The Challenge of Improving Corporate Governance by Creating Effective Audit Committees

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Abstract:
Even though there are many measures to put corporate governance (CG) in place and practice, an important tool essential for the success is the effective functioning of an audit committee (AC). As the eyes and ears of the board, the AC plays a pivotal role in helping to stop or reverse the rise in reported fraud incidents worldwide. Now-a-days, an AC is being looked upon as a distinct culture for CG and has received a wide-publicity across the globe. Regulation has bolstered the role of the AC in past years. Government authorities, regulators and international bodies all have indicated that they view an AC as a potentially powerful tool that can enhance the reliability and transparency of financial information. Being mandatory under the SEBI's Clause 49 of the Listing Agreement, an AC can be of great help to the board in implementing, monitoring and continuing 'good' CG practices to the benefit of the corporation and all its stakeholders.
This study performs a 'content' analysis on the AC reports of the top 500 listed companies in India during 2010 to 2013 to determine the information content of these reports and the extent to which these reports conform to the Clause 49 requirements of the SEBI. Also, discussed are the various trends about an AC characteristics viz., size, composition, activity, as well as, the extent of non-audit services provided by auditors in the top 500 listed Indian companies. The 2013 Companies Act in India makes comprehensive reforms to virtually all areas affecting corporate governance. Thus, an effective AC can be a key feature of a strong CG culture, bringing significant benefits to an organization. The effectiveness of the ACs is based on the characteristics of independence, financial expertise and diligence.
Keywords: *Improving corporate governance, effective audit committees, SEBI Clause 49, Sarbanes-Oxley Act, listing agreement, board of directors, financial reporting, India.*

1. Introduction

A corporation is a 'congregation' of various stakeholders, namely, customers, employees, investors, vendor-partners, government and society. The relationship between shareholders and corporate managers is fraught with 'conflicting' interests that arise due to the separation of ownership and control, divergent management and shareholder objectives, and information 'asymmetry' between managers and shareholders. Due to these conflicting interests, managers have the incentives and ability to maximize their own utility at the expense of corporate shareholders. As a result, corporate governance structures evolve that help in mitigating these agency conflicts. Awareness of the OECD (2014) 'Principles of Corporate Governance' is exceptionally high in the Asian region. All Asian economies are using the OECD Principles of Corporate Governance and outputs of the Asian Roundtable as a reference in the development of their regulations, corporate governance codes, listing rules, scorecards, as well as academic work. As Bhasin (2011) emphasized, "Corporate governance (henceforth 'CG') is the system by which businesses are directed and controlled. CG deals with conducting the affairs of a corporation in such a way that there is 'fairness' to all stakeholders and that its actions benefit the 'greatest' number of stakeholders. It is about openness, integrity and accountability." Auditing is one of the most important elements of CG and all the Codes of CG across the world require the listed companies to form an Audit Committee (henceforth, 'AC'). Thus, ACs is one of the mechanisms which help the Board of Directors to adopt better CG practices. Such ACs in the Board can help alleviate agency problems by reducing information asymmetry between insiders (managers) and outsiders (Klein, 1998). An effective AC is a leading aspect of a strong CG system (DeZoort et al., 2002). The board must set up an AC in order to monitor the accounting, reporting and auditing of financial statements. Auditing and reporting help in solving the agency problem and assists shareholders in monitoring and controlling the resources of a firm (Saad, 2010).

Corporate India witnessed the burgeoning economic growth since the 1990s that brought to the forefront the need for Indian companies to adopt corporate governance standards and practices, which are in line with international guidelines (Shrivastava and Kalsie, 2015). Indeed, CG is beyond the realm of 'law'. It stems from the culture and mindset of management and cannot be regulated by legislation alone. According to Cohen (2008), "The many instances of corporate misdemeanors have shifted the emphasis on compliance with substance, rather than form. What legislation can and should do is to lay down a common framework—the 'form' to ensure standards. The 'substance' will ultimately determine the credibility and integrity of the process. Substance is inexorably linked to the mindset and ethical standards of management." Corporations, therefore, need to recognize that their growth requires the cooperation of all the stakeholders; and such

cooperation is enhanced by the corporation adhering to the ‘best’ CG practices. In this regard, the management needs to act as “trustees” of the shareholders at large and prevent “asymmetry” of information and benefits between various sections of shareholders, especially between the owner-managers and the rest of the shareholders (Hakim et al., 2009). While large profits can be made taking advantage of the asymmetry between stakeholders in the short-run, balancing the interests of all stakeholders alone will ensure survival and growth in the long-run.

CG is a key element in improving the economic ‘efficiency’ of a firm. Here, Bhasin (2010) stated, “Corporations pool capital from a large investor base, both in the ‘domestic’ and in the ‘international’ capital markets. In this context, investment is ultimately an act of faith in the ability of a corporation’s management.” When an investor invests money in a corporation, he expects the board and the management to act as ‘trustees’ and ensure the safety of the capital, and also earn a rate of return that is higher than the cost of capital. In this regard, investors expect management to act in their best interests at all times and adopt good CG practices. The failure to implement “good” governance can have a ‘heavy’ cost beyond regulatory problems. Evidence suggests that corporations that do not employ meaningful governance procedures can pay a significant risk premium when competing for scarce capital in the public markets (Aguilera, 2009). No doubt, the credibility offered by good CG procedures also helps to maintain the confidence of investors (both foreign and domestic) to attract more patient, long-term capital, and will reduce the cost of capital. This will ultimately induce more stable sources of financing in the long-term.

During the last two decades, an “audit committee” has become a common ‘mechanism’ of CG internationally. According to Bhasin (2012), “An increasing number of earnings restatements by publicly traded companies, coupled with allegations of financial statement fraud and lack of responsible CG of high-profile companies, has sharpened the ever increasing attention on CG in ‘general’ and an AC in particular.” An AC is expected to monitor the reliability of the corporation’s accounting and auditing processes in order to protect shareholder interests (Agoglia, 2011) and prevent attempts to manipulate earnings numbers (Klein, 2002). Also, an AC serves as a mechanism to hold ‘external’ auditors accountable for the scope, nature and quality of their work (Dignam, 2007). The duties of an AC often include recommending the appointment of external auditors, reviewing the corporation’s financial statements, taking action on items and concerns raised by the auditors, mediating between the auditor and management, and advising on any significant findings in the external and internal audit investigations (Caskey, 2010). In 2002, the United States enacted the Sarbanes-Oxley (SOX) Act, requiring that all US publicly traded companies establish an ‘independent’ AC. Despite immediate public criticism of SOX’s AC requirements, there has been a noticeable increase in the number of countries now ‘mandating’ their use (Naciri, 2008). However, Bhasin (2012a) stressed, “When SOX was signed into law 10 of the world’s 40 largest capital markets had mandatory AC requirements. A significant number of countries amended their laws, regulations, or listing rules over the next 7-8 years to require that their own listed corporations establish an AC. In total, 31 of the world’s 40 largest capital markets now mandate that certain categories of listed corporations utilize an AC”, as shown in **Table-1**.

According to Beasley (2009), “An AC is increasingly responsible for the quality of financial reporting and oversight of the audit processes in large public companies.” The AC function has evolved in India over the years with recommendations of the Confederation of Indian Industries (CII), Kumaramanglam Birla Committee, new rules of the Securities and Exchange Board of (SEBI) and Company Law. Now-a-days, an AC is viewed as an oversight function of CG, financial reporting process, internal control structure, and audit functions. Government authorities, regulators and international bodies (for example, IOSCO and the OECD) have indicated that they view an AC as a potentially powerful tool that can enhance the reliability and transparency of financial information (Sandra, 2005). The SOX Act, 2002 has expanded the formal responsibilities of an AC. The status of an AC report has evolved from non-existence to voluntarily and now mandatory for publicly traded companies under the SEBI and Companies Act jurisdiction in India. Therefore, this paper seeks to “contribute to our understanding of the value and potential of an AC as a CG mechanism in a developing country like India.” It seeks to examine the structure and functions that are currently performed by an AC in the Indian corporate world.

2. Literature Review

The AC and auditor independence have been an important areas of research in the accounting literature. In the past, studies on an AC have focused on the independence, activity and on the financial expertise of the AC members. Recently, the research on auditor independence have focused on the extent of 'non-audit' services provided by the 'external' auditor as well audit firm tenure, both of which are generally seen as 'hindrances' to auditor independence. In fact, renewed interests on CG and an AC have emerged in light of the 'new' regulations that were enacted in the wake of the major corporate scandals, and the consequent enactment of the SEBI's Clause 49 in India and SOX regulations in the U.S. and in other parts of the world.

