THE AUDIT COMMITTEE - A GLOBAL PERSPECTIVE

AMIT K VYAS*

INTRODUCTION

In the simplest of terms, an Audit Committee can be defined as " a committee of directors constituted by the Board as an independent body for the purpose of overseeing and monitoring the accounting and financial reporting processes, audit of financial statements and the adequacy and efficacy of the internal control systems of a company"

The Audit Committee thus acts as a catalyst for effective financial reporting and hence is a very important component of best corporate governance practices" .

The ultimate goal is to restore and retain stakeholders' confidence by promoting accountability. It acts as a catalyst for effective financial and auditing practices by playing the role of the Board's oversight function. It is not the role of the audit committee to prepare financial statements or engage in the decisions relating to preparation of these statements.

Circumstances/Developments which have catapulted the role of the Audit Committee

It is clear from the above definition of the Audit Committee that its sole objective is to protect the interests of the stakeholders and ensure accountability of the management, and hence the reasons which led to its speedy evolution in the global arena have to be necessarily rooted in all acts of ommission and commission involving frauds, scams etc. This view point is substantiated by the following analysis of the nature of various scams, malpractices, frauds etc committed by corporates :-

(1) In the United States

(i) The Watergate scandal unfolded in the year 1972, and subsequent investigation revealed that companies were engaged in questionable political campaign finance practices and clear foreign corrupt practices. The ensuing scrutiny by the Securities & Exchange Commission (SEC) and the Congress contributed greatly to the enactment of campaign finance laws and the 1977 FCPA, which made trans-national bribery a criminal offence and required companies to implement internal control programs. In response, a private-sector initiative, called the National Commission on Fraudulent Financial Reporting (commonly known as the Treadway Commission) was formed in October 1985. It had as its major objective to identify the causal factors of fraudulent financial reporting and to make recommendations to reduce its incidence. The Commission issued its initial report in 1987, and among other initiatives, recommended that the organizations sponsoring the Commission work together to develop integrated guidance on internal control .The Treadway Commission made six specific audit committee recommendations aimed at deterring fraudulent financial reporting.

(ii) In October 1998 , following the response to the criticism of the financial reporting processes , the New York Stock Exchange and NASDAQ sponsored the formation of the Blue Ribbon Committee to recommend measures to improve the effectiveness of Audit Committees. Further, during the said period it had also been observed by the SEC that many listed corporates were resorting to the following types of questionable and unethical practices :-

- Mis-use of the concept of materiality to mask inappropriate accounting treatment;
- Deliberately over-stating one-time "big bath " restructuring changes in order to provide a

* *FCS, Counsel (Co Affairs & Legal), Larsen & Toubro Ltd, Mumbai. The views expressed herein are strictly personal and not of the employer organization of the author.*

cushion to satisfy future wall street earnings estimates;

- The mis-use of acquisition accounting particularly improper write-offs of acquired in-process research development, to in appropriately over-state future earnings;
- "cookie jar reserves" where companies over-accrue charges for such items as sales returns, loans, losses or warranty costs in good times and use those reserves to smooth future earnings in bad times;
- premature revenue recognition, before a sale is complete, before a product is delivered to a customer or at a time when the customer still has options to terminate , void or delay the sale;
- improper deferral of expenses to improve reported results

Accordingly, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (BRC) made 10 recommendations for improving audit committees' effectiveness. BRC also provided five broad guiding principles for audit committees to follow in devising company-specific policies. The BRC recommendations resulted in changes by NASDAQ, the NYSE, AMEX, and the SEC.

(iii) The enactment of the world famous Sarbanes-Oxley Act, 2002 (SOX) is a landmark event in the history of Corporate Governance and also the role of the Audit Committee. The specific events leading to passage of the Act are now well documented. The low points in this story are now household names — not just Enron, but also WorldCom, Tyco, Adelphia and others. There was other serious misconduct as well, including in the once-celebrated IPO market, which in too many cases lacked both fairness and integrity. The cost of this corner-cutting to investors was enormous. To address the widespread collapse of investor confidence and the recognition that something had gone seriously awry in segments of corporate America, Congress approved and the President signed into law the Sarbanes-Oxley Act. At the East Room signing ceremony, the President promised, "to use the full authority of the Government to expose corruption, punish wrongdoers, and defend the rights and interests of American workers and investors."

Within these goals, the principal objectives addressed in the Act can be grouped into the following themes:

- To strengthen and restore confidence in the accounting profession ;
- To strengthen enforcement of the federal securities laws ;
- To improve the "tone at the top" and executive responsibility;
- To improve disclosure and financial reporting; and
- To improve the performance of "gatekeepers."

