BoardMatters Forum
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Insights for boards and audit committees

Volume 8

In this issue

This edition of the BoardMatters Quarterly looks at two aspects that occupy the attention of the audit committee and the board. The first article assesses the debt/ equity classification under Ind AS since it could potentially have an adverse impact on companies and their balance sheets. Another article assesses the disclosure requirements stemming from Ind AS (IFRS converged standards) vis-à-vis Indian GAAP that could be challenging. We also take a brief look at EY's review of audit committee disclosures by the large listed companies in five key geographies globally and how they are faring in response to regulators' expectations around more effective disclosure standards. This edition also features our conversation with Mr. Harsh Mariwala, Chairman, Marico who shares his insights on establishing an effective board at one of the country's leading consumer products companies.

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Building a better working world

Debt vs. equity: insights for audit committees

Under Indian GAAP, the classification of an instrument as debt or equity is dictated by the legal form of the instrument. In economic terms, however, the distinction between share and loan capital can be far less clear-cut than the legal categorization suggests. For example, a redeemable preference share could be considered to be, in substance, much more like a liability than equity. Conversely, many would argue that a bond that can never be repaid but which will be mandatorily converted into ordinary shares deserves to be thought of as being more in the nature of equity rather than debt, even before the conversion. In this article, Dolphy D'Souza demystifies debt/equity classification under Ind AS, and also highlights the importance of debt/equity classification for audit committees.

Under Ind-AS, Ind-AS 32 ***Financial Instruments Presentation*** establishes principles for presenting financial instruments as liabilities or equity. Its key objective is to depict the economic substance of an instrument and not mere legal form. The economic substance of an instrument is decided based on the legal and contractual rights and the obligations attached to it.

Broadly speaking, an instrument can be classified as equity if and only if:

- The issuer has an unconditional right to avoid delivering cash or another financial instrument.
- If it is settled through own equity instruments, it is for an exchange of a fixed amount of cash for a fixed number of the entity's own equity instruments (generally known as the "fixed-for-fixed" principle.

In all other cases it would be classified as a financial liability.

Preference shares

A preference share that is redeemable at a future date or redeemable at the option of the holder of the instrument is a financial liability. A preference share that is not redeemable in cash or redeemable only at the option of the issuer does not satisfy the definition of a financial liability, because the issuer has an unconditional right to avoid delivering cash or other financial assets to the holder.

"Fixed-for-fixed" principle

When a financial instrument is settled through an entity's own equity instruments, it is classified as an equity instrument only if it is for an exchange of a fixed amount of cash for a fixed number of the entity's own equity instruments.

It is clear that a contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. An entity may have a contractual right or obligation to receive or deliver a number of its own shares, which varies so that the fair value of the entity's own equity instruments to be received or delivered equals the amount of the contractual right or obligation. In this case, the entity uses a variable number of its own equity instruments as a form of cash to settle the contract. Therefore, it does not evidence a residual interest in the entity's assets after deducting all of its liabilities.

Many contracts involving the issue of an entity's own equity instruments contain adjustment provisions, which upon the occurrence of future events adjust the number of equity shares to be issued in accordance with the contract. For example, adjustments may be required in events such as share split/share

consolidation, repurchase of shares, distribution of reserves or premiums as extraordinary dividend, or bonus or rights issue to existing shareholders.

Generally, the objective of these adjustment features is to protect both the holder of the contract and the existing shareholders by ensuring that their relative rights remain the same before and after the restructuring. For example, an entity with shares having face value of INR10 may enter into an agreement requiring it to issue 100 shares. If, before the fulfilment of that agreement, the entity has split each INR10 share into 10 shares having face value of INR1 each, it must issue 1,000, not 100, shares in order to give effect to the intention of the contract.

This raises the question of whether a contract with any such terms can be classified as equity under Ind-AS 32, considering that the number of shares to be ultimately issued on conversion is not fixed at the outset but may vary depending on whether a restructuring or other event occurs before the conversion.

