

Audit Committee in Various Legal Regimes: A Comparative Study of Developed and Developing Countries

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Abstract :

The audit committee is arguably the most important board sub-committee. Theoretically, the key role of the audit committee is to ensure the integrity of internal and external audit function and in order to play this role, the committee needs to be essentially engaged in assessment of audit fees and fees for non-audit work, independence of external auditors, informing the audit related issues to the board timely, reviewing arrangement for the whistle-blowers, and in absence of risk committee, assessing the systems in place to identify and manage both financial and non-financial risk. In order to identify the gap between the theory and practice, this paper examines latest statutes, statutory guidelines, and, relevant corporate governance code provisions of some selected developed and developing regimes. The paper identifies some common features of the audit committee in both the developed and developing regimes. However, the developing regimes are found to be struggling to establish the audit committee fully comprised of the members essentially either having experience of the industry or having recent and relevant experience as professional accountants. Further, the developing regimes are also found to have failed to make arrangements for the protection of the whistle-blowers.

Key words: Audit Committee, Internal audit, External Audit, Independence, Whistle-blowing.

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Audit Committee in Various Legal Regimes : A Comparative Study of Developed and Developing Countries

1. Prelude

The existence of an independent audit committee is recognized internationally as an important feature of good corporate governance. Theoretically, today's corporate world has divided itself into two rival distinctive systems, on the basis of corporate ownership structures, which have profound impact on the corporate governance mechanisms. These are: 'the Anglo-American model' and 'Roman-Germanic' (or Japan-German) model; the latter attracting the continental Europe, Japan and Canada. The Anglo- American model is characterized by the diffused or dispersed share ownership and the continental model by 'concentrated' or 'core' share ownership. In Britain as well as in most of its former colonies, a very few large companies are controlled or owned by the families or the large shareholders with opportunity to exercise dominant influence in the corporate activities. Thus, major shareholders are uncommon within the Anglo-American framework. Instead the institutional shareholders play an important role in the corporate ownership¹. On the contrary in Japan, Germany and continental Europe, companies having publicly traded shares typically have 'core' shareholders and/ or dominant creditors that exercise considerable influence over management.² . Further in Roman-Germanic system, securities market plays only a secondary role in the corporate governance arrangements, as major successful public companies are uncommon on the stock markets in some countries, notably Germany³ . This case has been just opposite in Anglo- American set up.

¹ Cheffins, B.R. (1997), "Company law: Theory structure and operation", Oxford, UK.

² Cheffins, B.R. (2001), "Does law matter, The Separation of Ownership and Control in the United Kingdom" the Journal of Legal Studies, Vol. XXX(2)

³ Cheffins, B. R. (2001), "The Metamorphosis of German Inc.:The Case of Executive Pay". The American Journal of corporate law, Vol. 49(3), 11

The Chittagong University Journal of Law

Another important distinction is that, the ownership and control in the UK and the USA is characterized as an ‘outsider’ or ‘arm’s length’ system. The outsider typology is used because share ownership is dispersed among a large number of institutional and individual investors rather than being concentrated in the hands of a small number of families, banks, or other firms.⁴ The term ‘arms length’ signifies the distant or detached approach the investors maintain with their companies giving the executive a leverage or freedom to manage the companies. In contrast to this position, the Japanese-German model can be characterized as ‘insider’ or ‘control oriented’ system, because under this system companies normally have controlling shareholders and dominant creditors. The nature of shareholder’s participation (hands-off/hands-on) under both systems has a considerable impact on corporate governance mechanisms. Thus while protection of minority shareholders constitutes a primary though not the only concern in continental Europe and Japan, the issue of managerial accountability is a top priority in the Anglo-American of corporate governance.

Under Anglo-American system of corporate governance, where the vast majority of the shareholders always stay at distant from the management, they are quite naturally not in a position to oversee whether the major management actions are taken in the interests of the shareholders. In such context, In the Anglo-American family of corporate governance (Bangladesh and India look like members of the family), formation of an audit committee has been considered significantly as a corporate governance mechanism to ensure the transparency and accountability of the management.

⁴ Cheffins, B.R. (1999), “Current Trends in Corporate Governance: Going from London to Milan via Toronto”, 10 *Duke Journal of Company and International Law* 5.