Table 1: Audit Committee Requirements for the 40 Largest Capital Markets

Capital Markets with "Mandatory" AC Requirements and Date of Implementation	Capital Markets with "No Mandatory" AC Requirements
1. Canada (1975)	1. Brazil
2. Nigeria (1990)	2. Iran
3. Hong Kong (1999)	3. Ireland
4. Thailand (1999)	4. Italy
5. India (2000)	5. Japan
6. Indonesia (2000)	6. Norway
7. Korea (2000)	7. Saudi Arabia
8. Mexico (2001)	8. Switzerland
9. Argentina (2001)	9. Venezuela
10. United States (Sarbanes–Oxley, 2002)	
11. Spain (2002)	
12. Turkey (2002)	
13. Australia (2004)	
14. Colombia (2005)	
15. Austria (2006)	
16. Portugal (2006)	
17. South Africa (2006)	
18. Russia (2007)	
19. Finland (2008)	
20. France (2008)	
21. The Netherlands (2008)	
22. Romania (2008)	
23. Sweden (2008)	
24. United Kingdom (2008)	
25. Belgium (2009)	
26. China (2009)	
27. Czech Republic (2009)	
28. Denmark (2009)	
29. Germany (2009)	
30. Greece (2009)	
31. Poland (2009)	

(Source: Fichtner, J. R. "The Recent International Growth of Mandatory Audit Committee Requirements," International Journal of Disclosure and Governance, 2010, Vol. 7, No. 3, page 234.)

A significant number of researchers, primarily from the Western and European countries, have studied various dimensions of an AC and its 'effectiveness'. These studies have led to a lively debate as to the proper composition of the membership of an AC. For example, Romano (2005) argues that an AC composed solely of independent directors, or even a majority of independent directors, do not limit the occurrence of

accounting 'improprieties', while Prentice and Space (2007) refutes this argument by citing numerous studies confirming that an 'independent' AC improves the financial reporting.

Despite the continuing debate as to whether "independent" directors are a necessary component of an AC, an overwhelming number of studies establish that the mere formation of an AC results in substantial benefits. For example, Knapp (1987) concluded that an AC can improve auditing because "An AC member tend to support auditor, rather than management, when audit disputes occur." On the other hand, Beattie (1999, 2007) in their research found that the presence of an AC is a very significant factor in enhancing the third-party perceptions of auditor independence. Wild (1996), however, found evidence that establishment of an AC enhances earnings quality, and Goodwin-Stewart and Kent (2006) found that an AC is associated with 'higher-quality' audits. Similarly, DeFond's (1991, 2005) study revealed that "over-statements of earnings are less likely among firms that have an AC," while Dechow's (1996) study found that "corporations manipulating earnings are more likely to have boards of directors dominated by managers and less likely to have an AC." Williams and Tower (2004) conducted a comprehensive simultaneous analysis of the association between five AC composition and operational characteristics features and earnings management based on a sample of 485 Singapore publicly traded organizations.

Moreover, in a study undertaken by McMullen (1996), the author concluded that "firms with an AC are associated with fewer shareholder lawsuits alleging fraud, fewer quarterly earnings restatements, fewer SEC enforcement actions, fewer illegal acts and fewer instances of audit turnover when there is an audit-client disagreement." By and large, while a vast majority of the studies conclude that an AC provides substantial benefits to the corporation, a handful of studies question their 'true' value. In particular, Beasley's (1996) study disputes whether an AC actually reduces the likelihood of fraud. Likewise, in a study of an AC in Spain, Pucheta-Martinez and de Fuentes (2007) determined that "the mere presence of an AC does not reduce the occurrence of error and non-compliance qualifications." However, the same study also determined that other factors, such as the size and independence of an AC did have a significant impact on certain aspects of financial reporting.

Unfortunately, very little research work has been done, both in India and abroad, on the role of an AC in improving CG. For example, Al-Mudhaki and Joshi (2004) examined the composition, focus and functions of an AC and the effects of the meetings and the criteria used in the selection of members by the Indian listed corporations based on 73 questionnaire responses in 2002. Similarly, Agarwal (2006) stated that "an AC of the board is today seen as a key fulcrum of any corporation. Being mandatory under Clause 49, an AC can be of great help to the board in implementing, monitoring and continuing good CG practices to the benefit of the corporation and its stakeholders." Moreover, Cohen (2010) expressed that CG issues have grown more salient in the light of the alleged corporate accounting scandals. Sandra (2005) conclude by saying that "comprehensive regulatory changes, brought on by recent CG reforms, have broadly redefined and reemphasized the roles and responsibilities of all the participants (especially the AC) in a public corporation's financial reporting process."

Researchers recently have deepened the study of governance and auditing outcomes with more recent evidence on auditor selection and retention, findings that governance characteristics influence auditors' risk assessments and planning decisions, some conflicting results related to governance and auditor fees (audit and non-audit), and evidence that internal audit budgets are associated with governance characteristics (Carcello, 2011). Other recent insights include the importance of an AC accounting expertise over broader financial expertise; the apparent potential for an AC compensation methods to influence an AC member judgments; the existence of substantive, ceremonial, and informal AC processes; a deeper understanding of an AC member evaluation of accounting disagreements and adjustments; and the serious consequences to directors when a company experiences accounting trouble.

Over the past two decades, the CG literature in accounting and auditing has grown rapidly. In the present study, our CG focus is primarily on the various dimensions of an AC. Documented evidence on effectiveness of an AC in enhancing 'good' CG has focused on various aspects, but the issue of interest in

this study is the support of an AC in enhancing 'auditor' independence. Knapp (1987), for example, found that "an AC is more likely to support across members of an AC. This is true regardless of whether the member is in a full-time (or part-time) position, such as corporate managers, academicians, and retired partners of certified public accounting firms." Similarly, Pearson (1980) and Dockweiler (1986) showed that "an auditor's reliance on management is reduced due to the direct communication with an AC." However, Lam (2000) found that "the appearance of independence of an AC would enhance auditor independence and improve transparency in financial reporting." Beattie (1999) also reported that "audit partners, finance directors, and financial journalists believed that an AC with independent non-executive directors strongly encourages auditor independence. Independent directors of an AC are expected to increase the quality of monitoring because they are not associated with the corporation either as an officers or employees; thus, they would act as the shareholder's watchdog." Similarly, Raghunandan and Rama (2007) revealed that "an AC that consists of qualified independent directors is better able to contribute towards auditor independence." To sum up, the extant literature provides 'strong' empirical support that both an independent AC and higher-levels of audit independence have a significant beneficial effect on enhancing the quality of disclosures, in reducing discretionary earnings management, increasing the informativeness of earnings, and in general enhancing the value of the firm. According to Narayanaswamy (2014), "Audit committees have received considerable attention globally in recent years. We examine the effects of the Satyam failure on changes in the composition and functioning of Indian audit committees." As Bhasin (2013a) reported, "A corporate collapse that shook India's markets and regulators, and widely noted of as India's Enron, should have led to major improvements in the functioning of audit committees (ACs) of Indian companies. Our empirical results show that the Satyam failure had a limited effect on Indian audit committees."

From the above description, it is amply clear that India presents an ideal case for the analysis of improving CG through making an effective use of an AC practices followed by the corporations because the economy has been undergoing rapid economic transformation in the financial services, tourism, information-technology sectors, and the 'niche' manufacturing gaining momentum too. In the Indian-context, there has been very limited number of AC studies, as compared to its Western and European counterparts. However, just two studies are available on the theme of an AC in India, which were done by Al-Mudhaki and Joshi (2004) and Agarwal (2006). The foregoing discussion suggests that the literature on the determinants of an AC disclosure in the Indian CG context is very limited and inconclusive. Thus, our present study builds on the previous literature of an AC practice and overall CG scenario in the Indian corporate sector.

A study by Abdulaziz (2014) aims at identifying the practices that should be taken into consideration by audit committees as a tool of corporate governance in Libyan commercial banks by investigating various perceptions on this topic. A study performed by Taruna and Shailesh (2015), sought to discover the current situation of CG practices in India of 100 companies. The results illustrate that firms in India are currently following governance practices by following binding and non-binding guidelines issued by SEBI in clause 49 of listing agreement regarding corporate governance. But still there is a range for upgrading towards an ideal state of governance in India for excellence. Similarly, the aim of the research study done by Ahmed, Anis and Imam (2015) was to investigate the effect of corporate governance factors such as institutional ownership, independent audit committee and external auditor size on capital structure of listed companies at Johannesburg (South Africa) stock exchange. A study by Bhasin (2012, 2016) performed content analysis on the AC reports of the top 500 listed companies in India during 2010 to 2013 to determine the information content of these reports and the extent to which these reports conform to the Clause 49 requirements of the SEBI. Also, discussed are the various trends about an AC characteristics viz., size, composition, activity, as well as, the extent of non-audit services provided by auditors in the top 500 listed Indian companies. The present study also contributes to the literature in an important sense that it analysed data from a developing country and an emerging capital market, which has not been widely studied before on the role of an AC in the context of CG requirements.