A contract not meeting the "fixed-for-fixed" criterion is classified as a liability because it does not evidence a residual interest in the entity's assets after deducting all of its liabilities. This is an important consideration for deciding the impact of adjustment features. If the adjustment attempts to put the holders of an instrument into the same economic position relative to ordinary shareholders after the restructuring as they were in before the restructuring, then the "fixed-for-fixed" criterion is still met. However, if this is not the case, the "fixed-for-fixed" criterion is not met.

To illustrate, consider an adjustment feature that states that if a company issues bonus shares to its existing shareholders, it will also provide the same benefit to the convertible securities issued by it. The benefit is computed by adjusting the number of shares to be issued on conversion in a proportionate manner. This effectively ensures that the per share value of the adjustment is equal to the per share value of the dilution in the shareholders' interest in the issuer's equity caused by the transaction. Such an adjustment is acceptable and does not violate the "fixed-for-fixed" criterion.

Consider another common adjustment feature that has a ratchet. A non-listed company has issued convertible security at a stated conversion price, and the entity may go for an IPO in the future. The terms of the convertible security provide that if the public offering price in the IPO is less than the conversion price, the conversion price is adjusted downward to the IPO price. This adjustment will clearly violate the "fixed-for-fixed' criterion because it gives an additional benefit to the convertible security holders vis-à-vis other equity shareholders.

Compulsorily convertible preference shares (CCPS)

Consider the example of a preference share that is compulsorily convertible into equity shares. It is interesting to note how the debt/equity classification changes with a change in the terms and conditions.

Scenario	Terms	Classification
Scenario 1:	The issuer entity has an obligation to redeem the CCPS if it fails to achieve a qualified IPO within five years from date of issue.	There is no unconditional right to avoid paying cash. CCPS are financial liabilities.
Scenario 2:	The issuer entity has no obligation to redeem the CCPS. The number of shares to be issued on conversion is variable and is determined by dividing the liability amount with the fair value of the shares at the date of conversion.	Since the number of shares to be issued on conversion is not fixed, the CCPS are financial liabilities.
Scenario 3:	The issuer entity has no obligation to redeem the CCPS. The number of shares to be issued on conversion is fixed upfront.	Since the number of shares to be issued on conversion is fixed, the CCPS are considered as equity.

Why debt/equity is classification important for audit committees

The classification of an instrument as debt or equity can ruin balance sheets and may have an adverse impact on companies. The debt/equity classification and ratio is key to determining an entity's liquidity and solvency. An instrument that is classified as equity under Indian GAAP but reclassified as debt under Ind AS could also potentially breach debt covenants. Any breach of debt covenants could lead to lenders increasing the interest rates or recalling the loan, neither of which is desirable for an entity. Classification of an instrument as a debt rather than equity would also dent the profit or loss account because servicing of debt is treated as an interest expense and charged to the profit or loss account, whereas payments to equity holder is treated as dividends and are not charged to the profit or loss account.

Audit committee's role in disclosure effectiveness

Making financial disclosures more effective has become a focus of regulators and standard setters across the globe. Investors, creditors, analysts and other stakeholders are also now asking more insights into an entity's performance, strategic direction and exposure to risk. With the implementation of Ind AS, the disclosure process is becoming more complex and onerous. Vishal Bansal discusses the key aspects of audit committees and the role they can play to enhance disclosure effectiveness.

Ind AS (IFRS converged standards) contains a significant number of additional disclosure requirements vis-à-vis Indian GAAP. The following is an overview of the key disclosures that may be particularly challenging:

a) Ind-AS 1 Presentation of Financial Statements requires an entity to disclose:

  (i) Judgments made by the management in applying accounting policies that have the most significant effect on the amounts recognized in the financial statements

  (ii) Key assumptions concerning the future that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year

  (iii) Information that enables the users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital

b) Ind AS 107 ***Financial Instruments: Disclosures*** requires an entity to disclose the following from a qualitative and quantitative perspective.

