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"Audit Committee: Should the Provision continue in India?"

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INTRODUCTION

Good corporate governance nurtures a system of transparent accountability. In the wake of various corporate scandals like Sahara, Satyam, Enron, both in India and around the globe, corporate governance gained its prominence with an eye of improving the financial scenario in the country by obtaining confidence of investors. The role of audit committee is very essential as it is the way to ensure reliability on financial statements.

It is difficult for Board of the company to take every decision with due diligence and to give equal time and effort required, therefore the board delegates such authority, by forming various committees to take forward work which requires more experience, focus and technical decisions. Hence, the Board constitutes the Audit Committee which is constituted with an objective to ensure that a company produces relevant, adequate, and credible information for investors as well as independent observers for study to assess the performance of the company. It codifies the various management assumptions regarding the recognition of revenue and expenses, makes observation regarding whether these assumptions are in conformity with the established procedures and standards.

However, the Board is responsible for the actions of the committee as the roles and powers along with the structure of the same. Serving as an audit committee member is a rewarding experience and provides an opportunity to make a difference for a public company, its shareholders, and the investing public. The audit committee provides the working of internal as well as the external auditors and ensures that all relevant disclosures are made as required by the law, and that the accounts give a full and accurate view of the financial status of the company.

Chapter XII (Section 173-195) of the Companies Act, 2013 deals with the provisions related to the meetings of board of directors of a company and its power. Section 177 of the Company's Act, 2013 specifically provides for the Audit Committee.

IMPORTANCE

An audit committee plays an important role for a company due to following reasons:

- Give noteworthy bits of knowledge to regulate and enhance financial practices and detailing. In high-performing organizations, audit committees give oversight. Audit committees meet with the CEO and financial officers to audit and keep up viability of hierarchical controls and outer financial reporting. They frequently work in together

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with the finance committee, which is normally centered on inside reports, operational issues and financial methodology.

- Establish and keep up productive anti-fraud programs. With their experiences and skill in financial, legal, management and operational issues, audit committee members can assume a proactive job working with the NFP's leadership team and auditors in making and intermittently evaluating an organization-wide fraud prevention and recognition program and guaranteeing that investigations are embraced if fraud is revealed. They can likewise support the organization's leadership team to set up an extensive morals and consistence program. The audit committee should assume a comparably proactive role in the review and refresh of both programs.
- Improve the internal audit function. An organizational structure that has the internal audit team revealing specifically to the audit committee adds to the general respectability of the internal audit function. Under this structure, the internal audit team can fill in as the audit committee's "eyes and ears" with respect to the organization's ability to meet its financial and consistence obligations and guarantee that the organization alters practices and internal controls as required.
- Direct the organization's external audit. An audit committee meets with external auditors to screen their administrations and exercises to guarantee that autonomy is kept up between the external auditor and the organization's management team. An audit committee also meets with external auditors to talk about their independent perceptions on management's capacity to keep up strong internal controls, appropriate financial reporting and sound business practices.
- Reinforce reliability with stakeholders. An NFP's reputation is its most prominent resource. An audit committee conveys a message of independence, credibility and trust. It likewise constructs confidence among present and potential constituents, contributors, creditors, and other stakeholders. NFPs and their audit committees can maintain and further expand on this positive message by uncovering the audit committee's role and composition, achieving transparency in financial disclosures, and communicating the organization's compliance and ethics policy[1].

ROLE OF AUDIT COMMITTEE

The role of the audit committee in a Company is decided by the Board of the company which includes the following:

1. To provide oversight of the company's financial reporting process and the revelation of its financial information to guarantee that the financial statement is right, adequate and believable.

[1] AICPO,five reasons your organization needs an audit committee, (last visited on 21 Feb., 2019)https://www.aicpa.org/interestareas/notforprofit/resources/governancemanagement/five-reasons-your-org-needs-an-audit-committee.html-

2. To help in prescribing the Board, the appointment, re-appointment and, whenever required, the substitution or expulsion of the statutory auditor and the fixation of audit fees.
3. To Approve of payment to statutory auditors for any other services rendered by the statutory auditors.
4. To prepare the annual financial statements with the help of management before accommodation to the board for approval, with specific reference to:
    - Matters which need to be incorporated in the Director's Responsibility Statement to be included in the Board's report;
    - The changes, assuming any, in accounting policies and practices and purposes behind the equivalent;
    - Main accounting entries involves estimating based on the activity of judgment by management;
    - Significant adjustments made in the financial statements emerging out of audit findings;
    - Compliance with posting and other legal prerequisites relating to financial statements;
    - Disclosure of any related party transactions;
    - Qualifications in the draft audit report.
5. To check on with the management, the quarterly financial statements before accommodation to the board for approval.
6. Reviewing the statement of uses / application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice and the report submitted by the monitoring agency monitoring the utilization of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take up steps in this matter.
7. To review and monitor the auditor's freedom and performance, and adequacy of audit process.
8. To observe the approvals or any resulting alteration of transactions of the company with related parties.
9. To investigate between corporate credits and ventures.
10. To observe the valuation of endeavors or resources of the company, wherever it is important.
11. To assess the inward financial controls and risk management framework.
12. To review the performance of statutory and internal auditors, adequacy of the internal control systems, with the administration.
13. To review the adequacy of internal audit function, including the structure of the internal audit department, staffing and rank of the official heading the department, reporting structure coverage and frequency of internal audit.
14. To discuss with internal auditors of any huge discoveries and follow up there on.

