

Guest blog

## Pillars of Governance: Audit Committee

Bharat Vasani and Varun Kannan



The regulatory architecture under the Companies Act, 2013 (“**Act**”), and the SEBI (**LODR**) Regulations, 2015 (“**LODR**”) places significant emphasis on the functioning of various committees of the Board of Directors (“**Board**”) of a listed company. While all Board committees have been entrusted with important responsibilities, a disproportionate amount of the regulatory burden has been placed on the Audit Committee. The Audit Committee has multifarious responsibilities under Section 177 and various other provisions of the Act, the LODR, and the SEBI (Prohibition of Insider Trading) Regulations, 2015 (“**PIT Regulations**”).

Today, the duties of the Audit Committee range from examining the financial statements and auditor’s reports, to approval of related party transactions (“**RPTs**”), to scrutiny of inter-corporate loans/ investments to evaluation of internal financial controls and whistle-blower complaints.

As per Regulation 18 of the LODR, at least two-thirds of the members of the Audit Committee must be independent directors. It is pertinent to note that such independent directors and other non-executive directors are not involved in the day-to-day management of a company’s affairs.

Thus, it begs the question of whether the imposition of such extensive responsibilities on individuals who are not involved in the day-to-day management deviates from the original objective behind mandating the constitution of an Audit Committee for specific scrutiny of accounting and financial matters? Interestingly, the Irani Committee<sup>1</sup> had observed that the Audit Committee’s primary responsibility would be to make recommendations to the Board on *accounting and financial matters*, including examination of financial statements, auditor’s reports, RPTs, etc.<sup>2</sup>

Post the coming into force of the Act, have the law-makers and regulators drifted from the original legislative intent by passing on ‘managerial responsibilities’ to

---

<sup>1</sup> Report of the Expert Committee on Company Law, chaired by Dr. Jamshed J. Irani, May 31, 2005 (“**Irani Committee Report**”).

<sup>2</sup> Paras 17.1, 32 and 33, Irani Committee Report.

the Audit Committee? Does this not violate the cardinal corporate governance principle of separation of roles of the Board (which involves oversight and supervision) and the management (to manage the day-to-day affairs of the company)? In this blog, the authors delve deep into the regulatory overload on Audit Committees and examine certain key issues in relation to the existing regulatory architecture.

## **Important Duties of the Audit Committee**

Some of the key regulatory responsibilities of the Audit Committee of a listed company are outlined below:

1. Examining the financial statements before it is submitted to the Board<sup>3</sup>, which includes reviewing whether the financial statements present a *true and fair view* of the state of the company's affairs, and comply with all the applicable accounting standards as per the requirements of Section 129(1) of the Act<sup>4</sup>; admitting matters in the Directors' Responsibility Statement prepared under Section 134(5) of the Act<sup>5</sup>; examining the auditors' report prepared in accordance with Section 143 of the Act and the Companies (Audit and Auditors) Rules, 2014<sup>6</sup>, and drafting the CARO report prepared in accordance with the Companies (Auditors Report) Order, 2020.
2. Reviewing the quarterly financial statements before submission to the Board for approval<sup>7</sup>.
3. Granting approval to RPTs as per Sections 177 and 188 of the Act, and Regulation 23 of the LODR. With effect from January 1, 2022, only the independent directors in the Audit Committee can approve RPTs<sup>8</sup>. The Audit Committee may also grant omnibus approval for RPTs after complying with the pre-conditions prescribed under Regulation 23(3).
4. Scrutinising inter-corporate loans and investments<sup>9</sup>.
5. Reviewing application of funds raised through a public issue, rights issue, preferential issue, etc<sup>10</sup>.
6. Appointment of statutory auditor, reviewing the auditor's independence and performance, and effectiveness of audit process<sup>11</sup>.

---

<sup>3</sup> Section 177(4) of the Act, Regulation 18 read with Part C of Schedule II of the LODR.

<sup>4</sup> Section 129(1) of the Act provides that the financial statements shall give a true and fair view of the state of affairs of the company or companies, comply with the accounting standards notified under section 133 and shall be in the form or forms as may be provided for different class or classes of companies in Schedule III of the Act.

<sup>5</sup> Part C of Schedule II of the LODR.

<sup>6</sup> Section 177(4) of the Act, Regulation 18 read with Part C of Schedule II of the LODR.