  (i) Extensive fair value information for all financial assets and liabilities, including those measured at cost/amortized cost

  (ii) The nature and extent of risks arising from financial instruments, and how the entity manages those risks

c) Ind AS 112 ***Disclosure of Interests in Other Entities*** requires extensive disclosures for subsidiaries, joint arrangements, associates and consolidated and unconsolidated structured entities. It requires an entity to disclose information that enables users to evaluate (i) the nature of, and the risks associated with, its interests in other entities and (ii) the effects of those interests on its financial position, financial performance and cash flows.

d) Ind AS 36 ***Impairment of Assets*** requires specific disclosures for CGU or group of CGUs if goodwill or intangible assets with indefinite useful lives are allocated to it. The disclosures required include key assumptions used to measure recoverable amounts, headroom and sensitivity analysis (the impact of reasonably possible changes in the key assumptions).

e) Nearly each Ind AS contains additional disclosures, with a potential to impact, depending on the entity's particular circumstances. For example:

  (i) Disclosures required under Ind AS 103 ***Business Combinations*** are likely to pose challenges for entities that have undertaken business combination.

(ii) Ind AS 12 ***Income Taxes*** requires critical disclosures such as explanation of relationship between tax expense (income) and accounting profit; an explanation of changes in the applicable tax rate(s); and the amount (and expiry date, if any) of deductible differences, unused tax losses, and unused tax credits for which no DTA is recognized in the balance sheet.

(iii) Ind AS 40 ***Investment Property*** requires the fair value of investment property to be disclosed.

(iv) The definition of "related party" under Ind AS 24 ***Related Party Disclosures*** is broader and covers an increased number of related party relationships.

Disclosures required by Ind AS will increase the transparency and accountability of financial statements. They will put additional onus on entities including their boards and audit committees, to ensure that the estimates and judgments made are justifiable, considering that they are publicly accountable for them.

Entities should not consider disclosure changes as a mere compliance exercise, instead they should view it as an opportunity to take a fresh look at how effectively they tell their story. Globally, entities that have successfully improved and streamlined their disclosures cite many benefits, including the following:

- Enhanced investor confidence due to communication of more meaningful information
- Increased efficiencies in preparing investor communications
- Improved coordination throughout the organization, including with the board, regulators and external advisors
- Strengthened market reputation and leadership

Role of the board/audit committee

Developing appropriate processes to enhance disclosures often requires coordination with the audit committee/board. A top-down commitment throughout the organization is necessary to sustain focus on improving the quality of information provided to investors. Audit committees should confirm and monitor that there is appropriate coordination with the key stakeholders. Communication with external auditors is also essential.

Audit committees should work with the management to instill a disclosure mind-set, bearing in mind that repetition and immaterial disclosures are areas for improvement. When reviewing documents, audit committees should focus on the general manner of presentation and wording of financial communications for clarity, transparency and the use of plain English. Audit committees should challenge the management to be innovative and enhance an understanding of the financial reports by streamlining these.

Audit committees also can provide helpful inputs on the scope and extent of disclosure effectiveness efforts. Entities must consider time, cost and resource constraints, as well as regulatory requirements. It may be more productive for an entity to target disclosure areas that are complex or time-consuming upfront rather than start with a blank sheet to rewrite Ind AS financial statements at the year-end.

Audit Committees also can encourage the management to make meaningful changes in its disclosures by creating a framework that enables the systematic implementation of leading practices based on the distinct information needs of various stakeholders. In order for disclosure-effectiveness efforts to be successful and sustainable, they should be treated as a journey and not as a one-time initiative. The objectives of disclosure effectiveness should be embedded into the entity's financial-reporting DNA.

