Notes

A Critical Appraisal of the Establishment of Audit Committee for Public Companies

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Introduction

Prior to the promulgation of the Companies and Allied Matters Decree[1], there was no provision in the company legislation in Nigeria for the appointment or election of an Audit Committee. For purposes of good corporate governance and accountability, some companies, on their own, had such committees on ad hoc permanent basis[2].

According to Orojo[3] Audit Committees are new in company management. In the United States, they were established in the seventies and later became a requirement of the New York Stock Exchange for listing of securities. Audit committees also became common in Canada and the United Kingdom about the same time. In all these cases, the composition was that of executive and independent directors. The mechanism was used by the independent directors to monitor the financial activities of the company as carried out by the executive directors.

In Nigeria, the Companies and Allied Matters Decree[4] made the establishment of an Audit committee mandatory for public companies only. Thus in addition to the report made by the auditors of the company to the members, they (the Auditors) are also required to make a report to an audit committee which shall be established by the public company.

The purpose of this paper, therefore is to examine this provision and critically appraise its efficacy and utility. This is more so that members of the committee are not entitled to remuneration[5] and yet, at almost all annual general meetings of companies the lobby for election into this committee makes this examination imperative.

Acts by or on Behalf of Companies

A cursory look at any corporate set up will show a dichotomy between the members in general meeting and the directors. Accordingly section 63(1) of the Decree provide thus:

> A company shall act through its members in general meeting or its board of directors or through officers or agents, appointed by, or under (the) authority derived from the members in general meeting or the board of directors.

Similarly section 65 of the Decree provides thus:

> Any act of the members in general meeting, the board of directors, or the managing director while carrying on in the usual way the business of the company shall be treated as the act of the company itself and the company shall be criminally and civilly liable therefore to the same extent as if it were a natural person.[6]

What can be garnered from these provisions is that a company, as an artificial entity cannot act on its own but through natural person.[7] Ipso facto the company is criminally or civilly liable for such acts.

Preparation of Financial Statements

The burden placed on directors of companies is enormous and yet there is no statutory qualification for their appointment. Directors of public companies are subject to various registration and disclosure requirements by regulatory authorities like the Corporate Affairs Commission, the Securities and Exchange Commission and the Nigerian Stock Exchange. One way of corporate accountability is the preparation of financial statements and Directors' Report. Accordingly section 331 of the Decree provides thus:

> (1) Every company shall cause accounting records to be kept in accordance with this section.
> (2) The accounting records shall be sufficient to show and explain the transactions of the company and shall be such as to:
> (a) disclose with reasonable accuracy, at any time, the financial position of the company; and
> (b) enable the directors to ensure that any financial statements prepared under this part of the Act comply with the requirements of this Act as to the form and content of the company's statement.

It is the duty of directors to prepare annual financial statements. These contents are well spelt out in the Decree.[8]

Examination of the Financial Statement

At every annual general meeting of a company it is mandatory for the company to appoint an auditor or auditors to audit the financial statements of the company.[9] The qualification for appointment as an auditor is spelt out in section 358 of the Decree.

According to section 359(1) of the Decree,

> The auditors of a company shall make a report to its member on the accounts examined by them, and on every balance sheet and profit and loss account ...which are laid before the company in a general meeting during the auditor's tenure of office.

The contents of the auditor's report are set out in the Sixth Schedule of the Decree.[10] The duties and powers of the auditors, are clearly spelt out. In the main, it is the duty of the auditors to carry out such investigations as may enable them to form an opinion as to whether proper accounting records have been kept and whether the company's balance sheet and profit and loss account are in agreement with the accounting records and returns. The purpose of an audit is to provide information on the financial position of the company. The essence of the report is that an independent person representing the shareholders satisfied himself through an examination of the books and accounts of the company that the directors and officers of that company have properly carried out their duty as required by the Decree in regard to the accounts and to report on the findings in accordance with law. Where however the auditors are not satisfied in regard to either of the particulars, they must state that fact in which case the report is qualified.[11] The auditor's report must therefore be a categorical statement as to whether there had been proper compliance with the provisions of the Decree regarding accounting disclosures in order to present in effect a true barometer of the company's state of affairs and as to its profits or losses for the given financial year. The auditors must be honest and also exercise such care and skill as is expected from them. Their primary duty is to show the true financial position of the company.[12]

Establishment of an Audit Committee

The Nigerian Law Reform Commission in reviewing company enactments in Nigeria recommended the establishment of an audit committee.[13] This recommendation was accepted by government hence the introduction of provision setting up audit committee for public companies.[14] Unfortunately under the Decree there is no specific provision on the mode of appointment of the committee except that the committee shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum number of six members) and shall examine the auditors' report and make recommendations thereon to the annual general meeting as it think fit.[15]

