

# **Audit Committees - A comparative study under the Companies Act 1956 and as proposed under the Companies Bill 2012 (as passed by Lok Sabha).**

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## **1. Why Audit Committees?**

The role of Audit Committees [A.Cs. hereinafter] as a tool for improving the Corporate Governance came into focus in a big way in the Indian context after the publication of the report of Kumar Mangalam Birla Committee on Corporate Governance appointed by the SEBI on 7<sup>th</sup> May, 1999 'to promote and raise the standards of Corporate Governance'. The Committee was appointed at a time when a number of reports and codes concerning misappropriations, frauds and mismanagement in the functioning of companies came to light and corporate sector was in rude shock. Number of committees were appointed internationally to study the problems concerning such malpractices and for improvement of corporate governance. Such studies, inter alia, considered the constitution of Audit committees. Prominent amongst these were reports of the Cadbury Committee, the report of the Greenbury Committee, the Combined Code of the London Stock Exchange, the OECD Code on Corporate Governance and the Blue Rebbion Committee on Corporate Governance in USA. The Kumar Mangalam Birla Committee in its report made number of recommendations in the context of Corporate Governance, an important one amongst these related to constitution of Audit Committee for improving governance in companies.

## **2. Kumar Mangalam Birla Committee's report concerning A.Cs.**

This Committee expressed the view that the need for having an A.C. grows from the recognition of the A.Cs.' position in the larger mosaic of the governance process, as it relates to the oversight of financial reporting. The Committee, therefore, recommended that a qualified and independent A.C. should be set up by the Board of a company. This would go a long way in enhancing the credibility of the financial disclosures of a company and promoting transparency.

## **3. SEBI's reaction to the Kumar Mangalam Birla Committee's suggestion concerning A.Cs.**

SEBI vide its Circular No. SMDRP/Policy/Cir-10/2000 dated 21<sup>st</sup> February, 2000, directed Stock Exchanges to insert a new clause 49 in their listing agreement(s) to give effect to the report of the Kumar Mangalam Birla Committee on Corporate Governance. The clause 49 included regulation on setting up of "Audit Committee". The Companies (Amendment) Act, 2000 introduced the concept of the "Audit Committee", in the Companies Act, 1956 by insertion of section 292A for the first time. Today, section 292A and clause 49 are the two basic provisions concerning Audit Committees. In May 2001, the Institute of Chartered Accountants of India (ICAI) came out with a Guidance Note on Certification of Corporate Governance under clause 49.

## **4. Other studies concerning Audit Committees**

Naresh Chandra Committee (NCC), appointed by the Department of Company Affairs (DCA), inter-alia, also made recommendations concerning Audit Committees in the context of Corporate Governance.

## **5. Naravana Murthy Committee [NM Committee]'s report on Corporate Governance, inter-alia, for A.Cs.**

This Committee was appointed by SEBI when NCC was already working. The need for the appointment of another Committee on Corporate Governance has been explained by the SEBI saying that it believes that efforts to improve corporate governance standards in India must continue. This is because these standards are themselves evolving, in keeping with market dynamics.

5.1 This Committee made the following mandatory recommendations in the context of Audit Committees:-

"The Committee felt that the audit committees in listed companies be required to review the following information mandatorily:-

Financial statements;

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- 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 Committee felt that all audit committee members shall be non-executive directors. It said that its recommendations should be implemented for all companies to which clause 49 applies, including the companies that have been registered with BIFR, subject to any directions that BIFR may provide in this regard.

