ROLE OF REGULATORS AND THE FUTURE OF AUDIT[1]

1. I am thankful to CII for having invited me to this Financial Reporting Conference and asking me to speak on the Role of Regulators and the Future of Audit. I view it as an opportunity to share my experiences and thoughts on the subject as we come to the conclusion of the first term of three years of the NFRA.
2. NFRA is the newest body to enter the arena of Financial Reporting and Audit Regulation. It is, therefore, natural that matters such as what exactly is the role of NFRA, what its functions and powers are, what it has done in the almost three-year period since it was set up, and what its plans for the future are, would most likely be still unclear to many. A brief summary of these matters, therefore, appears to be in order as the first item for me.
3. In addition, I wish to cover the following five subjects in this talk:
   - Standards and the Standard Setting Framework.
   - Independent, Stand-Alone Audit as a Viable Business Model.
   - The Financial Reporting Ecosystem.
   - Capacity Building of the NFRA.
   - The Future of Accounting and Audit.

What the NFRA is – the Law

4. NFRA is a creation of Sec 132 of the Companies Act, 2013. Though the section was enacted with the rest of the Act in 2013, it was finally notified only in 2018, after the PNB scam came to light. NFRA's functions are laid down by sub section (2) of Sec 132 as covering:
   a. Making recommendations to the Central Government on the formulation and laying down of accounting and auditing policies and standards for adoption by companies or their auditors. Accounting and auditing standards are now to be prescribed by Rules made under the Act by the Central Government, based on the recommendations of the ICAI, in consultation with and after examination of the recommendations of the NFRA;
   b. Monitoring and enforcing compliance with accounting and auditing standards in such manner as may be prescribed;
   c. Overseeing the quality of service of the professions associated with ensuring compliance with such standards, and suggesting measures required for improvement in the quality of services; and

[1] Speech delivered by Shri R. Sridharan, Chairperson, National Financial Reporting Authority, at **CII Conference on Financial Reporting & Governance Framework.** 16 September, 2021.

d. Performing such other functions relating to clauses (a), (b) and (c), as described above, as may be prescribed.

5. The Central Government has notified the NFRA Rules 2018 using its powers under this Section.
6. Rule 4 lays down that the NFRA shall protect the public interest and the interest of investors, creditors and others associated with the companies or bodies corporate under NFRA's purview by establishing high quality standards of accounting and auditing and exercising effective oversight of accounting functions performed by the companies and bodies corporate and auditing functions performed by auditors.
7. In addition, sub section (4) of Sec 132 vests NFRA with the power to investigate professional misconduct by any auditor of any of these companies. When such misconduct is proved, NFRA is empowered to impose monetary penalties up to ten times the fees received, and also to bar the auditor from being appointed as auditor or internal auditor of any company or body corporate for up to ten years.
8. In order to remove any chance of regulatory overlap, the said sub section very unambiguously provides that where the NFRA has initiated an investigation, no other institute or body shall initiate or continue any proceedings in such matters of misconduct.

<u>What the NFRA is – A Regulator of Corporate Financial Reporting</u>

9. It has become common to describe NFRA as an independent audit regulator. Audit Regulation is indeed a very important part of NFRA's role definition, but this does not exhaust the entire definition. Rule 4, that I read out earlier, requires NFRA to monitor the entire financial reporting chain. Indeed, the coherence and integrity of NFRA's objective will be meaningfully achieved only if Corporate Financial Reporting in its entirety is treated as being its legitimate remit.
10. Right from its inception, NFRA has been proceeding with its work programme only on the basis of this understanding.
11. Very early on, NFRA adopted a Charter for itself, to govern what it will do and how it will go about doing it. The Charter, which is available on our website[2], is as follows:

    - The objective of the National Financial Reporting Authority (NFRA) is ***to continuously improve the quality of all corporate financial reporting*** in India.

