

## FILLING THE GAPS IN THE LEGISLATIVE FRAMEWORK FOR AUDIT COMMITTEES OF LISTED COMPANIES IN NIGERIA

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### Abstract

This article examines the legal framework in Nigeria for audit committees, identifies and discusses the various gaps in the framework, which, the article argues, may undermine the committees' effectiveness. The article argues that the Nigerian legal framework, which classifies the audit committee as a committee of the company rather than of the board, mandates shareholders' representatives on the committee and forbids the committee's members from receiving remuneration, may create more problems for the committee's effectiveness. The article proposes reforms of the framework in light of global developments in this area.

**Keywords:** Audit Committee, corporate governance, remuneration, board, company

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### I. Introduction

Non-Nigerian corporate law scholars may find the legal framework for audit committees of listed companies in Nigeria somewhat unconventional, and thus questionable. Yet, it is arguable that part of its value lies in its uniqueness, which many may overlook easily for no other reason than its aberrance. To be sure, the audit committee of a listed company in Nigeria, unlike in the U.S., Europe and Canada, and other common law countries, is a committee of the company,<sup>1</sup> rather than of the board. Additionally, the law prescribes that the committee shall comprise equal representatives of the board and shareholders, subject to a maximum of six members.<sup>2</sup> Apart from the issue of status and composition, the other issues the law addresses are the functions of the audit committee and compensation of committee members.

Elsewhere,<sup>3</sup> however, the audit committee is readily, and understandably so,<sup>4</sup> treated as a

committee of the board, implying that only directors (as the board's representatives) can serve on the committee. Following the passage by the U.S. Congress of the *Sarbanes-Oxley Act* (SOXA) in 2002, policy makers in many countries have come to embrace some of the Act's audit-committee related provisions as a model along which they have designed their legislation and corporate governance policies on audit committees.<sup>5</sup> Because the audit committee has acquired a global notoriety and is receiving considerable attention in corporate governance discourse,<sup>6</sup> it has become imperative to examine, in relation to Nigeria, some related issues, especially the committee's functions, expected performance, composition, qualifications and *modus operandi*, at least, to ensure, if nothing else, that our corporate

conceptually, is the domain of corporate boards. Against this backdrop, it is inconceivable that shareholder representatives should have a role to play on an audit committee.

<sup>5</sup> See Paul Collier & Mahub Zaman, "Convergence in European Corporate Governance: The Audit Committee Concept" (2005) 13 *Corporate Governance: An Int'l Rev.* 753 at 760 (noting the influence of the United States' *Sarbanes-Oxley Act*, 2002 on the formulation of policies on audit committees in Europe).

<sup>6</sup> The notoriety arose from the role the academics, policy and law makers believed the audit committee played or did not play in the recent high profile corporate scandals, especially the Enron Corporation, Inc. See Permanent Sub-Committee on Investigations, Committee on Governmental Affairs (U.S. Senate), *The Role of the Board of Directors in Enron's Collapse* (July 8, 2002), 3 (finding (6)) and 4 (Recommendation (2) (hereafter SENATE REPORT); Note: "Earnings Management, the SEC, and Corporate Governance: Directors Liability arising from the Auditor Committee Report" (2002) 102 *Colum. L. Rev.* 168 (by Gregory S. Rowland). For some of the developments in relation to enhancing audit committee's oversight effectiveness, see generally F. Todd Dezoort, Dana R. Hermanson, Deborah S. Archambeault & Scot A. Reed, "Audit Committee Effectiveness: A Synthesis of the Empirical Literature" (2002) 21 *J. Acct'g. Lit.* 38.

<sup>1</sup> See *Companies and Allied Matters Act*, 1990, Cap. C20, Laws of the Federation of Nigeria (LFN), 2004, s. 359(3), hereinafter referred to as CAMA). Note that others have described the audit committee of a listed company as a statutory committee. However, it is this writer's view that such a description does not accurately portray the committee as a committee of the company, especially now that the laws in other countries mandate corporate boards of quoted companies to create audit committees.

<sup>2</sup> *Ibid.*, s. 359(4)(5).

<sup>3</sup> See the U.S.' *Sarbanes Oxley Act*, 2002, s. 205; Multilateral Instrument 52-110- Audit Committee (2003) 26 OSCB 4996, s. 1.1.; ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations* (2<sup>nd</sup> ed., 2007), Principle 4, Recommendations 4.1 and 4.2; Financial Reporting Council, *The Combined Code on Corporate Governance* (June 2006) (United Kingdom) 15, C.3.

<sup>4</sup> The role audit committee plays is easily classifiable as pertaining to the management of the business of a company, which,

governance practices in this area are not too far behind the global trend, notwithstanding the formal divergence in the law. Thus a central question that implicates the focus of this article is whether the legal framework in Nigeria for audit committees conduces to the committee's effectiveness.

Indeed, the Nigeria framework on audit committee raises two different, though related set of issues, which this paper will examine. The first arises from the status of the audit committee as a committee of the company, while the other relates to the adequacy of the law's provisions for the committee's effectiveness, given the committee's increasing importance and centrality to management accountability, financial reporting, and hence the corporate governance system. In relation to the first issue, classifying the audit committee, as the Nigerian law does, as a committee of the company, mandating that shareholder representatives serve on audit committees and providing that committee members serve gratuitously, this writer believes, raise some peculiar questions that require resolution.

Creating sufficient awareness on these questions, which are yet to form part of the mainstream discourse in this area in Nigeria, this paper will argue, may prove to be quite useful in the formulation of the jurisprudence of the enforcement of the relevant provisions of the law. Additionally, it will also help corporate boards in general and audit committee in particular to properly perceive their roles and responsibilities, as they design the governance processes for the discharge of their respective responsibilities. It is also important not to overlook the possible reform value of the analysis contemplated in this paper, as it may commend to policy and law makers the desirability of reforming some aspects of the audit-committee-related provisions of the law.

Specifying some of the issues the Nigerian framework on audit committee implicates may help put in perspective the discussion that will follow presently. Firstly, since the board may not control the choice of shareholders' representatives on audit committees, it is unclear what qualifications those nominated by the shareholders should possess.<sup>7</sup> Secondly, it is unclear whether shareholder representatives on audit committees will be subject to the same statutory duty of care and fiduciary duties as directors are, since those duties apply to directors *qua* directors. Thirdly, given the increasing importance of an audit committee to corporate governance effectiveness and the statutory specification of the committee's responsibilities in the applicable law,<sup>8</sup> it is worth considering whether the committee members

are under enhanced obligations, and thus subject to higher standard of duty of care, differently than the directors.

In relation to the foregoing second and third issues, we need to interrogate the point whether, absent statutory clarification, the gratuitous nature of the committee members' work bears any analytical relevance to the legally required standard of care and diligence of the committee members. Fourthly, it may be of interest to explore, despite the law's classification of the audit committee as a committee of the company, possible obligations of a board to the audit committee. This is because the audit committee is entrusted by law with responsibilities that are designed to advance a company's business and interest. Yet, it is the board of directors that is vested with the power to manage the business and affairs of a company, part of which an audit committee would inexorably be conducting. Consideration of this issue is underscored by the fact that the Act does not make separate provision for the funding of the committee's work, in consequence of which the committee is ineluctably dependent on the board for its operations. Not being a committee of the board, there seems to be no basis to assume that the board will readily fund the committee's activities without opposition, and if it does, to the same extent the committee may want.

