

## KCO BLOGS 2020

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### AUDIT COMMITTEE AND ITS ROLE TOWARDS EFFECTIVE CORPORATE GOVERNANCE

In the context of best corporate governance practices and the means by which these can be adhered by corporate entities, Audit Committee is an imperative composition, through which independent members of board, confer ample of assurance to shareholders in safeguarding their reaps by discharging its fiduciary duty.

#### Brief History and Background

Since midst of the past century, formation of Audit Committee as one of the integral board committee was apprehended in ensuring accuracy of publicly traded company's financial reporting, however, it was not until 1970s, when the New York Stock Exchange (NYSE) formally required boards of directors of listed companies to appoint an audit committee, followed by Nasdaq and AMEX in 1980s respectively.

On the opposing side of Atlantic ocean, although in UK fewer public listed enterprises had Audit Committees by 1970s, however, succession of failures in accounting and auditing profession and well publicized financial abuses in subsequent periods, such as, Polly Peck, Coloroll, Maxwell and BCCI together with high level of corporate sector debt gearing and the risks posed, led to renewed gravity from both inside and outside the accounting profession for its compulsion. This, stemmed the formulation of Cadbury Committee in 1992, recommendations of which, virtually stipulated for every UK-listed company to have an Audit Committee.

Elsewhere and by and large, with turn of the millennium and public outcry in the aftermath of Enron and Worldcom catastrophes in early 2000s, Audit Committees were made one of the listing prerequisite by corporate sectors watchdogs and listing markets around the globe.

#### Composition of Audit Committee under Best Practices

With regards to the exact structuring of Audit Committee, country to country requirements may somewhat vary, nonetheless, best practices adopted remain alike and necessitate the following:

1. Comprising of at least 3 members, divided between independent and non-executive directors, appointed by Nomination Committee (*another independent committee of board*) for a definite but extendable time span.
2. At least one member should have recent and relevant financial experience, by having relevant financial experience with an appropriate professional accountancy qualification or experience for defined minimum turn of years in role overseeing financial and audit related matters.
3. Chairman of the Audit Committee not to be the chairman of the Board as well.

## **Key Functions and Roles of Audit Committee**

- Monitors the integrity of the financial statements.
- Reviews the internal financial controls and risk management systems.
- Monitors and reviews the effectiveness of the internal audit function and thus enhancing its effectiveness and independence
- Makes recommendations in relation to the appointment of external auditors and fixing their remuneration and terms of engagement.
- Reviews and monitors the external auditor's independence, objectivity and the effectiveness of the audit process.
- Provides a reporting channel for whistleblowing.

## **How Audit Committee Contributes towards Best Corporate Governance Practices**

- Increased public confidence in the credibility and objectivity of published financial information.
- Assistance and guidance extended to other directors in meeting their responsibilities towards financial reporting process and risk assessment.
- Stronger control environment, as the internal audit function reporting directly to Audit Committee will help in increasing their independence and adding weight to their recommendations.
- Strengthens the independent position of external auditor by providing an autonomous platform for communication and reporting.
- Possible low conflict of interest arising between management and independent internal and external auditors.

## **Audit Committee Requirement in Pakistan**

Requirement for establishment of Audit Committee for listed Companies in Pakistan by the Securities and Exchange Commission of Pakistan (SECP), were first formally introduced through Code of Corporate Governance 2002. Succeeding changes aimed at its enhanced and sovereign role were made through Code of Corporate Governance, 2012 and Companies (Code of Corporate Governance) Regulations, 2017 ("2017 Code").

Existing/ current requirements of Audit Committee are laid down in section 27 of chapter IX of Listed Companies (Code of Corporate Governance) Regulations, 2019 ("2019 code"), issued on September 25, 2019, by the Securities and Exchange Commission of Pakistan (SECP), superseding the Listed Companies (Code of Corporate Governance) Regulations, 2017 ("2017 Code").

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