[2] https://nfra.gov.in/nfra-charter

- The quality of corporate financial reporting will be measured and evaluated essentially by its compliance with the law and the statutorily notified accounting standards and auditing standards.
- NFRA will strive for continuous improvement of corporate financial reporting across all types of Public Interest Entities (PIEs) and across all size categories of audit firms.
- NFRA aims to be an organization noted for *integrity, industry, and competence*.
- Persons who work for NFRA will adhere to the highest standards of *uncompromising integrity*, possess *a vision of transforming the quality of corporate financial reporting*, and display *high levels of initiative* and an *unflagging drive* for their work.
- NFRA aspires to known for:
- *Objectivity* - No subjective action from either members or staff, openness to all facts/views/opinions without any pre-conceived conclusions or pre-judging any matter.
- *Integrity* – Across cases/persons/firms, absence of multiple standards, uniform treatment of all those identically/similarly placed.
- *Impartiality* – Discharge of its functions without fear or favour.
- *Independence* – Equidistant from all stakeholders.
- *Fairness* – Not imposing unfair burdens especially with the benefit of hindsight
- *Transparency*– Fair and open processes.
- NFRA's functioning will at all times be mindful of the need to promote the ease and speed of doing business, and *will be guided always by the overall public interest*, with all its actions being strictly anchored by and lying within its legal mandate.

<u>What the NFRA is – its Domain</u>

12. Rule 3 specifies what classes of companies would fall under the purview of the NFRA. Other rules lay down what procedures should be followed in discharging the functions specified in the Act, some details about the internal administration of the NFRA etc.
13. NFRA's jurisdiction covers what has now come to be known as Public Interest Entities or PIEs. These are:

    all listed companies;

unlisted public limited companies with either turnover, or share capital, or borrowings, above certain specified thresholds[3];
all banking, insurance, and electricity generation and supply companies;
foreign subsidiaries of these entities of a certain size; etc.

In addition, the Central Government can make a reference to the NFRA for action in respect of any other company, or class of companies, in the public interest.

14. The total number of companies that come under NFRA's jurisdiction, based on the criteria in the Rules, is quite large. As of 31st March, 2019, we have identified 6465 such companies. Of these, 5356 are listed companies, 1011 are unlisted companies satisfying the prescribed threshold criteria, and 98 are banking, insurance, and electricity companies[4].
15. The auditor profile of these listed companies is equally diverse. NFRA has been able to obtain the names of auditors in respect of 5023 out of the total of 5356 companies. There is a total of 2304 auditors who audit these 5023 companies. Of these, 1578 auditors audit only one company each. At the other end, there are two individual firms that audit more than 100 companies each. The network firms of the Big Four account for 522 companies, and 75% of the market capitalisation. It is interesting to note that, in 2017, there were a total of 1925 audit firms registered with the PCAOB, of which 1390 did not issue any audit reports. The PCAOB had to, effectively therefore, deal with only 535 audit firms.
16. The listed companies are also exceedingly diverse in size. The Association of Mutual Funds of India (AMFI) periodically publishes a classification of listed companies into large cap, medium cap, and small cap[5]. The top 100 companies are classified as large cap. The market cap of this category is from Rs 13.46 lakh crores, down to Rs 37,746 crore. The next 150 companies are mid cap. Their market cap goes from Rs 36954 crores, down all the way to Rs. 11819 crores. The remaining are small cap, with market cap from Rs 11735 crores to Rs. 0.02 crores at the end. As many as1860 companies, out of the 5059 in the AMFI list, have a market cap of below Rs. 10 crores. The number below Rs 100 crores is 3276. The great diversity amongst listed companies perhaps is indicative of the need to define PIEs in a more restricted manner. Would it be really possible to have an effective audit committee for the smallest listed companies is also one question we need to ask.

How the NFRA Came About to Be

[3] Presently, these thresholds are Rs 500 cr of paid up capital, or Rs 1000 cr of turnover, or aggregate loans, debentures and deposits of Rs 500 cr.
[4] https://nfra.gov.in/nfra_domain
[5] https://www.amfiindia.com/research-information/other-data/categorization-of-stocks

17. As I explained earlier, NFRA is also what is called globally as an Independent Audit Regulator or IAR for short. All of you, I am sure, are fully aware of the events that rocked the audit and accounting profession around the turn of the century. The USA then saw the collapse of Enron and WorldCom, and also of Arthur Andersen, who audited the two companies, within a short span of time. The consensus then was that a fundamental reform of the manner in which accounting and auditing were conducted and regulated had to be brought about. This resulted in the US Congress enacting what is known as the Sarbanes Oxley Act, or SOX for short. SOX provided for the setting up of the Public Company Accounting Oversight Board, PCAOB for short, and for Strengthening Auditor Independence. It also provided for Increased Corporate Responsibility for Financial Reports, Enhanced Financial Disclosures by Companies, Corporate and Criminal Fraud Accountability, Enhanced Penalties for White Collar Crimes, etc. Clearly, the leitmotif of SOX is the protection of investors, and the entire architecture of institutional reform that SOX brings about is designed to achieve this end. The PCAOB commenced in 2002, and has, in many ways, been a trail blazer and exemplar in this area. We also need to keep in mind that SOX brought about major changes in corporate responsibility for financial reporting, the enforcement of which is largely with the SEC.