Leveraging the disclosure committee

Although disclosure committees are not mandatory, certain regulators such as the SEC in the US recommend them for public entities. In a recent survey by the Financial Executives Research Foundation (FERF) and EY, titled ***Unlocking the potential of disclosure committees***, 92% of the respondents indicated having either a formal disclosure committee or another group with similar responsibilities.

Disclosure committees are not board-level committees, but they do include senior-level executives, typically the corporate controller, chief accounting officer and general counsel, among others. These committees play an important role, centralizing an entity's thinking about disclosures and validating that disclosures are relevant, timely, coordinated and consistent. Indian entities may also consider constituting a disclosure committee or another group with similar responsibilities. If constituted, an audit committee may also want to better understand the role of and improve coordination with the disclosure committee.

Questions for boards and audit committees to consider

- Does the entity have a plan and process to improve disclosure effectiveness? If so, what are the planned improvements, and how were the targeted disclosure areas identified?
- If the entity is planning to improve its disclosures, is there a clear timeline and project management support to meet the deadlines?
- Does the audit commiattee interact with the disclosure committee? Do both committees equally understand plans to improve disclosure effectiveness?
- Has the entity reached out to analysts and investors to obtain feedback about the quality and transparency of its disclosures? What disclosures are most important to the entity's analysts and investors, and has the entity recently considered how to enhance those disclosures? Have analysts or investors requested additional disclosures?
- If the entity has eliminated immaterial disclosures, how did the management evaluate and document its materiality considerations?

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Enhancing audit committee transparency: EY's review of 2015 disclosures

This point of view sets forth key observations from EY's study of 2015 audit committee-related disclosures with a focus on the audit committee's oversight of the external audit process in five jurisdictions — Australia, Canada, Singapore, the United Kingdom (UK) and the United States (US).

Context

Policymakers in many countries continue to consider corporate governance reforms, including measures to strengthen audit committees and their disclosures. Specific developments in 2015 in the jurisdictions reviewed that affect audit committee disclosures include:

- The Australian Securities Exchange (ASX) Corporate Governance Principles now allow companies to provide corporate governance disclosures in either the annual report or the company website
- The Chartered Professional Accountants of Canada and the Canadian Public Accountability Board's "Enhancing Audit Quality" (EAQ) initiative of 2013 continues to have an impact on audit committee reporting
- The Singapore Accounting and Corporate Regulatory Authority's guidance for audit committees on the Audit Quality Indicators (AQIs) Disclosure Framework
- The UK Financial Reporting Council's guidance for audit committees in evaluating the effectiveness of the external audit process ‣ The US Securities and Exchange Commission's Concept Release on Possible Revisions to Audit Committee Disclosures
- The US Public Company Accounting Oversight Board's Concept Release on AQIs

Consistent with these developments, we observed a modest increase in some audit committee-related disclosures in the last year. Most audit committees continue to be transparent about their fundamental responsibilities to oversee the external audit process; however, disclosures remain limited in offering insights into how those responsibilities are carried out.

What we looked at

EY reviewed audit committee disclosures by the largest listed companies in each of the five jurisdictions. The focus was on large listed companies to facilitate the ability to make comparisons across jurisdictions. The review included the main company document covering governance-related disclosures in each jurisdiction and in some cases, this document refers to additional sources for more information.

What we found: six key observations

1. Audit committees still provide relatively few insights into how they oversee the auditor

Nearly 60% of companies we reviewed across the five jurisdictions disclose that the audit committee is responsible for the appointment, compensation and oversight of the external auditor.

This is consistent with our findings from last year. By contrast, disclosures related to how the audit committee oversees the external auditor are much less common. For example, fewer than one in five companies (15%) provide a statement regarding whether the audit committee is responsible for fee negotiations, while just over a third of audit committees (37%) disclose the factors used in the audit committee's assessment of the external auditor's qualifications and work quality. Factors disclosed include value delivered to shareholders, industry experience and the quality of the engagement team.