While there is specific provision in the Decree for the qualification for appointment as auditors,[16] there is no specific provision made as to the qualification of the directors and shareholders who are to serve as members of the committee. However, any member may nominate a shareholder as a member of the Audit committee by giving notice in writing of such nomination to the Secretary of the company at least 21 days before the annual general meeting. It is instructive to note that a poll cannot be demanded on the election of the audit committee members.[17] In practice while the directors present the three directors to represent them, the other three members are elected by the members in general meeting. This is a departure from the practice in other jurisdictions. For example in the USA and the UK where the composition is that of executive and independent directors.

Functions of the Audit Committee

Sections 359(6) of the Decree provides thus:

> Subject to such other additional functions and powers that the company's articles of association may stipulate, the objectives and functions of the audit committee shall be to:
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> (a) ascertain whether the accounting and report policies of the company are in accordance with legal requirements and agreed ethical practices;
> (b) review the scope and planning of audit requirements;
> (c) review the findings on management matters in conjunction with the external auditor and departmental responses thereon;
> (d) keep under review the effectiveness of the company's system of accounting and internal control;
> (e) make recommendations to the board in regard to the appointment, removal and remuneration of the external auditors of the company;
> (f) authorise the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

There is no gainsaying the fact that the institution of an audit committee is a laudable one. It is an important investor protection mechanism instituted as a form of checks and balances. According to Sasegbon[18] the auditors see to it that the directors have done their duties, the internal auditors ensure that there are no sharp practice and departures from prescribed rules internally; the external auditors see to it that neither the Directors nor the internal auditors collude to defraud and the audit committee checks them all. Generally in corporate governance, ownership is divorced from control. This is more pronounced in public companies. The directors who are the managers carry out the day-to-day activities of the company while the shareholders hold general meetings to examine the books kept by the directors from a historical perspective.

It can be argued therefore that the audit committee has a supervisory responsibility over that of the external auditors as the committee is empowered to examine the auditor's report and make recommendations to the board even in regard to the appointment, removal and remuneration of the external auditors of the company.

Evaluation of the Functions

It is pertinent to evaluate the functions of the audit committee in order to ascertain their virility and efficacy. The committee is to examine whether the accounting and reporting policies are in accordance with legal requirements and ethical practices. As has been observed, the auditors are professionally qualified accountants while the directors are not statutorily required to possess any special skill or qualification. Similarly, most shareholders are either illiterates or not versed in corporate and financial management. The shareholder members of the committee may not have seen a profit and loss account or balance sheet before. Yet they are expected to examine the work done by professionals. It would seem therefore that the work of the committee is superfluous. In addition, both the directors who are members of the committee as well as the banks even though they may have legal background and yet one of their functions is to ensure compliance with legal requirements. On the issue of ethical practices the audit committee may be competent to comment on this. In practice, you find a select few who are members of more than one audit committee. The result is that even if they are knowledgeable enough to examine the accounting policies they are thinly spread over many companies.

The audit committee is also expected to keep under review the effectiveness of the company's system of accounting and internal control. How can people not versed in financial management carry out this function? It is humbly submitted that unless there are statutory provision or clear guidelines on the appointment of members of the committee, the committee will merely rubber stamp what the external auditors have prepared. This cannot be the intendment of the provision.

This evaluation is not to suggest that the audit committee serves no useful purpose. Indeed the realisation by the external auditors that another body will examine their report will ginger them into preparing a comprehensive report. Similarly, where the members of the Committee (especially the shareholders) are individuals who are formidable and have sound knowledge of corporate management and accounting, the committee is an unequalled means of scrutinising the activities of the board of directors. Thus, the fear of exposure by the committee is an effective tool in ensuring best practices on the part of the board of directors.[19]

It is humbly submitted that all other functions of the audit committee can be effectively performed especially if the committee is properly constituted.

Akin to this analysis is the fact that although the members of the committee are due for re-election annually, they are not entitled to any remuneration. One wonders then why at every annual general meeting of a company the competition for election as a member of the committee is fierce. Could it be the case that this provision is being breached or there are some other benefits in kind? If consideration other than cash is furnished, the result is that the members will compromise their positions and defeat the purpose of the provision. Furthermore, there should be a fixed term for the members instead of this blanket provision of qualifying for re-election annually.