6. Comparative narration of provisions in the Cos. Act, 1956 and those contained in the Companies Bill, 2012.

<p>[i] Cos. Act, 1956 - Section 292(2)</p> <p>A new section 292A was inserted in the Cos. Act, 1956 by the Cos. (Amendment) Act, 2000 effective from 14<sup>th</sup> December, 2000. Relevant sub-sections of this section are as under:-</p> <p>"292-A. Audit Committee - (1) Every public company having paid up capital of not less than five crores of rupees, shall, constitute a Committee of the Board known as 'Audit Committee', which shall consist of not less than three directors, and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors".</p> <p>[2] Every Audit Committee, constituted under sub-section (1), shall act in accordance with terms of reference, to be specified in writing by the Board.</p> <p>[3] The members of the Audit Committee shall elect a Chairman from amongst themselves.</p>	<p>[ii] Cos. Bill, 2012-Clause 177</p> <p>177. [1] The Board of Directors of every listed company and such other class or description of companies, as may be prescribed, shall constitute an Audit Committee.</p> <p>[2] The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority.</p> <p>The majority of members of the Audit Committee including its chairperson shall be persons with ability to read and understand the financial statements. The Bill 2009 in its original form provided that at least one director in the AC will be having knowledge of financial management, audit or accounts. The 2009 Bill also provided that the Chairman of an Audit Committee shall be an independent director. But there is no such stipulation in the 2012 Bill.</p> <p>[3] Every AC of a company existing immediately before the commencement of this Act shall, within one year of such commencement, be</p>
<p>[4] The annual report of the company shall disclose the composition of the Audit Committee.</p> <p>[5] The Auditors, the Internal Auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee, but shall not have the right to vote.</p> <p>[6] The Audit Committee should have discussion with the Auditors periodically about internal control systems, the scope of audit, including the observations of the Auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.</p> <p>[7] The Audit Committee shall have authority to investigate into any matter in relation to the</p>	<p>reconstituted in accordance with sub-section (2).</p> <p>[4] Every AC shall act in accordance with the terms of reference specified in writing by the Board, which shall, inter alia, include-</p> <p>(i) the recommendation for appointment remuneration and terms of appointment of auditors of the company;</p> <p>(ii) review and monitor the auditor's independence and performance, and effectiveness of audit process;</p> <p>(iii) examination of the financial statement and the auditor's report thereon;</p> <p>(iv) approval or any subsequent modification of transactions of the company with related parties;</p> <p>(v) scrutiny of inter-corporate loans and investment;</p>

<p>items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.</p> <p>[8] The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.</p> <p>[9] If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefor, and communicate such reasons to the shareholders.</p> <p>[10] The Chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.</p> <p>[11] If a default is made 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 fine, which may extend to fifty thousand rupees, or with both".</p>	<p>(vi) valuation of undertakings or assets of the company, wherever it is necessary;</p> <p>(vii) evaluation of internal financial controls and risk management systems;</p> <p>(viii) monitoring the end use of funds raised through public offers and related matters.</p> <p>[5] The AC may call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review financial statements before their submission to the Board and may also discuss any related issues with internal and statutory auditors and management of the company.</p> <p>[6] The AC shall have authority to investigate into any matter in relation to the items specified in sub-section (4) or referred to it by the Board and for this purpose shall have power to obtain professional advice from external sources and have full access to information contained in the records of the company.</p> <p>[7] The auditors of a company and the key</p>
	<p>managerial personnel shall have a right to be heard in the meetings of the AC when it considers the auditor's report but shall not have right to vote.</p> <p>The stipulation in the 2009 Bill was that the auditors of a company and the key managerial person shall have the right to attend the meetings of the AC when it considers the auditor's report but shall not have the right to vote. There was no stipulation for being heard in the original Bill.</p> <p>[8] The Board's report under sub-section (3) of section 134 shall disclose the composition of an AC and where the Board had not accepted any recommendation of the AC, the same shall be disclosed in such report along-with the reasons therefor.</p> <p>[ii] Besides the above, clause 178(1) of the Bill provides for constituting Nomination and Remuneration Committee consisting of three or more non-executive directors out of which not less than one-half shall be independent directors:</p> <p>Provided that the chairperson of the company (whether executive or non-executive) may be appointed as a member of the Nomination and Remuneration Committee but shall not chair such committee.</p> <p>There are some common aspects applicable to all committees namely Audit Committee, Remuneration Committee and Stakeholders' committee. These are-</p>