18. In a recent speech[6] on "PCAOB 3.0: The Evolving Role of Investor Protection at the PCAOB" J Robert Brown, a member of the PCAOB, said that:

> "The PCAOB is an almost two decades experiment in the oversight of the audit profession by an independent regulatory organization. Before 2003, the audit profession was subject to self-regulation, a time when standards were written by practicing auditors without adequate public input and inspections were conducted by peer audit firms, a practice subject to extensive criticism.
>
> "The creation of the PCAOB ended the era of self-regulation. Perhaps the most far-reaching change made by Congress in setting up the PCAOB was to include in the statute an explicit mission to act in the interests of investors and the public. In setting standards, conducting inspections, and imposing disciplinary sanctions, the explicit objective was and is to act in the public interest".

19. After SOX, India went through the 2006 amendment to the Chartered Accountants Act that established the Quality Review Board, as a purely recommendatory body. The Satyam matter of 2009 saw the enactment of Sec 132 in the Companies Act, 2013. The PNB scam saw the section being brought into force.

[6] https://pcaobus.org/news-events/speeches/speech-detail/pcaob-3.0-the-evolving-role-of-investor-protection-at-the-pcaob, accessed on 16 Dec 2020.

20. Many countries all over the world have also set up IARs. There is also an International Forum of IARs, IFIAR, which has 55 member country IARs. Membership of IFIAR is open to regulators that are both: (a) Independent of the audit profession; and (b) Engaged in audit regulatory functions in the public interest.
21. IFIAR has drafted and adopted 7 Core Principles[7] that seek to promote effective independent audit oversight globally, thereby contributing to Members' overriding objective of serving the public interest and enhancing investor protection by improving audit quality. These Core Principles are as follows:
    a. The responsibilities and powers of audit regulators should serve the public interest and be clearly and objectively stated in legislation. The responsibilities and powers of audit regulators should, at a minimum, require independent oversight of the audits of public interest entities.
    b. Audit regulators should be operationally independent. The audit regulator should be operationally independent from external political interference and from commercial, or other sectoral interests, in the exercise of its functions and powers, including not being controlled in its governance by audit practitioners.
    c. Audit regulators should be transparent and accountable.
    These three core principles are grouped by IFIAR under Structure. The remaining four core principles are grouped under Operations.
    d. Audit regulators should have comprehensive enforcement powers which include the capability to ensure that their inspection findings or recommendations are appropriately addressed; these enforcement powers should include the ability to impose a range of sanctions including, for example, fines and the removal of an audit license and/or registration.
    e. Audit regulators should ensure that their staff is independent from the profession and should have sufficient staff of appropriate competence.
    f. Audit regulators should be objective, free from conflicts of interest, and maintain appropriate confidentiality arrangements.
    g. Audit regulators should make appropriate arrangements for cooperation with other audit regulators and, where relevant, other third parties.
    Though stated in terms of Audit Regulation, these principles apply equally to a Financial Reporting Regulator such as the NFRA.

<u>What the NFRA is – Activity so far</u>

[7] https://www.ifiar.org/?wpdmdl=2113, accessed on 16 Dec 2020.