Audit Committee in Various Legal Regimes : A Comparative Study of Developed and Developing Countries

Despite the fact that UK Company Law and Companies Act 1994 of Bangladesh do not provide any guidelines in relation to formation, responsibilities and other aspects of audit committee, Corporate Governance Codes place emphasis on the role of audit committee in ensuring transparency and accountability of financial and non-financial disclosures. However, the relevance of this board committee is debatable in case of smaller private companies on some valid grounds such as non-availability of independent directors and the viability of such committee for economic reason.

In general, the main role of the audit committee is to review the scope and outcome of audit, and to ensure that objectivity of the auditors is maintained. This would usually involve a review of the audit fee and fees paid for any non-audit work, and the general independence of the auditors. The audit committee usually provides a 'bridge' between internal and external auditors and the board, helping to ensure that the board is fully aware of all relevant issues related to audit. The audit committee's role may also involve reviewing arrangement of whistle-blowers. In addition, where is no risk management committee, the audit committee assess the systems in place to identify financial and non-financial risks of the company⁵ .

In the US, the collapses of Enron as well as some other corporate failures seem to have motivated the US law makers to introduce Sarbanes- Oxley Act 2002 to address the problems relating to financial reporting, auditing, internal accounting controls, whistle blowing, etc. Apart from these legislation and common law guidelines, the Corporate Governance Codes published in the UK and in the rest of the world raised the issue of independence of

⁵ Mallin, C.A. (2007), "Corporate Governance", 2nd Edition, Oxford University Press, UK

audit committee with due importance. In such a backdrop, this study is an endeavor to assess the role of the audit committee under Anglo- American system of corporate governance.

2. Objectives of the Study

The prime objective of the study is to assess the role of the audit committee in the countries which belong to Anglo-American family of corporate governance. To attain this objective, the study has thrown light on two leading developed as well as to developing regimes, namely, the UK, the USA, India and Bangladesh and the sub-objectives of the study have been identified as follows:

- (i) To present the role of the audit committee as prescribed by the Statutes, Statutory Instruments, and Corporate Governance Codes prevalent in selected developed and developing regimes;
- (ii) To make a comparative assessment of the positions of both developed and developing nations with regard to the domain of the audit committee;
- (iii) To make some policy recommendations in order to make the audit committee stronger and more effective.

3. Scope and Methodology of the Study

In the light of the objective of the study, the study considers the roles and responsibilities of the audit committee in a selected developed and developing regimes belong to Anglo- American family of corporate governance. Among the developed regimes, the study has taken into account the cases of the United Kingdom and the United States because the corporate governance literature clearly reveals the most critical kind of challenges faced by both the countries while dealing with insolvent liquidation of giant listed companies since 1990s. The United Kingdom illustrates the problem which is basically associated with principal-agent issues, such as, misuse of corporate assets by corporate directors,

Audit Committee in Various Legal Regimes : A Comparative Study of Developed and Developing Countries

overpayment of remuneration to directors and senior executive managers, and the lack of accountability of directors' action which ultimately resulted in the financial scandals in the companies, namely, Coloroll, Poly Peck, BCCI, and Maxwell. As like as the United Kingdom, the United States has a well developed capital market with widely spread shareholders where, by the virtue of larger shareholdings as compared to individual shareholders, the institutional shareholders seem to be emerged as a powerful element of corporate governance. Despite this feature of corporate governance, with the dawn of twenty first century, the country experienced a number of infamous corporate collapses including Enron and World Com and the crisis arisen from these collapses brought Sarbanes-Oxley Act to combat offences, such as, fabrication of financial statements, frauds and misappropriation of corporate assets by directors, and to dismantle the nexus between dishonest directors, executives, and auditors.

Among the developing nations, the study considers India and Bangladesh as both are democracies like the UK or the US and both belong to Anglo-American family of corporate governance. More so, since 1990s, both the countries have chosen private sector as the prime engine of economic development and both the countries have demonstrated commitment over the years to establish a transparent and vibrant capital market. However, it is not to deny that unlike the UK and the US the current corporate governance practices of the both regimes are not driven by any scandal, rather they are found to be driven by the policy makers at both public and private sector as part of a cautious attempt to prevent epidemics already devastated the other parts of the globe. With this backdrop, this study examines the role of audit committee in the aforesaid four countries in ensuring transparency and accountability of financial and non-financial disclosures. More categorically, This paper considers the reports of Cadbury

Committee 1992 and Smith Committee 2003 (UK), Sarbanes-Oxley Act, 2002 and Business Roundtable Principles of Corporate Governance, 2002 (US), Chandra report 2002 (India) BEI report 2004 (Bangladesh) and SEC Notification 2006 in order to examine the role of the audit committee.

