Give teeth to the audit committees

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The audit committee is the immune system of a corporation. It forms a key element in the corporate governance process, in the context of the financial disclosures to be made by a company. In addition to the mandatory appointment of an external auditor to verify accounts, listed companies and certain unlisted companies must establish audit committees.

The statutory basis for formation of audit committees lies in clause 49 of the listing agreement and in the Companies Act, 1956. The primary objective of these regulations is to assure the shareholders that the auditors who act on their behalf will safeguard their interests. Essentially, the goal of an audit committee is to prevent fraud. This requires it to implement and monitor an effective ethics and compliance programme.

Clause 49 requires all listed companies to form audit committees, which must meet at least four times a year. The eligibility criteria require all committee members to be financially literate, with at least one having financial and accounting management expertise. ("Financial literacy" has been defined as the ability to read and understand basic financial statements, along with experience in finance or professional certification in accounting.) Two-thirds of the committee must be independent and it must have three directors, among them an independent chairman.

Under section 292A of the act, unlisted public companies (but not private limited companies) with a paid-up capital in excess of Rs50 million (US$1 million) must have audit committees, the composition of which is the same as provided under clause 49. The company board defines the committee's scope. The committee is charged to make binding recommendations on the operations and financial management of the company's affairs.

The importance of an audit committee's responsibilities cannot be overemphasized. The fundamental task of the committee is to stringently monitor the company's financial reporting process, endeavouring to ensure that the disclosures are correct. In an increasingly interconnected world where scams are seemingly becoming commonplace, the scope and depth of the committee's work cannot be underestimated; it requires careful vigilance in a range of areas, including the work done by the auditors.

The principal focus of the committee members should be on getting to the bottom of issues which could potentially give rise to fraud. If tell-tale signs of irregularities are ignored, the company may end up in prolonged legal battles and be liable to sanctions that can cripple its business and severely damage its reputation.

Clause 49 empowers the audit committee to achieve its difficult objectives in three ways: (a) it can investigate any activity within the terms of reference prescribed by the board of the company; (b) it can seek information from any employee; and (c) it can obtain external professional advice. The committee is also obliged to review the financial statements of any unlisted subsidiary, especially its investments.

Further, under section 292(8) of the act, the recommendations of the audit committee on any matter relating to financial management (including the audit report) are binding on the company's board. If a board does not accept the recommendations of the committee, it must record its reasons and communicate these to the shareholders. As the act does not specify the mode of communication to be used, this directive is liable to be evaded.

Presently, failure to comply with any of the provisions of section 292 of the act makes both the company itself and every officer in default liable to punishment; this can include a monetary fine of Rs50,000 and imprisonment for up to a year. In our view, the regulators need to enforce this provision effectively.

The existing provisions under clause 49 and the act are not strong enough to prevent fraud, as the case of Satyam makes clear. Clause 49 does not provide any measures to keep audit committees free from company influence. Under the act, audit committees have little effective power in cases where the company board does not adhere to its recommendations.

To be effective, audit committees need to be truly independent. Legislators must empower them, enabling committee members to consistently challenge management and the auditors, and ensure that adequate and appropriate controls are maintained so that potential fraud within the company can be identified. Where unexplained anomalies are found, the committee must investigate. It is in the best interest of all – including stakeholders, employees and external advisers – for the audit committee to play an active role in preventing and punishing fraud.

In recent months – especially after Satyam – the Securities and Exchange Board of India has been considering revamping clause 49 of the listing agreement to strengthen disclosure norms. However, as with everything, no legislation is or ever will be effective if there is a lack of strong and determined enforcement.

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