

# Stakeholder activism – Audit committee considerations



## Board Leadership Center (India)

In general terms, stakeholder activism refers to influencing decisions and actions of an organisation or institution through pressure or dialogue. With increased awareness of their rights, powers, and remedies, stakeholders are now able to express their opinions in the event of any misconduct or corporate governance issues. There are many ways in which stakeholders can express their activism, including through voting, engaging in proxy contests, submitting shareholder proposals, initiating litigation, participating in boycotts or protests, launching campaigns, seeking media attention, and engaging in dialogue.

Companies attract activists, when they face challenges, such as inactive stock performance, weak earnings, governance issues, and overlooking ESG concerns. Thus, it usually occurs when there is a demand for greater transparency in corporate governance and/or concrete action on certain matters which are important to stakeholders. The impact of

stakeholder activism on a company can be either beneficial or detrimental, and is influenced by factors such as the type, intensity and result of the activism.

The audit committee is an important mechanism for ensuring high levels of corporate governance and they could benefit immensely if they are aware of such matters and being adequately prepared. They are independent, financially literate and are responsible for overseeing internal control, financial reporting, and statutory audit. The Companies Act, 2013 (2013 Act) and the Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Requirements), also lists down the scope of their corporate governance responsibilities.

To effectively cater and respond to stakeholder queries, and sometimes concerns, this document discusses some of the key considerations for audit committees:



## 01. Internal control over financial reporting and disclosure



Management is responsible for the preparation of the company's financial statements and related disclosures, as well maintaining effective Internal Control over Financial Reporting (ICOFR). Significant and material issues with respect to financial reporting and internal financial control could result in stakeholder activism. Audit committee has oversight responsibility for these areas and is actively engaged in the financial reporting.

For this purpose, audit committee should review and discuss the company's annual and quarterly financial statements. They must question the management on significant and/or unusual transactions, estimates, areas involving risk of material misstatement etc. They should also have periodic discussion with the management and statutory auditor regarding the status of ICOFR and whether instances of any failure in the internal financial controls and remediation action taken against such failure.

The audit committee should be vigilant and skeptical about fraud risk in financial reporting. For this purpose, audit committee should understand the incentives and pressures that may encourage management in financial reporting fraud. Therefore, should inquire whether fraud-tracking and monitoring systems, as well as fraud response plans are in place. Further, the shareholder activism could also be related to audit committee not spending adequate time in discharging their responsibilities. Therefore, audit committee should review and evaluate their own performance and effectiveness of their oversight role. Also, audit committee should ensure improving their communication and engagement with the different stakeholders to establish clear and consistent roles, responsibilities, and expectations.

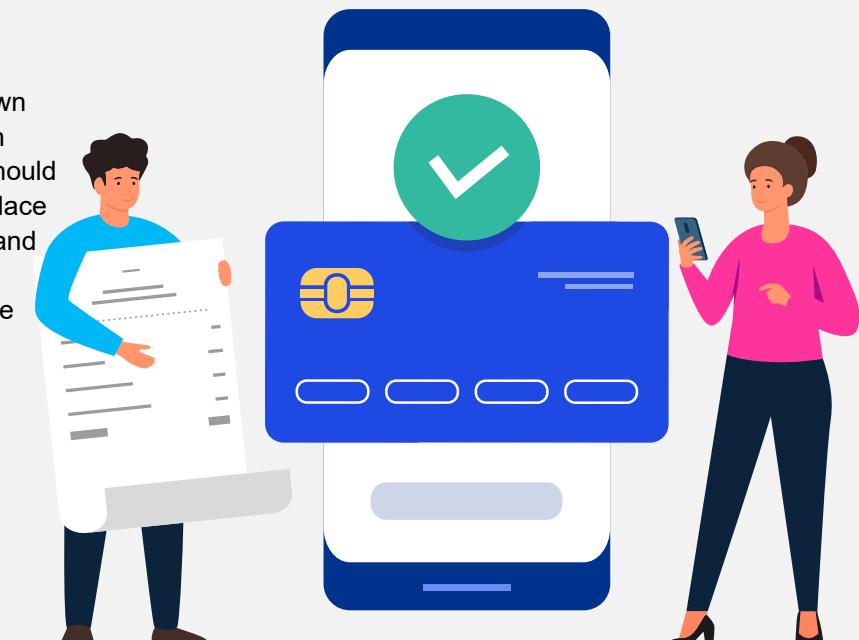
## 02. Related party transactions



In recent times, it has been observed that Related Party Transactions (RPTs) in certain situations have been used as a conduit for diversion of funds resulting in frauds and financial crimes. In many instances, transactions between related parties are structured in a way resulting in obvious conflict of interest and negligence of rights of non-controlling shareholders. Such instances have often triggered stakeholder activism.