3. Corporate Governance and Audit Committee Initiatives in India: An Overview

As Bhasin (2013b) reported, "During the last two decades, an AC has become a common mechanism of CG internationally. Originally, 'non-mandatory' structures used by a 'minority' of corporations, more recently numerous 'official' professional and regulatory committees in many countries have recommended their more 'universal' adoption and have advocated 'expanded' roles for an AC. Undoubtedly, a number of high-profile corporate scandals triggered an in-depth reflection on the regulatory role of the government in protecting the interests of shareholders." Over the past 30 years, financial markets in the U.S., the European Union, and different Asian countries have undergone several phases of CG reforms:

- 1970s: Financial misreporting and corporate collapses in the U.S. led to "independent" outside directors and AC.
- 1980s: Corporate collapses in the U.K. led to the "Cadbury Report".
- 1997-1999: The Asian Financial Crisis led to sweeping regulatory changes.
- 2002: The Enron fraud led to reform of corporation and auditor relationships, accountability for financial reports, greater board oversight, etc.

Often, increased attention on CG is a result of 'financial' crisis. For instance, the Asian financial crisis brought the subject of CG to the 'surface' in Asian countries. To quote Lin (2009), "Recent scandals disturbed the otherwise placid and complacent corporate landscape in the U.S. These scandals, in a sense, proved to be serendipitous. They spawned a new set of initiatives in CG in the U.S., and triggered a fresh debate in the European Union, as well as, in the Asian countries." Long renowned for their opaque business practices, Asian corporations have undergone a dramatic transformation on the CG front. Jamie Allen (2008), for example, states that "most of the countries/markets in the Asian region had taken the initiative long-back in 1990s by formulating and implementing an official code of CG," which is summarized in **Table 2**.

Beginning in the late 1990s, the Indian government started implementing a significant 'overhaul' of the country's CG system. As described by Afsharipour (2009), "These CG reforms were aimed at making boards and AC more independent, powerful and focused monitors of management, as well as, aiding shareholders, including institutional and foreign investors, in monitoring management." Similarly, Bhasin (2013) stated, "There have been several leading CG initiatives launched in India since the mid-1990s. The first was by the Confederation of Indian Industry (CII), which came up with the first 'voluntary' code of CG in 1998 (www.ciionline.org). In 1996, the CII took a special initiative on CG–the first institutional initiative in Indian industry. In April 1998, the country produced the first substantial code of best practice on CG after the start of the Asian financial crisis in mid-1997. Titled "Desirable Corporate Governance: A Code", this document was written not by the government, but by the CII (1997). It is one of the few codes in Asia that explicitly discusses domestic CG problems and seeks to apply best-practice ideas to their solution. In the late 1999, a government-appointed committee, under the leadership of Kumar Mangalam Birla (Chairman, Aditya Birla Group), released a draft of India's first 'national' formal code on CG for listed companies. The committee's recommendations (many of which were 'mandatory') were closely aligned to the international 'best' practices on CG—and set 'higher' standards than most other parts of the region at that time." However, the code was approved by the Securities and Exchange Board of India (SEBI) in early 2000, and was implemented in stages over the following two years (applying first to 'newly' listed and 'large' companies). It also led to changes in the BSE and NSE stock exchange listing rules.

Table 2: Development of CG Codes in the Asian Countries

Country	Date of main Code(s)	Are independent Director's required?	Are Audit Committees Required?
China	2002/2005	Yes	Yes
Hong Kong	1993/2004	Yes	Yes
India	1999/2005/2007	Yes	Yes
Indonesia	2001/2006	Yes	Yes
Japan	2003/2004	Optional	Optional
South Korea	1999/2003	Yes	Yes (large firms)
Malaysia	2001/2007	Yes	Yes
Philippines	2002	Yes	Yes
Singapore	2001/2005	Yes	Yes
Taiwan	2002	Yes (certain firms)	Yes (certain firms)
Thailand	1999/2006	Yes	Yes

(Source: Jamie Allen, Asian Corporate Governance Association: Corporate Governance Seminar, organized by Chubb Insurance and Solidarity, Bahrain, April 16, 2008, page 10)

According to Bhasin (2016), “The next move was also by the SEBI, now enshrined as Clause 49 (very similar to U.S. Sarbanes-Oxley Act, 2002) of the listing agreement. The Naresh Chandra Committee and Narayana Murthy Committee reports followed it in 2002. Based on some of the recommendation of these two committees, SEBI revised Clause 49 of the listing agreement in August 2003.” The SOX has received mixed (and increasingly ‘negative’) response in the U.S. However, Clause 49 and SOX share “similarities but different responses by market.” Perhaps, only some CG changes valuable and some CG changes positive in one environment and not others (Balasubramanian, 2008). Also, genesis of changes differs: Clause 49 was introduced by ‘industry’ initiative in India, but SOX was introduced in U.S. due to Enron like scandals. While SEBI proceeded to adopt considerable CG reforms, the implementation and enforcement of such reforms in fact, have lagged behind.

Reform of central public sector enterprises (CPSEs) is also high on the Indian government’s agenda. As Bhasin (2016a) explained, “Strong PSEs would be better prepared to enter the capital market to raise funds, which means practices must be in place to ensure accountability. The push by the government has resulted in some guidelines, which were issued by the Department of Public Enterprises (2007) (www.dpe.nic.in) in June. Even though these guidelines are voluntary, all CPSEs (both listed and non-listed) are meant to follow them, with compliance of these guidelines to be referred to in the Directors’ report, Annual report and the chairman’s speech during the Annual General Meeting. The Department will grade the companies on the basis of their compliance with the guidelines.” Issued on an experimental basis for a year, they will be revised “in the light of experience gained”. The Department of Corporation Affairs had set up “National Foundation for CG” (www.nfcgindia.org) in partnership with the CII, the Institute of Chartered Accountants of India (ICAI), and the Institute of Company Secretaries of India (ICSI). In addition, the ICSI has constituted annual awards for the companies with best governance practices. As Bhasin (2015) concluded, “In CG practices, India can be proud of what it has achieved so far, initially voluntarily and later under guidance of various regulators, while recognizing that obviously much more needs to be done.”

Recently, the Companies Act was enacted on August, 2013 which provides for major overhaul of corporate governance norms for all companies. Recently, Bhasin (2016b) said, “The Companies Act 2013 envisages radical changes in the area of corporate governance and is set to have far reaching implications. Securities Exchange Board of India (SEBI) with the objective to align with the provisions of the Companies Act 2013, issued revised Clause 49 to adopt best corporate governance practice and to make corporate governance norms more effective. The revised Clause came into effect from October 1, 2014 except for the clause relating to the constitution of a risk management committee which shall apply to the top 100 listed companies by market capitalisation, as at the end of the immediate previous financial year. According to Deloitte study (2015), “The Companies Act, 2013 has raised the bar for the Boards in India. The new concepts introduced in the Act such like: women directors on the Boards to bring in gender diversity, enhanced disclosure norms, small shareholder director, performance evaluation of Boards and directors, mandating corporate social responsibility, introducing the possibility of class actions; including internal financial controls and risk management as a part of oversight of the Boards and enhancing the role of the Independent Directors aim at enhancing the protection for minority shareholders, provide for investor protection and activism, a better framework for insolvency regulation and thus strengthen the foundations of good governance in Indian companies.” A comparison of the provisions of CG under revised Clause 49 and Companies Act, 2013 is briefly summarized in **Exhibit 1.**

Exhibit-1: Provisions of CG under revised Clause 49 and Companies Act, 2013

Particulars	Revised Clause 49	Companies Act, 2013
Woman director	Have to be complied with effect from October 1, 2014.	It provides one year transition period to comply with the requirement.
Limit on number of directorship for independent directors	Maximum 7 listed companies as independent director except where such person is WTD; the limit is up to 3 directorships.	The 2013 Act provides overall limits on the number of directorships by an individual i.e. maximum 20 companies (including 10 public companies). However, no specific limit is prescribed for independent directors.
Tenure of independent director	The maximum tenure of an independent director is capped at 10 years. However, if a person who has already served as an independent director for 5 years or more on 1 Oct. 2014, will be eligible for appointment for a term of 5 years only.	The overall term of an independent director is 10 years, except that under the 2013 Act, these requirements are applied prospectively.
Constitution of Audi Committee	Two-thirds of the members of the AC shall be independent directors. The chairman of the AC is to be an independent director.	The AC is to be formed with majority being independent directors i.e. more than half of the board to be independent. No specific requirement for the chairman to be an independent director.
Related Party Transactions	All material related party transactions shall require approval of the shareholders through special resolution and the related party shall abstain from voting on such resolutions.	All related party transactions which are not in the ordinary course of business or not at arm's length basis should also be approved by the board and shareholders. However, shareholders' approval is required for only certain transactions with the criteria for such approval defined differently.
Risk Management Committee	The revised clause 49 inserts a new requirement (for only top 100 listed companies by market capitalization as at the end of the immediate previous financial year) that a company shall also constitute a risk management committee.	The 2013 Act does not contain similar requirements.
Separation of offices of chairman and chief executive officer	No explicit provision earlier. Introduced as a non-mandatory provision.	Separation required unless articles of the company permit otherwise or the company does not has multiple businesses.

