

Audit Committee, Nomination and Remuneration Committee and Vigil Mechanism under Sections 177 and 178 of the Companies Act, 2013

Description

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Quick summary

- Every listed public company, and the prescribed classes, must have an Audit Committee of at least three directors with independent directors in the majority. Its terms of reference cover auditors, financial statements, related party approval, inter-corporate loans, valuation, internal financial controls and use of funds raised.
- The Nomination and Remuneration Committee has three or more non-executive directors, at least half independent, and recommends director and senior management appointments, board evaluation and remuneration policy.
- A Stakeholders Relationship Committee is needed where a company has more than 1,000 security holders at any time in a financial year.
- A vigil mechanism is required for listed companies and prescribed classes. Contravention carries a fine of Rs 1 lakh to Rs 5 lakh on the company and Rs 1 lakh on each officer in default.

Larger and listed companies must hand some of the Board's most sensitive work to committees dominated by independent directors. Section 177 sets up the Audit Committee and the vigil mechanism; section 178 sets up the Nomination and Remuneration Committee and the Stakeholders Relationship Committee.

Audit Committee (section 177)

Who must have one. The Board of every **listed public company**, and of such other classes of companies as may be prescribed, constitutes an Audit Committee.

Composition. A minimum of **three directors**, with **independent directors forming a majority**. The majority of members, including the chairperson, must have the ability to read and understand a financial statement.

Terms of reference. The committee acts under written terms of reference set by the Board, which include:

1. recommending the **appointment, remuneration and terms of appointment of auditors**;

2. reviewing and monitoring the **auditor's independence and performance**, and the effectiveness of the audit process;
3. examining the **financial statement** and the auditors' report on it;
4. **approval or any subsequent modification of transactions with related parties**. The committee may give **omnibus approval** subject to prescribed conditions. If a transaction (other than one under section 188) is not approved, the committee makes its recommendation to the Board. If a transaction not exceeding Rs 1 crore is entered into by a director or officer without the committee's approval and is not ratified within three months, it is voidable at the committee's option, and the director concerned must indemnify the company where it is with a related party or was authorised by another director. This does not apply to transactions, other than those under section 188, between a holding company and its wholly owned subsidiary;
5. **scrutiny of inter-corporate loans and investments**;
6. **valuation of undertakings or assets** of the company, wherever necessary;
7. **evaluation of internal financial controls and risk management systems**; and
8. monitoring the **end use of funds** raised through public offers and related matters.

Powers. It can call for the auditors' comments on internal control systems and the scope of the audit, review financial statements before they go to the Board, discuss issues with internal and statutory auditors and management, **investigate any matter** within its terms of reference or referred by the Board, obtain **professional advice** from external sources, and has full access to the company's records. The auditors and the KMP have a **right to be heard** in the committee's meetings when the auditor's report is considered, but no right to vote.

Disclosure. The Board's report discloses the **composition** of the Audit Committee and, where the Board did not accept any recommendation of the committee, that fact with the reasons.

Vigil mechanism (section 177(9) and (10))

Every **listed company** and the prescribed classes must establish a **vigil mechanism for directors and employees** to report genuine concerns, in the prescribed manner. It must have adequate **safeguards against victimisation** of the persons who use it, and **direct access to the chairperson of the Audit Committee** in appropriate or exceptional cases. The details are disclosed on the company's website (if any) and in the Board's report.

Nomination and Remuneration Committee (section 178(1) to (4))

Who must have one. The Board of every **listed public company**, and of the prescribed classes.

Composition. Three or more non-executive directors, of whom **not less than one-half are independent directors**. The chairperson of the company, whether executive or non-executive, may be a member but **shall not chair** the committee.

Functions.

- Identify persons qualified to become **directors** and persons who may be appointed in **senior management** under the laid-down criteria, and recommend to the Board their appointment and removal.
- Specify the manner of **effective evaluation of the performance** of the Board, its committees and individual directors, to be carried out by the Board, by the committee or by an independent external agency, and review its implementation and compliance.
- Formulate the criteria for determining **qualifications, positive attributes and independence** of a director, and recommend to the Board a **remuneration policy** for directors, KMP and other employees.