22. NFRA has defined its objective as the continuous improvement of the quality of corporate financial reporting in India. This objective is directly derived from both the Act and the Rules. Thus, NFRA's objective is not limited only to Audit Quality. NFRA has, therefore, designed its work programme to focus on this objective.
23. Rules 7 to 9 of the NFRA Rules specifically require the Authority to monitor and enforce compliance with accounting standards and auditing standards and oversee the quality of audit services. These Rules also lay down the processes by which such functions are to be carried out. The Inspection Programme that NFRA has instituted, pursuant to the above, has two components. The components are the Financial Reporting Quality Reviews, or FRQR for short, and the Audit Quality Reviews, or AQR for short.
24. Financial statements are presented as an integral part of the Annual Report of the Company. The Annual Report has many inter linkages amongst its constituent parts. NFRA's primary role, as explained in Rule 4 of the NFRA Rules, is to protect the public interest and the interests of investors, creditors, and others associated with companies or bodies corporate. The Annual Report is the mechanism through which all the information required by these stakeholders is sought to be provided. The primary objective of the FRQR is to assess and evaluate how well the information needs of these stakeholders has been met.
25. In undertaking the FRQR, NFRA's role also includes monitoring compliance with accounting standards.
26. The FRQR focuses on the role of preparers, i.e., those responsible for the preparation of financial statements and reports in accordance with the applicable accounting standards. Therefore, the FRQR evaluates how well the Chief Financial Officer, and the rest of the Management, and the Audit Committee, as well as the Board of Directors of the Company, have performed in preparing financial statements that show a true and fair view as required under the Companies Act, and in accordance with the applicable accounting standards.
27. The FRQR concludes with an advisory to the preparers, highlighting the matters that need improvement. In case there are violations of accounting standards and the law that require action to be taken under the law, the matter is reported to the authorities who can take action.
28. The AQR, on the other hand, has the objective of verifying compliance by the Audit Firm with the requirements of Standards on Auditing relevant to the performance of the Engagement. The AQR also has the objective of assessing the Quality Control system of the Audit Firm and the extent to which the same has been complied with in the performance of the engagement. NFRA's AQR process starts by asking the Audit Firm to provide to NFRA the Audit File (as defined by Para 6(b) of SA 230). Thereafter, the Audit Firm is issued a questionnaire. Once the Audit Firm provides its response to the questionnaire, the matters raised in the questionnaire are examined by referring to the relevant portion of the Audit File as identified by the Audit Firm. Subsequently, NFRA conveys its prima facie

observations/comments/conclusions on the various issues in the questionnaire to the Audit Firm. The Audit Firm's responses to NFRA's prima facie observations are examined and a Draft Audit Quality Review Report ("DAQRR") is then issued. The Audit Firm submits its written reply in response to the DAQRR. This is followed by a presentation to NFRA, if the Audit Firm so desires. After considering all the submissions made by the Audit Firm, NFRA completes its review and publishes the final report as mandated by the law.

29. Sec 132 of the Act empowers the NFRA to take action against auditors for professional misconduct. However, as far as other functionaries of the company who have a responsibility for financial reporting are concerned, penal powers continue to be vested with the Central government. This is so even as regards matters such as unacceptable delays in filing periodical returns with NFRA. To enhance the effectiveness of the implementation of the law, it is necessary to consolidate all the necessary penal provisions relating to financial reporting, and to vest them in the NFRA. This will allow for integrated regulation of all the participants in the financial reporting system.
30. NFRA's AQR activity thus far has been dictated by the cases that have led to major financial scams recently.
31. Going forward, NFRA proposes to adopt a risk-based approach for selection of companies. This has been outlined in NFRA's Conclusions on its recent Consultation. The factors that will be considered in this process will be grouped into two categories: External Impact Factors; and Risk of Material Misstatement ("RoMM") Factors. External Impact Factors will cover all metrics that seek to understand, identify and measure the financial impact that a company has on the economy and the environment. ROMM factors will identify metrics that can potentially predict the RoMM that may either escape the attention of auditors, or could be overlooked by auditors.
32. In respect of each of these two broad categories of indicators, companies would be classified into one of three buckets based on substantial, moderate and low external impact in terms of the External Impact Factors, and high, moderate and average RoMM.
33. Once the comprehensive list of metrics and their calculation methodology are detailed, a suitable method for calculating the Composite Index of the metrics under each category and the ranges for each of the three buckets under each category will have to be developed.
34. The result of the above classification would be a 3by3 matrix. NFRA will give the highest priority to companies which are in the high RoMM/substantial external impact cell. Whereas companies which are in the average RoMM/low external impact cell would normally not be subject to detailed enquiry, unless the resource position of NFRA so permits.
35. The selection criteria of companies and audits for Inspections will also include random methods of selection so as to ensure that appropriate responses are possible to emerging situations. NFRA is conscious of the need for transparency in the approach to Inspection.

However, NFRA has also to consider any unintended consequences that could follow upon complete and detailed disclosure of the risk-based methodology, in terms of the potential risk of loss of the element of surprise. This could prove detrimental to the effective discharge of NFRA's functions and duties. Therefore, NFRA will disclose only the high-level principles of its Inspections approach.

