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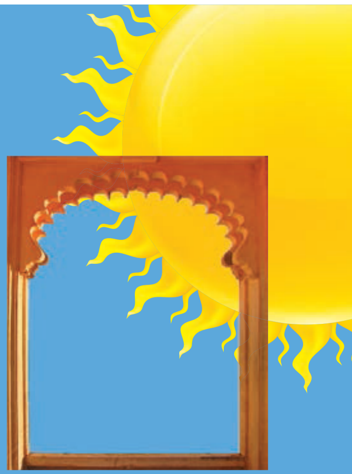
AUDIT COMMITTEE: REGULATIONS AND MARKET RESPONSE



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Executive Summary

Audit Committee is an important governance mechanism designed to ensure the adequacy and credibility of the financial statements. The independence of these committees is critical for the survival and growth of corporates, particularly in countries with concentrated ownership such as India, where the potential for value-reducing related party transactions could be high. Regulations relating to the role, structure and the composition of audit committees have an important bearing on the effectiveness and independence of audit committees. The current Indian regulations (and even some of the proposed ones) relating to structure and composition have tended to remain below international standards. The Indian experience indicates strong market response to changes in regulations, especially when they weaken, even though there are several instances of companies voluntarily adopting standards higher than those required by the regulations. While there is a case for strengthening regulations relating to audit committees, it is in the long term interest of companies to adopt their own 'inspirational list of best practices', that go beyond those prescribed under law.

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Box 1: Credibility of financial statements – lessons from Enron

At the time it happened, the downfall of Enron was the biggest debacle in corporate history. In December 2001, Enron Corporation, once the seventh largest company in America, filed for bankruptcy and simultaneously, Enron's external auditor, Arthur Anderson–one of the five largest audit and accountancy partnerships in the world– was dissolved de facto. Enron's shareholders lost a staggering USD 74 billion and about 21,000 employees lost their jobs.

How did the demise of a company, once recognized as one of the best places to work at, come about so abruptly? In the two years prior to filing for bankruptcy, Enron's stock price rose sharply by 56% and 87% respectively, beating the market index by a huge margin. By December 31, 2000, Enron's market capitalization exceeded USD 60 billion, 70 times earnings and six times book value. Ordinarily, this kind of exuberance of the stock market about the company's future prospects would have been desirable and reasonable. But because the financial statements put out by Enron, on which these expectations were based, were later found to be inaccurate--hiding huge amounts of debts from failed projects, inflating asset values and so on--all the conclusions derived from them also proved to be false.

The moral of the Enron story is simple yet powerful: the interests of the companies are well served if their financial statements indicate an accurate picture about their performance. If financial statements are unreliable, then what can be trusted?

Audit Committee: an important governance mechanism

The audit committee is an important governance mechanism designed to ensure that a company produces relevant, adequate and credible information that investors as well as independent observers can use to assess company performance. In the case of Enron (See Box 1), this mechanism failed, which was one of the main reasons for the falsification of its financial statements, which led ultimately to the company's downfall. Enron's Audit Committee, although composed of highly educated individuals, could not create effective internal controls, or review thoroughly the dangerous accounting procedures used by the company to create deceptive financial statements. It also failed to identify that their external auditor Arthur Anderson was party to the irregularity because of a conflict of interest. Following the Enron debacle, there were far reaching changes in regulations relating to the role, structure and powers of audit committees the world over and India was no exception.

In India, Clause 49 of the Listing Agreement exhaustively outlines the functions that the audit committee is required to play (See Box 2).

Box 2: Functions of Audit Committee

According to the Clause 49 of the Listing Agreement, the important functions of the audit committee are to:

- provide 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;
- review the adequacy of the internal control systems, including the structure of the internal audit department and frequency of internal audit;
- recommend to the Board regarding the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor, and
- fix audit fees and decide on the extent of non-audit services that can be rendered by the statutory auditor.

To discharge these functions effectively, it is obvious that the independence of audit committee is paramount, especially in countries with concentrated ownership structures such as India, where controlling shareholders often occupy key management positions and where the incidence of related party transactions is high.

While there is considerable debate on the minimum number of independent directors in a board, there is a general convergence of opinion regarding the need for the highest degree of independence of the audit committee, since it is critical for ensuring the credibility of the entire audit process. Empirical research tends to support the view that *independent* audit committees have a significant effect in improving the quality of financial reporting, lowering cost of capital, reducing discretionary earnings management, and minimizing the probability of financial fraud.

Evolution of regulations related to size and composition

There is a concerted move across countries to (a) have an audit committee of a minimum size, (b) ensure that the members are financially literate and (c) have them independent of the management. As regards the last regulatory objective, it may be noted that independence in form *per se* may not guarantee independence in function; but it is nevertheless *a necessary condition*.

