 13/12//2000) contains a provision



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relating to establishment of Audit Committee by every public company having paid-up capital of Rs. 5 crore or more.

Clause 49 of the uniform listing agreement prescribed by Securities and Exchange Board of India is applicable to all listed companies. Clause 49 of listing agreement deals with corporate governance and prescribes the setting up of a qualified and independent Audit Committee.

As per section 292A of Companies Act, 1956, Audit Committee should have discussions with the auditors periodically about internal control systems, scope of audit including the observations of auditors and review of the half yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems. It shall have authority to investigate into anything in relation to such matters and shall have full access to information contained in records of the company.

As per clause 49 of the listing agreement, Audit Committee is empowered to investigate any activity within terms of reference, seek information from any employee, obtain outside advice and secure attendance of outsiders, if necessary. Its role shall include recommending appointment and removal of external auditor, fixation of audit fees, approval of payment for other services, review with the management of the annual financial statements before submission to the Board, reviewing the adequacy of internal control system, oversight of company's financial reporting process and disclosure of its financial information to ensure that financial statements are correct, sufficient and credible, reviewing the adequacy of internal

audit function, reviewing the company's financial and risk management policies, reviewing the functioning of whistle blower policy and looking into reasons for substantial defaults, etc.

Summary of Provisions of Audit Committees

As required by section 292A of the Companies Act, 1956, every public limited company (listed or unlisted) having a paid-up capital of at least Rs. 5 crore shall constitute a Committee of the Board to be known as Audit Committee. The provisions in respect of the same are as follows:

- ❖ The Committee shall have at least three (3) members (directors).
- ❖ Two-third (2/3) of the members shall be non-executive directors.
- ❖ The Board of Directors shall prescribe the Committee's terms of reference in writing.
- ❖ The statutory auditor, the internal auditor and director in-charge of finance shall attend every meeting of the audit committee but shall not have the right to vote.

The recommendations of the Audit Committee will be binding on the Board. Though the Board is a superior body, yet it cannot override the recommendation of the committee. In case the Board does not accept the recommendations of the Audit Committee, it will have to record the reasons and communicate the same to the shareholders.

- ❖ Half-yearly and annual accounts should be discussed by the audit committee with auditors before presenting the same to the Board.
- ❖ The Audit Committee shall have right to investigate any matter covered under the broad terms of reference.

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- ❖ The Chairman of the Audit Committee shall attend the annual general meeting to provide clarifications on matters relating to audit
 - ❖ The constitution and composition of the Audit Committee is to be disclosed in the annual report of the Company.
 - ❖ Auditors—internal and external—and Director (Finance) shall attend the meeting but not have right to vote.
 - ❖ Audit Committee should discuss internal controls, scope of audit, observations of auditors, review of periodic financial statements etc. and compliance of internal control system.
 - ❖ The minutes of the Audit Committee are required to be placed before the next Board Meeting.
 - ❖ In the absence of any provision made in this section regarding quorum of the Audit Committee, the same needs to be laid down by the Board while constituting the Committee. SEBI guidelines stipulate a quorum of two members or one-third of the members of the Committee, whichever is higher with a minimum of two independent directors.
- If not spelt out, the whole of the committee, it appears, must meet. [Re - *Liverpool Household Stores Association Ltd.* [1890] 59 LJ Ch 616].
- ❖ Any default in complying with the provision of section 292A may attract imprisonment up to one year or fine up to Rs. 50000 or both. The prosecution lies against the company and every officer of the company who is in default. The offence is compoundable under section 621A.

- ❖ The provisions in clause 49 of the Listing Agreements as required by the Stock Exchanges are not identical with the above provisions. All listed companies having a paid-up capital of minimum Rs 5 crore will also have to follow the requirements as per Clause 49.

Financial Expertise of Members of Audit Committee

The Audit Committee is formed to regularly review processes and procedures to ensure the effectiveness of internal control systems so that the accuracy and adequacy of the reporting of financial results is maintained at high level at all times. To discharge the responsibility, it is important for the members of Audit Committee to have formal knowledge of accounting and financial management or experience of interpreting financial statements.

The Listing Agreement requires at least one director having financial management and accounting knowledge expertise to be a member of Audit Committee while other members should be financially literate. Section 292A(5) of the Act specifies that Director-in-charge of Finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.

Functions of Audit Committee under Section 292A

The Audit Committee constituted under this section shall act in accordance with terms of reference to be specified in writing by the Board. The Audit Committee should have periodic discussions with the auditors about the following matters:

- Internal Control System.
- Scope of audit including the observation of auditors.
- Review the half-yearly and annual financial statement before submission to the Board.
- Compliance of internal control system.

The Audit Committee shall also have authority to investigate into the matters in relation to the items specified in this section or matters referred to it by the Board of Directors. To carry out such investigation the Audit Committee will have full access to information contained in the records of the Company and external professional advice, if necessary.