4. Audit Committee Scenario in India

There has been growing recognition in recent years of the importance of CG in ensuring sound financial reporting and deterring fraud. The audit serves as a monitoring device and is thus, part of the CG mosaic (Cohen, 2002; Kaushik, 2009). It is claimed that the auditing system in India is comprehensive and well supported by law, which ensures that impartiality, objectivity and independence of statutory auditors are maintained (Giridharan, 2004). However, experience has shown that certain weaknesses and lacunae do exist in the Indian system. Various types of accounting manipulations, irregularities and leakages go unnoticed to the detriment of the public and shareholders." However, over the years, this arrangement was felt inadequate in view of the changing business scenario and it is felt that a greater interaction and link between the auditors and the top echelon of management is needed. The effectiveness of the ACs are based on the characteristics of independence, financial expertise and diligence (Kumar, 2015). The importance of "tone at the top" in deterring fraud cannot be overstated. According to a PwC study (2015), the following are the AC considerations:

- Consider whether the committee has a robust approach for evaluating "tone at the top."
- Consider whether the committee is influencing company culture through the questions they ask and the information they request.

- Assess whether the tone of management communications stresses the importance of ethics and compliance and encourages employees to speak up with any concerns.
- Leverage one-on-one meetings with internal and external auditors and ensure the effective use of private sessions to understand sensitive issues.
- Take into account the data from employee satisfaction surveys, exit interviews, and upward and peer feedback.
- Evaluate how rehearsed and scripted interactions with management are.
- Understand the extent to which executives are being driven to meet challenging targets as key performance expectations.
- Assess the feasibility of rotation of CFOs at international operations.
- Evaluate whether committee members have a sufficient understanding of the sensitivity of the market to reported earnings and the dollar amount that impacts earnings per share by one cent.

As Bhasin (2015a) asserted, "The series of accounting scandals have intensified pressure from the stakeholders and the regulators on an AC to do the jobs, for which they were hired. Even though most corporations have an AC, their role has been limited due to the lack of expertise and time." An 'active' AC is important because it indicate the commitment to the issues of interest because of the reports it release about the activities undertaken during the financial year and the efforts made to ensure adequate internal control (Chatterjee, 2011). In addition, an AC must be given the role to approve and review audit fees, thus neutralizing the bias of management influence on the negotiations with the auditors. Of equal importance, auditor 'independence' can be safeguarded if an AC is composed of a majority of independent and non-executive directors and this might indicate that their independent status would contribute to auditor independence through bridging communication networks and neutralizing any conflict between the management and the auditor (Puri, 2010). Indeed, an AC can go a long-way in "enhancing the credibility of the financial disclosures of a corporation and promoting transparency." Thus, it is essential for the Indian corporations to accept and continue with the reforms that are 'demarcated' by the challenges of the 'new' millennium.

4.1 Legal Framework for an Audit Committee

Public corporations in India face a 'fragmented' regulatory structure. Recently, Bhasin (2016c) said, "The Companies Act is administered by the Ministry of Corporate Affairs (MCA) and is currently enforced by the Company Law Board (CLB). The MCA, the SEBI, and the stock exchanges share jurisdiction over 'listed' corporations, with the MCA being the 'primary' government body charged with administering the Companies Act of 1956, while SEBI has served as the securities market 'regulator' since 1992." However, Afsharipour (2009) very aptly sums up the situation as: "Like CG standards in the U.S. and the U.K., India's CG reforms followed a fiduciary and agency cost model. With a focus on the agency model of CG, the Clause 49 reforms included detailed rules regarding the role and structure of the corporate board and internal controls."

An AC has been prescribed as a part of CG to be followed by the 'listed' corporations under clause 49 of the Listing Agreement, and by certain 'public' corporations under the Companies Act, 1956. Now-a-days, an AC is an important tool to consider and decide on all financial parameters and policies, internal controls, review of auditing, project implementation, reconstruction, merger and amalgamation, and any financial irregularities (Puri, 2010). Recently, Bamahros and Bhasin (2016) stressed, "It is noteworthy to know how the constitution of an AC generally takes place, and the so called directors being members of an AC are 'really' independent and discharge their 'fiduciary' duties entirely in an 'unbiased' and 'unobtrusive' manner."

4.1.1 The Indian Companies Act, 1956: Section 292A was inserted in the Companies Act, 1956 with effect from December 13, 2000, providing that "every public corporation having a paid-up capital of not less than Rs. 5 crore shall constitute a committee of the board of directors known as an AC." As Bhasin (2013) stated,

"It provides an AC should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review of half-yearly and annual financial statements before submission to the board, and also ensure compliance of internal control systems. The supremacy of an AC is recognized in the manner that recommendations of an AC on any matter relating to financial management including audit report shall be binding on the board and, if the board does not accept the recommendations of an AC, it shall record the reasons therefore, and communicate such reasons to the shareholders." In the event of default of the provisions of Section 292A, the corporation and every officer in default shall be punishable with imprisonment for a term up to one year or with fine up to Rs. 50,000 or with both. The offence is compoundable under section 621A of the Act. A non-banking financial corporation (NBFC) having assets of Rs. 50 crore and above as per its last audited balance sheet is required to constitute an AC, consisting of not less than 3 members of its Board of Directors. The AC constituted by an NBFC under section 292A of the Companies Act, 1956 shall be the AC for this purpose.

4.1.2 SEBI Clause 49 of Listing Agreement: Based on the recommendations of the Committee headed by Mr. Kumarmangalam Birla on CG in "listed" corporations, the SEBI amended the Listing Agreement on February 21, 2000 by providing therein Clause 49 on CG. On October 29, 2004 a 'revised' Clause 49 was introduced, which was finally made effective from December 31, 2005. As Bhasin (2015B) observed, "All existing listed-corporations having a paid-up share capital of Rs. 3 crore and above or net worth of Rs. 25 crore or more at any time in the history of the corporation, have to comply with the same. The corporations seeking listing for the 'first' time have to comply at the time of seeking 'in-principle' approval for such listing. The clause 49 provides for appointment of independent directors, AC and several other parameters for disclosure to and for protection of interest of shareholders."

5. Research Methodology

Regulators, investor advocates, and other stakeholders have increasingly called for companies to build trust with investors in recent years. Much of this attention has focused on the audit committee's (ACs) role in supporting investor interests. Here, Bhasin (2016d) said, "Annual reports are an ideal place to apply an AC framework because they allow us to compare AC positions and trends across different corporations, industries and countries. They are an instrument for communicating issues comprehensively and concisely, and they are produced regularly, so they can be used to analyze management attitudes and policies across reporting periods."

The main objective of the present research study is to survey the prevailing practices of an AC disclosure made by the corporate-sector in India over a four year period from 2010-11 to 2013-14. Accordingly, the sample-size of the present study consists of top 500 listed companies from India in terms of their market capitalization, as on March 31, 2013. The annual reports and other relevant information of the selected corporations were obtained from the database provided by SANSCO—Annual Reports Library Services (www.sansco.net).

Reports on the AC were subjected to a "content" analysis to identify the title and format of such reports. The content analysis of annual reports involves 'codification' of qualitative and quantitative information into 'pre-defined' categories in order to derive 'patterns' in the presentation and reporting of information. The 'coding' process also involved reading the annual report of each corporation and coding the AC information according to pre-defined categories. Over the last decade, content analysis has been used by several leading researchers to study the performance and reporting (Beattie, 2007). Therefore, as part of the present study, 'content' analysis has been used to analyze the extent of an AC disclosures made by the top 500 listed companies in India. By looking at the disclosures made within their annual reports, one can examine the extent to which Indian corporations 'publicly' document the presence (or importance) of an AC. Specifically, the paper covers the following aspects related to an audit committee: (a) The structure and composition of an AC; (b) The criteria used to select an AC members; (c) Examining the importance of functions currently performed by an AC and also to analyze any differences in the practices of companies in this regard; (d) The areas of an AC review focus; and (e) The effects of meetings on an AC functions.