<sup>7</sup> Part C of Schedule II of the LODR.

<sup>8</sup> Regulation 23(2) of the LODR Regulations.

<sup>9</sup> Section 177(4) of the Act Section 177(4) of the Act, Regulation 18 read with Part C of Schedule II of the LODR.

<sup>10</sup> Section 177(4) of the Act, Regulation 18 read with Part C of Schedule II of the LODR.

<sup>11</sup> Sections 139 and 177 of the Act, Regulation 18 read with Part C of Schedule II of the LODR.

7. Appointment of registered valuer and valuation of undertakings/ assets of the listed entity, where necessary<sup>12</sup>.
8. Evaluating internal financial controls and risk management systems<sup>13</sup>.
9. Reviewing adequacy of the internal audit function, frequency of internal audits, and discussing significant findings with internal auditors<sup>14</sup>.
10. Reviewing findings of any internal investigations by internal auditors into matters where there is suspected fraud/ irregularity/ failure of internal control systems of a material nature and reporting the matter to the Board<sup>15</sup>.
11. Reviewing the functioning of the whistle-blower mechanism<sup>16</sup>.
12. To consider the rationale, cost-benefit, and impact of schemes of arrangement on the listed entity and its shareholders<sup>17</sup>.
13. Reviewing the utilisation of loans/ advances/ investment by the holding company in the subsidiary exceeding INR 100 crore or 10% of the asset size of the subsidiary<sup>18</sup>.
14. Reviewing information relating to management letters, letters of internal control weaknesses issued by statutory auditors, etc<sup>19</sup>.
15. Adhering to the requirements under the PIT Regulations, wherein Audit Committees have the responsibility to review compliance with the PIT Regulations at least once every financial year and verify whether the systems for internal control are adequate and operating effectively<sup>20</sup>.

### **Some Contentious Issues**

#### **Only independent directors can approve RPTs**

With effect from January 1, 2022, only independent directors on the Audit Committee can vote to approve RPTs. Does this not violate the principle of *collective responsibility* of the Board, as enshrined under Section 179 of the Act? This new requirement also gives rise to various unanswered questions, such as whether the other directors in the Audit Committee can invoke the immunity clause under Section 149(12) of the Act<sup>21</sup> on the ground that they have no power to approve RPTs?

<sup>12</sup> Section 177 and 247 of the Act, Regulation 18 read with Part C of Schedule II of the LODR.

<sup>13</sup> Section 177 of the Act, Regulation 18 read with Part C of Schedule II of the LODR.

<sup>14</sup> Sections 138 and 177 of the Act, Regulation 18 read with Part C of Schedule II of the LODR.

<sup>15</sup> Regulation 18 read with Part C of Schedule II of the LODR.

<sup>16</sup> Regulation 18 read with Part C of Schedule II of the LODR.

<sup>17</sup> Regulation 18 read with Part C of Schedule II of the LODR.

<sup>18</sup> Regulation 18 read with Part C of Schedule II of the LODR.

<sup>19</sup> Regulation 18 read with Part C of Schedule II of the LODR.

<sup>20</sup> Regulation 9A(4) read with Schedule B and Schedule C of the PIT Regulations.

<sup>21</sup> Section 149(12) of the Act provides that:

“Notwithstanding anything contained in this Act,—

(i) an independent director;

(ii) a non-executive director not being promoter or key managerial personnel,

Since April 1, 2022, the Audit Committee's workload has increased disproportionately due to SEBI's revised regulatory architecture for RPTs under the LODR ("**New RPT Regime**") coming into force. The new rules expand the definition of "*related party*"<sup>22</sup> and "*RPTs*"<sup>23</sup>, and also cover transactions undertaken at the subsidiary level. Under the New RPT Regime, apart from RPTs entered into by a listed company, *prior* Audit Committee approval will also be required for RPTs between two (a) unlisted subsidiaries; and (b) foreign subsidiaries of the listed company that exceed the prescribed materiality thresholds<sup>24</sup>. The absolute monetary threshold of INR 1000 crore for 'material RPTs' has exacerbated the problem.

While such independent directors will now have to shoulder the entire burden of RPT approval, it is pertinent to examine whether they are given sufficient time to review the same. These developments need to be viewed in the backdrop of the fact that four Audit Committee meetings in a financial year are consumed in reviewing the quarterly financial results; and independent directors may not have sufficient time to examine aspects such as the material terms of the RPT, pricing, technical competence of the counter-party, etc.

