AC - REVOLUTION OF RISING EXPECTATIONS
AUGUST 9, 2024

SUMMARY OF DISCUSSIONS

Background

Auditors and Audit Committees (ACs) have long been perceived to be the ultimate custodians of the interests of the stakeholders of companies. It has been their role to ensure that the companies stay on the straight and narrow path, and do not take liberties with laws, regulations and standards. In a few high profile cases, the Auditors and/or the ACs have been found to fall short. At the same time, the expectations from the stakeholders have increased significantly. More recently, NFRA, the new Regulator, has observed that both Auditors and ACs will have to measure up, and that the AC cannot hide behind the auditors. In this context, it is necessary for persons with insights gained from experience to collectively shed light on whether the expectations are disproportionately high, and what the Auditors and ACs should be doing to meet those exacting standards. The roundtable was organised in this context.

DISCUSSIONS

WHO IS RESPONSIBLE FOR CORPORATE GOVERNANCE?

- Corporate governance is not the responsibility of any one individual. There has been a tendency to blame the Audit Committees (ACs) and the auditors, and to assume that they were not doing their job properly, when things went wrong. The unjustified expectation that ACs and auditors can find solutions to all governance problems has to change. The ACs report to the Board, and so to hold only the AC accountable, is not fair. It has to be understood that, corporate governance is the collective responsibility of different stakeholders.

PROMOTER/ TONE AT THE TOP

- In a number of companies, the promoter decides the practices that would be followed. If the promoter does not believe in sound corporate governance practices, the AC and the auditor cannot ordinarily make much difference, since they are external persons. Board members are supposed to be facilitators, and not investigators. The Board is not supposed to curtail the powers of management, and constantly look over its shoulder and interfere.

AUDIT COMMITTEE

- **Composition of AC** – The composition of the AC plays a vital role in deciding its effectiveness. On some occasions, the composition is decided as per the dictates of the promoter. Such ACs then perform as per her/his directions. However, in forward-looking companies, ACs add value, and invest quality time in their deliberations. They take charge, and focus not only on compliance matters, but also on other matters that they deem important. Since the AC is best served by persons with financial expertise, it is important that at the Board-level itself, persons with such competence are inducted. Every sector has specific issues, and AC members with complementary skills can add value. Members who cannot contribute to the AC, should not agree to be on the committee. With complementary skills of AC members, different responsibilities can be assigned to them, so that AC as a committee can be enabled to perform better.

- **Role of AC** – The attitude of the Board towards the committee, as also role clarity in the minds of AC members, is important for the proper functioning of ACs. There is often lack of role clarity in the minds of AC members, as also an expectation-reality mismatch caused by different stakeholders having different expectations from the AC. Some ACs routinely ask managements if anything is wrong, and feel that their diligence function has been duly performed. This is unacceptable. Over time, there are a large number of compliance related items that come to the AC, thereby taking much of the time available for AC meetings. Accounting standards too are becoming increasingly very complex, and for an AC member, who lacks financial knowledge, it is impossible to keep pace. Internal audit (IA) and internal controls also take up a lot of the AC's time. With a crowded agenda, concept of materiality also has been lost sight of, thereby impacting adversely on the functioning of ACs. The mandated items for an AC to consider are far higher in banks and insurance companies. Further, being the oldest committee of the Board, there is a tendency for items that do not specifically belong to any other committee, to find their way to the AC. It is important for ACs to understand their role, and push back on items that can be addressed by other committees of the Board. While time spent by AC members in the meetings of the committee should never be a constraint, it should not result in too many meetings or meetings which are suboptimal. Because of the current environment, AC members are being forced to address a number of issues, including those involving matters of interpretation. A number of these questions could relate to transactional matters, and not strategy. It is vital for ACs to ask meaningful and probing questions, and thereby challenge management.

