

# **Corporate Governance Through Audit Committee**

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# Corporate Governance

- Corporate governance is the system by which
  - business corporations are directed and controlled to meet certain level of desired balance and transparency in operations
- Generally sought to be achieved through rules

# Stakeholders

- Shareholders
- Customers
- Employees
- Environment and Society at large
- Regulators
- Government
- Vendors/Suppliers
- Banks and Other lenders

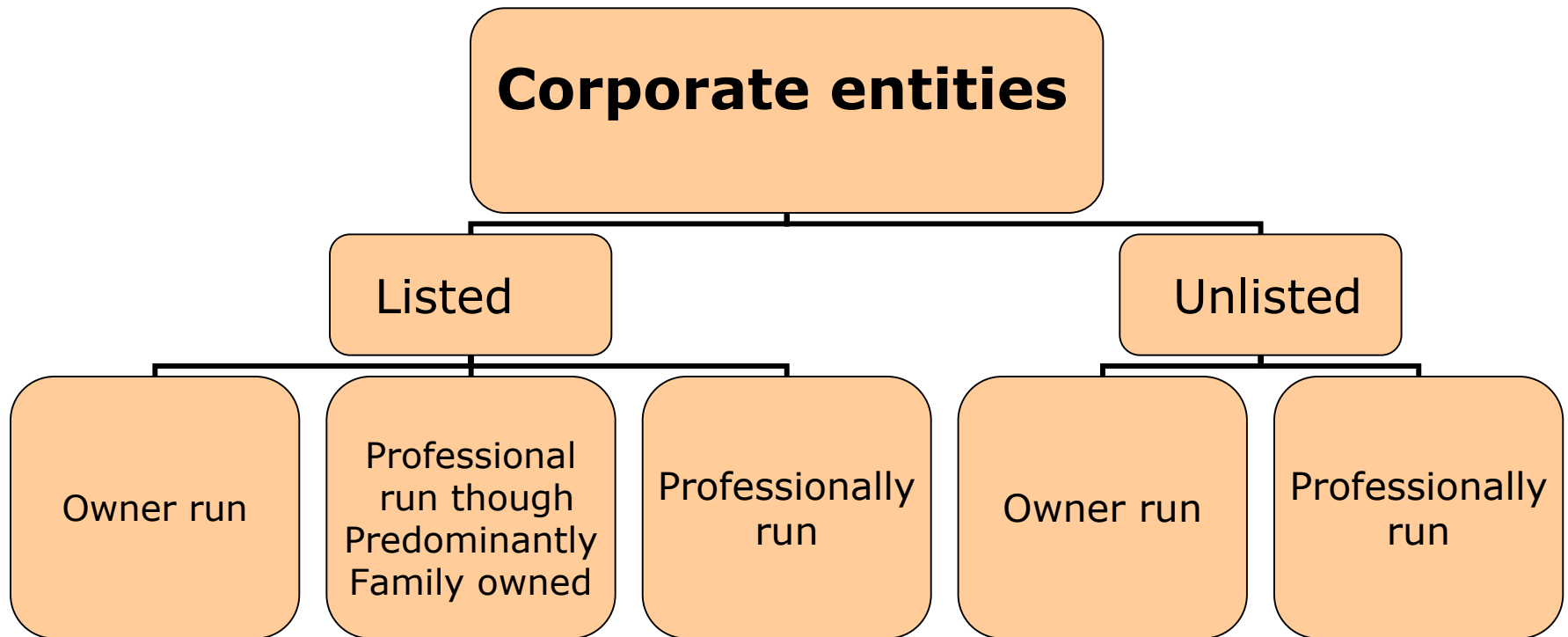
Board to be responsible to all the stakeholders

# Need of Audit Committee for Corporate Governance

- Corporate governance deals with issues of accountability and fiduciary duty
- Corporate history is abounded with instances of malfeasance in businesses/organizations
- Check on the economic and the overall financial health of the organization
  - Any manipulation has financial implication

The onus of corporate governance lies with the audit committee

# Governance: Classification of entities



# Issues in Listed Owner controlled organizations

- Owned, controlled and operated by members of one or several families
- Choice of Directors is biased
- Ability of Directors to think beyond owner/family and articulate freely is restricted
- Organizational culture – Structures and Processes
- Corporate governance not generally incorporated

Tendency for owner's power to be overwhelming

# Types of Business Organizations (contd..)

Listed : Professionally run though predominantly family owned

- Majority stake held by family members
- Better Corporate governance expected
- Issue: Is there a close relationship between family members and the independent directors?

Professionally held Companies

- Better Corporate governance
- Conflict between current management and strategic needs
- Issue: Are Boards strong enough to oppose CEOs?

# Corporate Governance and controlling stake of promoting groups in Listed organizations

- Need for entrepreneurs to invest in ventures needs no stressing
- The promoters' share should be diluted over a period of 7-10 years to less than 30%(?)
- Would enable participation of other investors in the venture and initial promoters can encash on the growth of the project
- Issue: Should there be prescriptive structures?