There have been instances where the Audit Committee had to refer RPT matters to the Board of Directors for its guidance as it was uncomfortable with certain aspects of the transaction.

#### *Review of the financial statements and auditor's reports*

As per Regulation 18 of the LODR, all members of the Audit Committee must be financially literate, and at least one member must have accounting or financial management expertise. Is it realistic to assume that at least a few members of the Audit Committee have sound domain knowledge of the applicable accounting standards to recommend the financial statements to the Board for approval and adoption?

Given the complexity of business models, does the Audit Committee have the bandwidth to scrutinise the financial statements in detail, and review whether they present a *true and fair view* of the state of the company's affairs, and comply

---

*shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently".*

<sup>22</sup> SEBI has amended the definition of "*related party*" under Regulation 2(1)(zb) of the LODR.

<sup>23</sup> SEBI has amended the definition of "*related party*" under Regulation 2(1)(zc) of the LODR.

<sup>24</sup> Regulation 23(2) of the LODR.

with the requirements of Schedule III of the Act and the applicable accounting standards?

In this regard, another important function is to ensure that the internal financial controls are working effectively to prevent any fraud, financial mismanagement, etc. Many Audit Committee members have expressed concerns that it is impossible to draw such conclusion purely basis the deliberations at the Audit Committee meetings. A hyper-interrogating 'intrusive' director may endanger his peaceful co-existence on the Board. Most board members sign vital declarations they are legally required to make regarding compliance with the accounting standards and internal financial controls etc, under Section 134(5) of the Act, without specific domain knowledge on those aspects.

Moreover, it is important for the Audit Committee to meet the statutory auditor and internal auditors regularly outside of the Audit Committee and Board Meetings. Such meetings provide an important opportunity to get an informal feedback on the internal controls and areas of concern. But how many Audit Committee members actually do it?

*Should the MD/CEO participate in the Audit Committee's deliberations?*

International best practices suggest that the MD/ CEO should not attend and participate in the Audit Committee's deliberations so that the CFO does not feel constrained while expressing his views. The MD/ CEO could be invited to the meeting only to explain specific aspects, based on the request of the Chairman of the Audit Committee. Unfortunately, in India, most MD/ CEOs are invited to attend the Audit Committee meeting as a permanent invitee and participate in all deliberations.

For improving the quality of deliberations at Audit Committee meetings, it may be worthwhile to adopt international best practices where the MD/ CEO is not permitted to attend the entire Audit Committee meeting as a permanent invitee and can join the meeting only at the request of the Chairman of the Audit Committee to explain specific aspects.

*Appointment of a 'lead independent director'*

Given the range of responsibilities cast on independent directors, the Parliament and Regulators should consider introducing the concept of a 'lead independent director' in India, which has been successfully implemented in the West. Such director provides effective leadership to the body of independent directors. It has proved to be very effective in asking tough questions to the management team

and raising the substantive issues at the Board and the Audit Committee meetings. It is particularly useful when there is an Executive Chairman of the Board.

Perhaps the Regulators have, so far, shied away from mandating the appointment of a 'lead independent director' fearing that it may lead to creation of a parallel power centre and dilute the authority of the CEO/Chairman.

### **Concluding Thoughts**

Two critical changes are required in the present regulatory architecture to further empower the Audit Committees to discharge its role effectively. Like in the more developed jurisdictions, the Audit Committee should consist entirely of independent directors with no permanent invitees from the Management Team except the CFO and the Company Secretary. Secondly, appointment of lead independent directors should be made mandatory for the top 500 listed companies by market capitalisation. Such lead independent director should be provided with the office space, secretarial support, and direct access to all the members of the management team.

While the Regulators have done a splendid job in prescribing a laundry list of factors to be considered for determining 'independence' of directors to eliminate any potential conflict of interest, the behavioural aspects remain largely unaddressed. But can '*independence of mind*' ever be legislated?