The recommendations of the Audit Committee on any matters relating to financial management including the audit report shall be binding on the Board. In case the Board does not agree with the recommendations made by the Audit Committee, the Board shall record the reasons for disagreement and communicate the same to the shareholders to be reported in Annual General Meeting. The view of

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shareholders on such matters shall be final.

Penalty for Contravention of Section 292A

For default in complying with the provisions of this section the company and every officer who is in default shall be punishable with imprisonment for a term, which may extend to one year or with a fine, which may extend to 50,000 rupees or with both.

Audit Committee under Clause 49

Revised clause 49 of the listing agreement provides for specific requirements of an Audit

Committee. The companies shall be required to comply with the requirements of clause 49 in relation to Audit Committees, viz:

- (a) qualified and independent Audit Committee
- (b) meeting of Audit Committee
- (c) powers of Audit Committee
- (d) role of Audit Committee
- (e) review of certain information by Audit Committee

Qualified & Independent Audit Committee:

A qualified and independent audit committee shall be set up, by all eligible companies giving the terms of reference, subject to following stipulations -

- (i) The Audit Committee shall have minimum three directors as members. Two-third of the members of Audit Committee shall be independent directors.
- (ii) All members of Audit Committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
- (iii) The Chairman of the Audit Committee shall be an independent director.
- (iv) The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries.
- (v) The Audit Committee may invite such number of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meeting 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.
- (vi) The Company Secretary shall act as the secretary to the Committee.

Though it is desirable that a Company

Secretary is made the secretary of the Audit Committee, if there is no Company Secretary (as in case of some banks), some other senior officer may be designated as secretary to Audit Committee. The Chairman of the Audit Committee should be both—an independent director as well as financial expert. The other directors who are members of Audit Committee should be financially literate meaning thereby that they should possess ability to read and understand the basic financial statements such as balance sheet, profit and loss account and cash flow statement. To be an expert, the Chairman should possess requisite experience in the field or professional certification or should have had worked in a senior position with financial supervisory functions. It is expected of Audit Committee Chairman to be present at the annual general meeting and reply to shareholder's queries, if any.

Meetings of the Audit Committee

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

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The Audit Committee should meet at least four times in a year. At least two independent members should be present in all meetings. In view of the quarterly results, it will otherwise also become necessary for Audit Committee to

meet at least once in a quarter. There is no bar on the maximum number of sittings an Audit Committee can have.

Powers of Audit Committee

The Audit Committee shall have powers, which should include the following –

- (a) To investigate any activity within its terms of reference
- (b) To seek information from any employee
- (c) To obtain outside legal or other professional advice
- (d) To secure attendance of outsiders with relevant expertise, if it considers it necessary.

The terms of reference shall be given by the Board of Directors but it cannot curtail the functions or role of Audit Committee as envisaged in Clause 49. The Audit Committee shall be empowered to investigate any activity falling within the scope of its terms of reference. It would be desirable to adopt a charter of Audit Committee containing details of terms of reference and conduct of Audit Committee meetings etc. The Audit Committee shall be empowered to seek information from any person—both internally as well as externally—which it feels to be appropriate. It can seek information from employees, secure attendance of outsiders with relevant expertise, if necessary and even call for outside legal or professional advice for its guidance on any matters relevant to the operations and functioning of the company.

Audit Committee Interface

The Audit Committee seeks to safeguard the interest of various stakeholders of an organisation and details out the various bodies with which the Audit Committee interfaces.

Shareholders are the ultimate beneficiaries in an organisation's framework. Hence, the Chairman of the Audit Committee is accountable to shareholders and is required to reply to/

satisfy queries regarding audit and accounting functions raised by shareholders at the Annual General Meeting.

The primary interface of Audit Committee is with auditors, both internal and external. The Audit Committee has to ensure that the internal control systems designed to ensure proper accounting and auditing practices are discharging their duties well and not taking recourse to fabricated accounting techniques against the interest of stakeholders.

Similarly, Audit Committees have to interface with statutory auditors. Statutory auditors are the invitees in the Committee's meetings.

The Audit Committee is essentially an offshoot of Board of Directors to bridge in the gap of general managerial functions and specialised auditing and accounting functions that the constitution discharges.

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The Audit Committee has to be constituted of independent directors basically who are functionally literate. Therefore, it calls for professional directors on the Board.

The Audit committee serves as a tool in the hands of regulators like Securities and Exchange Board of India (SEBI), Ministry of Company Affairs (MCA), Reserve Bank of India (RBI), etc.