(2) In the United Kingdom

The concept of Corporate Governance was basically imported into U.K from the U.S. The following scams and scandals in the corporate world are the root factors for the evolution of the role of audit committee : -

(i) In the early 1990s, Polly Peck, a company in the top 100 of the Financial Times Index went into insolvency. The receivers had to struggle for quite a number of years to find the misappropriated assets and to make sense of the accounts;

(ii) The Bank of Credit and Commerce International (BCCI) , which received thousands of deposits from Asian Shopkeepers in the U.K , collapsed ruining many;

(iii) Robert Maxwell , the founder of the Maxwell Group , disappeared into the sea never to return, leaving behind a collapsed empire and several thousand pensioners without pensions;

(iv) Allied Lyons, the U.K Food & Drink conglomerate, announced losses in early 1991 of 147 million pound sterling from foreign exchange trading. The losses arose as a result of a substantially short U.S Dollars position in the spot market at a time when the U.S Dollar had strengthened;

(v) In March 1993, one of the largest hotel organizations in the U.K Queens Moat Houses, told its Banks that the Financial Results for the 1992 calendar year were likely to fall short of expectations and that the preference dividend due the next day could not be paid. The borrowings were approximately 1 billion pounds sterling;

(vi) In 1995 , the Bank of Barings collapsed after a

British futures trader trading in the Singapore Office under a false accounting reference committed the Bank to unlimited open foreign exchange losses.

The development of Corporate Governance in U.K has been very swift. Financial reporting irregularities led to the establishment of the 'Financial Aspects of Corporate Governance Committee' led by Sir Adrian Cadbury. The resulting Cadbury Report published in 1992 outlined a number of recommendations around the separation of the role of the chief executive and chairman, balanced composition of the board, selection processes for non-executive directors, transparency of financial reporting and the need for good internal controls. The Cadbury Report included a Code of Best Practice and its recommendations were incorporated into the Listing Rules of the London Stock Exchange.

In 1995, following concerns about directors' pay and share options, the Greenbury Report recommended extensive disclosure in annual reports on remuneration and recommended the establishment of a remuneration committee comprised of non-executive directors. Again, the majority of the recommendations were endorsed by the Listing Rules.

In January 1996, the Hampel Committee was established to review the extent to which the Cadbury and Greenbury Reports had been implemented and whether the objectives had been met. The Hampel Report led to the publication of the Combined Code of Corporate Governance (1998) covering areas relating to structure and operations of the board, directors' remuneration, accountability and audit, relations with institutional shareholders, and the responsibilities of institutional shareholders. The said Combined Code was superceded by a new revised Code in 2003 w.e.f 1st November 2003 and this revised code was based on the recommendations of the Higgs Report (Report submitted by Derek Higgs to the Chancellor of the Exchequer and the Secretary of State for Trade and Industry and the Smith Report (A report and proposed guidance by an FRC-appointed group chaired by Sir Robert Smith)

(3) In India

The process of reform of Company Law and the Listing Agreement has been very slow and has not been able to keep pace with the global developments. The Stock Markets of India are also replete with a plethora of scams starting with the Harshad Mehta Scam of 1992, followed by the M.S Shoes scam, the CRB Fraud, the menace of phony I.T Companies, frauds by Plantation companies and the Ketan Parekh scam of 2001. The phenomenon of 'vanishing companies' is perhaps unique to India in terms of the number of such companies (or perhaps, those which 'existed') duping investors off thousands of crores of rupees, and for the alarming regularity with which this phenomenon has occurred. Between April 1992 and March 1996 more than 4,000 companies raised more than Rs 54,000 crore from investors through public and hybrid issues. Another 1,500 companies raised over Rs 34,000 crore through rights issues at very high premium. But the net effect remains the same and that is a large number of aggrieved investors.

The provisions relating to Audit Committee were introduced in the Companies Act 1956 (the Cos Act) by virtue of the Companies (Amendment) Act 2000, w.e.f 13/12/2000, in the form of section 292A . This section has made it mandatory for all public limited companies having a paid up share capital of not less than Rs 5 crores to constitute an Audit Committee. The said section has laid down the composition, role and powers of the audit committee (analysed in the paras following hereafter)

The Securities & Exchange Board of India (SEBI) formed an expert committee under the chairmanship of Shri Kumar Mangalam Birla to submit recommendations for compliance with Corporate Governance standards by listed companies. SEBI was of the firm view that " Corporate Governance is considered to be an important instrument of investor protection. Adoption of globally acceptable practices of Corporate Governance would ensure that the Indian Investors are in no way less informed and protected than their counterparts in the best developed capital markets. "Thereafter , pursuant to the recommendations of the said Committee Report, Clause 49 was introduced to the standard listing agreement, which provided for compliance with the laid down standards by the listed entities. Clause 49 sub-clause II lays down the requirements in this regard with respect to the composition, role and powers of the audit committee.