**About the authors**

**Bharat Vasani** is partner in the General Corporate and TMT Practice at the Mumbai office of Cyril Amarchand Mangaldas. He can be reached at [bharat.vasani@cyrilshroff.com](mailto:bharat.vasani@cyrilshroff.com)

**Varun Kannan** is Associate in the General Corporate Practice at the Mumbai office of Cyril Amarchand Mangaldas. Varun can be reached at [varun.kannan@cyrilshroff.com](mailto:varun.kannan@cyrilshroff.com)

These blogs were first published by Cyril Amarchand Mangaldas, as a part of the 'Gatekeepers of Governance' Series and can be accessed here or by typing this url: <https://corporate.cyrilamarchandblogs.com/>

This is a part of a series **Pillars of governance**.

1. Pillars of governance: Statutory auditors
2. Pillars of governance: Audit committee
3. Pillars of governance: Independent directors
4. Pillars of governance: Nomination and remuneration committee

These were first published by Cyril Amarchand Mangaldas, as Gatekeepers of governance and can be accessed [here](#) or by typing this url: <https://corporate.cyrilamarchandblogs.com/>



**Disclaimer**

This document has been authored by Bharat Vasani and Varun Kannan. The views expressed in the document are personal to the authors and do not necessarily reflect the opinion of IiAS or of its employers.

IiAS shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. The information contained herein is solely from publicly available data, but we do not represent that it is accurate or complete and it should not be relied on as such. This document is provided for assistance only and is not intended to be and must not be taken as the basis for any voting or investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigation as it deems necessary to arrive at an independent evaluation of the individual resolutions referred to in this document (including the merits and risks involved). The discussions or views expressed may not be suitable for all investors. The information given in this document is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. IiAS reserves the right to make modifications and alterations to this statement as may be required from time to time. However, IiAS is under no obligation to update or keep the information current. Nevertheless, IiAS is committed to providing independent and transparent recommendation to its client and would be happy to provide any information in response to specific client queries. Neither IiAS nor any of its affiliates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of the information. The disclosures of interest statements incorporated in this document are provided solely to enhance the transparency and should not be treated as endorsement of the views expressed in the report.

**Confidentiality**

This information is strictly confidential and is being furnished to you solely for your information. This information should not be reproduced or redistributed or passed on directly or indirectly in any form to any other person or published, copied, in whole or in part, for any purpose. This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject IiAS to any registration or licensing requirements within such jurisdiction. The distribution of this document in certain jurisdictions may be restricted by law, and persons in whose possession this document comes, should inform themselves about and observe, any such restrictions. The information provided in these reports remains, unless otherwise stated, the copyright of IiAS. All layout, design, original artwork, concepts and other Intellectual Properties, remains the property and copyright of IiAS and may not be used in any form or for any purpose whatsoever by any party without the express written permission of the copyright holders.

**Other Disclosures**

IiAS is a SEBI registered research entity (proxy advisor registration number: INH000000024) dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions of about 750 listed Indian companies (<https://www.iiasadvisory.com/iias-coverage-list>). Our products and services include voting advisory reports, standardized services under the Indian Corporate Governance Scorecard, and databases ([www.iiasadrian.com](http://www.iiasadrian.com) and [www.iiascompayre.com](http://www.iiascompayre.com)). There are no significant or material orders passed against the company by any of the Regulators or Courts/Tribunals.

This blog by is a commentary on the general trends and developments.



**About IiAS**

Institutional Investor Advisory Services India Limited (IiAS) is an advisory firm, dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions for over 950 companies that account for over 96% of market capitalization.

IiAS provides bespoke research and assists institutions in their engagement with company managements and their boards. It runs two cloud-based platforms, SMART to help investors with reporting on their stewardship activities and ADRIAN, a repository of resolutions and institutional voting pattern.

IiAS with the International Finance Corporation (IFC) and BSE Limited, has developed a Corporate Governance Scorecard for India to evaluate company's governance practices and market benchmarks. More recently, IiAS has extended its analysis to ESG and is also empanelled with AMFI as an ESG Rating Provider.

IiAS has equity participation by Aditya Birla Sunlife AMC Limited, Axis Bank Limited, Fitch Group Inc., HDFC Investments Limited, ICICI Prudential Life Insurance Company Limited, Kotak Mahindra Bank Limited, RBL Bank Limited, Tata Investment Corporation Limited, UTI Asset Management Company Limited and Yes Bank Limited.

IiAS is a SEBI registered entity (proxy advisor registration number: INH000000024).