On the terseness of the law's provision, this paper will explore some of the global efforts that have been made through law reforms and policies initiatives to clarify what law and policy makers and other self-regulatory bodies expect of audit committees. Part of the arguments the paper will make is that policy and law makers in Nigeria as well as individual companies may adopt those reforms and initiatives to fill the *lacunae* in the Nigerian law.

Lastly, in light of the global developments in this area of corporate governance, especially the increasing convergence of laws and policies,<sup>9</sup> this paper will examine the expediency of the Nigerian law that treats the audit committee as a committee of the company, rather than of the board from the point of the economics of aberrance. Analysis will focus mainly on the implications of the Nigerian position for cross-listing of securities abroad. Cross-listing of shares of domestic companies on foreign securities exchanges has become a common mechanism in the search for global capital. But cross-listing is not costless, as cross-listing companies are required, as part of listing requirements, to comply with the listing rules of the host countries, which inexorably include their corporate governance standards. In this respect, companies registered in Nigeria, but are seeking to cross-list their shares abroad, may need to constitute another audit committees of the board, since audit committees in most, if not all, countries abroad are differently conceptualised than they are in Nigeria.

This paper will argue that, in light of anecdotal evidence, the presence of shareholder representatives

<sup>7</sup> It is crucial to note that, recently, the Nigeria's Securities and Exchange Commission released a Code that weighs in on this issue. See Securities and Exchange Commission, *Code of Conduct for Shareholders' Association in Nigeria* (December 2007) 9, para. 3(a) ("Shareholders should ensure that members who are elected into the Audit Committee of their respective companies have knowledge of accounting and internal control processes.").

<sup>8</sup> See CAMA, s. 359(6).

<sup>9</sup> See Collier & Zaman, *supra* note 5.

on audit committees may not have added significant value to the effectiveness of audit committees, especially as representatives are appointed without adequate appreciation of the depth of their responsibilities. Most of these representatives thus serve without the intellectual capabilities to discharge their duties. It will further argue that retention of the Nigerian version of the audit committee framework, apart from compounding enforcement, may prove to be too expensive and a waste of human resources for companies wishing to cross-list abroad.

The paper is arranged as follows. Part II discusses the importance and centrality of audit committee to corporate governance, the aim being to provide an analytical framework with which to appreciate (1) the role and responsibilities of the committee, (2) the issues discussed in this paper on the implications of the Nigerian position, and (3) to help understand what sort of reform of our law policy and law makers may undertake. Part III discusses the Nigerian legal framework on audit committee and focuses on the governance implications of conceptualizing of the committee as a committee of company, rather than of the board. Part IV highlights the paucity of provisions on the audit committee structure and processes and discusses global reforms and initiatives which the Part recommends to the Nigerian law and policy makers as desirable supplements to the Nigerian law. Part V takes a prospective look at the desirability of the Nigerian law that characterises the audit committee as a committee of the company and discusses the economics of this aberration in the larger context of globalisation of investments and corporate governance practices and the cost implications of this uniqueness in the particular context of cross-listing. It recommends that the Nigerian in terms of conceptualisation be brought in line with the global trend, as doing so will minimise the cost to domestic companies of cross-listing, and thus the cost of seeking capital abroad.

## II. Importance and Centrality of The Audit Committee to Corporate Governance

The agency theory of corporate governance provides an intellectual context within which we may better understand the importance and centrality of an audit committee.<sup>10</sup> Under this theory, the separation of ownership and control, which characterises the modern corporation,<sup>11</sup> magnifies the importance of specialisation of responsibilities,<sup>12</sup> and thus reinforces

<sup>10</sup> See Sandra C. Vera-Munoz, "Corporate Governance Reforms: Redefined Expectations of Audit Committee" (2005) *J. Bus. Ethics*

<sup>11</sup> See generally Adolf A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (New York: The Macmillan Company, 1962: first published 1932).

<sup>12</sup> See Henry G. Manne, "Our Two Corporate Systems: Law and Economics" (1967) 53 *Va. L. Rev.* 259 at 260-61; Eugene Fama, "Agency Costs and the Theory of the Firm" (1980) 88 *J. Pol. Econ.* 288 at 289.

the importance of agency to the corporate system.<sup>13</sup> The use of agents in a representative system, although efficient, is not costless, as corporate managers, as agents, may, and often, have different agendas than those of the shareholders and corporations for whom they act.<sup>14</sup> Indeed, it is arguable that the policy shift from the traditional conception of a corporate board as a passive instrumentality in governance to one that demands enhanced oversight and increased board activism stems from a realisation that the board is the most crucial, cost efficient primary institution that can effectively monitor management.

Thus the agency theory of governance reinforces a correlation between agency costs and the separation of ownership and control<sup>15</sup> and also the claim that, *ceteris paribus*, the level of agency costs will rise with increased dispersion of share ownership which induces collective action problem, shareholder passivity and rational apathy,<sup>16</sup> and provides corporate managers the opportunities and motivations to engage in opportunistic behaviours.

From recent experiences, one area management has explored to advance their private agendas and create underserved wealth at the expense of the investors is that of earnings management and manipulation of financial figures.<sup>17</sup> Usually, high-risk accounting practices<sup>18</sup> are the ready mechanisms adopted by management. Because financial reporting that is indicative of good performance has significance influence on investment decisions<sup>19</sup> and on the opinions of financial information analysts, such as financial analysts and rating agencies, managers have been found to manipulate financial figures and engage in high-risk financial reporting practices to give a false sense of performance, induce favourable ratings by rating agencies, and thus create a false market for the company's shares.<sup>20</sup>

Additionally, insidious financial reporting has been linked in the literature, among other things, to

<sup>13</sup> Ige O. Bolodeoku, "Corporate Governance: The Law's Response to Agency Problems in Nigeria" (2007) 32 *Brooklyn J. Int'l L.* 467 at 468.

<sup>14</sup> See Kathleen M. Eisenhardt, "Agency Theory: An Assessment and Review" (1989) 14 *Academy of Management Review* 57 at 58.

<sup>15</sup> See Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *J. Fin. Econ.* 305 at 308.

<sup>16</sup> See James S. Ang, Rebel A. Cole & James Wuh Lin, "Agency Costs and Ownership Structure" (2000) 55 *J. of Fin.* 81 at 84 ("the aggregate expenditure on monitoring by nonmanaging shareholders decreases as their individual ownership shares decline. This is due to the well-known free-rider problem in spending for quasi-public goods, such as monitoring effort.")

<sup>17</sup> See Arthur Levitt (former Chairman, U.S. SEC), "The Numbers Game," (being paper delivered at the NYU Center for Law and Business (Sept. 28, 1998) [hereinafter Levitt, *The Numbers Game*], available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>; See also Rowland, *supra* note 6.

<sup>18</sup> See SENATE REPORT, *supra* note 6 at 14-26.

<sup>19</sup> See Paul M. Healey & Kristina G. Palepu, "The Enron Fall" (2003) 17 *J. Econ. Perspectives* 3 (for how such accounting practices may produce results that influence investors' decisions).