4. Audit Committee in the Developed Regimes

4.1 United Kingdom

Report of the Cadbury Committee (1991), which is the oldest and one of the most influential documents on corporate governance outlines the roles of the audit committee⁶ very categorically as: “(i) making recommendations to the board on the appointment of the external auditor, the audit fee, and any questions of resignation or dismissal; (ii) review of the half- yearly and annual financial statements before submission to the board; (iii) discussion with the external auditors about the nature and scope of audit, co-ordination where more than one audit firm is involved, any problems or reservations arising from audit, any matters which the external auditors wishes to discuss, without the presence of executive board members; (iv) review of the external auditor’s engagement letter; (v) review for the company statement on internal control systems prior to endorsement by the board; and (vi) reviews of any significant findings of internal investigations”. In connection with internal audit function the Cadbury Committee suggests⁷ that “the audit committee should ensure that it is adequately resourced and has appropriate standing within the company”. The Cadbury report asserts on appointing only non-executive members in the audit

⁶Cadbury Report (1992), “Report of the Committee on the Financial Aspects of Corporate Governance”, Developed by the Financial Reporting Council, the London Stock Exchange and the Accounting Profession, UK, Recommendation no. 4.35

⁷ supra note 6, Recommendation no. 4.35f

Audit Committee in Various Legal Regimes : A Comparative Study of Developed and Developing Countries

committee including a majority of independent directors in order to establish auditors' independence⁸.

In the Post-Enron era, Combined Code Guidance 2003 (Smith Report) makes an in-depth study on size, complexity and risk profile of the listed companies and recommends on the roles and responsibilities of the audit committee in a comprehensive manner. The code encourages even the smaller companies with fewer than three non-executive and independent directors to have an audit committee. The combined code guidance asks the smaller companies to make an explanation if they consider the provision of audit committee is inappropriate to their circumstances⁹.

The roles and responsibilities of audit committee as recommended by Combined Code Guidance cover a wide range of corporate governance issues such as financial reporting, internal audit process, whistle blowing, external audit process and independence¹⁰. These are discussed below:

Provision 5.1 of the Code does not limit the role of the audit committee to review significant financial statements; it also expands the role to review the clarity and completeness of disclosure in the financial statements. Provision 5.5 of the Code requires the audit committee to monitor the integrity of the company's financial control system.

⁸ supra note 6, Recommendation no. 4.35

⁹ Combined Code Guidance (2003), "Audit Committees: Combined Code Guidance" a Guidance by FRC-The Group chaired by Sir Robert Smith Submitted to Financial Reporting Council (FRC) London in Dec. 2002 and Published in Jan, 2003, Provision No.1.3.

¹⁰ Combined Code Guidance (2003), "Audit Committees: Combined Code Guidance" a Guidance by FRC-The Group chaired by Sir Robert Smith Submitted to Financial Reporting Council (FRC) London in Dec. 2002 and Published in Jan, 2003, Provision No.5.

The Chittagong University Journal of Law

Provision 5.6 provides that audit committee, in the absence of the other arrangement, e.g. the risk committee, should assess the scope and effectiveness of the system established to identify, assess, manage and monitor financial and non-financial risks.

Provision 5.9 of the Code provides that the audit committee should review the arrangement by which the staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control or any other matters.

Unlike the Pre-Enron Codes, Combined Code Guidance stresses on internal audit process to monitor the functions of the management. Provision 5.10 provides that the audit committee should monitor and review the internal audit activities.

The Combined Code Guidance also has made some pragmatic recommendations on the role of audit committee in relation to external audit process. Provision 5.17 of the Code recommends that the audit committee should assess the qualification, expertise and resources, effectiveness and independence of the auditors annually. Provision 5.22 provides that the audit committee should have procedures to ensure the independence and objectivity of the external auditor annually, taking into consideration relevant UK professional and regulatory requirements. Provision 5.23 requires the audit committee to seek reassurance that the auditors and their staff have no family, financial, employment, investment or business relationship with the company (other than in the normal course of business). Provision 5.26 outlines the role of audit committee in allowing external auditors to engage in non-audit services. According to this provision, the audit committee should develop and recommend to the board the company's policy in relation to the provision of non-audit services by the auditor. It is also provided that the audit committee's objective should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity.