	(i) In case of any contravention of the provisions of clause 177 (supra), the company be punishable with fine, which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer of the company, who is in default, shall be punishable with imprisonment for a term, which may extend to one year or with fine, which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees, or with both.
	<p>Clause 178 of the Bill. These being not relevant in the context of Audit Committee, their constitution and other aspects concerning these are not being mentioned in this write up.</p> <p>(ii) Sub-clause (9) and (10) in clause 177 are two new provisions which are not there in the existing Act. These are:</p> <p>(9) Every listed company or such class or classes of companies, as may be prescribed, shall establish a vigil mechanism for directors and employees to report genuine concern in such manner as may be prescribed.</p> <p>(10) The vigil mechanism under sub-section(9) shall provide for adequate safeguards against victimization of persons who use such mechanism and make provision for direct access to the chairperson of the Audit Committee in appropriate or exceptional cases.</p>

From the foregoing account of the provisions relating to Audit Committees in the present Act and in the 2012 Bill, it could be seen that the provisions in the existing Act are more detailed compared to those in the 2012 Bill. Brevity is proposed to be achieved at the cost of explicitly!

## 7. Observations on the two provisions

7.1 Section 292A was enacted on the basis of the recommendations of the Kumar Mangalam Birla Committee, which conceived a very useful and important role for the audit committees in the context of the functioning of the corporate sector. It has been said in the report that the need for having an Audit Committee grows from the recognition of its role in the larger mosaic of the governance process, as it relates to the oversight of financial reporting. A well-functioning system has to have three main groups responsible for financial reporting - the Board, the internal auditor and the outside auditors. The Audit Committee has an important role to play in this process, since a sub-group of the full Board shall monitor the process. Certainly, it is not the role of the Audit Committee to prepare financial statements or engage in the myriad of decisions relating to the preparation of those statements. It's job is clearly one of oversight and monitoring. The progressive standards of governance applicable to the full Board should also be applicable to the Audit Committee. Hence, a qualified and independent Audit Committee is imperative for the companies to enhance the credibility of the financial disclosures of a company and promoting transparency. This aspect has not been kept in view in drafting the new clause 177 in the Bill.

## 8. Differential aspects in the two provisions

The points of difference between the existing section and the provision proposed in the Bill [clause 177] could be mentioned as under:-

[i] In the existing Act, there is clear stipulation about the companies [namely, companies having paid up capital of not less than 5 crores of rupees], who are mandatorily to have audit committees.

The corresponding provision in the Bill provides that besides the listed companies, in the case of some other categories of companies also, the need for having such committees can be prescribed by the

Government through Rules!

[ii] The proposed section does not mention how the Chairman of the Audit Committee will be appointed. In the existing law, the Chairman is to be elected by the members of the committee and there is no requirement that he can only be an independent director.

[iii] The existing audit committees are to be reconstituted within a year after coming into force of the new Act in accordance with the requirement of the new section concerning audit committees.

[iv] In the existing section, there is no mention relating to terms of reference of the committee in a specific way. The determination of terms of reference has been left to the decision of the Board, which have to be stated in writing by the Board. In the new provision, though the terms of reference have to be specified by the Board, some matters have been specifically mentioned in sub-clause (4) of clause 177, which have necessarily to be included in terms of reference of audit committees [see supra para (4) in 2<sup>nd</sup> column(supra)].

[v] Both the provisions provide for the disclosure regarding the composition of the audit committees in the annual reports.

[vi] Sub-section (7) in section 292A and sub-clause (6) in clause 177 are almost identical.

[vii] Sub-section (5) of section 292A is in the nature of a direction for the statutory auditors, internal auditors and director-in-charge of finance for attending the meetings of the audit committees. The sub-clause (7) of clause 177 gives such persons 'right' to attend such meetings but does not make it obligatory for them to be present in such meetings.

[viii] Sub-section (8) of section 292A stipulates in specific terms that "the recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board". There is no such corresponding provision in the new Bill [clause 177]. However, it has been provided in sub-clause (8) that if Board has not accepted any recommendation of the Audit Committee, the same shall be disclosed in the Annual Report of the company along with the reasons therefor.