Policy safeguards. The remuneration policy must ensure that (a) the level and composition of remuneration is reasonable and sufficient to attract, retain and motivate directors of the quality required; (b) the relationship of remuneration to performance is clear and meets appropriate benchmarks; and (c) remuneration to directors, KMP and senior management is a balance between fixed and incentive pay reflecting short and long-term performance objectives. The policy is placed on the company's website (if any), and its salient features and changes, with the web address, are disclosed in the Board's report.

"Senior management" means the core management team excluding the Board, comprising all members of management one level below the executive directors, including functional heads.

Stakeholders Relationship Committee (section 178(5) and (6))

A company with **more than one thousand** shareholders, debenture-holders, deposit-holders and other security holders **at any time during a financial year** constitutes a Stakeholders Relationship Committee. Its chairperson is a **non-executive director**, and the Board decides the other members. It **considers and resolves the grievances of security holders**. The inability to resolve or consider a grievance in good faith is not a contravention.

Attendance and penalty

- The chairperson of each committee, or any member authorised by him, **attends the general meetings** of the company (section 178(7)).
- **Penalty (section 178(8)):** for contravention of section 177 or section 178, the company is punishable with a fine of **not less than Rs 1 lakh, up to Rs 5 lakh**, and every officer in default is liable to a penalty of **Rs 1 lakh**, as the section reads after the 2020 amendment (the India Code print of the amended words is repetitive, so confirm the figure against the latest official text).

A short checklist

1. Test whether your company is a listed public company or in a prescribed class; if so, set up the committees by Board resolution with written terms of reference.
2. Check the composition rules: three directors with an independent majority for audit; three non-executive directors with at least half independent for nomination and remuneration.
3. Put the vigil mechanism policy on the website and mention it in the Board's report.
4. Count security holders each year against the 1,000 threshold.
5. Record in the Board's report the composition of the Audit Committee and any recommendation of that committee which the Board did not accept.

Points to check

- This post follows the Companies Act as published on India Code, including its amendments up to the

footnotes in that edition. The prescribed classes of companies for each committee, the omnibus approval conditions and the vigil mechanism rules are in the Rules, which were not reviewed.
- Listed companies must also follow the SEBI listing regulations, which add further requirements on the number of meetings, independent directors and the role of each committee.
- The India Code print of section 178(8) repeats the penalty words after the 2020 substitution. This post reads it as a fine of Rs 1 lakh to Rs 5 lakh on the company and Rs 1 lakh on each officer in default, and that reading should be confirmed.

Frequently asked questions

Which companies must have an Audit Committee?

Every listed public company, and other classes of companies prescribed by the Rules. It must have at least three directors, with independent directors forming a majority. The majority of members, including the chairperson, must be able to read and understand a financial statement.

What does the Audit Committee do?

It acts under written terms of reference set by the Board, which include recommending the appointment, remuneration and terms of auditors; reviewing the auditor’s independence, performance and effectiveness of the audit; examining the financial statements and the auditors’ report; approving related party transactions; scrutinising inter-corporate loans and investments; valuation of undertakings or assets; evaluating internal financial controls and risk management; and monitoring the end use of funds raised through public offers.

Can the Audit Committee approve related party transactions in advance?

Yes. It may make omnibus approval for related party transactions proposed to be entered into, subject to the prescribed conditions.

Who must have a Nomination and Remuneration Committee?

Every listed public company and the prescribed classes. It consists of three or more non-executive directors, not less than one-half of them independent. The chairperson of the company may be a member but cannot chair the committee.

When is a Stakeholders Relationship Committee required?

When the company has more than 1,000 shareholders, debenture-holders, deposit-holders and other security holders at any time in a financial year. Its chairperson must be a non-executive director, and it considers and resolves the grievances of security holders.

What is a vigil mechanism?

A mechanism for directors and employees to report genuine concerns, which every listed company and the prescribed classes must establish. It must protect users from victimisation and give direct access to the chairperson of the Audit Committee in appropriate or exceptional cases. Its details are disclosed on the company's website and in the Board's report.

What is the penalty for contravention?

A fine of not less than Rs 1 lakh, up to Rs 5 lakh on the company, and a penalty of Rs 1 lakh on every officer in default (as the section reads after the 2020 amendment).

Official sources

- India Code: The Companies Act, 2013 (sections 177, 178)
- Ministry of Corporate Affairs

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