Chapter 6

AUDIT COMMITTEE & CORPORATE GOVERNANCE

CORPORATE GOVERNANCE

1. *Meaning*: Corporate Governance deals with promoting corporate fairness, transparency and accountability. It is concerned with structures and processes for decision-making, accountability, control and behaviour at the top level of organizations. It influences how the objectives of an organisation are set and achieved, how risk is monitored and assessed and how performance is optimized.
2. *Definition*: Corporate Governance can be defined as "the formal system of *accountability* and *control* for ethical and socially responsible organisational decisions and use of resources". *Accountability* relates to how well the content of workplace decisions is aligned with the organization's stated strategic direction. *Control* involves the process of auditing and improving organisational decisions and actions.
3. *Scope*: Corporate Governance arrangements are key determinants of a Firm's relationship with the society at large, and encompass the following aspects –
   (a) Power given to Management and control over Management's use of such power,
   (b) Management's accountability to Stakeholders,
   (c) Formal and informal processes by which Stakeholders influence management decisions.]
4. *Pervasive*: The question of good "Corporate Governance" arises in all categories of Indian Companies –
   (a) Public Sector Units (PSUs) where the Government is the majority Shareholder and the general public holds minority stake.
   (b) Multi-National Companies (MNCs) where the Foreign Parent is the dominant Shareholder.
   (c) Domestic Business Groups where the Promoters (and their friends & relatives) are the dominant Shareholders, Government owned financial institutions hold a comparable stake, and the balance is held by the general public.
5. *Legal Framework*: In India, the legal framework of Corporate Governance is contained in Sec. 292A of the Companies Act (relating to Audit Committee) and Clause 49 of Listing Agreement with SEBI (in respect of Listed Companies).

Audit Committee [Sec. 292A]

Sec. 292A provides the followings:

(1) Every public company having paid-up capital of not less than Rs. 5 crores shall constitute an "Audit Committee" which shall consist of not less than 3 directors and such number of other directors as the Board may determine of which 2/3 of the total number of members shall be directors, other than managing or whole-time directors.
(2) Every Audit Committee so constituted shall act in accordance with terms of reference to be specified in writing by the Board.
(3) The members of the Audit Committee shall elect a chairman from amongst themselves.
(4) The annual report of the company shall disclose the composition of the Audit Committee.
(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.
(6) The Audit Committee should have discussions 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.
(7) The Audit Committee shall have authority to investigate into any matter in relation to the 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.
(8) The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.
(9) If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefore and communicate such reasons to the shareholders.
(10) The chairman of the Audit Committee shall attend the AGMs of the company to provide any clarification on matters relating to audit.
(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 Rs. 50,000, or with both."

Clause 49 of Listing agreement

Clause 49 of the listing agreement covers SEBI guidelines regarding Corporate Governance. Issues addressed in Clause 49 regarding Corporate Governance are:

(a) Board's Director including its composition and compensation;
(b) Provisions regarding composition and functioning of Audit Committee

(c) Management of subsidiary companies;
(d) Disclosures of important issues regarding related party transactions accounting policies, principle of risk management, accounting for proceeds from public issues, right issues, preferential issues, etc;
(e) Content of management discussion and analysis;
(f) Information to shareholders;
(g) CEO/ CFO certification;
(h) Report of Corporate Governance and compliance certificate.

Constitution and procedures of Audit Committee under Clause 49:

(a) The audit committee shall have minimum 3 directors as members. Two-thirds of the members of audit committee shall be independent directors.
(b) All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.
(c) The Chairman of the Audit Committee shall be an independent director.
(d) The Chairman of the Audit Committee shall be present at AGM to answer shareholder queries.
(e) The audit committee may invite such of the executives, as it considers appropriate to be present at the meetings of the committee.
(f) The Company Secretary shall act as the secretary to the committee.
(g) The audit committee should meet at least 4 times in a year and not more than 4 months shall elapse between two meetings.
(h) The quorum shall be either 2 members or 1/3 of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.
(i) The audit committee may exercise following powers, in addition to others:
- To investigate any activity within its terms of reference.
- To seek information from any employee.
- To obtain outside legal or other professional advice.
- To secure attendance of outsiders with relevant expertise.