Conclusion

With the failed banks syndrome, we may move to failed corporate entities. In all these failed banks, was it the case that they had no external auditors? It is submitted that they were legally bound to have and yet the reports did not seem to reflect the true financial position of most of the banks even though this may not have been the fault of the auditor who is a professional. Therefore the requirements that auditors are to examine the financial statements of companies does not entail examining the actual day-to-day entries. It would seem that what the auditors examine is the accounting records only. As professionals the report will be couched in a way that the lay man may only be carried away by the glossary nature of the reports and accounts.

Herein lies the problem of the audit committee. A situation where a layman examines a professional is not only ludicrous but preposterous. While the establishment of the audit committee is an additional check on the directors it is humbly submitted that the Law Reform Commission should quickly re-visit the issue and amend the decree accordingly.

An appraisal of the functions of the audit committee vis-a-vis that of external auditors point to the fact that the two are meant to complement each other. For this laudable objective to be achieved, the following recommendations are made:

(a) It is the directors who are duty bound to prepare the financial statements and yet some of them sit on a committee that examines their reports. It is like a judge sitting on appeal over the same judgement. Consequently, the composition of the audit committee should be re-examined. For instance, membership should be titled in favour of shareholders and non-executive.

(b) By the nature of public companies, the shareholding is usually large. Most shareholders do not bother to attend meetings. As it is, only shareholders whose nomination reach the company secretary within the stipulated period and have the highest number of votes are elected. In practice, candidates are sponsored by Shareholders Association who may have their own interest to protect instead of that of the shareholders as a whole. There is the need to ensure that those to be elected are properly screened and possess a certain minimum number of shares or attain a level of education.

(c) The audit committee is expected to examine the accounts prepared by professional. For a virile audit committee there must be a laid down qualification for members e.g. limiting membership to those versed in corporate and financial management.

(d) It would seem that the reason for not providing for remuneration for the audit committee is to ensure independence. It is recommended that there should be some from of incentive like sitting allowance and transport allowance. This is to ensure that the companies do not furnish unauthorised consideration via the back door. It is humbly submitted that this benefit in kind may be the motive behind the fierce competition to serve on the committee. Nigerians are not known to be that generous to serve on such committee gratuitously.

(e) The provision of the Decree assumes that the audit committee is infallible and therefore there is no provision for its control. It is therefore submitted that the Decree should be amended to reflect the fact that members of the committee can be removed like an auditor. Similarly, their tenure should not be more than two consecutive years.

Company legislation is fast developing world-wide. Until 1990, there was nothing like formal establishment of an audit committee for public companies. For it to be virile and make an impact in corporate governance and accountability, it is submitted that the present provisions in the Decree are inadequate. There is therefore the need to re-examine them to make them efficacious.

NOTES

1. Decree No. 1 of 1990 (hereinafter called the Decree) now Cap 59 Laws of the Federation 1990).

2. Orojo J. O. Company Law & Practice in Nigeria (3rd edition Lagos, Mbeyi Associates (Nig.) Ltd. 1992 p. 396.

3. Orojo, Ibid. See also Sasegbon, D: Nigerian Companies 4 Allied Matters Decree: Law & Practice, (Lagos DSC Publications Ltd. 1991 Vol. 1 p. 584.

4. See section 359(3), Decree No. 1 of 1990 (hereinafter referred to as "the Decree").

5. See the proviso to section 359(4) of the Decree.

6. See also Lennard's Carrying Co. Ltd. v. Asiatic Petroleum Co. Ltd. (1915) AC 705; and Bolton (Eng.) Co. Ltd. v. Graham & Sons Ltd. (1957) 1 QB 159.

7. See Ferguson v. Wilson (1866) L.R. 2 ch. 77.

8. See section 334 of the Decree.

9. See section 357 of the Decree.

10. See section 359(2) of the Decree. See also section 360(4) of the Decree.

11. See Sasegbon, Op. Cit at 579 and Pacific Acceptance Corporation Ltd. v. Forsyth (1967) 92 W.N. (N.S.W.) 29.

12. See In Re London and General Bank (No. 2) (1895) 2 Ch. 673.

13. See P. 286 of the Report on the Reform of Nig. Comp. Law, Vol. 1 Nig. Law Reform Commission, Ikoyi, Lagos (1988).

14. See section 359(3) of the Decree.

15. See section 359(4) of the Decree.

16. See section 358 of the Decree.

17. See section 359(3) of the Decree.

18. Sasegbon, Op. Cit at 584.

19. Omotoso, O.F. (1999) "Improving Corporate Governance: The Role of Virile Audit Committees", The Journal of the Institute of Chartered Secretaries and Administrators of Nigeria, Vol. 1 No. 6, April 1999, Page 21.