The 2013 act and SEBI listing regulations lay down the regulatory provisions for audit committees with respect to approval for RPTs. Audit committees should ensure that there are policies and procedures in place to correctly classify the RPTs. They must understand the structure of the underlying transaction and the commercial relevance. Audit committees should be encouraged to ask probing questions to the management such as if the transaction price is at

arm's length and if contract terms are benchmarked with unrelated third-party entities. While verifying whether the transaction is in the ordinary course of business, also check the frequency of occurrence of the transaction. The audit committee may also consider if there are adequate independent checks and balances while evaluating RPTs.



## 03. Oversight of statutory auditors



Recent regulatory reviews have demonstrated that lack of independence and objectivity of statutory auditors could result in stakeholder activism due to factors such as extended association between the audit firm and the audited entity, lack of experience, lack of client-specific knowledge, etc. To address this concern, prior to appointment of statutory auditors,

To tackle issues relating to appointment of statutory auditors, boards and audit committees should consider following:

- Ensure compliance with rotation requirements for the audit firm and audit partner as prescribed in the 2013 Act
- Verify if any regulatory actions have been taken against the prospective statutory auditors
- To ensure transparency, members of the audit committee should reveal to stakeholders the criteria used to select the statutory auditor
- The review of independence and performance of statutory auditors should be conducted annually.



The audit committee members should also discuss critical aspects of audit approach with the appointed statutory auditors. There must be two-way effective communication throughout the period of the audit between the audit committee and the statutory

audit committee members should formulate a process for selection of audit firm wherein they should evaluate the competency, capability, experience, and independence of the prospective statutory auditor. The prospective statutory auditor should be experienced enough to undertake audit engagements of a size similar as that of the concerned entity.

## 04. Ethical practices and compliance



Adhering to corporate compliance and behaving ethically are crucial for enhancing corporate governance. Setting an ethical tone at the top is critical for creating an ethical culture within the organisation. For this purpose, the board members and senior management should adhere to ethical behaviour and set an example. The audit committee should ensure that the organisation has a comprehensive code of conduct that outlines its values, policies, and ethical standards that govern its operations. It should also be ensured that these guidelines are reviewed and modified on a regular basis to address changing business practices, changes in laws and regulations and stakeholder expectations.

The audit committee should also check whether the

auditors. Audit committee members must understand and discuss the reporting implications on significant matters such as audit qualifications, emphasis of matter and other matter in the audit report.

organisation conducts regular training and awareness programmes on ethics to help employees comprehend the ethical standards and report any potential ethical concerns. Also, it should be discussed with the management as to whether technology enabled tools can be used to monitor and enforce ethical policies.

Organisations should have a system for managing compliance, comprising policies, procedures, and controls, to guarantee compliance with relevant laws, regulations, and industry standards. Audit committee should review the internal audit reports to monitor the status of compliance. Audit committees could also resort to benchmarking with peer companies and independent evaluation and assessment.

## 05. Whistleblower complaints



Whistle-blowing procedures are a major line of defence against fraud and audit committee members should ensure that such procedures are effective. Following are the key points to be considered relating to whistleblower mechanism:

It should extend to all stakeholders, within and outside the organisation



Organisations should document and disseminate whistleblowing policies and procedures



The whistleblowing policy should allow acceptance of anonymous complaints



Concerns raised by stakeholders are responded to within a reasonable time frame



Implement measures to protect whistleblowers from victimisation and protect their confidentiality.



## 06. Communicating key issues to stakeholders



Stakeholders demand transparency in corporate governance and expect management and audit committee members to understand their expectations.

The audit committee should regularly communicate key issues, policy changes, remuneration decisions, litigative issues, audit issues, etc. to the stakeholders.

### Bottom line

Audit committees review financial reporting process and corporate governance structure of any organisation. Good corporate governance practices can help in reducing the likelihood of stakeholder activism by promoting transparency, accountability, and good decision-making. The audit committee acts as a liaison between the board of directors, senior management, external auditors, and internal auditors. The audit committee role is not limited to compliance and regulatory matters. The audit committee members should enhance its oversight of analysis of the financial statements of the company, evaluation of the performance and independence of external auditors and monitoring the efficacy of internal financial controls.

Accordingly, the audit committee should not limit itself to the 'regulatory agenda' but should also invest time and resources in comprehending the organisation's strategic, operational, and cultural facets. Audit committee should act in the best interest of the organisation and its stakeholders, and to uphold the highest standards of integrity and ethics.



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