Scope of Audit Committee

The Audit Committee as a tool for review and oversight of Board's auditing and accounting functions has scope in following five functional areas of management:

- ❖ Financial Management
- ❖ Internal Auditing
- ❖ External Auditing
- ❖ Legal Processes
- ❖ Communication
- ❖ Financial Management – Audit Committee should take care of ‘integrity’ while ‘objectivity’ of the information in financial reports rests with the management. Audit Committee shall review background information on the competence and integrity of all members of the financial management group of the company.

For financial reporting purposes, Audit Committees need to assure that management is managing identified risks so that financial statement assertions will not be in any way misstated. In this regard, Audit Committees may request management and auditors to present a review on various components of internal control in order to ensure that internal controls provide a reasonable assurance that the financial accounts are maintained and accounted for properly.

- ❖ **Internal Auditing** – The Audit Committee needs to assure that the company’s comprehensive internal audit program evaluates the adherence to management’s policies and procedures. As part of the monitoring component of the entity’s system of internal control, the scope of the internal audit monitoring should extend to various types of audits, i.e., financial, operational, compliance, ethics and fraud, systems, and risk audits. The Audit Committee should also review the internal audit plans as well as the organisational structure and composition of the internal audit department.
- ❖ **External auditing** – The Audit Committee’s meetings and agenda needs to be directly linked to the auditing cycle consisting of a pre-audit interview, an optional interim audit interview, a post-audit interview, and

a follow-up interview.

The matters to be considered should ordinarily include a review and discussion on matters such as the audit plan, accounting and auditing developments that impact the financial statements, risk assessment and related risk control processes, an analytical review, the personnel assigned to the audit team, an internal financial audit plan, and estimated audit and non-audit fees payable to auditors.

Audit committees or external auditors may also request an interim audit interview to address problem areas and discuss the progress of the audit.

Audit Committees also focus on deviations from the audit plan, the analytical review, significant discoveries resolved and unresolved matters, any disagreements with management, and material audit adjustments as well as immaterial uncorrected misstatements. Additionally, Audit Committee should review the appropriateness of accounting policies

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(e.g. conformity with industry practices and alternative accounting principles and consistency in nature) and any changes in accounting principles, with impact thereof.

Audit Committee is also required to focus on recommendations for improvement in internal

control, approving the internal audit plan for the following year, and recommending the appointment of external auditors. It may also engage in a performance review of management, the internal audit group or the external auditors. Audit Committee might also review the external audit and non-audit fees that must now be disclosed in the annual financial statement.

- ❖ Legal processes – The Audit Committee is also required to overlook some legal functions that include the standard of independence for the Audit Committee members. This may involve in-house or outside legal interface. Its scope would cover any pending litigation against external auditors, as well as any impairment in their independence, compliance with key legislative acts (e.g. FEMA, Companies Act, 1956, RBI Act, SEBI guidelines, other industrial and revenue legislations, review and legal force of Audit Committee Charter, pending litigations and claims against the company or filed by the company, investigations, contracts, related party transactions, etc.
- ❖ Communication – Communication brings in the desired results. The findings and recommendations ought to be communicated to all concerned. Communication could be with internal or external sources such as –
 - Chairman / managing director
 - Members of Board of Directors
 - Audit Committee members
 - External auditors
 - Internal auditors
 - Independent professionals
 - Regulators
 - Shareholders (members)
 - Stakeholders (other than members)
 - Management team and employees

Such communication would cover interviews, interactions, seeking clarifications, discussions

with auditors, discussions on disagreements and written disclosures. Audit Committee charter is also a communication of Audit Committee with others concerned.

Functions of Audit Committee

The main function of Audit Committee is to assess and review the financial reporting system to ensure that financial statements are correct, sufficient and credible. It reviews with the management the annual financial statements before their submission to the Board. It also provides proper direction and oversees the

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Audit Committee stands upon four fundamental pillars to discharge its functions-

- Financial Management including responsibility, integrity, objectivity of information of financial reports and transparency in disclosures.
- Auditing -
 - Internal
 - External
- Legal compliance to ensure -

- Legal compliance
- Charter compliance
- Audit independence
- Review and assessment of financial implications of litigations and claims against the company
- Ensuring security of assets accounting standards and going concern.
- Communication and quality assurance -
 - With shareholders
 - Presentation of Board of Directors
 - Quarterly reviews
 - Compliance of Accounting Standards
 - Preparation and improvement in the Audit Committee charter
 - Selection of members of the Audit Committee
 - Appraisal and performance review
- (e) The going concern assumption.
- (f) Compliance with accounting standards.
- (g) Compliance with stock exchange and legal requirements concerning financial statements.
- (h) Any related party transactions.
- ❖ Reviewing with the management, external and internal auditors, and the adequacy of internal control systems.
- ❖ Reviewing the adequacy of internal audit function, 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.
- ❖ Discussion with internal auditors on any significant findings and follow up thereon.
- ❖ Reviewing 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.