<sup>20</sup> The Enron's case still remains the *locus classicus* on the issue. See The Senate Report, *supra* note

adoption by management of stock option plans as a core component of management compensation package,<sup>21</sup> especially by creating expectations of rapid growth intended to induce positive response from the market, and thus provide beneficiaries of the stock option plans an opportunity to make huge gains by simply exercising their stock option rights.<sup>22</sup>

Given the inevitability of agency costs to the corporate system, the best that may reasonably be done is to manage the costs effectively, by ensuring, among other things, that an effective system of control is in place to check opportunistic behaviours by management. Undoubtedly, control of agency costs may be done by both internal and external mechanisms. Corporate boards are at the heart of the internal control mechanism, and there seems to be a global acceptance that, except strengthened and independent, corporate boards would be less effective as monitors.<sup>23</sup> The traditional desire to achieve boards' effectiveness requires specialisation of boards' operations and thus the use by corporate boards of committees.<sup>24</sup> At the time when powerful chief executive officers dominated the internal governance system, a corporate board was no more than a passive instrumentality.<sup>25</sup> However, increasing clamour for independent and active boards of directors has occasioned reforms of board structures, composition, processes and values and a global acceptance of the inevitability of active boards. Part of the reforms to enable corporate boards perform its oversight responsibility is the move through policy statements and, sometimes, statutory reform to "professionalise" and empower the audit committee as the body to oversee financial reporting.<sup>26</sup> The usual assumption in this regard is that, by taking over the oversight responsibility for financial reporting,<sup>27</sup> the board, through the audit committee could act to protect the shareholders' interest and help maintain the integrity of the capital market.<sup>28</sup>

<sup>21</sup> Note that the usual theoretical significance of option plan, which is often asserted by management, is to create alignment of the interests of management, as agents, with those of the shareholders (or even the corporation), as the principal. See Healey & Palepu, *supra* note 16 at 13; Jensen & Meckling, *supra* note 13.

<sup>22</sup> See Healey & Palepu, *supra* note 16 at 13.

<sup>23</sup> See Matteo Tonello & Carolyn K. Brancato, *Corporate Governance Handbook 2007: Legal Standards and Board Practices* (The Conference Board, 2007) 14, 29.

<sup>24</sup> Under the Nigerian law, a corporate board is empowered to operate through committees consisting of such members of the board as the board may think fit. See CAMA, s. 64(a); See also Tonello & Brancato, *supra* note at 36.

<sup>25</sup> See Myles L. Mace, "Directors: Myth and Reality", in Thomas Clarke (ed.), *Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance* (2004) 96.

<sup>26</sup> See Blue Ribbon Committee, Report and Recommendations on Improving the Effectiveness of Audit Committees (1999), available online at ; Smith Report, *Audit Committees: Combined Code Guidance* (London: Financial Reporting Council, 2003)

<sup>27</sup> See Maria Consuelo Pucheta-Martinez and Christina de Fuentes, "The Impact of Audit Committee Characteristics on the Enhancement of the Quality of Financial Reporting: An Empirical Study in the Spanish Context" (2007) 15 Corp. Gov.: An Int'l Rev. 1394; Collier & Zaman, *supra* note 5.

Because of its importance, the audit committee has received, perhaps, the greatest attention in recent corporate governance reforms and literature.<sup>29</sup> Emphasis has been placed on the committee's enhanced oversight responsibilities, and the independence, educational and professional experience of its member. Additionally, there is hardly any disputation in academics and among policy makers that the audit committee plays a central role in the workings of a company's internal control system.<sup>30</sup> Given its role and responsibilities, the audit committee is now being perceived globally as the committee that can effectively liaise with management (and internal auditors), oversee the external auditors, communicate with the board for actions, and thus ensure reliable financial reporting.<sup>31</sup>

Indeed, it is arguable that it is the increasing importance of the audit committee to a corporate governance scheme that has informed researches on the link between the effectiveness of internal auditors and the characteristics of the audit committee,<sup>32</sup> impact of audit committee characteristics on financial reporting,<sup>33</sup> impact of audit committees on external audits,<sup>34</sup> and the relationship between the independence of audit committee and firm value,<sup>35</sup> among others. The foregoing analysis thus provide a good backdrop for the examination of the regulatory framework of the audit committee in Nigeria

### III. Audit Committees in Nigeria

#### A. The Law

In setting out the responsibilities of a company's external auditor the CAMA provides in section 359(3)

<sup>28</sup> Collier & Zaman, *supra* note 5.

<sup>29</sup> See Blue Ribbon Committee, Report and Recommendations on Improving the Effectiveness of Audit Committees (1999), available online at

<sup>30</sup> Gopal V. Krishnan & Gnanakumar Visvanathan, "Reporting Internal Control Deficiencies in the Post-Sarbanes-Oxley Era: The Role of Auditors and Corporate Governance" (2007) 11 Int'l J. Audit. 73.

<sup>31</sup> See Matteo Tonello & Carolyn K. Brancato, *Corporate Governance Handbook 2007: Legal Standards and Board Practices* (The Conference Board, 2007) 60; ASX Corporate Governance Council, *supra* note 3 at 25 (Principle 4); MULILATERAL INSTRUMENT 52-110 (Audit Committee) (2003) OSBB 4996 at 5000, para. 2.3; Financial Reporting Council (CCC), *supra* note 3 at 15, para C3.2.

<sup>32</sup> See Mazilina M. Zain, Nava Subramaniam & Jenny Stewart, "Internal Auditors' Assessment of their Contributions to Financial Statement Audits: The Relation with Audit Committee and Internal Audit Function Characteristics" (2006) 10 Int'l J. Audit 1; Jenny Goodwin, "The Relationship between the Audit Committee and the Internal Audit Function: Evidence from Australia and New Zealand" (2003) 7 Int'l J. Audit 263.

<sup>33</sup> See Maria Consuelo Pucheta-Martinez and Christina de Fuentes, "The Impact of Audit Committee Characteristics on the Enhancement of the Quality of Financial Reporting: An Empirical Study in the Spanish Context" (2007) 15 Corp. Gov.: An Int'l Rev. 1394.

<sup>34</sup> See Jenny Stewart & Lois Munro, "The Impact of Audit Committee Existence and Audit Committee Meeting Frequency on the External Audit: Perceptions of Australian Auditors" (2007) 11 Int'l J. Auditing 51.

<sup>35</sup> See Kam C. Chan & Joanne Li, "Audit Committee and Firm Value: Evidence on Outside Top Executives as Expert-Independent Directors" (2008) 16 Corp. Gov.: An Int'l Rev. 16.

that “the auditor shall in the case of a public company also make a report to an audit committee which shall be established by the public company.” Section 359(4) further provides that the committee shall (1) consist of equal number of directors and representatives of the shareholders of the company (subject to a maximum of six members; (2) examine the auditors’ report and make recommendations on it to the annual general meeting as it may think fit; and that (3) members of the audit committee shall not be entitled to remuneration and shall be subject to re-election annually.

Section 359(6) sets out the functions of the audit committee, which include the following:

- (a) ascertain whether the accounting and reporting 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 relation to the appointment, removal and remuneration of the external auditors of the company; and
- (f) authorize the internal auditor to carry out investigations into any activities of the company which may be of interest or concern to the committee.

It is worth noting that the CAMA’s provision on the objectives and functions of the audit committee are not exhaustive, as the Act anticipates that a company may, in its articles, specify further functions and powers for the audit committee. Additionally, it seems that the Act does not intend that the audit committee shall account to the board of directors. The only instance the Act addresses the relationship between the committee and the board is in terms of the recommendations the Act requires the committee to make to the board concerning external auditors’ appointment, remuneration and removal. It is equally unclear what relationship the committee has with the general meeting, except (a) the obligation the Act imposes on the audit committee to examine the auditors’ report and make recommendations in relation thereto to the general meeting, and (b) annual re-election of audit committee members. Clarification of the relationship would have been helpful, especially in relation to the needs of the committee.