We observed an increase in the disclosure of the factors used in the audit committee's assessment of the auditor's qualifications

and work quality in Singapore (from 33% to 47%) and Canada (from 10% to 20%). In Singapore, this may be explained by the publication of revised guidance for audit committees by Singapore authorities which includes information for evaluating the external auditor. In Canada, this may reflect the influence of the EAQ initiative (see "Context"). Among other things, the EAQ focused on the role of the audit committee in external audit oversight.

2. **Most audit committees continue to disclose that they consider the impact of non-audit services on auditor independence**

A statement that the audit committee considered the impact of non-audit services when assessing auditor independence continues to be the most common disclosure (80%) across the five jurisdictions. This may reflect the fact that each jurisdiction has requirements or guidance covering audit committee oversight of non-audit services. It also may reflect the continued focus of policymakers on the audit committee's oversight of non-audit services provided by the external auditor.

In most cases, these disclosures highlighted that the audit committee considered the specific non-audit services provided by the auditor and/or the level of non-audit fees paid to the auditor.

3. **The key areas of focus disclosed by audit committees continue to vary**

We looked again this year at disclosures about the audit committee's work. We found that few companies disclosed information about the topics discussed by the audit committee.

Many echoed the responsibilities audit committees have under their charter. Cybersecurity was identified as an increasing area of focus for audit committees across the five jurisdictions. Most disclosures acknowledge cybersecurity vulnerabilities and the need for the audit committee to monitor these going forward. Disclosures of other areas of focus varied across the five jurisdictions.

In the UK, audit committees are required to disclose the significant issues they considered in relation to the financial statements in the past year. Consistent with our 2015 findings, the most common issues disclosed included revenue recognition, impairment of goodwill, pension accounting and going concern. In addition, around half of UK audit committees disclosed a focus on tax issues, a small increase since last year.

In the US, audit committees are required to disclose whether they specifically discussed with the auditor certain matters in accordance with US auditing standards, such as responsibilities of the auditor in relation to the audit. However, some US companies voluntarily disclosed additional topics discussed with the auditor. The volume and the topics disclosed are generally the same as the 2014 reporting season, and included cybersecurity and risk compliance.

In Canada, over half of reviewed companies voluntarily disclosed key topics the audit committee considered in the past year, a small increase compared with last year. The most common topic disclosed was cybersecurity. Around 15% of companies in Australia voluntarily disclosed key topics the audit committee worked on, and these included tax and anti-corruption. We did not observe disclosure of key topics in Singapore.

4. **Disclosure of auditor tenure is increasing but continues to vary significantly across jurisdictions**

Consistent with last year, disclosure of auditor tenure remains the highest in the UK (85%). There also has been an increase in UK audit committees disclosing when they plan to issue an audit tender.

This likely reflects the active UK audit tendering environment, resulting from the introduction of mandatory audit tendering in 2012 and the pending implementation of the European Union audit legislation, due to take effect in June 2016.

Disclosure of auditor tenure also was relatively high and has increased since last year in the US (from 50% to 59%) and in Canada (from 57% to 62%). In the US, this increase may reflect continued investor interest in the topic. In Canada, the increase may reflect the fact that auditor tenure and its impact on audit quality have been discussed as part of the EAQ initiative, mentioned above.

The disclosure of auditor tenure was much lower in Australia, although it did increase slightly from last year (27% to 29%). Disclosure on this topic remained low in Singapore (3%).

5. Disclosure by audit committees on why their choice of external auditor is in the best interests of the company and/or shareholders is an emerging practice

In most jurisdictions, we observed no disclosures about whether or how the choice of external auditor is in the best interests of the company and its shareholders. We found that most audit committees included a statement recommending the appointment or reappointment of the external auditor, or a statement that the audit committee was satisfied with the performance of the auditor.

In the US, however, more than half of companies provided an explicit statement that the choice of external auditor is in the best interests of the company and/or shareholders. While not a regulatory requirement in the US, the disclosure of this information has increased in the last year and is likely a response to investor interest in enhanced disclosures regarding the audit committee's oversight of the audit relationship.