- **Role of the AC Chair** – The AC Chair sets the tone for AC meetings, and signals to the Board, and the management, the seriousness of the AC. Before accepting this position, he/she should be fully aware of the operations of the company. AC Chair also has to influence other members to be guided by the quality expected from AC's deliberations. If the AC Chair is seen to be asking the correct questions, and persuading the members to do so, the CFO and other members of the management would come better prepared for meetings, and would, over time, begin to anticipate questions, as also to provide valuable information. It is for him/her to get all the members, as also the CFO, to contribute to discussions. Monthly briefings, monthly meetings with the CFO, in-depth conversations with the statutory auditor and internal auditor, and pre-AC meetings are all initiatives that the AC Chair should take. The quality extracted from management, from auditors as also other from members of the AC would depend on the AC Chair.

- **Related Party Transactions (RPTs)**- ACs have a critical role in approving RPTs. The complexity of regulations relating to RPTs, as also the AC's role in it, has increased vastly. A number of ACs often do not apply independent judgement while approving RPTs. They rely on the conclusions arrived at by management. There has to be some rigour in the process of examination and approval.

- **Internal audit (IA)** - ACs should leverage IA meaningfully. They should spend time before finalising the scope of IA. Equally importantly, they should focus on the size, the capability and the cross competence of the IA team. Gap analysis of the team should ideally be done by the AC. Employees should be incentivised to join IA, so that the best talent with business experience comes to it. The IA team should be encouraged to flag systemic issues, and not look at only transactional issues. The team should also function independently, without fear or favour.

- **Oversight on subsidiaries** – As per SEBI LODR Regulations, monitoring of subsidiaries by the AC is an essential task. This is because some errant companies have been known to use subsidiaries for siphoning money.

- **Processes within the company** – Many companies fail because they do not have proper systems, controls, or processes, or because systems, controls and processes have not kept pace with the expansion of the business. In such cases, even a well-intentioned promoter can do little to keep the company on even keel.

- **Information flow to AC** – If the AC feels that the information flow to it is inadequate, it should, without hesitation, ask for additional information. Quarterly meetings are often not enough for sharing information regarding all major happenings. There should be a system of sharing information between the meetings, since the gap between meetings would often render the information dated or less relevant.

- **Accountability** - The role of the AC is to ensure that there are proper processes, and checks and balances. Even if the AC ensures that, some process might fail. The accountability of the AC should take into account its diligence, intent and effort. Well-intentioned ACs also find it difficult to find all the mistakes in what is presented to them. If management has decided to misrepresent accounts, it would be difficult for the AC to find it out. To hold AC accountable for executive action, or inaction, is not correct. There must be a difference in how a well-intentioned AC is treated, even if some mistakes have crept in unnoticed. There is a need to create pride in AC members being associated with the committee. At present, there is fear of being accused of carelessness, or worse.

- **Continuing education** – Owing to the onerous responsibilities cast on the AC, some ACs have proactively started having sessions with the statutory auditor to keep themselves updated. Regrettably, this practice, at present, is being followed only by a select few.

- **Understanding business** – Some ACs do not fully understand the business of the company. It is difficult to understand the business, and the company's performance, on the basis of the P&L alone. There is a need for ACs to spend time to understand all aspects of the business of the company. They should also carve out time for factory visits. There are a number of promoters and managements who would be happy with the AC not understanding the business, since the questions asked will not be sharp and pointed, and managements will get away unchallenged.

- **Power to appoint external experts** – While the Companies Act, 2013 allows the AC to appoint external experts, if required, to advise on complex issues, in reality, many ACs do not take advantage of this opportunity. In a number of companies, the seeking of external advice is viewed negatively by the management. As a result, a large number of ACs rely on the CFO or other senior persons for any additional insights that they may find useful.

- **Use of technology** – Technology is underleveraged when it comes to performing the control and analysis function. With proper dashboards, AC can use technology very effectively for monitoring. ACs, and in turn Boards, should also be open to discussing the role that artificial intelligence can play in this. Not to do so would be to turn a blind eye to modern aids to decision-making.

- **Remuneration of ACs** – In a number of companies, the compensation paid to AC members is not in line with the time commitment and liability associated with the role. The rewards should be commensurate with the risks and responsibilities.