One can hardly be comfortable with the terseness of the Act’s provisions relating to a committee that is expected to play a crucial role in corporate governance, especially as a lot of issues that should be addressed remain unclear. As it relate to the first issue this paper seeks to discuss, classifying the audit committee, as the Nigerian law does, as a committee of the company, the mandatory requirement that shareholder representatives serve the committee and

the gratuitous nature of the committee members’ work raise further issues in respect of which the Act provides no guidance. Yet their resolutions may be crucial not only to how those provisions may shape the jurisprudence on the liability of audit committee members, but also how committee members are likely to view their responsibilities. Thus, an examination of these issues, this writer believes, could help interested constituencies in filling the gaps in this area of the law.

### **B. Qualifications of Audit Committee Members**

The Act does not provide any guidance on the qualifications or professional experiences that members serving on audit committees should possess, at the minimum. Yet, as noted above, the literature has established a clear nexus between (1) the quality of internal audit and audit committee characteristics,<sup>36</sup> (2) audit committee characteristics and external audit,<sup>37</sup> (3) audit committee and firm value,<sup>38</sup> and audit committee characteristics and financial reporting.<sup>39</sup>

In essence, the quality of committee members is a crucial factor in determining audit committee’s effectiveness. DeZoort et al. defines an effective audit committee as one that “has qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight functions.”<sup>40</sup> Indeed, this definition is reflective of the statutory functions the committee is expected to have.

A cursory assessment of the provisions of section 359(6) will show that, to be meaningful on audit committees, members should possess sufficient knowledge in accounting principles, internal control systems, internal audit functions and processes and law. Indeed, this view receives support from current global policies on qualifications of audit committee membership,<sup>41</sup> which now place emphasis on financial literacy,<sup>42</sup> financial expertise,<sup>43</sup>

<sup>36</sup> See the citations in footnote 32.

<sup>37</sup> See Stewart & Munro, *supra* note 34.

<sup>38</sup> See Chan & Li, *supra* note 35.

<sup>39</sup> See Pucheta-Martinez & Fuentes, *supra* note 33.

<sup>40</sup> See F. T. DeZoort, D. Hermanson, D. Archambeault & S. Reed, “Audit Committee Effectiveness: A Synthesis of the Empirical Audit Committee Literature” (2002) 21 J. Acctg. Lit. 38.

<sup>41</sup> See the Code of Corporate Governance in Nigeria (2003), Part C, para. 13; ASX Corporate Governance Council, *supra* note 3; Financial Reporting Council, *supra* note at 15, C.3.1; OSCB, Multilateral Instrument 52-110 – Audit Committee, Part 3; Smith Report, *supra* note 26 at 9, para. 3.16.

<sup>42</sup> This term means “the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the company’s financial statements.” See OSCB, Multilateral Instrument 52-110 – Audit Committee, *supra* note 3, Part I, s. 1.1.

<sup>43</sup> A financial expert is defined as “a person who has:

independence,<sup>44</sup> and above all, knowledge of the committee's responsibility as well as knowledge of the committee's centrality to an effective system of corporate governance.

Regrettably, however, anecdotal evidence on board practices in Nigeria does not show that the board and shareholders, who the law requires to nominate representatives on audit committees, understand the importance of the following requirements. In fact, there is anecdotal evidence that among the board's representatives on audit committees are the companies' chief financial officers (CFOs). Additionally, there is hardly any assurance that shareholder representatives are financially literate or that some of them possess financial expertise.

The Code of Corporate Governance in Nigeria gives considerable attention to the audit committee and, among other things, the qualification of its members. The only requirement is that members "should be able to read and understand basic financial statements, and should be capable of making valuable contributions to the committee."<sup>45</sup> There is yet no insistence, even by the Code on the presence of a person with financial expertise on an audit committee. Given the complexity of accounting principles which undergird most financial reporting, it can hardly be gainsaid that it is time the requirement of financial expertise on audit committee became a requirement of the law. One can only hope that the recent Code of Conduct for Shareholders' Associations by the Securities and Exchange Commission,<sup>46</sup> which emphasises the qualification of shareholder representatives appointed to audit committees, would provide further education and guidance in the choice of shareholders' representatives.<sup>47</sup> This writer is of the

view that the law or any policy statement on audit committee qualifications should add as a requirement a continuing education programme that will include training on financial reporting, the company's internal control system, and the importance of audit committee (its structure, characteristics and process) to the committee's oversight responsibility and corporate governance.

### **C. Appraising the Performance of Audit Committee Members: By which Standard?**

Audit committees of public companies in Nigeria will usually comprise two categories of members, namely, directors, who are boards' representatives and non-director members, who are shareholders' representatives.<sup>48</sup> However, because the CAMA does not define the standard of duty expected of audit committee members, one is bound to wonder how members of the committees may be assessed, especially when such assessment implicates possible liability of committee members. Determination of the standard for assessing the conduct of audit committee members is underscored by the fact that there is a statutory definition of the committee's responsibilities. Moreover, there has been a considerable focus and emphasis on the importance of the audit committee, and its centrality to an effective system of corporate governance and oversight of management's financial reporting.

#### **1. Director-Members of the Audit Committee**

To be sure, the director-members of an audit committee are subject to statutory fiduciary duties and duty of care under the Act.<sup>49</sup> The contents of directors' statutory duty of care have been sufficiently interpreted by courts in the common law world,<sup>50</sup> and such interpretations would readily assist our courts in the interpretation of the Nigerian provisions on the subject, as they affect the conduct of audit committee members. Section 282(1) the CAMA provides that

"Every director of a company shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interest of the company, and shall exercise that degree of care, diligence and skill which a reasonably prudent director would exercise in comparable circumstances."

Subsection (2) of the Act further provides that failure to take reasonable care as required by the above provision shall be a basis for an action in negligence and breach of duty. While application of fiduciary duty requiring directors to discharge the duties of their office honestly and in good faith

- (a) an understanding of financial statements and the accounting principles used by the issuer (company) to prepare its financial statements;
- (b) the ability to assess the general application of such accounting principles in connection with the accounting for estimates, accruals and reserves;
- (c) experience preparing, auditing, analysing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the issuer's financial statements, or experience actively supervising one or more persons engaged in such activities;
- (d) an understanding of internal controls and procedures for financial reporting; and
- (e) an understanding of audit committee functions.

See *ibid.*

<sup>44</sup> The trend is for all audit committee members to be independent/outside directors. For a prototype definition of independence in this context, see OSCB, Multilateral Instrument 52-110 – Audit Committee, para. 1.4 (emphasis here is for members not to have any direct or indirect material relationship with the issuer or company, which the Instrument defines in para. 1.4(3)).

<sup>45</sup> See Securities & Exchange Commission/Corporate Affairs Commission, *Code of Corporate Governance in Nigeria* (October 2003), Part C, para. 13(a).

<sup>46</sup> See SEC, *Code of Conduct for Shareholder Associations in Nigeria* (December 2007).

<sup>47</sup> See *ibid.*, para. 3(a) ("Shareholders should ensure that members who are selected into the Audit Committee of their respective companies have knowledge of accounting and internal control processes.")

<sup>48</sup> See CAMA, s. 359(4).