36. NFRA has so far published four Audit Quality Review Reports. Some more are in progress. Three Disciplinary Orders have also been finalised. NFRA has also forwarded one report to Government for action against functionaries other than auditors. What these Reports and Orders have done is to clearly enunciate what NFRA will look at when it examines audit quality, and in what manner. They also clarify the scope available under the law for the provision of non-audit services by the statutory auditor, and the understanding of terms such as professional misconduct, gross negligence, lack of due diligence, etc, as applied to disciplinary proceedings under Sec 132(4). In all these matters, we believe that NFRA has broken new ground. NFRA has explained why it would also be necessary for the courts to examine all these matters afresh. The jurisprudence on this subject is yet to evolve and get stabilised. One reason is the paucity of case law. The other, and more important, reason is the vast change in the context and rationale for audit regulation that has happened in the years since Enron. We are not yet at a point where the higher judiciary has started engaging itself with these issues. Nevertheless, NFRA is confident that the approach it has adopted is robust enough to withstand critical judicial scrutiny.

Standards and the Standard Setting Framework

37. NFRA measures the quality of corporate financial reporting essentially by its compliance with the law and the statutorily notified accounting standards and auditing standards.
38. Attempts by various regulators to reduce Audit Quality to a single numerical index have not so far been successful. In practical terms, Regulators use the extent of non-compliance with auditing standards as the measure of audit quality.
39. The accounting and auditing standards in force in India are almost entirely the same as their global counterparts. Divergences from the global standards are minimal.
40. As far as accounting standards are concerned, the Finance Minister announced in his 2014 Budget Speech that "There is an urgent need to converge the current Indian accounting standards with the International Financial Reporting Standards (IFRS). I propose for adoption of the new Indian Accounting Standards (Ind AS) by the Indian companies from the financial year 2015-16 voluntarily and from the financial year 2016-17 on a mandatory basis" (Para 128). The coverage of Ind AS, which are converged with the IFRS, has progressively expanded. As far as Auditing Standards go, the ICAI states that "It is one of the membership

obligations of the Institute to actively propagate the pronouncements of the International Auditing and Assurance Standards Board (IAASB) of the IFAC to contribute towards global harmonisation and acceptance of the Standards issued by the IAASB"[8]**.** These Standards adopted by the ICAI have now got statutory recognition.

41. In a sense, it can be said that we have put the process of standard-setting out of the scope of influence of domestic interest lobbies. There is also no gainsaying the fact, as NFRA's experience so far indicates, that compliance with these standards is likely to achieve a high quality of financial reporting. At the same time, we need to be aware of the influence of various international lobbies in the standard-setting process. This seems to be well documented in the relevant academic literature.
42. In his book titled *Political Standards*[9], Karthik Ramanna describes the standard-setting process as representing a "thin political market". Such markets are, he says, by their very nature one-sided and unrestrained vis-à-vis the general interest. "Accounting rules cannot be determined without the substantive expertise and experience of special-interest groups that, by definition, also have strong commercial interests in the outcome and enjoy little political opposition from the general interest because of the abstruse nature of the subject matter"[10].
43. Based on extensive research on the standard-setting process in the US and with the IFRS, Ramanna concludes that "In several instances, I find evidence of rules that benefit one or more special-interest groups (e.g., industrial corporations, financial firms, and audit firms) at the potential expense of the general interest. In other words, the evidence suggests special-interest capture of the accounting rule-making process. But unlike the traditional understanding of capture, where powerful interest groups are able to strong-arm regulators to obtain rules in their favour, several instances of capture in accounting rule-making are more subtle"[11].
44. Sometimes, even governments seem to swing into action. Ramanna recounts at length how China was able to force a significant dilution in the disclosures of Related Party Transactions in the case of state-owned enterprises because of the need to get their financial statements accepted in global anti-dumping investigations. Ramanna also describes Tata Steel's role in the introduction of para 46 in AS 11.
45. Given the fact that we have adopted global standards almost completely, our attempt must be to enhance our participation, and increase our voice, in the standard setting process. If we were to look at the period from 2011 onwards till June 2021, there were a total of 186

[8] *Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*. Institute of Chartered Accountants of India. 2008
[9] Ramanna, Karthik. *Political Standards. Corporate Interest, Ideology, and Leadership in the Shaping of Accounting Rules for the Market Economy.* 2015. The University of Chicago Press.
[10] Ibid. p xviii
[11] Ibid. p xvii.

completed IFRS Projects. Indian bodies had commented in 102 cases. Of these, the ICAI had commented on 70, SEBI on 62, and other agencies and individual companies on 10. As far as Auditing Standards go, the ICAI has participated in the consultation on one standard, out of 11, in the same period.