[ix] The quantum of punishment for contravention of the provisions relating to audit committee has been made more stringent in certain respects in the Bill as could be seen from the following details:-

Persons liable to punishment	Fine [Rs.] Minimum	Maximum [Rs.]	Imprisonment
Company	1 lakh	5 lakh	-
Every officer in default	25,000	1 lakh	One year

In the existing provision, no distinction has been made in the matter of punishment between the company and its officers. Both were made liable for imprisonment upto one year and fine, which may extend to Rs. 50,000. Because of problem of giving imprisonment punishment to an artificial person, a distinction has been made in the matter of prosecution between a company and its officers.

[x] A strange situation concerning the functioning of the Audit Committee has been noticed from clause 177. Sub-section(10) of section 292A provides that the Chairman of the Audit Committee shall attend the AGM of a company to provide any clarification on matters relating to audit. Strangely enough, there is no such provision in clause 177. However, in cases of Nomination and Remuneration Committees mentioned in clause 178, sub-clause(7) stipulates that chairpersons of the committees proposed under clause 178 (or in his absence), his authorized representative shall attend the general meeting of company. Why a provision of this nature, in the context of audit committees, has been dispensed with is not understandable.

## 9. SEBI's conception of A.Cs.

Vide Circular SMDRP/Policy/Cir. 10/2000 dated 21.02.2000, SEBI, accepting the recommendation of the Kumar Mangalam Birla Committee's report concerning AC, made amendments to the listing agreement and incorporated a new clause 49 in the listing agreement. The broad aspects of this clause, concerning the functioning of the A.Cs., are as under:-

- The AC should have minimum three members, all being non-executive directors, with the majority being independent, and with at least one director having financial and accounting knowledge.
- The Chairman of the Committee should be an independent director.
- The Chairman should be present at annual general meeting to answer shareholder queries.
- The Company Secretary should act as the Secretary to the Committee. There is no stipulation for this in the new clause.

## 10. Concluding comments

10.1 The new Cos. Bill has been prepared in the background of 5 objectives mentioned in the concept paper circulated by the Company Affairs Department regarding new company legislation.

These were as under:-

- (1) To bring the Corporate Law in consonance with the changes that have occurred in the economic development.
- (2) To delete the redundant provisions and to regroup the scattered provisions relating to specific subjects.
- (3) To condense, simplify and rationalize the provisions of company law.
- (4) To delink the procedural aspects from the substantive law.
- (5) To give an overview of the form of the re-codified Cos. Bill containing only 289 sections (then) and a few schedules, in place of existing 781 sections and 15 schedules.

Regretfully, it is seen that these expectations have not been fulfilled by the Lok Sabha passed Companies Bill 2012!

10.2 The exercise of reducing the number of sections in the Cos. Act has been achieved by covering many of the provisions in the existing Act by Rules, to be made in the exercise of power relating to delegated legislation by the Department of Co. Affairs. Section 292A, which laid down the exercises, rights and duties of the A.Cs., has been condensed. The need of the time is to strengthen the functioning of the A.Cs. to safeguard the interest of stakeholders. This occasion could have been taken to achieve this. But this has not been done. Only the provisions in the existing Act have been paraphrased to shorten the size of the new Act. A provision, which made the acceptance of the recommendations of the A.C. mandatorily by the Board has been dropped. Similarly, compulsory presence of statutory and internal auditors and director-in-charge of finance in A.C. meetings and presence of chairperson in the AGMs meetings has been dispensed with without any convincing grounds. There seems to be no ground for not retaining these in the 2012 Bill. When the necessity is to give more powers to the watchdog committees, making the provisions lukewarm seems to be totally not in tune with the need of the times.

10.3 Few other aspects relating to functioning of A.Cs., also need consideration. Merely legislation cannot improve corporate governance. Strict implementation is equally necessary to avoid situation like those noticed in Satyam's case. NM Committee's report sometime back shows that the compliance report of the Mumbai Stock Exchange revealed that approximately only 53% of the companies complied with the requirement contained in the Kumar Mangalam Birla Committee's report.