- **AC and Risk Management Committee (RMC)** - Interface between AC and RMC is important. Some companies have at least one common member between the 2 committees, so that the member(s) can present the views or the decisions of one committee to the other. Some companies have the practice of having a common AC and RMC. This however ignores the fact that the roles of the AC and the RMC are different. What is better is to have a common member, on a rotational basis. It is also important for the Chief Risk Officer (CRO) to meet the AC and for the Chief Internal Auditor (CIA) to meet the RMC, so that the two committees can address matters of common concern.

STATUTORY AUDITORS

- **Increased expectation** - The role, as also the expectations from auditors have evolved. Earlier, they were expected to work only with management. Now, there is an increasing appreciation that ACs and auditors have to work together. To however think that one can hide behind the other, in the event of a problem, is to fool oneself.

- **Talent** – There is a talent crunch at the entry level in the audit profession. The pool of persons entering the audit profession is perhaps not of the same quality as in the past. A number of talented persons choose to not enter the profession because of lower compensation, fear of Regulators, and/or perceived lack of proper guidance. Audit firms are constrained when it comes to paying adequate salaries since they are often competing with what investment bankers and startups would pay. Audit firms themselves are struggling because the scope of work and compensation have not have kept pace with increased outlays. As a result, the quality of audit is bound to suffer.

- **Rotation of auditors** – With the provision of rotation of auditors, the incentive for audit firms to continue in audit has further diminished. With the limited persons that the firm may have, post receiving an assignment, the firm invests in knowledge and infrastructure. However, with a fixed term, and lack of reappointment post that, till the cooling off is over, the firms sometimes have existential issues. The audit firm then has to constantly be looking for newer clients, to justify cost of salaries etc.

- **Compensation** – A number of auditors look at ERP, and satisfy themselves about the affairs of the company. Visits to factories are often skipped. The explanation given for this is that in a competitive environment, with audit fee reducing, this is the only way for audit firms to continue to survive in business.

CHIEF FINANCIAL OFFICER

- The competence of the CFO is perceived to be not as it used to be in the past. Increasingly, there is a trend towards accounts / funding persons becoming CFOs. Such persons often lack knowledge of finance. In US companies, there is a Chief Accounting Officer, who understands accounting, and thus the role of CFO is that of a business driver. This is lacking in some Indian companies.

REGULATOR

- **Intent of the Board** - There is a need to appreciate that ACs and auditors alone cannot be held accountable for corporate governance practices in a company. There are instances where the Board and AC do all the right things, and yet find themselves in trouble. There are also instances where the Board and ACs blindly agree with management. It would seem that the punishment in both the cases is identical.

- **Decision-making** - To expect Boards to comment in detail on the appropriateness of all unanimous decisions, or to expect ACs to justify their decisions, is an avoidable approach. Second guessing Board decisions, at the time of scrutiny, is also not fair. Errors of omission are increasingly not being punished, and so there is a culture of not taking decisions.

- **Judgement call** – In accounting issues, there are a number of judgement calls that are taken both by the ACs and the auditors. It is inherent in the work. This is often not appreciated, and they are held accountable with the benefit of hindsight.

- **Changes in law and regulations** - There have been a number of amendments to the Companies Act, 2013 and SEBI LODR Regulations. Regulations have sometimes been amended to respond to isolated cases. This episodic response is inappropriate. There are very major penalties, often for relatively small irregularities. There is also a need for the judiciary to undergo training to understand the Companies Act, 2013 and SEBI LODR Regulations since in the event of cases being filed, the conclusions would be just and fair.

- **Accountability** - Accountability for regulatory action is often not spoken about. There is a need to have an independent forum where genuine concerns with the Regulator can be flagged, and those can then be appropriately presented to the Regulator. This forum is not intended for questioning the power or authority of the Regulator, but to convey genuine concerns.

- **Capacity building** - Capacity building of Regulators, and not only the newer Regulators, is also very important.

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