46. Our focus on Ind ASs would benefit from hard data about the actual coverage of the standards. As of 31 March, 2021, MCA reported 12,99,710 registered companies. Of these, 65,942 were public limited companies, 36524 were One Person companies and 11,97,244 were private limited companies. Ind ASs apply to all listed companies, and companies with a net worth of Rs 250 crores or more. According to MCA 21 statistics as of 31 March, 2019, only 3568 companies in India with net worth exceeding Rs 250 crores had filed their returns till June 2021. Of these, 2939 had filed under Ind AS. On the other hand, 14581 companies with net worth below Rs 250 cr have also filed under Ind AS. The initial understanding is that these companies below Rs 250 cr net worth have filed under Ind AS because they are listed, or they are subsidiaries, associates etc of companies covered by Ind AS. This would seem to indicate that we need to examine if Ind AS based accounting and auditing is the best way to go in respect of all companies. There is a very large segment of corporate entities for whom appropriate accounting and auditing standards need to be framed. This should prove a fertile area for coordinated research between academics, professionals, and regulators.
47. NFRA needs to consider standard-setting as a core activity and build up expertise so as to effectively promote the public interest.

Independent Stand-Alone Audit as a Viable Business Model

48. Starting with Enron, the deleterious impact of the provision of non-audit services on the independence of the auditor has been well-documented. Arthur Andersen's conflicts of interests leading to loss of independence were significant. It is said[12] that Arthur Andersen was accused of applying lax standards in its audits because of a conflict of interest over the significant consulting fees generated by Enron. During 2000, Arthur Andersen earned $25 million in audit fees and $27 million in consulting fees. Healy and Palepu say that "Whether the auditors at Andersen had conflicted incentives or whether they lacked the expertise to evaluate financial complexities adequately, they failed to exercise sound business judgment in reviewing transactions that were clearly designed for financial reporting rather than business purposes. When the credit risks at the special purpose entities became clear, requiring Enron to take a write-down, the auditors apparently succumbed to pressure from

[12] Healy, Paul M. and Krishna G. Palepu. *The Fall of Enron*. Journal of Economic Perspectives—Volume 17, Number 2—Spring 2003—Pages 3–26. https://pubs.aeaweb.org/doi/pdfplus/10.1257/089533003765888403, accessed on 16 Dec 2020.

Enron's management and permitted the company to defer recognizing the charges. Internal controls at Andersen, designed to protect against conflicted incentives of local partners, failed"[13] . According to a UNCTAD paper "Both the Powers Committee and bodies of the United States Senate which have investigated Enron's collapse have taken the view that lack of independence linked to its multiple consultancy roles was a crucial factor in Andersen's failure to fulfil its obligations as Enron's external auditor"[14].

49. Mark Stevens[15] traces the origin of the growth in importance of non-audit services to the competitive pressures of the 1980s. Amongst the Big Eight, he says, client companies could perceive no significant difference. In the more recent words of John Kingman, "Certainly, among the Big 4, audit services are frankly often much of muchness".[16] Hence, clients were interested in CPAs who could serve as business advisers[17]. Andersen proved itself early to be the smartest, most aggressive player in the new consulting game[18].
50. The National Commission on Fraudulent Financial Reporting of the US, known as the Treadway Commission, reporting in 1987, had said that:

> "The tone that the top managements of public accounting firms set is just as important in the firms as that set by top managements in public companies. Many public accounting firms are large organizations in which personnel face institutional and individual pressures not unlike those that personnel of public companies face. In public companies such pressures have the potential to contribute to fraudulent financial reporting. In both large and small public accounting firms, these pressures have the potential to compromise the skepticism and professional judgment that are critical to audit quality and the detection of fraudulent financial reporting"[19]. They also specifically referred to Fee and Budget Pressures and said that "Intense competition among accounting firms contributes to significant pressure on audit fees, often with corresponding pressure to reduce staff, time budgets, and partner involvement in audit engagements. Such pressures may not be conducive to the thorough investigation of