Audit Committee in Various Legal Regimes : A Comparative Study of Developed and Developing Countries

4.2 United States

The role of the audit committee as provided by Sarbanes-Oxley Act 2002 reflects the recent experiences of corporate failures in the United States. Section 301 of the Act outlines the responsibility of the audit committee as: (i) appointing, compensating and overseeing of any registered accounting firm to audit services; (ii) establishing procedure for the receipt, retention and treatment of complaints regarding accounting, internal control and audit; and (iii) engaging independent counsel or other advisers whenever it is necessary. Section 201(H) provides that the audit committee must approve non-audit services to be provided by the auditors. Section 204 of the act requires that the accounting firm must report to the audit committee all critical policies to be used, all alternative treatments Generally Accepted Accounting Principles (GAAP) that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm.

Like Combined Code Guidance 2003 another Post-Enron Code 'Business Roundtable (BRT) Principles of Corporate Governance' considers the role of the audit committee with due significance in ensuring transparency of accounts and audit. The BRT Principles of Corporate Governance identifies some key roles of audit committees which are worth mentioning. These are given below:

- “- The audit committee should understand the corporate risk profile and oversee the corporations risk assessment and management practices.
- The audit committee is responsible for supervising the corporation's relationship with its outside auditors. The audit committee should consider the independence of the outside auditor.

The Chittagong University Journal of Law

- The audit committee should review and discuss with management and outside auditor, the corporation critical accounting policies and the quality of accounting judgments and estimates made by management.
- The committee should understand and be familiar with the corporations system of internal control and on a periodic basis should review with both internal and outside auditors the adequacy of the system.
- The audit committee should provide a channel of communication to the board for the outside auditor and internal auditors and may also meet with and receive reports from finance officers, compliance officers and the general counsel¹¹.

5. Audit Committee in Developing Legal Regimes

Defining hard and fast the role and responsibilities of an audit committee in developing nations like India and Bangladesh is difficult to some extent because these countries have some genuine shortcomings in respect of formation of an audit committee. These countries have some real challenges to make the audit committee effective as well. Unlike the UK and the US, these countries have scarcity of experts in the field of accounting and finance to represent audit committee. Moreover, the available experts are not highly motivated to sit on an audit committee because of very poor sitting fees offered to them in one hand and the small-sized companies as well as losing enterprises, for additional expenses spent on audit committee, consider it as an unnecessary burden on the other.

¹¹ BRT Report (2002), “Business Roundtable Principles of Corporate Governance”, The Business Roundtable, an Association of Chief Executive Officers Committed to Improving Public Policy, USA, Available at Internet: <http://www.businessroundtable.org/pdf/704/pdf>

Audit Committee in Various Legal Regimes : A Comparative Study of Developed and Developing Countries

Despite these facts, both Chandra report and BEI report recognize audit committee as a cornerstone of corporate governance and hence identify the role of the audit committee in the context of Post-Enron era.

5.1 India

The roles and responsibilities of the Audit Committee as suggested by Chandra report are mainly spelled out in recommendation 4.8 which is titled as 'Audit Committee Charter'. According to this charter, audit committee has the following responsibilities:

“In addition to disclosing the names of the members of the audit committee, and dates and the frequency of the meetings, the chairman of the audit committee must annually certify whether and to what extent each of the functions listed in the audit committee charter were discharged in the course of the year. This will serve as committee’s ‘action taken report’ to shareholders.

The disclosure should also give a succinct but accurate report of the task performed by audit committee, which would include, among others, the audit committee’s views on the adequacy of internal control system, perception of risk and in the event of qualification, why the audit committee accepted and recommended the financial statements with qualifications. The statements should also certify whether the audit committee met with statutory and internal auditors of the company without the presence of management and whether such meetings revealed materially significant issues or risks”¹².

¹² Chandra Report (2002), “Chandra Report on Corporate Audit Governance”, India, Available at Internet: //D:\WINNT\Profiles\Administrator\Desktop\Upload files\Chandra Report.htm, Recommendation No. 4.8.