10.4 Mere appointment of committees or making Rules by the Government's Department of Company Affairs (DOC) cannot improve corporate governance unless there is proper realization on the part of the management of corporations that it is in their interest to adhere to the principles of sound corporate governance and there is machinery to ensure the implementation on the desired lines. Merely providing for fines and threat for

prosecution cannot improve the situation. Deterrence by exemplary punishments is equally necessary. Further, to go on adding to the areas where compliance is to be done and make these long winding can, in the ultimate, be counter-productive. Still, there are many areas, where the paths have not been lighted by the audit committees and uncertainty still prevails concerning these. Adverse reports of A.Cs. need to be publicized to enable others to benefit and create awareness regarding their effective functioning. Some punitive action for the members of the A.Cs. for failure in their functions could also have been thought of and mentioned for public debate.

10.5 Moreover, mere judging compliance on the basis of statements and reports cannot disclose the correct state of affairs. SEBI has itself admitted before the NM Committee that there are reports that mention areas of non-compliance of clause 49 of the listing agreement, but provide no explanation for auditor's not qualifying the reports or for reasons of non-compliance. It has been also reported that many companies are not complying with the requirements relating to Remuneration Committee, Board procedures, management and report on corporate governance.

10.6 Hence, the need is not to multiply areas of compliances and constitute periodically committees or make law/rules. The need is to pay more attention on the compliance relating to existing requirements and on quality of compliance. Only when satisfaction is reached in regard to compliance as per the existing rules/bye-laws that the area of compliance should be widened on the basis of experience gained from working.

10.7 And, finally, a study needs to be made by the DOC or SEBI to study the impact of the functioning of the A.Cs., which are there now for almost 12 years. In DOC's examination reports, good work done should be appreciated and bad condemned. The position noticed need to be circulated for the benefit of corporate sector and also for creating deterrence by mentioning about the action taken against those, who have not adhered to the requirements of A.Cs. or where deficiencies have been pointed out. Also, duplication needs to be avoided. Presently, both SEBI & DOC are concerned with A.Cs. - many times SEBI exceeding the requirements prescribed by the Cos. Act in its Clause 49 of the Listing Agreement. Agreement needs to be arrived at about the areas, which SEBI & DOC are to cover in the context of functioning of A.Cs. Both should not deal with the same issues, as is the position at present.

## 11. Final summing up

There is not much change in the Companies Bill concerning Audit Committees vis-a-vis the position under the Companies Act, 1956. The changes made are merely from the angle of reducing the size of the Bill - not for strengthening the functioning of ACs. Actually one aspect of the weakness in clause 177 was mentioned by Standing Committee (SC) while examining the Bill. The suggestion of the SC and the Government's response these were as under:

S. No.	Clause/title/issue	Suggestion	Comments of Ministry
106(i)	177: Composition of Audit Committee	The requirements in respect of constitution of audit committee are different in the provisions of clause 177 and clause 49 of Listing Agreement on some parameters. The two would need to be harmonized with each other.	Kind attention is drawn to recommendation at Para 12.22 and 12.31 of report of Hon'ble Committee. The provisions proposed in the new Bill are in accordance with such recommendation. The provisions of the Bill have been seen and commented upon by various stakeholders including the SEBI which chose not to comment on this provision. Therefore, it can be presumed that SEBI will carry out necessary harmonization of such minor details.

11.1 Instead of leaving the harmonization to SEBI, initiative in this matter ought to have been taken by the DOC and SEBI should have found solution to problem cohesion - not DOC leaving the matter only to SEBI.

11.2 The enactment of a new law regarding companies, in replacement of the 1956 Act, provided an excellent opportunity to streamline this major enactment relating to functioning of the corporate sector entrenched in, industry business and commerce in a big way. Regretfully, this golden opportunity seems to have been lost by apathetic attitudes - the lost one being passing of the Bill by the Lok Sabha by voice vote without any discussion! The discussion in the write up concerning Audit Committees shows that the new provisions have diluted their power, authority and functioning. Similar position prevails in regard to certain other strategic provisions. The objective highlighted in the concept paper (in para 10) have not been achieved despite the reform process being started in the year 1997!

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