Finally, as part of this study, an attempt will be made to examine and analyze the trends about various characteristics of an AC, such as, their size, composition and activity, as well as, extent of non-audit services provided by the auditors in the top 500 listed Indian companies.

6. Findings and Analysis of Results

The SEBI's Clause 49 (2004) and other regulatory changes have put tremendous demands on an AC. As Bhasin (2016e) stressed, "Having the right directors on an AC—with mandated independence and financial literacy combined with integrity, healthy skepticism and judgment, knowledge of the corporation and industry, and the courage to challenge decisions—is an important driver of an AC effectiveness." The AC members must learn "how to work smarter and to allow enough time to complete their ever-lengthening list of duties." In fact, given their 'pumped-up' workload, they are struggling to know what to put at the top of the list (Ahmed et al., 2009). As Heffes (2007) lucidly puts it: "The AC has a lot on their plates and so they need help to ensure they see the forest, not just the trees. While they should review information carefully and challenge management when necessary; they should not be resolving everyday issues or making management decisions."

This section presents detailed trends about various characteristics of an AC, such as, their size, composition and activity, as well as, extent of non-audit services provided by the auditors in the Indian corporations. These trends are presented for the top 500 listed corporations in India, based on their market capitalization as on March 31, 2013, for four years covering the financial years 2010-11 to 2013-14. As stated earlier under the research methodology, all the required annual reports and other secondary sources of information in respect of the top 500 listed corporations were outsourced (Sarkar and Sarkar, 2010) and extracted from the private database maintained by SANSCO services (www.sansco.net). Moreover, Tables 3 to 8 are constructed based on the disclosures made in the "Corporate Governance Reports" filed by these corporations. In fact, the year 2006 marks the year when all the listed firms were required to comply with the revised provisions of the SEBI's Listing Clause 49, which were first notified on October 29, 2004 but came into effect from January 1, 2006. Table 4 summarizes AC trends from the size view point.

Table 3: Distribution of Corporations According to Size of Audit Committee

Size of Audit Committee (AC)	2010-11	2011-12	2012-13	2013-14
2	0.30	2.19	0.51	1.25
3	57.19	50.27	51.39	49.87
4	29.64	33.61	34.43	36.84
5	7.78	9.02	9.87	8.02
6	2.99	3.83	3.04	3.26
7	2.10	0.55	0.51	0.50
8	0.00	0.27	0.00	0.25
9	0.00	0.27	0.25	0.00
Average Size of AC	3.62	3.66	3.66	3.62
No. of Corporations	334	336	395	399

(Source: Annual Reports of top 500 Listed Corporations in India, SANSCO)

According to Carcello (2002), "The AC plays an important role overseeing and monitoring the financial reporting process, internal controls, and the external audit. They provide a communication bridge between management and the internal and external auditors." No doubt, to maintain integrity of their monitoring functions, an AC is required to perform their responsibilities 'diligently'. As per Clause 49, "A qualified and independent AC shall be set up. The AC shall have minimum three directors as members. Two-thirds of the members of AC shall be independent directors." Judged in the context of Clause 49 regulations requiring listed corporations to have an AC with a minimum of 3 members, **Table 3** shows that nearly all (98.75%) corporations have complied with this regulation. However, a large majority of the corporations have already constituted their AC, with the minimum size required under the regulations; however, with one-third (36.84) of the corporations adding one 'extra' member. In fact, there are very few Indian corporations (just 4%) that have an AC with more than 5 members in 2013-14.

In fact, an AC has been formed to act both as a ‘conduit’ of information supplied by the management to the auditors, and at the same time to ‘insulate’ the auditor from the pulls and pressures of the management (Sharma, 2007). An AC is, therefore, required to be “independent” of the management and has the ‘key’ responsibility of deciding the scope of work, including the fixation of audit fees and the determination of the extent of non-audit services. As Sarkar and Sarkar (2010) very aptly pointed out, “The basic idea is to make the auditor not to be dependent on ‘inside’ management, both in terms of discharge of its functions as well as in terms of its survival.” Table 5 and 6 summarizes the trends regarding the AC independence in the Indian corporate-sector. Recalling that Clause 49 requires all ACs to have at least 2 to 3 of its members as “independent” directors, **Table 4** shows that the “mean” of independent directors to be 79 over these four years from 2005-06 to 2008-09. Surprisingly, 15.32% of the Indian listed corporations did not comply with Clause 49 regulations in 2011. However, by and large, corporations in India seem to be making a serious effort to comply with the regulations, with the extent of non-compliance significantly decreasing from 15.32% in 2011-12 to 10.35% in 2013-14.

Table 4: Trends in Audit Committee Independence: Distribution of Corporations

Fraction of Independent Directors	Year			
	2010	2011	2012	2013
$f < 2/3$	8.16	15.32	12.76	10.35
$2/3 \leq f < 3/4$	18.43	18.11	22.45	23.48
$3/4 \leq f < 1$	18.43	22.84	25.51	28.28
$f = 1$	54.98	43.73	39.29	37.88
No. of Corporations	334	366	395	399
Fraction of Independent Directors (ID)	0.85	0.78	0.78	0.79
Fraction with Managing Director (MD) in the Audit Committee (AC) (%)	19.51	19.70	19.90	22.47

(Source: Annual Reports of top 500 Listed Corporations in India, SANSCO)

A striking observation with regard to independence of an AC is “the steady decline in the percentage of corporations with fully independent AC.” While during 2010-11 more than half of the corporations (54.98) had ‘voluntarily’ chosen to have a fully independent AC, this percentage has steadily declined, surprisingly, to just over one-third (37.88) by 2013-14. What is instead observed is a very steady move to have an AC, which are just in accordance with the minimum independence requirement that is prescribed under the law. Given the size distribution of an AC, a fraction between 2/3 and less than 1 implies a ‘mandatory’ compliance under the Clause 49 regulations.

This is further borne out by the steady ‘increase’ in the proportion of corporations that have an “executive” (or management) director present in an AC from 2011 to 2013. Recall that until 2006, when the revised Clause 49 came into effect, an AC was required to consist only of non-executive directors, with majority of them being independent. The revised Clause 49, shockingly removed the non-executive director requirement and instead specified that an AC to have a minimum of three members, with two-thirds of them being independent. Given the specification of a minimum size of three, however, the move from the majority to two-thirds rule did not impose any extra independence burden. The only effect of the revised Clause 49 regulations was that “management directors could now be part of an AC.” Unfortunately, what we observe since then is a change in AC composition that seems to be a direct response to the change in the regulation. The steady decline in fully independent AC is also consistent with this change in regulation, as non-executive directors are more likely to be also ‘independent’ directors. Moreover, ‘non-executive’ directors could be ‘independent’ directors, or ‘gray’ directors. “Gray” directors are those who are related to the executive directors or have a financial interest in the corporation. It should be noted that corporations belonging to “business groups very often have family members serving as ‘gray’ directors on corporation boards.”

After the CG scandals of early 2000, policy-makers all around the world have responded by creating “codes” to improve ‘ethical’ standards in business (Amran et al., 2010). A common theme in these

guidelines is the ‘independence of the boards of directors that oversee corporate managers.” For example, in 2002, the NYSE and NASDAQ submitted proposals that required boards to have a majority of independent directors with no material relationships with the corporation (Magilke, 2009). An ‘independent’ director is defined as someone who has never worked at the corporation or any of its subsidiaries or consultants, is not related to any of the key employees, and does not/did not work for a major supplier or customer. The rationale for this ‘policy’ recommendation is that board members with close business relationships with the corporation or personal ties with high-ranking officers may not assess its performance dispassionately, or may have vested interests in some business practices. To quote Ravina and Sapienza (2009), “Some criticize the emphasis on independent board members, claiming that while they are independent in their scrutiny, they have much less information than insiders. If the executives want to act against the interest of the shareholders, they can simply leave outsiders in the dark. Thus, since the independent board members have very limited information, their monitoring could be extremely ineffective.”