The above stated section 292A and clause 49, sub-clause II relating to Audit Committee are poised for a substantial change in view of the recommendations made by the following :-

(i) The report submitted by the Dr J.J Irani Committee (This committee was appointed to review and

suggest changes/modifications to the proposed provisions of the Concept Paper on Company Law (laid open for public inspection on the 4th August 2004) ;

(ii) The new Clause 49 of the Listing Agreement notified by SEBI vide Circular No-SEBI /CFD/ DIL/CG/1/2004/12/10 dated 29th October 2004 shall come into effect from 1st January 2006. This is based largely on the recommendations of the report of N.R Narayanamurthy Committee which was set up by SEBI to revisit the prevailing clause 49 ;

(iii) The recommendations of the Naresh Chandra Committee Report:- The Naresh Chandra Committee was appointed by the Dept of Company Affairs to make recommendations on the various Corporate Governance issues including the independence of auditors, role of independent director etc. This committee was appointed in light of the enactment of SOX in the U.S.

Role of the Committee in the global perspective

Law/Code relating to the Committee - Countrywise	Crucial provisions
The Combined Code- London Stock	– To consist of not less than three non-executive directors and a majority of them shall be independent; – Terms of reference to be determined by the Board; – Role to include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the auditors; – The committee shall review and monitor the non audit services being provided by the auditors with a view to balance the maintenance of objectivity and value for money
The Sarbanes-Oxley Act 2002 (applicable to entities listed on NASDAQ and the New York Stock Exchange)	– The committee has been defined as a committee of the board for the purpose of overseeing the accounting and financial reporting processes and audit of financial statements. If such a committee has not been formed than the entire Board shall be treated as the Audit Committee; Each of the member of the committee shall be independent.; – Independent director is prohibited from accepting any consulting, advisory or other compensatory fee from the company or from a affiliated person of the company or its subsidiary ; – The committee shall be directly responsible for the appointment, compensation and oversight of work of any audit firm engaged by the company for the purpose of preparing or issuing an audit report or related work and each such audit firm shall report directly to the audit committee ; – The Committee shall have the authority to engage independent counsel and other advisors for carrying out its duties; – The Committe shall establish procedures for :- (i) the receipt, retention and treatment of complaints received by the company regarding accounting, internal controls or auditing; and (ii) the confidential, anonymous submission by employees of concerns regarding questionable accounting or audit matters.

COMMONWEALTH AUTHORITIES AND COMPANIES ACT 1997 :- Board Audit Committee Charter March 2005

- (SECT 44) as applied by Australia for listed companies

– The Audit Committee is a sub-committee of the Board established to assist the Board discharge its responsibilities particularly in relation to financial reporting, risk management and internal control. The Committee also monitors compliance with relevant requirements of other laws and regulations;

– The Committee will consist entirely of non-executive Directors. It will have a minimum of three members, at least one of whom should possess accounting or related financial management expertise;

– Membership of the Committee will be reviewed periodically by the Board with the aim of ensuring an appropriate balance between continuity of membership, the contribution of fresh perspectives and a suitable mix of skills, knowledge and experience ;

– The Committee will meet quarterly or more frequently as required. Special meetings may be called at the request of any Committee member or the external or internal auditors;

– The Managing Director, Chief Finance Officer, Group Financial Controller, internal and external auditors will have the right to attend all meetings of the Committee ;

– The attendance of any two members of the Committee will constitute a quorum that will be sufficient to transact the affairs of the Committee;

– The Board will be kept informed of the Committee's activities by an oral report from the Committee Chairman following each committee meeting ;

– The Committee will provide an annual report to the Board on the operation and performance of the Committee.

– The Committee will:

(i) Review the annual financial statements prior to their consideration by the Board. This will include a discussion with the auditors of any major transactions and accounting Issues, accounting policies adopted and the proposed audit report.;

(ii) Assess any proposed changes in accounting practices or policies (by February each year), prior to their consideration by the Board. In addition, the Committee will review any accruals, provisions, asset revaluations or estimates that significantly affect the financial statements as well as other sensitive matters, such as disclosure of related party transactions.