5.2 Bangladesh

Code of corporate governance for Bangladesh also outlines key responsibilities of the audit committee in its Recommendation 10.3. Out of a list of responsibilities, two are worth mentioning:

- “(i) To approve and appointment of internal auditor, ensure adequate resources, appropriate access to information and independence so that internal audits can be effectively performed to high standards; review all internal audit reports and plans and monitor management responsiveness; meet the internal auditor at least once a year without management being present to discuss any issues arising from internal audits;
- (ii) To assess the independence of external auditors; assess annually their qualifications expertise, resources and effectiveness of the external audit; review and approve the annual audit plan; meet regularly with the external auditor including at least once in a year without management being present to discuss any issues arising from the external audit”¹³ .

The Securities and Exchange Commission’s Notification 2006 is a significant development as the same has been aimed at bringing a substantial change in the arena of corporate governance in Bangladesh. Securities and Exchange Commission, Bangladesh has issued a Notification imposing some conditions on “Comply or explain basis” to the companies listed with any stock exchange in Bangladesh, Salient features of the said notification with regard to audit committee are:

¹³ BEI Report (2004), “The Code of Corporate Governance for Bangladesh”, Bangladesh Enterprise Institute, Dhaka, Bangladesh, Pp.15-16

Audit Committee in Various Legal Regimes : A Comparative Study of Developed and Developing Countries

The Board should select one member as chairman of the Audit Committee who should have a professional qualification and must have knowledge, understanding or experience in Accounting and Finance. The Audit Committee should report to the Board of Directors on the following findings (i) Conflict of interests (ii) Fraud or irregularities or material defect in the internal control system. (iii) Infringement of laws, rules and regulations (iv) Anything which has material impact on the financial conditions and results of operations giving a period of time for rectification. The Audit committee should report to the SEC Bangladesh if such rectification has unreasonably been ignored by the board or the management. Reporting on activities carried out by the Board of directors during the year should be disclosed in the Annual report under the signature of the Chairman of the Audit Committee.

6. The Role of the Audit Committee: A Comparative Analysis

It is evident from the above discussions on audit committee that all six corporate governance codes and legislation significantly consider the role of an independent audit committee and expect it to be represented by fully or at least majority of non-executive/independent directors. The Cadbury committee which took the cases of BCCI and Maxwell into consideration while setting the principles rightly identified a wide range of responsibilities for the audit committee such as responsibilities in respect of financial reporting, checking internal control system, and coordinating internal and external audit. However, some critics observe that Cadbury recommendations rest on the linked assumption that the audit committee composed of independent NEDS would improve the auditor's independence and thus act to corporate reporting and enhance the standard of corporate governance. These assumptions remain largely unchallenged and although early doubts were expressed by some commentators and some subsequent researches have raised the question about audit

The Chittagong University Journal of Law

committee impact and about the link between auditor independence and improved corporate reporting¹⁴.

In the Post-Enron era, the role of audit committee has got a different shape as the self-serving interests of some audit committee members in some bankrupt enterprises made the functioning of the audit committee absolutely loyal to the management.

In Enron, Lord Wakeham, a member of Enron's audit committee received annual consultancy fees of \$72000 and John Mendelson, another member of the committee influenced Enron successfully to donate \$ 1.6 Million to a university of Texas medical centre, where he was the president. Moreover, the audit committee members were found to provide inadequate vigilance to monitor internal financial control system (one audit committee member sat on 16 corporate boards at one time), which ultimately produced fabricated financial reports hiding the real financial difficulties of the company in the near future¹⁵

In this context the Combined Code Guidance 2003 addresses many of these issues by recommending the audit committee to monitor the integrity of the company's internal financial controls, to make an assessment of risk aspects of the business, to make arrangement for inquiring into the matters as brought to notice by the whistleblower (a new word added to audit committee literature) and monitor both internal and external audit process etc. However, this guidance is criticized by Chambers on the ground of complexities. According to him, "the combined code 2003 is even more complex with main as well as supporting principles (both of which have the same apparent mandatory status) as well as

¹⁴ Laura, F.S. (2003), "Audit Committees: Begging the Question?", Corporate Governance, Vol.11, No.3, P.41

¹⁵ Wearing, R. (2005), "The Case of Corporate Governance", Sage Publications 2005, London, UK, Pp.70-72

Audit Committee in Various Legal Regimes : A Comparative Study of Developed and Developing Countries

“comply or explain” provision; but there continues to be no reference to the apparently mandatory principles of the code”¹⁶ 93)

Sarbanes-Oxley Act examines the role of audit committee critically in the context of cases of failure of such committee to provide an appropriate surveillance to accounting and audit work. The Act requires some new responsibilities such as making inquiry on the matters complained by the whistleblowers, making an in-depth study on internal control system and approval of non-audit services which later adopted by many Post-Enron corporate governance codes.