In India, the constitution of Audit Committees is now mandatory for listed companies, both under Clause 49 and the Companies Bill 2012. [i] The original Clause 49 regulations (SEBI, 2000) required the audit committee to have a minimum of three members and to be constituted entirely of non-executive directors, with independent directors forming a simple majority and the Chairman being an independent director. The revised Clause 49 (SEBI, 2004) removed the non-executive director requirement and instead specified that the audit committee needs to have a minimum of three members with two-thirds of them being independent. [ii] More recently, the Companies Bill 2012 (Section 177) follows the revised Clause 49 regulations by not insisting on the audit committee to comprise only non-executive directors but reverts to a simple majority rule from the two-thirds rule. Significantly, <u>Section 177 does not require the Chairman of the audit committee to be an independent director.</u>

To raise the quality of audit committee functioning, the revised Clause 49 regulations also require that *all* audit committee members be 'financially literate' with at least one member having 'accounting or related financial management expertise' (SEBI, 2004). This again has been subsequently modified in the Companies Bill 2012 which provides that "*majority* of members of the audit committee including its Chairperson shall be persons with ability to read and understand the financial statement."

Where do Indian regulations stand?

It can be seen from Table 1 that while there is a noticeable convergence in standards among the developed countries as well as many emerging economies with regard to the composition of the audit committees, the regulations in India are different. It may be possible to argue that the Indian regulations are designed to suit India's own institutional setting and that the practices based on these regulations may be termed as India's "own best practices". The question however remains as to whether these practices in India inspire the confidence among investors about the independence of the audit committee, especially keeping in view the international standards.

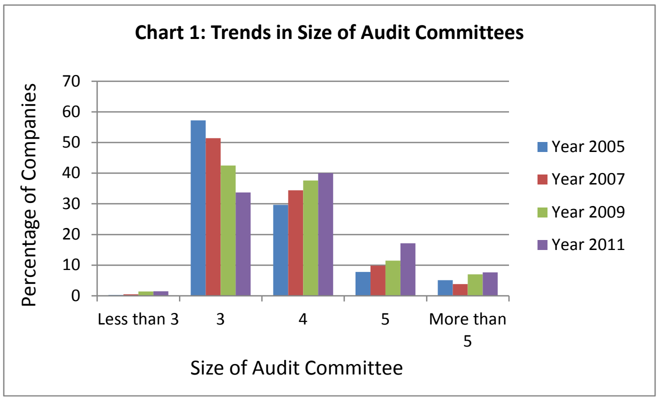
Table 1: Audit Committee: Comparison of standards across countries

Regulation (Country)	Size	Composition	Chairman
Companies Bill 2012 (India)	Minimum 3	Non-executive: Not required Independent: Majority	<u>Independence</u> <u>Not required</u>
NYSE Listing Standards, 2004 (USA)	Minimum 3	Independent: All	Independent*
ASX Corporate Governance Council (Australia)	Minimum 3	Non-executive: All Independent: Majority	Independent
The Combined Code on Corporate Governance, 2003 (UK)	Minimum 3	Independent: All	Independent*
Main Board Listing Rules, 2005, HKEx, (Hong Kong)	Minimum 3	Non-executive: All Independent: Majority	Independent
Code of Corporate Governance, 2005, (Singapore) Brazil China	Minimum 3	Non-executive: All Independent: Majority	Independent

* By implication. Not explicitly mentioned in the regulation

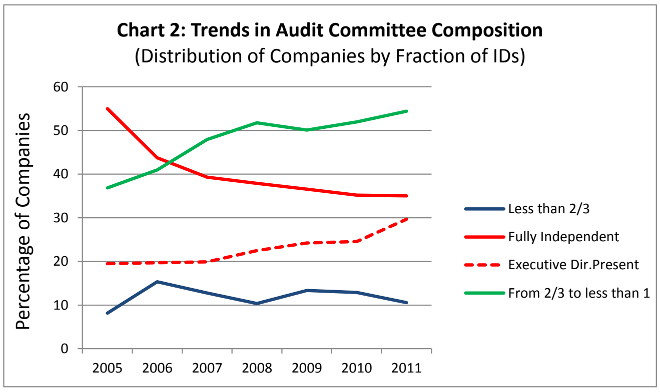
Trends in Audit Committee characteristics in India

How has the corporate sector responded to the regulations relating to the size and composition of audit committee? [iii] An analysis based on a panel of the top 500 listed companies for the period 2005 to 2011 presented in Chart 1 shows that a vast majority of the companies have an audit committee with three to four members with very few companies having more than five members. Also, between 2005 and 2011, there is a discernible trend of more and more companies having audit committees that are bigger than the minimum size of three required under Clause 49. This is perhaps because the revision of Clause 49 in 2006, which permitted executive directors to be part of the audit committees, induced companies to include executive directors in their audit committees. [iv] This is further borne out by the steady increase in the proportion of companies that have an executive or management director present in audit committees (See Chart 2). The change in audit committee composition observed since 2006 thus seems to be a direct response to the change in regulation.



Source: Corporate Governance Reports
Sample: Top 500 listed companies in terms of market capitalization as on March 2008.