(iii) Review jointly with management, the external auditors and, if necessary, legal counsel, any litigation, claim or other contingency, including tax assessments, which could have a material effect upon the financial position or operating results of the Corporation.

(iv) Discuss with the external auditor the auditor's judgments about the quality and acceptability of the corporation's accounting principles;

(v) Review with the external auditor issues such as the clarity of the Corporation's financial disclosures and other significant decisions made by management in preparing the financial statements.

(vi) The Committee will satisfy itself that management is ensuring an appropriate organisational culture committed to ethical and lawful behaviour, internal control and risk management. The committee will also assess management's programs and policies that deal with the adequacy and effectiveness of internal controls and risk management frameworks.

Proposed changes in the Indian laws towards achieving global standards

Committee/Clause /Provision which has recommended amendments/ modifications/ changes	Core recommendations
(1) Dr. J.J IRANI COMMITTEE REPORT ON COMPANY LAW	(i) Majority of directors to be independent if the company is required to appoint independent directors ; (ii) Chairman of the Audit Committee should be independent; (iii) The Chairman of the Audit Committee should be required to attend the Annual General Meeting of the company to provide any clarification on matters relating to audit. If he is unable to attend due to circumstances beyond his control , any other member of the Audit Committee may be authorized by him to attend; (iv) Definition of an Independent Director : - An independent director should mean (inter-alia) a non executive director who (inter-alia) :- (a) Apart from receiving director's remuneration, does not have and none of his relatives or firms/ companies controlled by them has any material pecuniary interest. (b) is not and none of his relatives is related to the promoters or persons occupying management positions. (c) is not affiliated to any non-profit organization that receives significant funding from the company, its promoters, its directors, its senior management or its holding or subsidiary company; (d) has not been and none of his relatives has been, employee of the company in the immediately preceding year. (e) is not , and none of his relatives is a partner or part of senior management (or has not been a partner or part of senior management) during the preceding one year, of any of the following :- (i) the statutory audit firm or the internal audit firm that is associated with the

company, its holding and subsidiary companies;

(ii) the legal firm(s) and consulting firm(s) that have a material association with the company, its holding and subsidiary companies.

(f) is not and none of his relatives is a material supplier , service provider or customer or a lessor or lessee of the company, which may affect the independence of the director.

(g) is not and none of his relatives is a substantial shareholder of the company i:e holding 2% or more of the voting power.

Explanation :- The term 'Relative' should mean the husband, the wife, brother or sister or one immediate lineal ascendant and all lineal descendants of that individual whether by blood, marriage or adoption.

(h) The concept of materiality is relevant from the view point of the recipient and not from the view point of the company. The term 'material' needs to be defined in terms of the percentage. In view of the committee, 10% or more of the recipient's consolidated gross revenue/receipts for the preceding year should form a material condition affecting independence. For determining materiality of pecuniary relationship, transactions with an entity in which the director or his relatives hold more than 2% shareholding should also be considered;

Weaknesses/Grey Areas/Shortfalls in the proposed Clause 49 when compared to the SOX provisions :-

(i) A completely independent Audit Committee is a 'sine qua non' for adopting the best global practices of corporate governance. However, the proposed Clause 49 falls short of expectations in this regard by having permitted even non independent directors to be a part of the audit committee.

(ii) The authority and effectiveness of the Audit committee can be best illustrated and proved by its direct dealings with the external auditors. The Indian provisions have not permitted this.

(iii) The proposed clause 49 should have made clear cut provisions providing for empowering the Audit Committee to engage experts, lawyers, counsel etc for the purpose of carrying out its duties effectively.

Basic flaws which need to be overcome to make the role of an Audit Committee more powerful in the Indian context

(1) The stipulations relating to compliance with Corporate Governance standards must be contained only in the listing agreement as is the case in the U.S & U.K. In other words repugnancy between the provisions of the Companies Act and the Listing Agreement, relating to audit committee should be avoided. It is also paramount to determine and carve out the jurisdiction and domain of the two regulators namely SEBI & The Ministry of Company Affairs of India for effective supervision and enforcement of the provisions relating to Corporate Governance;

(2) The concept of Independent Director which has now become controversial needs to be implemented only in case of companies having substantial public stake. This will also serve the purpose of investor protection and make the management more accountable;

(3) The Role, Functions etc of the Audit Committee need to be specifically laid down instead of leaving the same loose and vulnerable to misapplication and misinterpretation.