Independent Director

As per Clause 49 of the listing agreement, an Independent Director shall mean a non-executive director of the company who:
(i) apart from receiving director's remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiary(s) and associates which may affect independence of the director;
(ii) is not related to promoters or persons occupying management positions at the board level or at one level below the Board;
(iii) has not been an executive of the company in the immediately preceding three financial years;
(iv) is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
- The statutory audit firm or the internal audit firm that is associated with the company, and
- The legal firm(s) and consulting firm(s) that have a material association with the company.

(v) is not a material supplier, service provider or customer or a lessor or lessee of the company which may affect independence of the director and
(vi) is not a substantial shareholder of the company i.e. owning two per cent or more of the block of voting shares.

Comparison of Audit Committee Requirements as per Clause 49 and Sec. 292A

	Clause 49 of Listing Agreement	Section 292A of the Companies Act, 1956
Applicability	(a) For entities seeking listing for the first time. (b) For existing listed entities which were required to comply with revised Clause 49 i.e., those having a paid up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company, by April 1, 2005.	Every public company having minimum paid up capital of Rs. 5 Cr. shall constitute an audit committee immediately on the enactment of Companies (Amendment) Act, 2000. i.e., with effect from December 13, 2000
Member Composition	Minimum three directors shall be members. Two thirds of the members of audit committee shall be independent directors.	The audit committee shall have minimum three directors of which two-third of the total number of such directors shall be directors other than managing or whole time directors.
Knowledge of Members	All members shall be financially literate	No such reference

Chairman	The Chairman of the Audit Committee shall be an independent director	The members of the Audit Committee shall elect a Chairman for amongst themselves.
Interaction of Statutory auditor	A representative of the external auditor, when required shall be present as an invitee for the meetings of the Audit Committee	The auditors shall attend and participate at meetings of the audit committee, but has no right to vote.
Secretary	Company Secretary will work as Secretary of audit Committee.	No Such reference.

Additional requirements as per Sec. 292A which are silent in clause 49 of the Listing agreement:

(a) Every Audit Committee so constituted shall act in accordance with terms of reference to be specified in writing by the Board.
(b) The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.
(c) If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefore and communicate such reasons to the shareholders.

Previous Years questions

Q. No. 1: Section 292A of the Companies Act, 1956 provides that every public company having paid up capital not less than Rs. 5 crores shall constitute a committee of the Board known as "audit Committee". Briefly discuss the additional requirements as per Sec. 292A which are silent in clause 49 of the Listing agreement. [Nov. 02 (8 Marks)]

Q. No. 2: Write short note on: Audit Committee. [Nov. 02 (4 Marks)]

Q. No. 3: Explain the constitution and functions of audit Committee u/s 292A of the Companies Act. [May 04 (8 Marks)]

Q. No. 4: Write Short note on: Corporate Governance. [Nov. 04 (4 Marks)]

Q. No. 5: Elaborate under clause 49 of the Listing agreement, who is an independent director. [May 08 (6 Marks)]

Misc. Questions on Company Audit

Q. No. 1: Miranda Spinning Mills Ltd. is a sick company and has accumulated losses of Rs. 10 crores. The company has Rs. 12 crores in its share Premium Account. The Management desires to adjust the accumulated losses against the share premium balance. Advise the company giving your reasons. [Nov. 04 (8 marks)]

Answer: Section 78 of the Companies Act, 1956 deals with the application of amount exists in Securities Premium Account. Accordingly, the balance standing to the credit of Securities Premium Cacount can only be utilized for the following pruposes only:

(a) for issue of fully paid bonus shares,
(b) for writing off of preliminary expenses of the commission paid or
(c) for writing off of discount allowed on any issue of shares or debentures of the company or
(d) for paying the premium on redemption of preference shares or debentures of the company.

Hence, it is not permitted to the company to adjust its accumulated losses against the share premium account.

Q. No. 2: What is the meaning of "Small and Medium sized Company" as per the Companies (Accounting Standards) Rules, 2006? [Nov. 07 (8 Marks)]

Answer: Small and Medium Sized Company under Company (Accounting Standards) Rules 2006, means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;
(ii) which is not a bank, financial institution or an insurance company;
(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;
(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and
(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.