Table 5: Trends in Audit Committee Independence: Distribution of Corporations

Fraction of Independent Directors	Size = 3				Size = 4			
	2010	**2011**	**2012**	**2013**	**2010**	**2011**	**2012**	**2013**
f < 2/3	7.41	7.73	8.50	6.53	6.06	15.97	10.29	9.72
2/3 ≤ f < 3/4	28.04	32.04	39.50	42.21	0.00	0.00	0.00	0.00
3/4 ≤ f < 1	0.00	0.00	0.00	0.00	48.48	52.10	61.76	62.50
f = 1	64.55	60.22	52.00	51.26	45.45	31.39	27.94	27.78
No. of Firms	189	181	200	199	99	119	136	144
	Size = 5				Size = 6			
	2010	2011	2012	2013	2010	2011	2012	2013
f < 2/3	23.08	30.30	38.46	31.25	11.11	28.57	16.67	15.38
2/3 ≤ f < 3/4	0.00	0.00	0.00	0.00	33.33	35.71	58.33	61.54
3/4 ≤ f < 1	50.00	51.52	38.46	59.38	0.00	21.43	8.33	15.38
f = 1	26.92	18.18	23.08	9.38	55.56	14.29	16.67	7.69
No. of Firms	26	33	39	32	9	14	12	13

(Source: Annual Reports of top 500 Listed Corporations in India, SANSCO)

Tables 5 describe the ‘fraction’ of independent directors on the AC of corporations in India as a measure of AC independence, and how this has changed over the 4 years’ time period from 2010-2013 for the Indian corporations. This is shown for corporations with different sizes of audit corporations, where the size is 3, 4, 5, or 6. The trends in independence presented in Table 5 for different sizes of AC confirms that “the decline in fully independent AC is true for of all sizes, though the decline is more pronounced for an AC which is bigger in size.” Unfortunately, the bigger-size AC has higher ‘non-compliance’ with the Clause 49 requirements. For example, in 2013, almost one-third (31.25) of the AC with size of 5 did not have the requisite number of independent directors required under Clause 49.

Undoubtedly, an AC plays a ‘vital’ role in ensuring the independence of the audit process. In a recent study conducted by Sharma (2011), the author concludes as: “This study is the first to demonstrate that an AC can moderate threats to auditor independence thus, protecting the quality of financial reporting.” To maintain integrity of their monitoring function, an AC is required to perform their responsibilities “diligently”. Because diligence is extremely difficult to observe directly, research uses an AC meeting ‘frequency’ as a proxy for diligence (Raghunandan and Rama, 2007). Prior research by Vineeta Sharma (2009), however, focuses on the consequences of an AC meetings and very clearly demonstrates ‘greater’ meeting frequency is usually associated with a ‘reduced’ incidence of financial reporting problems, and ‘greater’ external audit quality. SEBI’s Clause 49 requires the AC “to have, at least, 4 meetings per year with not more than four months of gap between two successive meetings.” Accordingly, **Table 6** presents the distribution of corporations according to the number of meetings held. It can be very clearly observed that “there is a steady improvement in compliance with this requirement; only 6.28 percent of the corporations holding less than 4 meetings in 2013-14.” Moreover, the ‘average’ number of meetings held is nearly five (4.82) in the last two years, namely 2012-13 and 2013-14, respectively. It appears that many corporations are ‘more’ frequently

holding their meetings, as per their individual requirements, and were not simply following the 'dictates' of the law.

Table 6: Meetings Held by an Audit Committee (AC)–Distribution of Corporations

No. of Meetings Held	Year			
	2010	**2011**	**2012**	**2013**
0	0.93	0.56	1.03	0.50
1	0.62	3.36	1.28	0.25
2	2.17	1.96	1.28	1.01
3	11.46	6.16	3.59	4.52
4	39.94	43.14	44.10	45.23
5	24.46	23.81	25.13	26.88
6	9.91	11.48	12.31	11.31
7	10.53	9.52	11.28	10.30
Average No. of Meetings Held	4.67	4.62	4.83	4.82
Number of Corporations	323	357	390	398

(Source: Annual Reports of top 500 Listed Corporations in India, SANSCO)

"As per the 'spirit' of the SEBI's listing requirements, an AC needs to meet at appropriate times throughout the year, thus, ensuring that they have enough time to discuss various issues fully. While the AC meetings are occurring more frequently and for longer periods, chairs should ensure the AC has time to reflect on issues and not just comply with legal requirements," said Bhasin (2016f). Undoubtedly, an important issue with respect to meetings is the 'duration' of the AC meeting, and the 'preparation-time' that is given to the AC members to have 'meaningful' discussions about the financial operation of the corporations. For instance, FICCI and Thornton (2009) conducted a CG review of 500 mid-sized Indian corporations which show that "in 50% of the corporations AC meetings lasted for less than two hours, while in only 9% of the corporations did the meetings went beyond four hours. The majority of the corporations gave an 'average' preparation time of up to 7 days to the AC members in terms of mailing them the agenda of the meetings, while only 6% gave time of more than two weeks."

As Bhasin (2016g) stated, "An important dimension of an AC 'effectiveness' that has gained the attention of regulators and academics is the 'financial' expertise of the AC members. Both the SOX and SEBI's Clause 49 mandates the disclosure of whether or not an AC includes a financial expert. However, the operationalization of who is a financial expert was and still is a controversial issue." For example, Krishnan and Visvanathan (2008) have argued that effective AC members are those who have "general management" experience rather than those who have an "accounting or financial" background. The SEC, initially, proposed a 'narrow' definition to include only accounting financial experts—that is, directors with experience as a CPA, auditor, CFO, controller, or chief accounting officer. However, subsequently the SEC defined financial expert 'broadly' to include non-accounting financial experts, such as directors with experience as a CEO or president. Was the SEC correct in defining financial experts to include both accounting and non-accounting experts? Because an AC is the ultimate 'monitor' of the financial reporting process, an AC financial expertise is a key determinant of its 'effectiveness'. However, Krishnan and Lee (2009) in another study found that "firms with higher 'litigation-risk' are more likely to have 'accounting' financial experts on their AC. However, this association occurs for firms with relatively 'strong' governance but not for those with 'weak' governance."

Additional characteristics of an AC for the 500 top-listed corporations in India are presented in **Table 7** for the financial year 2013-14 which presents key measures of AC "quality" that have been the focus of reform initiatives. Among these are: (a) the presence of members with accounting degree, (b) the number of directorships held by an independent director, (c) the tenure of the independent director, and (d) the mean age of independent director serving on the AC. While an AC independence is of paramount importance for ensuring the integrity of the financial reporting process, there is a growing recognition that "what is perhaps more important is the financial literacy and commitment of the AC members to discharge the various functions entrusted to them by the law."

Table 7: Audit Committee Characteristics (Sample Means): 2010-2013

Various Characteristics of an Audit Committee	Mean Score
Size of Audit Committee (Nos.)	3.65
Size of Board of directors (Nos.)	8.92
Audit Committee has a member with an accounting degree (%)	63.00
Board of directors has a member with an accounting degree (%)	95.00
Number of Audit Committee members with an accounting degree (Nos.)	1.35
Number of Board of director members with accounting degree (Nos.)	2.78
Percentage of Audit Committee members with an accounting degree (%)	40.13
Percentage of Board of director members with an accounting degree (%)	31.82
Total Number of directorships of independent directors serving in the AC (Nos.)	2.61
Median tenure of independent directors serving in the Audit Committee (Yrs.)	6.53
Median age of independent directors serving in the Audit Committee (Yrs.)	58.29

(Source: Annual Reports of top 500 Listed Corporations in India, SANSCO; Directors Database, Bombay Stock Exchange)

As Dhaliwal (2010) succinctly puts it: “While SOX proposes a ‘narrow’ definition of financial expertise, to include individuals with experience in accounting or auditing, the SEC controversially adopted a ‘broader’ definition of financial expertise that includes accounting and certain types of non-accounting (finance and supervisory) financial expertise.” Motivated by the SOX requirement that ‘public’ companies disclose whether they put a financial expert on their AC, we test whether the market reacts favourably to the appointment of directors with financial expertise to the AC. We find a positive market reaction to the appointment of accounting financial experts assigned to an AC but no reaction to non-accounting financial experts assigned to AC, consistent with accounting-based financial skills, but not broader financial skills, improving the AC ability to ensure high-quality financial reporting (DeFond, 2005). According to SEBI’s Clause 49, “All members of an AC shall be financially literate and at least one member shall have accounting or related financial management experience.” For example, Bindal (2011) very appropriately pointed out, “While Clause 49 does not require all AC members to possess accounting degrees, it can be hardly imagined that an AC will be able to do justice to its role without any of its members having a formal training on the complexity of the accounting process and the various accounting and auditing standards that confront today’s corporations.” Here, Bhasin (2015, a) stressed, “There is no doubt that all ‘fresh’ appointed AC members need a ‘robust’ orientation-program, allowing them to understand their role and the corporation’s financial reporting process, so that they can ‘add’ value to the AC sooner.”