6. Many audit committees disclose information related to their composition with a focus on independence and financial expertise

Because of the specific requirements placed on the composition of audit committees in many jurisdictions, we observed a significant number of audit committees disclosing the independence (75%) and financial expertise (75%) of their members. It is less common for audit committees to disclose other aspects of their composition, including industry expertise (11%) and diversity (negligible).

While our review focused on audit committee-related disclosures, we found that where information about industry expertise and diversity is disclosed, this is typically done on a boardwide rather than committee-specific basis:

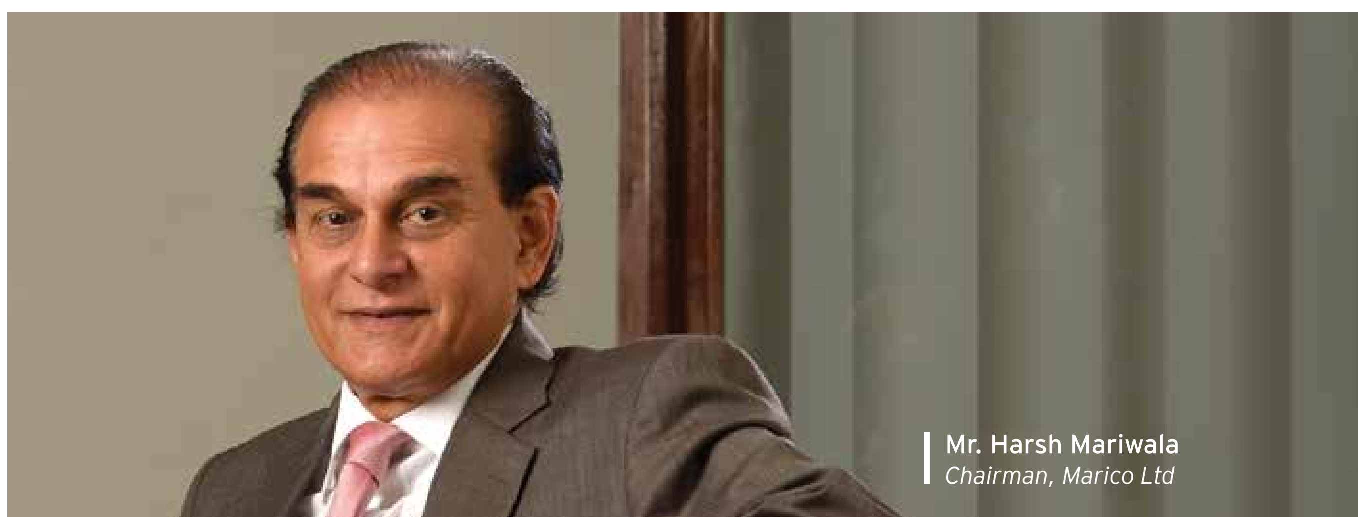
- A small number of companies provide a statement about industry expertise on the board, while many companies include information about industry expertise within the board director biographies.
- Many companies provide a statement about the board's approach to diversity. This is consistent with the focus on improving board diversity in many markets.

Conclusion

Our latest study highlights some modest increases in the number of audit committee-related disclosures. Nevertheless, our findings show there remains significant scope for audit committees to provide further insights of relevance to investors and others, including about how they carry out their important audit oversight role. This will help give investors and others the information they need to assess the effectiveness of audit committees and the external auditor.

Source: Centre of Board Matters

"Culture needs to be anchored on meritocracy, openness and trust, and one that creates value for all stakeholders – and not just shareholders"



Mr. Harsh Mariwala
Chairman, Marico Ltd

Marico has transformed from a traditional commodity-driven business into a leading consumer products company with strong brands and an international presence spanning key geographies across Asia and Africa. Apart from other factors, a key defining aspect that has contributed to creating this successful enterprise is the active role of its board. The journey to developing a strong and independent board started from a considered focus few years ago. Mr. Harsh Mariwala, Chairman, Marico, shares insights about the continuing journey that has led to establishing an effective board.