<sup>49</sup> See CAMA, ss. 279 and 282.

<sup>50</sup> For Australia, see *Daniels v. Anderson* (1995) 16 A.C.S.R. 607 (Court of Appeal of New South Wales); See

(commonly perceived as the duty of loyalty) usually focuses on directors' conflict of interests, abuse of corporate opportunities, directors' transactions with the companies on whose boards they serve and misuse of corporate assets and information, it is only recently that the Delaware courts indicated a readiness to extend the good faith duty to activities of directors outside those mentioned above.

In *In Re Caremark International Inc. Derivative Litigation*,<sup>51</sup> the Delaware Chancery Court established the principle that a board has an obligation to "exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." Indeed, the Court's decision in *In Re Walt Disney Co. Derivative Litigation*<sup>52</sup> was more direct on the link between the good faith duty and awareness and implementation of corporate governance best practices. Not only did Chancellor William Chandler III underscored the importance of good faith in the performance of corporate duties, his Honour stated that directors and officers are expected to fully understand current best practices as well as ensure that business decisions are taken in light of widely-recognized corporate governance standards.

Given the increasing attention on the importance of an audit committee to corporate governance and the evolution of governance standards and practices for the committee, a case could be made that directors would have a good faith duty not only to appraise themselves with audit committee-related standards and practices but also to implement them and put themselves in a position to make informed decisions and conduct effective oversight of management.

In *Peoples Departmental Stores Inc. (Trustee of) v. Wise*,<sup>53</sup> the Supreme Court of Canada provides a good analysis of the statutory duty of care and skill under section 122(1)(b) of the *Canada Business Corporations Act* (CBCA). The interpretation provided by the Court, this writer believes, may serve as a guide to the Nigerian courts in interpretation and application of section 282(1) of the CAMA, as the provisions of section 122(1)(b) of the CBCA are *in pari materia* with that of the relevant portion of section 282(1) of the CAMA.

First, while noting that section 122(1)(b) of the CBCA requires more of directors and officers than the traditional common law duty of care, the Canadian Supreme Court held that the words "in comparable circumstances" in the section introduces "a contextual element into the statutory standard of care."<sup>54</sup> The contextual approach dictated by section 122(1)(b) of the CBCA, the court further held, "not only emphasises the primary facts but also permits

prevailing socio-economic conditions to be taken into consideration."<sup>55</sup> Second, the Court held that the statutory standard of care is an objective one, which makes it clear that "the factual aspects of the circumstances surrounding the actions of the director or officer are important . . ."<sup>56</sup> Third, and of importance to directors, the court observed that "the emergence of stricter standards puts pressure on corporations to improve the quality of board decisions. The establishment of good corporate governance rules should be a shield that protects directors from the allegations that they have breached their duty of care."<sup>57</sup>

On a comparative basis, the Court noted that Canadian courts, like their counterparts in the United States, the United Kingdom, Australia and New Zealand, approach the enforcement of duty of care with deference to the fact that directors and officers often have business expertise that courts do not have. In particular the Court emphasised the need for courts to recognise that "[m]any decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made."<sup>58</sup> Such emphasis is to prevent the temptation to "see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available *ex post*."<sup>59</sup> To prevent the risk of hindsight bias, the Canadian courts have developed a rule of deference to business decisions called "business judgment rule" which is the same rule adopted by the American courts.<sup>60</sup>

It seems that, on a reasonable interpretation of the approach adopted by the Canadian Supreme Court, and given the application of the business judgment rule, the decision process a board puts in place matters to the courts' assessment of a breach by the directors of their duty of care. The rule requires courts to see that directors make a reasonable decision not a perfect decision, and reinforces the need for judicial reluctance to second-guess the application of business expertise to the considerations that are involved in corporate decision making, since courts are ill-suited to do so.<sup>61</sup> Notwithstanding, the foregoing admonition, however, the Court made it clear that courts "are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made."<sup>62</sup>

There is no doubt that courts in Nigeria will find the exposition by the Supreme Court of Canada to be valuable as they interpret the Nigerian laws. If context matters, the board's responses to the new challenges

<sup>51</sup> 698 A.2d 959 (Del Ch. 1996).

<sup>52</sup>

<sup>53</sup> [2004] 3 S.C.R. 461.

<sup>54</sup> *Ibid.* at 491

<sup>55</sup> *Ibid.*

<sup>56</sup> *Ibid.*

<sup>57</sup> *Ibid.*

<sup>58</sup> *Ibid.* at 492.

<sup>59</sup> *Ibid.*

<sup>60</sup> *Ibid.* at 491.

<sup>61</sup> *Ibid.* at 493.

<sup>62</sup> *Ibid.*

of corporate governance in keeping its members abreast of contemporary governance issues, principles and standards, and adapting its processes so it can implement desirable changes that current governance reforms and policies require will provide, in part, the context to adjudge the conduct of the board's representatives on the audit committee members. Moreover, the undoubted notoriety of the audit committee and the emphasis that is being placed on the committee's vigilance, processes, and members' qualification, so as to ensure meaningful discharge of the committee's oversight responsibility as regards financial reporting, may further provide another basis for an objective judicial review of the reasonableness of the conduct of the board's representatives on the audit committee.

## 2. *Non-Director Members of the Audit Committee*

In Nigeria, however, it does not seem that the statutory duty of care and diligence will apply with equal force to the non-director audit committee members, since those provisions apply to directors *qua* directors. If so, by what standard of conduct will the shareholder representatives on audit committee be judged? If they are to be judged differently, is a duality of assessment of the conduct of the audit committee members desirable or efficient?

Since shareholder representatives on audit committees are not directors, courts may have recourse to the principles of common law on the standard by which the conduct of this class of audit committee members will be judged. Shareholder representatives on the audit committee may be described more appropriately as agents of the company, since the governing legislation categorises the audit committee as a committee of the company. To begin with, assessment of the standard of care and diligence of an agent usually turns on whether the underlying agency is for reward or gratuitous.<sup>63</sup> In the former, there does not seem to be any difference between the standard of conduct expected of the agent and that which the courts have declared are expected of directors under the statutory duty of care.<sup>64</sup> In the latter, however, different standard seems to apply.

It is the law that a gratuitous agent is not even required to perform any obligation under the agency relationship.<sup>65</sup> However, if the agent performs the duty, s/he is not expected to display more than the skill s/he possesses, except s/he holds herself or himself out as possessing a higher skill. Although the English Court of Appeal appears to lean in favour of a formulation of a gratuitous agent's duty based on objective standard, there is sufficient indication in the Court's decision of the need to consider the peculiar circumstances of each case, among which is the

agent's actual skill. In *Chaudhry v. Prabhaker*<sup>66</sup> the English Court of Appeal restated the duty of a gratuitous agent to be

“such skill and care as persons ordinarily exercise in their own affairs or, where the agent has expressly or impliedly held himself out to his principal as possessing skill adequate to the performance of a particular undertaking, such skill and care as would normally be shown by one possessing that skill.”<sup>67</sup>

However, Stuart-Smith LJ, with whom other Justices agreed, observed that the standard of the duty expressed above is an objective one, “and is not simply measured by the agent's honest statement that he would have similarly acted if he had been transacting the business on his own account, however foolish that may be.”<sup>68</sup> Worthy of note is his Lordship concession that, in the case of an unpaid agent, part of the relevant circumstances a court would consider would be the actual skill and experience that the agent had, except the agent represented a greater skill than he actually had.<sup>69</sup>