<b>Companies</b>	<b>Promoter Share (%)</b>	<b>Non-Promoter Share (%)</b>
Bajaj Auto	29.85	70.15
Bharati Airtel Ltd	60.95	39.05
Essar Steel Ltd	87.08	12.92
Hindalco Industries Ltd	27.06	72.95
Jindal Steel & Power Ltd	59.04	40.96
Ranbaxy	34.86	65.15
Reliance Industries	50.98	49.02
Tata Motors	33.43	66.57
Tata Steel	30.52	69.48
Wipro	79.58	20.42

Source: CMIE

# Clause 49 of the Listing Agreement

- Audit Committees composition
  - Minimum 3 directors, all drawn from the company's non-executive directors, majority being independent
  - All members to be financially literate and at least one shall have accounting or related financial management expertise
- Issues
  - Although independent, may not be taking decisions independently and can succumb to pressures
  - Qualification should be more specific such as CAs?

## Clause 49 of the Listing Agreement (contd..)

- Chairman shall be an independent director and shall be present at AGM
- Committee should meet at least thrice a year
  - One before finalization of annual accounts and one every six months
- Minimum two independent Directors to be present in meetings
- Issues
  - Should the Chairman be personally held responsible for Committee decisions?
  - Committee meets for financial review should be 4 times as quarterly results are declared

# Mandatory review by Audit Committee

- Financial statements and draft audit report
- MDA of financial condition and results of operations
- Reports relating to compliance with laws and to risk management
- Management letters of internal control weaknesses issued by statutory internal auditors
- Records of related party transactions
- Appointment, removal and terms of remuneration of the internal auditor

Should the Audit Committee be questioning operations?

# Subsidiaries Companies

- Audit Committee of listed holding company to review the financial statements, particularly investments of unlisted subsidiary company

# Whistle Blower Policy

- To detect frauds, irregularities and encouraging employees to come forward to report irregularities to the Audit Committee
- The employment and other personnel policies of the company shall provide safeguards to protect "whistle blowers" from unfair termination and other unfair prejudicial employment practices.

How often have these policies worked?

# Issues for further discussion

- Areas of vulnerability
- Depreciation
- Capitalization of expenditure
- Transactions between related companies, firms and trusts
- Losses in investment company's subsidiaries
- Qualified report
- Methodology of receivable / recognition

# Areas of Concern

- Cases and situations where Directors/Family members prevail over certain decisions of Audit Committee
- Conflict between Audit Committee and other members
- Misuse of Insider information which is privy to members of the Audit Committee, before the information is made public



# Issues

- Tenure of members of Audit Committee should be restricted to 5 years
- A member of the Audit Committee should have a break of 3 years to be reappointed on the committee
- Age criteria essential for Audit Committee members - 60 years

# Suggestions towards further Corporate Governance

- Provisions of corporate governance to be in the Companies Act rather than in the listing agreements
- It would be applicable, then to all companies, not just to listed companies, as many times, non listed companies account for a sizeable portion of the revenues/income of the economy

# Suggestions towards further Corporate Governance

- Right of appointing nominee Directors by regulatory/statutory bodies and/or Government to be removed
- This would avoid conflict of interest
- Many countries are now adopting this
- Even in India, a few of the regulators have adopted this practice

# What do rating agencies look at?

- Assessment of management capability
- Financial transparency and disclosures
- Influence of majority stakeholders
- Board effectiveness and composition

# Rating on Corporate Governance

- Companies should be rated separately on corporate governance based on a criteria
  - Disclosures standards
  - Timing of disclosures
  - Standing of auditors
    - Should auditors also be graded or ranked?

**Good Corporate Governance  
ensures  
Good Business**

Thank You

# Corporate Governance (contd..)

- Corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders
- Corporate governance is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company

How far are these principles followed in India?



# Corporate Governance in other countries

- The Cadbury Report (1992), titled *Financial Aspects of Corporate Governance*, chaired by Adrian Cadbury contains recommendations on Corporate Governance, reporting functions of Boards and the role of auditors. The aim being to mitigate corporate governance risks and failures
- The report's recommendations have been adopted in varying degree by the European Union, the United States, the World Bank and others.

# Corporate Governance in India

- CII's trailblazing recommendations on Corporate Governance
- Committee under chairmanship of Mr. Kumar Mangalam Birla
- The Naresh Chandra Committee on Corporate Audit and Governance .
- The N R Narayana Murthy Committee on Corporate Governance .

# Power of Audit Committee

- To investigate any activity within terms of its reference
- Seek information from any employee
- Obtain outside legal or other professional advice
- Secure attendance of outsiders with relevant expertise, if considered necessary

# Key Role of Audit Committee

- Ensure correctness, sufficiency and credibility of financial statement
- Recommend appointment and removal of auditors, fixation of audit fees and approval for payment for non-audit work of statutory auditors
- Review of Annual financial statements before submission to the Board, with particular reference to:
  - Changes in accounting policies
  - Major accounting entries involving estimates and judgment

## Key Role of Audit Committee (contd)

- Significant adjustments arising out of audit findings
- Compliance with accounting standards
- Compliance with listing and other legal requirements relating to financial statements
- Qualifications, if any, by auditors in their Report

# Key Role of Audit Committee (contd)

- Review adequacy of internal control systems with management, internal and external auditors
- Review financial and risk management policies
- Review adequacy of internal audit function
- To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders and creditors