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15. To review the findings of any internal investigations by the internal auditors into issues where there is suspected fraud or irregularity or a disappointment of internal control systems of a material nature and revealing the issue to the board.
16. To discuss with statutory auditors before the audit begins, about the nature and extent of audit as well as post-audit discussion to find out any area of concern.
17. To observe the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividends) and creditors.
18. To audit the working of the Whistle Blower mechanism.
19. To approve of appointment of CFO (i.e., the whole-time Finance Director or any other person heading the finance function or discharging that function) after evaluating the qualifications, experience and background, etc. of the candidate.
20. To carry out any other function as is mentioned in the terms of reference of the Audit Committee[2].

FUNCTIONS OF AUDIT COMMITTEE

- To boost the confidence among the members.
- To investigate into the matters observed and referred by board.
- To discuss about matters related to internal control system
- To carry out oversight functions including financial statements, financial reporting process and system of internal accounting and financial control.
- To maintain accuracy and consistency of information.
- To uphold the principles of independent review of audit process.
- To create confidence that audit reports are prepared on taking into the account of the interest of the citizen.

POWERS OF AUDIT COMMITTEE

- To open access to management and right to seek additional information's.
- To call attendance of the committee members when required.
- To meet auditors (external and internal) without management.
- To seek information from any employees.
- To obtain outside legal and other professional advice.

AUDIT COMMITTEE UNDER COMPANIES ACT,2013

In Accordance With Section 177 read with **Rule 6** of the companies (Meetings of the board and its powers) Rules, 2014 under Companies Act 2013 which provides that the following Class of Companies shall constitute an Audit committee of the board:

- Every LISTED COMPANY

[2] Audit Committee,https://finapp.co.in/audit-committee/-

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- Every Other public company:

(a) Having paid up capital of 10 crores or more

(b) all public company having turnover of 100 crores or more

(c) Which having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding 50 crores or more.

Note: The above mentioned terms used, **Paid up Capital** and **Turnover** is defined u/s **2(64) of the Companies Act, 2013** and **2(91)of the Companies Act, 2013**[3].

NOTE:

- The paid up share capital OR
- turnover OR
- outstanding loans, or
- borrowing or
- debentures or
- deposits,

As the case may be, as existing on the date of last audited Financial Statements shall be taken into account for the purpose this rule.

<u>VIGIL MECHANISM (WHISTLE-BLOWING MECHANISM)</u>

Following hereunder are the objectives behind establishment of vigil mechanism:

- It provides for adequate safeguards against exploitation of employees and directors
- To provide direct access to the chairperson of the audit committee
- To encourage ethical corporate behavior in the Company.
- To reward and motivate employees for sharing valuable information to the management

  As per Section 177, Read with Rule 7 of companies (Meetings of Board and its powers) Rules, 2014, following are the companies which shall establish a vigil mechanism for directors and employees to report genuine concerns or grievances[4]:

- Every listed company **AND**
- The other class of Companies which shall:
  - Accept deposits from the public,
  - Have borrowed money from banks and public financial institutions excess of Rs.50 Crores.

[3] The Companies Act, 2013 (last visited on 20thFeb. 2019), http://ebook.mca.gov.in/Default.aspx?page=rules.