In addition, Johnstone (2011) very strongly observes as: “Internal controls have long been recognized as important in ensuring high-quality financial reporting.” Similarly, Bhasin (2016, a) observed, “The AC is formed to regularly review processes and procedures to ensure the effectiveness of internal control systems so that the accuracy and adequacy of the reporting of financial results is maintained at high-level at all times. To discharge their responsibility, it is important for the members of an AC to have ‘formal’ knowledge of accounting and financial management, or experience of interpreting financial statements.” The Listing Agreement (Clause 49) requires “all members of an AC shall be financially literate and at least one member shall have accounting or related financial management expertise.” Clause 49, by way of explanation, defined the term ‘financially’ literate as “the ability to read and understand basic financial statements, e.g., balance sheet, profit and loss account and statement of cash flows. Further, a member will be considered to have accounting or related financial management expertise if he/she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual’s financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.” Unfortunately, the explanations given above are not free from some ambiguity. **Table 7** shows that 63% (about two-thirds) of the top 500 Indian listed corporations had an AC with at least one member with an accounting degree. However, where an AC did not have a member with an accounting knowledge, it was very likely the board had one such a member. On an average, 40.13 percent of the AC members had an accounting degree. Similarly, percentage of board members with an accounting degree was 31.82. However, ‘median’ tenure and ‘age’ of independent directors serving in the AC during 2013-14 was 6.63 and 58.29 years, respectively.

Another fundamental condition which needs to be fulfilled by all AC members is their ability to devote 'sufficient-time' to effectively discharge all the functions assigned to them by law (Ward, 2009). For instance, Emmerich (2006) advises as: "To be sure, prospective AC members must understand that more will be required of them—more time and more efforts—than may have been demanded in the past. It seems clear that all aspects of the 'legal' system are likely to place a heavier emphasis on independence and to demand greater attention and involvement (that is, greater commitment) from corporate directors in general, but especially from AC members, than in the past." The legal standards for measuring the independence and the duties of an AC member, by-and-large, have not changed. As we have seen, the current SEC regulations discourage directors with more than three directorships to be members of an AC because "over the commitment that comes with too many directorships might hamper the ability of the directors to dutifully carry out all the functions expected of him/her." In this context, it is encouraging to note from Table 7 that the 'average' number of directorships held by the independent directors in the top 500 listed Indian corporations during 2013-14 was 2.61, less than three. This is a welcome development and will hopefully persist in the coming years. In this context, Zabihollah (2003) states: "Having the right directors on the AC—with mandated independence and financial literacy combined with integrity, healthy skepticism, knowledge of the corporation and industry, and the courage to challenge decisions—is an important driver of AC effectiveness."

In the past, some Western researchers have examined the relation between CG characteristics and the audit fees. Strong governance could increase the demand for auditing (thereby increasing fees) and/or reduce auditors' assessments of risk (thereby reducing fees). For example, Krishnan and Visvanathan (2009) in their study found that "audit fees are negatively associated with accounting expertise on the AC, but only in corporations with strong governance. Audit fees increase with board size, board meetings, AC meetings, and CEO duality. Also, the relation between audit fees and AC accounting expertise is negative, when earnings management risk is low, but positive when the earnings management risk is high." Thus, an AC with accounting experts appears to demand more 'extensive' auditing when 'risk' is higher. Conversely, research by Lassila (2010) finds that "the use of the auditor for tax services is positively related to CG strength—composite of board size, board independence, audit committee size, audit committee independence, shareholders' rights, and institutional ownership."

Table 8: Non-Audit Services and Non-audit Fees

Services rendered by Auditors	**2011-12**	**2012-13**
Corporations where Auditors rendered Non-audit Services	(%)	(%)
Indian Business Groups	83.90	85.15
Indian Standalone	75.73	70.54
Foreign Business Groups	84.21	88.24
Foreign Standalone	70.37	62.96
All Corporations	80.00	79.40
Non-audit to Audit Fees by Ownership Groups (Median)	(%)	(%)
Indian Business Groups	42.00	34.88
Indian Standalone	39.54	26.30
Foreign Business Groups	53.92	56.38
Foreign Standalone	79.42	86.89
All Corporations	46.67	35.65
Non-audit to Audit Fees by Size (Median)	(%)	(%)
Small (< 750 crores)	48.33	35.42
Medium (> 750 and < 3400 crores)	41.43	33.50
Large (> 3400 crores)	55.36	44.44
All Corporations	46.67	35.65

(Source: Annual Reports of top 500 Listed Corporations in India, SANSCO)

Now, moving over to issues relating to auditor independence and non-audit fees, **Table 8** presents some relevant statistics for the top 500 Indian listed corporations for two years, viz., 2011-12 and 2012-13. It can be observed that in 80 and 79.40% of the corporations in 2011-12 and 2012-13 respectively, the statutory auditor was also rendering non-audit services. During these two years, there is virtually no significant change. Comparative figures available for the US in 2000, which predates the passage of the SOX Act,

shows that out of the 16,700 corporations, which were registered with the SEC, only 4,100 (or 25%) purchased non-audit services from the external auditor. According to a study conducted by Abbott (2007), “Our results are consistent with firms with independent, active, and expert AC being less likely to outsource routine internal auditing activities to the external auditor. However, the outsourcing of non-routine internal audit activities, such as, special projects and EDP consulting are not negatively related to effective AC.”

Indeed, interesting differences surface during 2012-13 when the ‘aggregate’ picture is broken down into ‘ownership’ groups. Two important observations can be made on Table 8. First of all, nearly 85% of corporations belonging to ‘business’ groups (either domestic or foreign) buy ‘non-audit’ services from the ‘statutory’ auditor. For the same period, the percent for ‘standalone’ firms, who bought ‘non-audit’ services from the ‘statutory’ auditor was 70.54 (domestic) and 62.96 (foreign), respectively. Secondly, the percentage of ‘foreign’ group corporations buying ‘non-audit’ services shows an ‘increase’ (from 84.21 to 88.24) from 2012 to 2013, while ‘Indian’ standalone corporations exhibit a ‘decline’ from 75.73% to 70.54%. Furthermore, Table 8 also presents the extent of non-audit fees relative to audit fees earned by auditing firms for top 500 listed Indian corporations. Current regulations require that “non-audit fees not to exceed audit-fees.” As the data in the table demonstrates, “the extent of non-audit fees in both years was well below the statutory limit.” More encouragingly, the extent of non-audit to audit fees has declined for all corporations under study from 46.67% in 2006-07 to 35.65 in 2012-13. Decomposition by ownership groups shows that extent of non-audit fees (56.38%) to be much higher for foreign corporations than for domestic corporations (34.88%) in 2012-13. On an average, the ratio of non-audit to audit fees were 42% in 2011-12 compared to 53.92% for foreign group corporations and 79.42% for foreign standalone corporations. More strikingly, while ‘domestic’ corporation exhibits a decline in the non-audit fee percentage from 42 to 34.88%, with the decline being more pronounced for ‘standalone’ corporations (from 39.54 to 26.30%), ‘foreign’ corporations exhibit a marginal increase from 53.92 to 56.38%. However, there was a sharp increase from 79.42 to 86.89% in the case of foreign standalone firms. Furthermore, decomposition with respect to ‘size’ shows that the extent of non-audit fees to be higher (55.36 and 44.44%) in the ‘larger’ bigger corporations for both years. However, all corporations, irrespective of their size, showed a significant decline in non-audit fee from 46.67 to 35.65% in 2008. Moreover, in a research study undertaken by Magilke (2009), the author warns that “stock-based compensation impacts the AC member preferences for biased reporting.”

As Bhasin (2016, a) concluded, “To sum up, the above analysis of the empirical trends about an AC, and auditor independence in the context of top 500 listed Indian corporate sectors presents a “mixed” picture. On the one hand, we observe an increasing trend in compliance with the Clause 49 regulations.” At the same time, we also observe a tendency to gravitate to the minimum standards with respect to an AC composition. There is a little ‘voluntary’ move to compose a ‘fully’ independent AC. Instead, what we observe is an increasing trend of inside management being present in the AC. Compared to this, the trends in auditor independence are better. The data with respect to non-audit services and extent of non-audit fees tend to suggest that domestic standalone corporations, which are also likely to be relatively smaller in size, are very steadily moving towards the notion of auditor-corporation independence envisaged under the regulations. “Without any hesitation, we personally feel this is a very welcome development on the front of AC and auditor independence in the Indian corporate sector,” as Bhasin (2012) said.