Like Combined Code Guidance (2003), Business Roundtable Principles of Corporate Governance provides an extensive role of the audit committee covering the issues raised after the US corporate collapses. The Principles considers the audit committee as ‘grapevine’ between board and auditors (both internal and external) for any kind of support required from finance and compliance officers. But the basic limitation of BRT Principles is that it does not throw any light on the issue of whistle blowing which earned much attention by other Post-Enron Corporate Governance Codes.

Apart from the conventional roles of the audit committee as mentioned in Cadbury report, the Chandra report also claims more vigilance by the audit committee on internal control system, internal audit process and external audit. One might consider Chandra report as a less comprehensive one than other Post-Enron Codes, but in the context of a developing economy like India, Chandra report’s recommendations might seem a revolutionary

¹⁶ Chambers, A.D. (2005), “Audit Committees: Practice, Rules and Enforcements in the UK and China”, Corporate Governance, Vol.13, No.1, P.93

ones as it prescribed the formation of audit committee even for some unlisted companies¹⁷.

Bangladesh Enterprise Institute's (BEI) adhoc taskforce has got adequate time and opportunity to examine those latest developments in the field of corporate governance in Post-Enron era. Therefore, some codes of BEI relating to audit committee suggest a broad range of responsibilities for audit committee members in addition to some conventional responsibilities. BEI codes recommendation no. 10(d) suggests the strengthening of the office of the internal auditor, which might reduce the need for whistle blowing by the employees by risking their jobs. Recommendation 10(e) of the code also reveals a wide a range of responsibilities of audit committee to deal with external audit process.

The SEC Notification 2006, Bangladesh may be considered as a landmark step in respect of establishing vigilance of a board committee in the listed companies on their internal and external audit function despite some genuine critics. As a matter of fact, although the Notification requires professional qualification of audit committee chairman, it is not categorically spelled out and, therefore, there is a room for appointing a chairman who is not a professional accountant. In addition, the Notification totally ignored the necessity for establishing arrangements to protect the whistle-blowers.

7. Conclusion and Policy Recommendations

The commonality of the above mentioned legal documents is all of them have placed emphasis on the objective role of the main board sub-committee, that is, audit committee as to ensure the integrity of the internal and external audit function. However, It is evident

¹⁷ supra note 12, Recommendation No. 4.7

Audit Committee in Various Legal Regimes : A Comparative Study of Developed and Developing Countries

from the comparative study of the legal regimes that there are many areas where developed regimes have taken more radical stances than the developing regimes which include, assessment, monitoring and management of financial and non-financial risks by the audit committee, assessment of independence of external auditors by a thorough analysis of whether they have any financial, family, employment, investment or business relation with the audit client, making sufficient arrangement for protection of whistle blowers, and discouraging the statutory auditors from supplying a wide range on non-audit services. It is also revealed that one of the developed regimes (UK) advised the formation of the audit committee in smaller non-listed companies. In contrast, in the developing regimes like India and Bangladesh, the background of formation of audit committee is far more recent as compared to the developed regimes and the existence of this committee is found only in the listed companies. Moreover, the role of this board sub-committee as per regulatory requirement is not as wide as it is in the developed regimes. In such a context, this study makes a number of policy recommendations in order make the audit committee more effective. These recommendations are: appointing only the non-executive directors with recent and relevant experience of accounting and finance as the member of the audit committee, offering attractive remuneration to the audit committee members for their additional time commitment instead of mere sitting fees, engaging the audit committee while appointing the statutory auditors, allowing the audit committee to oversee whether adequate measures are taken by the statutory auditors in connection with the audit process to ensure the integrity of statutory audit work, assigning the responsibility to the audit committee to scrutinize if any provision of non-audit service by the statutory auditor would impair the integrity of the audit work, and permitting the audit committee to make arrangement for hearing and protection of whistle blowers.