Although the Court in *Prabhaker* hinted that the standard of care, even for a gratuitous agent is an objective one, the fact that assessment of that conduct will necessarily be conditioned by the actual skill of the agent implies that a shareholder representative on an audit committee may not be expected to do more than his or her skill would permit. Thus, it may be unreasonable to expect a shareholder representative without financial expertise or financial literacy to bring those skills to bear on his or her contributions on the audit committee. A strong case can thus be made that the standard of care and diligence expected of shareholder representatives (especially those without the requisite knowledge in accounting or financial statement matters) is not necessarily the same as those expected of the director-members of the committee, in light of section 359(4) of the CAMA, which provides that audit committee members shall work without remuneration,

This writer is of the view that it will be a disservice to the corporate system, now that a corporate governance renaissance is just taking hold in Nigeria, especially with regards to the importance of audit committees to financial reporting oversight, to have disparate standards for audit committee members. To deal with the problem just discussed effectively, a reform of the law is recommended to clarify that the standard of care and skill which applies to directors will equally apply to all members of the audit committee, notwithstanding the absence of remuneration for members.<sup>70</sup> It will then be left for individual audit committee members to decline the invitation to serve where, in light of the seriousness of the job to be done and complexity of deliberations,

<sup>63</sup> See generally G.H.L. Fridman, *The Law of Agency*, 7<sup>th</sup> ed. (London: Butterworths, 1996) 158-64.

<sup>64</sup> See *People v. Wise* [2004] 3 S.C.R. 461 (Supreme Court of Canada); *Francis v. United Jersey Bank*, 432 A 2d 814 (1981).

<sup>65</sup> Fridman, *supra* note 63 at 156.

<sup>66</sup> [1988] 3 All E.R. 718.

<sup>67</sup> *Ibid.* at 721.

<sup>68</sup> *Ibid.*

<sup>69</sup> *Ibid.*

<sup>70</sup> See the discussion on remuneration of audit committee members in Part III.G., *infra*.



they consider themselves unsuitable to remain or serve on the committee.

**D. Should Audit Committee Members be subject to Enhanced Duty of Care?**

For the sake of analysis under this section, we disregard the analysis in the last section and, for the moment, assume that all audit committee members are subject to common duty of care and diligence. The issue, therefore, is whether the committee's unique responsibilities under the Act and its increasing importance to corporate governance and an effective system of internal control should subject them to an enhanced duty of care than that to which other directors are subject.

No direct authority exists on the issue in Nigeria. However, it is clear from our law that the governing legislation imposes the same level of duty of care and diligence on both the executive and non-executive directors. Moreover, given the contextual component in the analysis of the directors' statutory duty of care and skill, which, the Supreme Court in Canada emphasised in *People*, there is much to commend the argument that the antecedents a company has of financial improprieties and scandal and the unrelenting emphasis being placed on the desirability of vigilance on the part of a company's audit committee may well constitute the context in which a court will review the conduct of members of the audit committee.

There is a trend in the U.S. to recognize a higher monitoring obligation for audit committee members than non-audit members and other non-executive directors. In *re JWP Inc Securities Litigation*,<sup>71</sup> officers and directors were sued for disclosure violations when JWP was forced to restate its audited consolidated financial statements due to numerous accounting irregularities which were discovered by JWP's new president. The write-offs reflected on the restated financial statements were extensive and wiped out JWP's net worth, forcing the company into bankruptcy. The court held that directors who had served on JWP's audit committee, and who had signed the corporation's Annual Form 10-Ks, had "actually made" the misrepresentations contained in those filings. Crucial to the decision of the Court in this case was the fact that, although these outside directors had not played a role in the day-to-day operations of the company, there was evidence that they were repeatedly informed by the company's auditors that the internal auditing procedures were an "area of concern which needed to be improved."

In the case of Nigeria, the starting point is that the law does not impose disparate standard of care and diligence on directors. In particular, section 282(4) provides that "the same standard of care in relation to the directors' duties to the company shall be required for both executive and non-executive directors." As discussed earlier, however, the Nigerian law makes the audit committee a committee of the company

rather than of the board, implying that the liability of members and the standard of conduct expected of them stem directly from their responsibilities as defined by law, and on what they can reasonably be expected to do in the discharge of those responsibilities. In other words, the nature of the committee's responsibilities will shape the expected level of behaviour on the part of the committee members and the standard they will be held to.

As indicated in section 359(6) of the Act, the audit committee's functions will require it to liaise with and give directions, whenever necessary, to the internal auditor. The committee's review of findings on management may require it to take further action, just as its review of the scope and planning of audit requirements may require a desirable line of action the committee should take. Additionally, the law appears to require of the audit committee some level of activism, especially in the context of the committee's duty to ascertain whether the company's accounting and reporting policies accord with legal requirements and agreed ethical practices. The Act also imposes on the audit committee a duty to review the effectiveness of company's accounting system and internal control. Indeed, it is arguable that the latter responsibility will require the audit committee to call on management to defend the internal control policy and to justify to it the basis of the design, in light of the company's objectives and the risks management has identified as likely to undermine the attainment of the objectives. Basically, the audit committee must understand the essence of internal control and be active in its implementation and monitoring.

The foregoing only reinforces the importance of the audit committee's process, structure, continuous education programme, independence and assertiveness, without which it may be difficult for a court to hold that the committee has put itself in a position to faithfully and diligently discharge its responsibilities. Moreover, country specific circumstances may matter. Directives on training of audit committee members issued by the regulatory authorities, the level of awareness they create on how audit committee members should discharge its mandate may provide further context for any judicial analysis of the expected level of conduct of audit committee members.

**E. Exploring the Boards' Responsibilities toward Audit Committees**

Both the corporate board and audit committee have different, but complementary roles to play in the internal corporate control system. The two institutions act directly for the company. However, the issue whether the board has certain responsibilities toward the audit committee seems relevant because of the larger role it performs in corporate governance. Under the CAMA, the board of directors is entrusted with the responsibility to manage the business and affairs of the company.<sup>72</sup> The scope of this responsibility is

<sup>71</sup> 928 F Supp. 1255 (S.D.N.Y. 1996).

<sup>72</sup> See CAMA, s. 63(3).

wide, and can only be delimited by the Act and the articles of association.<sup>73</sup>

Given the stated responsibilities of an audit committee under section 395(4)(6), this writer is of the view that the committee is equally involved in the business of the company, albeit in a special and limited form. It is in this context that this writer makes the case that the board owes the committee a duty, which this section will explore.

To be sure, the Act does not clarify whether the audit committee can determine the nature of, and control, the logistics that will enable it perform its responsibilities. In the absence of such empowerment, it is arguable that the legislatures that the audit committee, once established, is empowered to take all the necessary steps and exercise all such powers as are necessary for the effective performance of its statutory obligations. On the other hand, one may safely assume that the audit committee will operate within the existing structure in place. This implies that it will be the board's responsibility to provide the necessary support and facilities to the committee, so it can properly perform its functions. For instance, it is expected that the audit committee will require funds to implement some of its policies. It may decide to seek expert advice, which has, indeed, become a global trend that many believe would ensure the committee's effectiveness. The committee may want to train its members in contemporary corporate governance practices as they affect audit committee's responsibilities. Since the committee has no control over the treasury, it is only sensible to expect the board to provide the necessary support, financial or otherwise, to enable the committee implement its policies and perform its duties. Perhaps, a case could be made that, since the Act requires the committee to report to the general meeting, the latter is the more appropriate body to which the committee would submit its budget for approval.