What aspects have been important to establishing an effective board at Marico?

The success of a board depends on all stakeholders. It is anchored on a combination of three different aspects: guidance from the chairperson, the value of inputs from the executive management, and the independence and commitment of board members. A few years ago, we started our journey to put this belief into action. The board was invited to actively engage in a transparent discussion to debate Marico's strategy and even discuss the organizational culture and what needed to change. This formed the basis for a 12-month agenda with two or three key topics the board takes an in-depth look at. The topics tend to change each year depending on their relevance and impact on Marico's business. This approach has led to greater board engagement on aspects of immense value to Marico.

How crucial is it to have diverse skill sets on the board? How does that reflect from Marico's perspective?

The diverse nature of a board can be a significant advantage. When different individuals combine their unique skill sets into an over-arching collective whole, it can be extremely effective. At Marico, there are specific parameters defined as being imperative: commitment, independence and the ability to add value. In addition to a professional managing director, there are currently six independent directors, many of whom are either former or current CEOs at other organizations. Functionally, they are diverse, including a venture capitalist, a retail expert, an HR specialist and leaders at FMCG organizations. With the average age of the board members in the early 50s, they are a good blend of being relatively young and experienced, and are extremely well connected to business realities.

As I mentioned, how these different individuals come together as a team is important. Aspects such as strong interpersonal skills and a consensus-driven approach help raise the efficacy of the deliberations among the board members.

What is Marico's approach to keeping the board stay truly "connected" between board meetings?

It's true that in between board meetings, people tend to lose touch sometimes. To address that, we prepare a monthly synopsis of key developments at the organization that keeps them connected to Marico. The board members are also encouraged to share an outside-in view of Marico basis their interactions with analysts and other stakeholders in the market. That has been very helpful as apart from gaining insights from relevant quarters, it does keep the company in the mind space of the board members in a very real manner.

How has Marico ensured that the board and the management continue to play a complimentary role?

That is a good question as it is important that the board and the management are able to optimize each other's strengths so as to deliver value. Being clear on the areas for which the board is accountable also helps separate it from areas that should be under the purview of the management. Generally, boards should help strengthen brands and identity, but they should not formulate the company's strategy. The board can definitely challenge the management by asking questions as part of a healthy introspection process, but it has to restrict itself from involvement in operational aspects. This approach can keep the board fully abreast of the organization's strategic direction without impacting the management from functioning effectively.

How have the Marico board and the executive management gone about assessing each other, with an eye on delivering any improvements that may be required?

The company engages in an annual board insights study, which entails a questionnaire being sent to the board members and the MD's executive team. The objective of the exercise is to collate a comprehensive view of how the board and the executive management assess each other. This is followed with an annual two-day retreat. While the first day is a strategy session in which the board engages with the executive management, providing feedback on the performance of the individuals and the aspects key to organization's continued success in the future, the second day focusses more on the board's effectiveness and the independent directors. Such an engagement tends to be very thorough and has been very valuable for all involved. As far as the board committees on audit and nomination and remuneration are concerned, we have independent directors presiding over these meetings so as to maintain a very fair sense of objectivity.

What aspects do you believe will be imperative for maintaining high standards of board effectiveness?

I believe the peer-evaluation process could become strict. Apart from a focus that just identifies the positives of the board members' performance, the evaluation clearly needs to change and assess other aspects also. Secondly, filling in competency gaps by bringing new people and talent on board to address the market realities at different points will help Marico be fully prepared for the future. Lastly, I see the cultural fabric of the company as being even more important when the founders of Marico are no longer with the company. How firmly their values are preserved and institutionalized will play a key role. This culture is anchored on meritocracy, openness and trust, and aims to create value for all stakeholders – and not just shareholders.

Notes:

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Building a better working world

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