[4] Securities and Exchange Board of India (SEBI), Clause 49 Regulations, Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004. http://www.sebi.gov.in

COMPARISON OF AUDIT COMMITTEE UNDER CA, 1956 WITH THAT OF CA, 2013

COMPANIES, 2013	COMPANIES ACT, 1956
• Applicable section is 177	Applicable section is 292A read with Clause 49 of listing agreement
• Every listed company **AND** all public company with paid up capital of Rs.10 Crores or more; all public companies having turnover of Rs. 100 Crores or more; all public companies, having in aggregate , outstanding loans or borrowings or debentures or deposits exceeding 50 croreshave to constitute the Audit Committee.	Every public company having paid up capital of not less than Rs. 5 Crores have to constitute the Audit Committee.
It **does not require attendance** of chairman at the AGM.	It **requires attendance** of chairman at the AGM to advice on the matters related to audit.
The auditors of the company and the KMP shall have the right to be heard in the meetings of the audit committee when it considers the auditor's report but shall not have the right to vote.	As per Section 292A(5) of CA,1956, **Auditors, Internal auditors if any, and the director in charge of finance** shall attend and participate at the meeting of Audit committee but shall not have right to vote.
Minimum of 3 Directors Independent director forming a majority. Majority of members including chairperson shall be persons with ability to read and understand the financial statements	The audit committee shall consist of not less than 3 directors, 2/3rdof the number of total strength of its members, shall be the directors other than MD or WTD.
Penal provisions are now more strict and stringent for both Company and officers in default.	Penal provisions are not that much rigorous and tough.

A BRIEF LOOK ON THE LAWS APPLICABLE TO AUDIT COMMITTEE

Section 177 of Companies Act, 2013	Every Listed Company and other class as defined in Rules require to constitute Audit Committee.
Section 92(f) of Companies Act, 2013	To mention the meetings of audit committee and its attendance details in the annual return.

Rule 6 of Companies (Meetings of board and its powers) Rules, 2014.	Abovementioned Class of Companies to constitute the Audit committee of Board
Rule 7 of Companies (Meetings of board and its powers) Rules, 2014.	Establishment of vigil mechanism
Rule 3 of companies (Audit and Auditors) Rules, 2014.	Involvement of Audit Committee in appointment and selection of Auditors

CONSTITUTION OF AUDIT COMMITTEE

The audit committee shall consist of a minimum of 3 directors with independent directors forming a majority.

Provided that majority of members of audit committee including its chairperson shall be the person who shall be able to read and understand the financial statements.

ENHANCED ROLE OF AUDIT COMMITTEE

The Role of Audit Committee has been enhanced to review the utilization of loans and/or advances from/investment by the holding company in the subsidiary exceeding Rupees 100 crores or 10% of the asset size of the subsidiary whichever is lower including existing loans/advances/investments existing as on the date of coming into force of this provision (Insertion of a new sub-clause 21 in Part C Clause A of Schedule II of Listing Regulation relating to Corporate Governance).

This time Uday Kotak Committee on Corporate Governance added further responsibility on the Audit Committee to review utilization funds of the listed entity imparted in unlisted subsidiary including foreign subsidiaries. The fixed limits are to certify that the Audit Committee review only such loans and/or advances as significant[5].

AUDIT COMMITTEE -FAILURE

Toshiba - A case of internal audit failure.

Toshiba, a 140-year-old pillar of Japan Inc, is caught up in the nation's biggest accounting scandal since 2011. In 2011, Olympus Corp was involved in a scandal. In July 2015,Toshiba Corp president Hisao Tanaka and his two ancestors quit after agents found that the company expanded its profit by at least $1.2 billion amid the period 2009-2014.Toshibais one of the early adopters of the corporate governance reforms started in Japan. The corporate governance structure satisfied corporate governance standards. Over and over cases of corporate governance failures have given proof that good corporate governance structure does not really prompt to good corporate governance. Association culture is a basic

[5] Agam H Maloo,Implications of Kotak Committee Report on Corporate Governance in India,(last visited on 21 Feb, 2019), https://blog.ipleaders.in/kotak-committee-report

determinant of nature of corporate governance. Some of the observations of the independent investigation committee of the company on internal audit demand discussion and debate.
The investigation committee observes, "As per the division of obligations tenets of Toshiba, the corporate audit division is responsible for evaluating the corporate divisions, the organizations, branch organizations, and partnered organizations. Be that as it may, in all actuality the corporate audit division chiefly given consultation services to the 'administration' being completed at every one of the organizations, and so on (as a major aspect of the business activities audit), and it once in a while directed any administrations from the point of view of a bookkeeping review into regardless of whether a bookkeeping treatment was suitable."

The perceptions of the committee give the impression that the fault of the internal auditing Toshiba was that it centered on consultation service rather than assurance service. In Toshiba, the top management used to set targets that are unachievable. There was excessive pressure from the top management to accomplish those objectives. The variable pay is a critical part of the total pay..The remuneration of official officers includes a base pay dependent on title and a job pay dependent on work content. 40% to 45 percent of the job remuneration depends on execution of the general organization or business division. 'Test' to accomplish unachievable targets and execution-based pay give enough inspiration to oversee income. In this way, accounting audit ought to have been a center region for internal audit. Internal audit can work freely only if the audit committee is capable, autonomous and powerful, and the internal auditor reports to the audit committee.