Beyond the foregoing, the audit committee, as indicated in section 359(6) of the CAMA, may need to interact with key members of the management group, especially the internal auditors, the Chief Financial Officer of a company, and other key managers the committee believes may help its deliberations. As will be seen presently, contemporary global practice support the position that audit committees take on more responsibilities, especially in relation to procedures for the receipt, retention and treatment of complaints of unethical practices. A successful discharge of such responsibility will require the support of management and the board.

Lastly, part of the board's responsibilities is to nominate its representatives for audit committee membership. In this respect, it is expected that a board will nominate directors it knows can enhance the committee's effectiveness, given its broad knowledge of global expectations and the importance of reliable financial reporting. If a board were to treat even the

issue of nomination of members to the committee with sheer recklessness, it is arguable that it would be in breach of its fiduciary duties and statutory duties of care to the corporation. Indeed, if a board were to be uncooperative in any of the foregoing circumstances, it should not be difficult for a court to hold that the board and its directors violate their statutory fiduciary duties and duty of care and diligence to the company.

#### **F. Funding the Oversight Responsibilities of the Audit Committee**

As it is, the audit committee is vested with oversight responsibility regarding internal control and financial reporting. In other words, the committee is, in a way, a monitor of management. Not unexpectedly, the sensitivity of this responsibility and its extensiveness will often require the committee to have a budget for its activities, which, under extant framework, management or the board will have to fund. Such an arrangement leaves the audit committee at the mercy of management whose activities (as regards financial reporting and internal control) the committee is expected to monitor. Given the oversight tone set by an audit committee of a company, it will be reasonable to surmise that there may be instances of outright disagreement between management and the audit committee, which may force the former to frustrate the latter from effectively implementing its oversight policies.

To prevent a dominant managing director and a passive board frustrating the audit committee, it is suggested that the funding of audit committee requires statutory clarification. This suggestion is informed by the need for an audit committee to be independent not only in terms of membership, but also in relation to its finances. In this regard, an amendment of the relevant provisions of the law is suggested to empower audit committees to have a budget that will be funded by the company. With a budget, we can then expect the audit committee to implement such policies it considers desirable for the effective performance of its duty under law.

#### **G. Critique of the No-Remuneration Policy for Audit Committee Members**

As already noted, the Nigerian law does not permit audit committee members to receive remuneration for their services. Of course, a no-remuneration policy does not preclude adequate reimbursement for out-of-pocket expenses that members incur to attend committee meetings. Apart from the possible effect which such a policy may have on the formulation of applicable standards of duty of care and skill for audit committee members, which this paper already discussed, this writer is of the view that a no-remuneration policy for audit committee members is retrogressive and inefficient. More importantly, it may undermine needed commitment on the part of the committee members, especially the non-director members of the committee. It is thus suggested that, at the minimum, audit committee members should be remunerated as directors are.

<sup>73</sup> *Ibid.*

Firstly, the audit committee is arguably the most important committee of a quoted company in contemporary corporate governance practices. Indeed, its significance, especially in status, underscores the scope of the committee's responsibilities, the clamour for more knowledgeable (especially in accounting and financial statement matters) personnel for the committee, and the preference for independence of the committee members. In the particular case of Nigeria, the audit committee, as earlier pointed out, is a statutory committee of the company. In light of the committee's centrality to reliable financial reporting and to the oversight role it is expected to perform, it is sensible to motivate the committee members by permitting them to earn moderate remuneration for their efforts and commitments. A no-remuneration policy will only create a black market for remuneration, which, to actualise, may involve the committee members, management and the board in some collusion. Not unexpectedly, such collusion may not occur without a price, which may take the form of lowering of oversight standards by the committee, overly liberal enforcement of stated procedures or remaining aloof when, indeed, the committee should be more definitive. Alternatively, lack of remuneration may promote shirking or other cognate behaviours that could undermine the committee's effectiveness.

Secondly, because the director-members of the audit committee are entitled to remuneration *qua* directors, they are unlikely to experience the same level of disenchantment with the work of the audit committee as the shareholder-representatives. In fact, a board is always, by whatever device, at liberty to structure the pay of its members (including those who serve on the audit committee) to reflect the additional commitments of time and resources that committee membership requires. In essence, the only members of an audit committee in Nigeria that is truly unremunerated are the shareholder-members of the audit committee, one of whom is traditionally the Chair of the committee. It can hardly be gainsaid that such disparity in treatment of members as regards remuneration could create not only disaffection among members, but also undermine the commitments of non-director members of the committee. This may trigger all sorts of agency problems that could have grave consequences for the company.

Lastly, the no-remuneration policy for audit committee members further underscores the oddity of the Nigerian position, which mandates shareholder-representatives on the audit committee. Of course, remuneration of audit committee members would not have become an issue if the committee were a committee of the board. In that case, it would be left for the board to determine and recommend to the company what the directors are to receive in remuneration, in light of their work load. However, since in Nigeria, membership of an audit committee is from two different groups, it is desirable for the

members to have a sense of equal treatment, which the current no-remuneration provision of the law does not seem to advance.

Remuneration of audit committee members is unlikely to create any legal problem elsewhere, since members are usually directors who are usually remunerated. However, the recommendation in the Smith Report that additional and adequate remuneration be paid to audit committee members for their special time, commitment and role<sup>74</sup> may help to further reinforce the position taken in this paper that the Nigerian law, which forbids remuneration, is inefficient, and thus requires a review.

#### **IV. Audit Committee Structure, Responsibilities and Processes: Looking Beyond The CAMA For Supplement**

Provisions relating to audit committee's structure, responsibilities and processes under the CAMA are particularly terse. As a result, many audit committee-related issues are left unresolved. In that situation, it will not be out of place to look elsewhere for supplements to make audit committees in Nigeria more effective. In the last six years, there have been tremendous audit committee-related developments, whether in terms of law or policy reform, which may be adopted as supplements to our law. It is fair to say that the Nigeria's *Code of Corporate Governance*, 2003 provides some insights which audit committees may follow. Notwithstanding the value the Nigerian Code may add, examination of the emerging global policies in this area could still be of use. This section will focus on insights on audit committees' responsibilities and on membership.

##### **A. Additional Insights on Audit Committee's Responsibilities**

As noted earlier, the CAMA provisions on the functions of the audit committee are not exhaustive; the Act recognises that further supplementary provisions may be made by a company via the articles of association.<sup>75</sup> Given contemporary developments, it is this writer's view that additional provisions on the responsibilities of audit committees, which complement the Act should be adopted. Interestingly, there is a significant convergence in this area, so that policy makers in Nigeria can be assured that adoption of the global initiatives can only enhance the local provisions, and assist the committee in the achievement of its statutory objectives.

Some of the additional insights are that the audit committee must

(1) have a written charter that sets out its mandate and responsibilities.

<sup>74</sup> See the Smith Report, *supra* note 26 at 10, para. 3.15 ("In addition to the remuneration paid to all non executive directors, each company should consider the further remuneration that should be paid to members of the audit committee to recompense them for the additional responsibilities of membership.").

<sup>75</sup> See CAMA, s. 359(6).