Role of Audit Committee

According to Clause 49, the role of the Audit Committee shall include the following -

- ❖ Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
- ❖ Recommending the appointment and removal of external auditor, fixation of audit fee and also approval for payment for any other service.
- ❖ Reviewing with management the annual financial statements before submission to the board, focusing primarily on:
 - (a) Any changes in accounting policies and practices.
 - (b) Major accounting entries based on exercise of judgment by management.
 - (c) Qualifications in draft audit report.
 - (d) Significant adjustments arising out of audit.
- ❖ Discussion with external auditors before the audit commences about nature and scope of audit as well as post-audit discussion to ascertain any area of concern.
- ❖ Reviewing the company's financial and risk management policies.
- ❖ To 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.

Apart from above, if the company has set up an Audit Committee pursuant to provisions of Companies Act, then such Audit Committee shall have such additional functions and features as are contained in the listing agreement.

Review of information by Audit Committee:

The Audit Committee shall mandatorily review the following information:

- ❖ Financial statements and draft audit report, including quarterly / half-yearly financial information;
- ❖ Management discussion and analysis of financial condition and results of operations;
- ❖ Reports relating to compliance with laws and to risk management.
- ❖ Management letters / letters of internal control weaknesses issued by statutory / internal auditors; and
- ❖ Records of related party transactions.
- ❖ The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.



Prerequisites for Effective Audit Committee

An Audit Committee should ensure the following –

- ❖ Audit policy/charter – The Committee should review its policy/charter. The Committee and counsel should review the charter from a liability avoidance standpoint and assure that it contains only duties and obligations actually undertaken by the Committee.
- ❖ Resources for functioning – An Audit Committee will need financial resources for funding to retain outside legal/professional counsel preferably, without management's approval and to retain independent accounting and auditing firms for second opinion.
- ❖ Membership of Committee – Committee members should be so chosen that they can devote reasonable time to Audit Committee work. They should also be financial experts or be from finance background.
- ❖ Understanding accounting policies – The Committee should regularly review the accounting policies with an outside accounting firm to not only understand the policies and their meanings but also how they impact the bank and results of operations.
- ❖ Corporate disclosures – Audit Committee should get involved into corporate disclosures instead of relying on CFO or internal management's statements.
- ❖ Access to books – Audit Committee should have ready access, at all times to all books, records and employees of organisation.
- ❖ Investigations – Audit Committee should have uncontrolled power to conduct any investigations in order to appropriately fulfil its responsibility.
- ❖ Internal audit and consulting services – Outside internal audit firms should not be involved with any other kind of audits. Audit Committee should also examine potential areas of ethical conflict.
- ❖ Independence of directors – Only independent Directors should serve on Audit Committees.

- ❖ Frequency of meetings – Committee should meet at least quarterly.
- ❖ Independence of auditors – Committee should make regular inquiries to ensure that the independent external audit firm remains independent.
- ❖ Internal Controls – Committee should actively solicit information about the appropriateness of the internal controls in place.
- ❖ Interaction with Management/Auditors – Committee should require the management and the external auditor to fully inform it about any financial irregularities, regulatory investigations, potential liabilities or other sensitive information.
- ❖ Responsibility for frauds – Investing public is concerned with safety of moneys rather than discharge of legal responsibility of Audit Committee function. This should not be overlooked.

Audit Committee Charter

The Audit Committee, to meet its objectives must have a charter, which is a detailed description of its functional responsibilities. Its aim is to have a clear-cut defined role for itself to avoid any conflict in functional relationship with management and auditors. A well-defined written charter spells out the role, duties and responsibilities of Audit Committee and the authority it derives from the law and board of directors.

The Audit Committee should have a written charter, tailored to the company environment, clearly indicating Audit Committee duties and responsibilities. The charter should be reviewed and approved after due consideration by Board of Directors and updated periodically by Audit Committee. The charter should also indicate the background and experience requirements for Committee members, process of selections, orienting and updating these members, defining the Committee's authority

and specific responsibilities related to business and financial risk identification and related controls, compliance with laws and regulation and oversight to internal and external audit functions. It should also set forth guidelines for the Committee's relationships and meetings with members of the management, auditors and others, define its reporting requirements and review procedure, define risk controls, planning of audit, financial reporting, assessment of auditor performance and system of assessing Audit Committee performance.

According to the Audit Committee charter of Infosys Technologies Ltd., primary objective of the Audit Committee is to monitor and provide effective supervision of the management's financial reporting process with a view to ensuring accurate, timely and proper disclosures, and transparency, integrity and quality of financial

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reporting. The Committee oversees the work carried out in the financial reporting process by the management, the internal auditors and the independent auditor, and notes the processes and safeguards employed by each.

To conclude, it can be said that the Audit Committee of any Board is like the central fulcrum of the management. While it is imperative to have Audit Committee to ensure good corporate governance, it is also true that one cannot think of corporate governance without a functional Audit Committee. □