7. Conclusion and Recommendations

“In August 2014, India signed the Companies Act, 2013 into law, ushering in sweeping reforms to its CG laws and practices. Although companies were given one-year to compliant with the new provisions of the law, the Companies Act not only modernizes Indian CG to meet standards of other large global markets, but it also takes India into unchartered CG territory,” Bhasin (2016g) said. The year 2014 is shaping up to be a year of dramatic governance changes for Indian companies, as boards will be tasked with adding new committees and diversifying board membership and the periodic rotation of a company’s external auditor will become mandatory. While significant improvements have been effected in required standards of corporate governance, there is also some concern regarding overly increasing compliance and regulatory costs and efforts for companies as well as their independent directors. Among the major provisions of the

Act are those of restraining voting rights of interested shareholders on related party transactions, recognition of board accountability to stakeholders besides shareholders, and extension of several good governance requirements to relatively large unlisted corporations (Balasubramanian, 2014).

Recently, Bhasin (2016a) stated, "The issues regarding CG have received major attention owing to their apparent importance for the economic health of companies, especially after plethora of corporate scams and debacles in the recent times. High ethical values can reduce costs to achieve a high CG standard and make it more sustainable. Improving CG is an issue of critical importance to India today and for future developments." The Indian government has realized that good CG is necessary to improve corporate competitiveness and to attract foreign investors. It is believed that with better CG, listed firms can reduce agency costs, become more competitive in global markets, and fulfil their social responsibilities (Rajput and Bharti, 2015). Similarly, Goel, Bansal and Sharma in their study concluded, "We found that CG indicators (like board size, number of independent directors in a board, and percentage of independent members in an audit committee) do significantly affect the efficiency of working capital management. We also found that an increase in independence of the board and audit committee compels the management to be conservative in managing short term capital, which in turn negatively affects WCM efficiency."

One of the major responsibilities of the board of directors is to ensure that shareholders and other stakeholders are provided with high-quality disclosures on the financial and operating results of the entity that the board of directors' have been entrusted with governing (UNCTAD 2006). Here, Bhasin (2015) commented, "Unfortunately, with the rapidly growing instances of corporate failures and the rising dissatisfaction with the functioning of the corporations gave rise to the need of reassuring the stakeholders. As a result, the emphasis was laid on improving the CG practices across the globe." Moreover, Bhasin (2015C) stated, "Post-Satyam scandal in India investors' confidence in the CG system is low. Therefore, audit and AC are being widely questioned by the regulators and investors." Experience with ACs has shown that the remit of the AC includes a wide-range of areas from oversight of external and internal audit and financial reporting matters to internal control systems review, risk management, and legal and regulatory compliance matters (Barron, 2015). The ACs needs to understand that the level of interest they exhibit in a particular area will drive behaviors. By simply asking questions and requesting information about tone and fraud deterrence, management will generally respond with more emphasis on and consideration to the topic. If they believe the AC is concerned, they will pay attention. And the information directors request, when evaluating and influencing tone, can be a strong reminder to management (Paula, 2016). We suggest they consider a variety of possible metrics, observations and information including:

- Employee satisfaction surveys.
- Exit interview comments/data (15% of directors now do this).
- Peer feedback through annual assessments (25% of directors now do this).
- Candor versus overly scripted meetings—CEO communications messaging the importance of ethics and compliance and proper behaviour.
- Lack of rotation of international finance heads in certain locations – Internal and external auditor input Board-level discussions about tone (68 % of directors now do this).
- Board discussions about insider trading controls (44 % of directors now do this).

As Bhasin (2016a) emphasized, "As the eyes and ears of the board, the audit committee plays a pivotal role in helping to stop or reverse the rise in reported fraud incidents worldwide. Regulation has bolstered the role of the audit committee in past years. In today's complex and evolving business environment, audit committee can make a strong contribution." An effective AC can be a key feature of a strong CG culture, bringing significant benefits to an organization. Over the past 70 years, the AC concept has grown from a committee designed to nominate and arrange the deal of engagement with the auditor to a committee responsible for overseeing the integrity of the corporation's financial reporting process (Hinzpeter, 2009). As the responsibilities of an AC grew, so did the number of countries 'mandating' the use of an AC in corporate boardrooms. No doubt, after the passage of the Sarbanes-Oxley in July of 2002, the number of major capital market countries requiring an AC has more than tripled. Even though the "membership

requirements for an AC vary," it is very clear that the majority of major capital market countries view "an AC as a critical component of the financial reporting process."

In an effort to restore 'investors' confidence in the wake of recent financial reporting scandals, the Clause 49 of the Indian listing agreement mandates that "an AC be fully independent and have at least one financial expert." Undoubtedly, in India the concept of CG has already been embedded in the statutes, viz., Company Act, 1956 and SEBI's Clause 49 of the listing agreement. However, the listing agreement is "a weak instrument, as its penal provisions are not hurting enough." Several 'regional' stock exchanges where a large number of corporations are listed lack effective organization and skills to monitor effective compliance with CG requirements as stipulated by SEBI. Moreover, a vast majority of corporations which are not listed on any of the stock exchanges will remain outside the purview of SEBI's measures. It is therefore, desirable that the Companies Act needs to be amended suitably for enforcing 'good' CG practices in India. Today, an AC of the board is being seen as the key 'pivot' of any corporation. Being 'mandatory' under Section 292A of the Company Act, 1956 and Clause 49 of the listing agreement, "an AC can be a facilitator of board to implement, monitor and continue good CG practices for the benefit of the corporation and its stakeholders." Moreover, an AC is empowered to function, on behalf of the board of directors, by assuming an important 'oversight' role in the CG intended to protect investors and thereby ensure corporate accountability. Besides, an AC has 'oversight' responsibility over the CG, the financial reporting process, internal control structure, internal audit functions, and external audit activities.

As part of this research study, we examined top 500 listed corporations in India in terms of market capitalization as on March 31, 2013. Accordingly, we summarized the trends about various characteristics of an AC, their size, composition, activity, as well as, the extent of non-audit services provided by the auditors in the Indian corporation sector from 2010-11 to 2013-14. However, the above analysis of the empirical trends about AC and auditor independence presents a "mixed" picture. On the one hand, we observe an 'increasing' trend in compliance with the Clause 49 regulations. However, at the very same time, we also observe a tendency to gravitate to the 'minimum' standards with respect to an AC composition. Moreover, there is a little 'voluntary' move to compose a fully-independent AC. Instead, what we observe is an increasing trend of "inside" management being present in an AC. Compared to this, the trends in auditor independence are far better. The data with respect to non-audit services and extent of non-audit fees tend to suggest that "domestic standalone corporations, which are also likely to be relatively smaller in size, are very steadily moving towards the notion of auditor-corporation independence envisaged under the regulations." Without any hesitation, we personally feel this is a very welcome development on the front of AC and auditor independence in the Indian corporate sector.

Recently, Bhasin (2016) said, "The series of accounting scandals have intensified pressure from stakeholders and regulators on an AC to do the jobs for which they are hired. Even though most corporations have an AC, their role has been limited due to lack of expertise and time." An 'active' AC is important because it indicate the commitment to the issues of interest because of the reports it release about the activities undertaken during the financial year and the efforts made to ensure adequate internal control. Besides, an AC must be given the role to approve and review the audit fees, thus 'neutralizing' the "bias of management influence on the negotiations with the auditors." Of equal importance, auditor independence can be safeguarded if an AC were composed of a majority of independent and non-executive directors and this might indicate that their independent status would contribute to auditor independence through bridging communication networks and neutralizing any conflict between the management and the auditor (Cohen et al., 2007). Thus, an AC can go a long-way in enhancing the credibility of the financial disclosures of a corporation and promoting transparency. No doubt, it is essential for the Indian corporations to accept and continue with the CG reforms that are 'demarcated' by the challenges of the 'new' millennium. These results should be of direct interest to policy makers and stock exchange regulators throughout the world, who seek to enhance auditor independence by means of general regulatory change. Those who do not require an AC in listed corporations are in a 'shrinking' minority. As a result, corporate managers in 'developing' countries (like India), who are considering a move into a 'larger' capital market will likely need to establish an AC before their stock may be traded on a listed market.

To sum up, adequate, relevant and high quality disclosures are one of the most powerful tools available in the hands of independent directors, shareholders, regulators and outside investors to monitor the performance of a corporation. The effectiveness of the ACs is based on the characteristics of independence, financial expertise and diligence. This is particularly important for emerging economies like India, where there is "insider" dominance. To this extent, measures that strengthen auditor independence and enhance the powers, functions, and the independence of an AC will be crucial in the governance of the Indian corporations. Governance risk is a key determinant of market pricing of listed securities. A high perceived "independence quotient" of a corporation's auditing process can be reassuring to outside shareholders that can help reduce the risk premium of raising capital thereby providing a strong business case for strengthening both an auditor and AC independence.

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