(2) pre-approve all non-audit services to be provided to the company issuer by its external auditors

(3) be satisfied that adequate procedures are in place for the review of the company's disclosure of financial information extracted or derived from the company's financial statements.

(4) establish procedures for: (a) the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters; and (b) the confidential, anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters.

(5) review and approve the company's hiring policies regarding employees and former employees of the present and former external auditors of the issuer.<sup>76</sup>

(6) perform annual performance self-evaluation

There is also a global trend as to the sort of information that should be brought to the notice of the audit committee.<sup>77</sup> This include

(1) Management's assessments of the business risks the company faces, and its planned responses to those risks.

(2) Controls over treasury activities, including cash management, hedging, derivatives, foreign currency transactions, and use of new or unusual financial instruments.

(3) The legal environment, including the status of pending lawsuits or administrative proceedings and the status of product and environmental liability and warranty reserves as well as reserves, if any, made because of legal issues

(4) Industry-specific issues, such as regulatory issues or information about the competitive environment.

(5) The effect new tax laws and other regulations may have on the company.

(6) The company's foreign operations, including locations, and controls over financial reporting.

(7) Extent of work performed for governments and compliance with related contractual terms.

(8) The company's policies and procedures for reviewing officers' expenses and perquisites.

(9) Reports of complaints of violations of ethics programs, particularly with respect to accounting and auditing issues.

(10) New accounting requirements that can affect the company's financial statements

## **B. Additional Insights on Audit Committee Membership**

While the requirement of the CAMA on audit committee membership cannot be changed, except through the legislative process, it is still possible to accommodate some perspectives in this regard in the quest for an effective audit committee system. Global expectations are that

(1) Members of the audit committee must be financially literate<sup>78</sup>

(2) An audit committee must have a financial expert<sup>79</sup>

(3) The audit committee should comprise only<sup>80</sup> independent directors,<sup>81</sup> that is, have members who have no financial relationship with the company that may interfere with the exercise of their independence from management and the company.<sup>82</sup>

<sup>78</sup> This term means "the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the company's financial statements." See OSCB, Multilateral Instrument 52-110 – Audit Committee, *supra* note 3, Part I, s. 1.1.

<sup>79</sup> See the definition in footnote 43.

<sup>80</sup> See Financial Reporting Council, *supra* note 8 at C3.1. Investment and Financial Services Association, *Corporate Governance: A Guide for Fund Managers and Corporations – Blue Book* (2004). Note that, under the ASX Corporate Governance Council's Recommendations, audit committee members are to consist only of non-executive directors, majority of whom are independent directors. See ASX Corporate Governance Council, *supra* note 3, Principle 4, Recommendation 4.2.

<sup>81</sup> I adopt the definition of independence adopted by the Australian Stock Exchange, which, under its corporate governance principles, define an independent director as follows:

An independent director is a non-executive director (i.e. is not a member of management) and:

1. is not a substantial shareholder of the company or an officer or, or otherwise associated directly with, a substantial shareholder of the company;
2. within the last three years, has not been employed in an executive capacity by the company or another group member, or been a director after ceasing to hold any such employment;
3. within the last three years has not been a principal of a material professional adviser or material consultant to the company or another group member or an employee materially associated with the service provided;
4. is not a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer;
5. has no material contractual relationship with the company or another group member other than as a director of the company;
6. has not served on the board for a period which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interest of the company;
7. is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act in the best interests of the company

See ASX Corporate Governance Council, *supra* note 3, Principle 2. Note that it is customary for each board to determine its own level of materiality.

<sup>82</sup> See the New York Stock Exchange Listing Guide, section 303.01 (B)(2)(a).

<sup>76</sup> See Ontario Securities Commission's Board, Multilateral Instrument 52-110 – Audit Committee, (2003) 26 OSCB 4996 (June 27, 2003), Part 2, s. 2.3; Financial Reporting Council (FRC), *The Combined Code on Corporate Governance* (June 2006), C.3.2; ASX Corporate Governance Council, *Principles of Good Governance and Best Practice Recommendations*, 2<sup>nd</sup> edition (2007), Principle 4 (Reporting).

<sup>77</sup> See The Conference Board: *Corporate Governance Handbook 2007: Legal Standards and Board Practices* (2007) 63-64.

(4) The audit committee is chaired by an independent chair, who is not chair of the board

(5) It is also generally perceived as ideal that an audit committee should have the authority to

(a) engage independent counsel and other advisors as it determines necessary to carry out its duties;

(b) set and pay the compensation for any advisors it employed.

## V. The Status of Audit Committee

While the global trend is to treat the audit committee as a committee of the board, and to require that only directors can serve on it, the Nigerian law treats the committee as a committee of the company and requires that both the board and shareholders nominate representatives to the committee in equal numbers. To be sure, there is some identifiable value to the Nigeria's unique approach. At least, shareholders are given a rare opportunity to make inputs in a core decision-making process that directly affects their interests. Moreover, the presence of shareholder representatives on audit committee may have a positive influence on how director-members on the committee conduct themselves, since the presence of non-board members on the committee may be of informational advantage to shareholders seeking enforcement of breaches of fiduciary duties against directors, especially where the board is reluctant to initiate such proceeding in deserving circumstances.

However, considerations and analysis differ in terms of the economics of the Nigerian position. Earlier, this paper discussed the difficulty that might be encountered in developing a holistic doctrinal framework for the enforcement of duty of care and diligence against non-director members of the audit committee, especially as committee members are to serve without remuneration. More crucially, however, the globalisation of investments and increasing mobility of capital, which may induce domestic companies to cross-list their securities abroad, may expose cross-listing companies to additional expenses of complying with the corporate governance standards of the host countries, whose laws conceptualise the audit committee differently than the Nigerian law does.

With anecdotal evidence suggesting that not too much value is being added to the process and deliberations of audit committee by having shareholder representatives on boards, this writer

takes the position that Nigeria needs to revisit the status of the audit committee. It is standard practice that shareholder representatives are not often nominated to audit committee with due consideration of the competencies an audit committee would need and that which the representatives possess. Additionally, shareholder representatives, as agents, may suffer from conflict of interests and be easily derailed from providing the needed oversight by the desire to secure positional benefits or advantages. In light of the foregoing, this writer suggests that, like other countries, and in line with global standards, it will be more fruitful to reform the Nigerian law and re-conceptualise the audit committee as a committee of the board.

## Conclusion

We live in the age of enhanced corporate governance standards and oversight of management. As this paper has shown, the audit committee has a crucial role to play in providing effective oversight or monitoring of management. As lived experiences in the corporate governance landscape have shown, earnings management, financial reporting and high-risk accounting practices are the ready devices employed by corporate managers to secure undue benefits at the expense of investors. It is these developments that have underscored the primacy of the audit committee in the areas of reliable financial reporting and effective internal control system.

Against the foregoing backdrop, this paper reviewed the legal framework for audit committee in Nigeria with a view to identifying its weaknesses and finding solutions that may help fill the gaps. Sadly one may conclude in this regard the a lot more clarifications need to be made to make in the legal framework. As indicated, resolution of the many unresolved issues, which the legal framework in Nigeria implicates, would play some gap-filling role. However, because there have been enormous developments in corporate governance practices as they relate to the audit committee, the paper also recommended that adoption of some of the global initiatives on audit committee structure, processes and functions, which could be done without any infraction of the law, would provide valuable supplement to the Nigerian law. In appropriate cases, the paper recommended outright reform of the existing law to address some of the concerns the law creates.