Recalling that Clause 49 requires all audit committees to have at least two-third of its members as independent directors, Chart 2 shows that most of the companies have complied with the regulation--indeed, with many companies choosing to have a fully independent audit committee (ie., audit committees comprising only independent directors). A significant observation however, is the steady decline in the percentage of companies with fully independent audit committees from more than 50 % in 2005 to just over one-third by 2011. Not surprisingly, this trend was accompanied by a trend increase in the percentage of companies compliant with minimum independence requirement, but falling short of 'fully independent' character. [v]



Source: Corporate Governance Reports
Sample: Top 500 listed companies in terms of market capitalization as on March 2008.

Independence in functioning of the Audit Committee

While the functions of appointment, re-appointment, and the removal of the statutory auditor as well as the fixation of audit fees are listed on paper (under Clause 49 and under the Companies Bill 2012) as functions of the audit committee, in practice, the audit committee is only a recommending body to the Board of Directors in respect of these functions. Similarly, with respect to related party transactions (RPTs), while Clause 49 entrusts the audit committee with the responsibility of "reviewing with the management" the disclosure of all related party transactions, it does not entrust it with the ultimate power to approve such transactions. [vi] Likewise, Section 188(1) of the Companies Bill 2012 makes the Board of Directors the final consenting authority for approving any related party transactions. Should the Board disagree with the recommendations of the audit committee, Section 177(8) of the Companies Bill 2012 (and currently Section 292-A of the Companies (Amendment) Act, 2000) only require the Board to disclose this fact along with the reasons for doing so in its Directors' Report. The power of the Board to overrule the recommendations of the audit committee has to be seen in context of the current Companies Bill of 2012 which only requires companies to have a minimum of one-third of the Board members to consist of independent directors irrespective of whether it has an executive or non-executive Chairman, allowing in effect the Board to be dominated by inside directors. Do all these augur well for the independence of the audit committee?

Way Forward

The audit committee is an important mechanism for ensuring good governance. To the extent companies recognize this, it may be useful for them to have their own inspirational list of "best practices" which they might voluntarily set for their audit committees.

To begin with, every audit committee can have a Policy Charter that is reviewed periodically and updated on a regular basis. This Charter could clearly outline the role and functions of the audit committee with respect to:

- overseeing the integrity of the company's financial statements and financial statement audits,
- overseeing the company's internal controls over the financial reporting process, and
- vetting the independent auditor's qualifications and independence as well as deciding its remuneration.

The audit committee might give a report at the end of the year outlining the extent to which it has carried out the tasks specified in the Charter.

Since the discharge of the audit committee functions requires adequate financial knowledge and expertise, <u>all</u> audit committee members may need to comply with the financial literacy requirements of the securities exchange(s) on which the company is listed. For this, the company could select the members of the audit committee with appropriate qualifications, to begin with and subsequently offer them opportunities for continuing education to upgrade their skills in financial reporting and other relevant areas. Since skill up-gradation is likely to take some time, the audit committee could have the flexibility to seek the advice and assistance from outside legal, accounting, or other technical advisers.

Finally, it is desirable that the audit committee is not only independent in its function but also perceived to be so by outsiders. For this, companies might consider including in the committee only independent directors as some Indian companies have already done or at least, only non-executive directors with independent directors forming a majority, in keeping with the trends in other countries.

A qualified, active, and independent audit committee can increase investor confidence and reduce the risk premium of raising capital, thereby contributing to the growth of the company in the long run. This is far more important for companies to recognize and act on than merely to comply with the regulations.

Box 3: Towards value-adding Audit Committees

Independence in function

- ✓ Audit committee (AC) can have a Policy Charter and an Annual Report Card
- ✓ Related party transactions, over and above those specified under Schedule 1A of the Companies Act 1956, could be approved by the AC
- ✓ AC could set audit and non-audit fees and approve all non-audit services
- ✓ Majority of IDs could be the quorum for AC meetings

Expertise and commitment

- ✓ AC to provide for training of its members for acquiring financial expertise
- ✓ AC could disclose the qualification of all its members
- ✓ AC can voluntarily adopt limits on multiple directorships by its members

Independence in form

- ✓ Perception is important
- ✓ Voluntary adoption of best practices with respect to AC composition

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i) The Companies Bill of 2012 was passed in the Lower House of the Indian Parliament on December 18, 2012 and is currently awaiting approval by the Upper House.

ii) If the audit committee has 3 members (minimum required size), the two-thirds rule does not impose any extra constraint as opposed to the simple majority rule

iii) Top 500 companies are in terms of market capitalization as on March 31st, 2008.

iv) Though the revised version of Clause 49 was notified in October 2004, it was implemented with effect from January, 2006.

v) This refers to the line 2/3 to less than 1 in Chart 2.

vi) There are certain relationships which escape the reach of Schedule 1A of Companies Act – e.g. mother's brother and brother's son/daughter. Transactions with even these relatives should be brought within the purview of approval by the audit committee like any other RPTs.

About NSE CECG

Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavored to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The 'Quarterly Briefing' which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.