In Toshiba, the audit committee was neither proficient nor free. The three outer members of the audit committee had no knowledge of money and bookkeeping. An ex-Chief Financial Officer (CFO), who was the CFO amid the time allotment when accounting inconsistencies happened, was the only whole-time member of the audit committee. Therefore, the internal audit was not independent of the administration. Earnings management had the implied endorsement of the top management. Therefore, it is not astonishing that accounting audit was rejected from the extent of internal audit. It is incorrect to infer that the accounting audit did not get the consideration of the internal audit because its attention was on providing consultation service. Contemporary literature characterizes internal audit as 'assurance and consulting service'. The issue is of adjusting between consultation service and assurance service. Issue emerges when the internal auditor forgets that the internal audit is fundamentally a confirmation work. The consultation service streams from the assurance service.

Despite of the fact that, the primary target of operation audit is to obtain affirmation that the internal control that is introduced to achieve operation objectives is satisfactory and working adequately, the auditees look to the internal auditor for suggestions and consultancy. Such consultation service is a by-product of the assurance service. Auditees should not be denied the benefits of internal auditor's understanding of the industry and the business, and the challenges before the auditees in achieving operation objectives. Avoidance of consultation service from the extent of internal audit would result in problematic usage of internal audit resources.

Organization culture likewise decides the adequacy of internal audit. The investigation committee observes, "A corporate culture existed at Toshiba whereby employees could not act in opposition to the expectation of their bosses ". In such a culture an upstanding internal auditor cannot survive, particularly if he is not free of the management. Perhaps, it is the reason that the internal audit in Toshiba had picked the simple way of concentrating on 'consultation service' just without revealing internal control weaknesses. Internal auditor is the 'eyes and ears' and 'go-to man' of the audit committee. Therefore, internal audit failure leads to corporate governance failure[6].

Satyam Computers Services Ltd.

The case of Satyam Computers Services Ltd is an example of corporate failure in India where audit committee played the major role in the scam. The Company failed every pillar of corporate governance and deceived authorities like SEBI, Registrar of Companies and other authorities. One of the best audit company- Price water house Coopers, audited the books of the said company for ten years but failed to take into due diligence regarding the frauds as it never verifies the forged statements with the bank and debtors etc. The audit committee did not take any step in curbing the malpractices in the company and failed to recognize fraudulent activities[7]. After this scam, the SEBI amended clause 49 of Listing Agreement to improve corporate governance.

CONCLUSION

The audit committee is formed to regularly review processes and procedures to ensure the efficacy (success) of internal control systems so that the **accuracy** and **competence** of the reporting of financial results is maintained at high level at all times.

Thus, the role of audit committee is to perform as a **catalyst (channel)** for effective and transparent financial reporting. Hence, Penal provisions are now more strict and stringent for both Company and officers in default in Companies Act, 2013. Rigorous analysis of an organization's operations and maintenance of systems of internal controls can help detect and prevent various forms of fraud and other accounting irregularities. Without a proper audit system, an organization cannot be able to create reliable financial reports for internal or external purposes.

Having strong audit systems can help reduce various risk forms in an organization, including the information risk , the risk of fraud and misappropriation of assets, as well the risk

[6] Toshiba-a-Case-of-Internal-Audit-Failure(last visited on 20thFeb. 2019) https://www.business-standard.com/article/opinion/toshiba-a-case-of-internal-audit-failure-115080900760_1.html.
[7] Arpit Khurana,Corporate Governance: - A Case Study Of Satyam Computers Services Ltd, (last visited on 20thFeb, 2019),http://www.srjis.com/pages/pdfFiles/147367354829.%20ARPIT%20KHURANA.pdf.

management on operations of an organization. The outcome of the audit process is vital for investors and shareholders of an organization as they get to know the performance of the controls enacted.

For improving the effectiveness of the audit committee, we need to lay down a comprehensive code of conduct and rules and regulations. The suggested best practices are:

- Minimum financial qualification and functional experience recommended for eligibility to be an audit committee member should be raised from just comprehensive knowledge of financial statements where only the Chairman is required to be an expert in the committee.
- There should be a minimum of six audit committee meetings in a year—two meetings devoted to evaluating the thorough control environment and risk management related matters comprehensively;
- There must be a check on the maximum number of audit committees a person can be a member of;
- The audit committee meetings to be held at least a day before the board meeting, to allow for enough time to deliberate and discuss key issues;
- Appointment of the audit committee should be done through a well-defined selection procedure and should not be done by the chairman or board or promoters;
- The tenure of the audit committee membership should be evidently defined, and a transparent succession planning process must be there; and
- The appointment of internal auditors and their reporting should be done by and to the audit committee.

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