[13] Ibid, p. 15
[14] Cornford, Andrew. Enron And Internationally Agreed Principles for Corporate Governance and The Financial Sector. http://www.unctad.org/en/docs/gdsmdpbg2420046_en.pdf, accessed on 16 Dec 2020. p. 9.
[15] Stevens, Mark. *The Big Six. The Selling Out of America's Top Accounting Firms*. 1991. Simon and Schuster.
[16] Kingman, Sir John. Letter to the Secretary of State, Department of BEIS, December, 2018. p 4. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/765547/auditor-appointment-letter-to-greg-clark-december-2018.pdf. Accessed 15 Sep, 2021.
[17] Stevens. Op Cit. p 162.
[18] Stevens. Op Cit. p 112.
[19] *Report of the National Commission on Fraudulent Financial Reporting*. October 1987. p 56. https://www.coso.org/Documents/NCFFR.pdf accessed 30 Aug 2021

red flags indicating the potential for fraudulent financial reporting or to the thorough exercise of professional judgment and skepticism."[20]

51. Reading all this at the present time, the overwhelming feeling is that we seem to have been there several times before. And yet, not much appears to have really changed.
52. The Treadway Commission, however, did not recommend the two measures that have since come to be recognised as central to curbing the incentives to go along with managements in fraudulent financial reporting. These are the elimination of self-regulation of the audit profession, and the ban on provision of non-audit services. It, however, noted the public obligation of the independent public accountant who audits the accounts of public companies.
53. The United States Supreme Court, in its 1984 decision in the case of United States vs Arthur Young had held that "An independent certified public accountant performs a different role from an attorney, whose duty, as his client's confidential adviser and advocate, is to present the client's case in the most favorable possible light. In certifying the public reports that depict a corporation's financial status, the accountant performs a public responsibility transcending any employment relationship with the client, and owes allegiance to the corporation's creditors and stockholders, as well as to the investing public".[21]
54. The foundation of good audit quality clearly is independence. The Guidance Note on Independence of the Auditors issued by the ICAI admirably summarises what this means in practice.
55. The Companies Act, 2013, has built in several provisions to give statutory backbone to the lofty idealism of the Guidance Note. Sec 144 of the Act lists several categories of non-audit services that a statutory auditor is prohibited from providing. Sec 141(3) prohibits auditors with subsisting business relationships from being appointed as auditors, or continuing as such if any such assignments are taken up. Sec 144 prohibits these non-audit services from being provided either directly or indirectly. The explanation to Sec 144 gives a comprehensive meaning to the word "indirectly" saying that the provision of the prohibited services by any one of five modalities would attract the ban.:
56. In a sense, India has already built into law the separation of audit and non-audit services that other countries are only now attempting to achieve. For instance, the UK FRC, after having waited futilely for the government to make the necessary changes in the law, has issued a 22 point action plan for the Big Four to operationally separate their auditing units[22]. They have

[20] Ibid. p 56

[21] United States v. Arthur Young & Co., 465 U.S. 805 (1984)

[22] Financial Reporting Council. Operational Separation Principles. 3 July, 2020. https://www.frc.org.uk/getattachment/281a7d7e-74fe-43f7-854a-e52158bc6ae2/Operational-separation-principles-published-July-2020.pdf. Accessed on 18 Dec 2020.

been given four years to actually put this into effect. This FRC edict has been described by the *Financial Times* as marking the largest shake-up of the industry in decades[23]. The FRC's plan seeks to ensure the firms pay auditors in line with the profits of their audits, ringfence the finances of the audit division with a separate profit and loss account, and introduce an independent audit board to oversee the practice.

57. The questions that are left to be resolved are whether such an independent, stand-alone, audit, conducted in full compliance with the prescribed standards, is likely to be a viable business model at current rates of auditors' fees; and, if not, which is my understanding of the situation, what can and should be done, in the light of the valuable public good nature of independent audit. Certainly, an audit, rigorously conducted in compliance with the standards, is not something that would be considered as value additive by managements. The reluctance on the part of managements to spend anything more than the absolute minimum on this activity is understandable. On the other hand, the apathy towards good quality financial reporting among user groups is a great dampener. Sir John Kingman proposes that the auditor be appointed, and his fee fixed, by an independent body representing the public interest. He identifies the restructured audit regulator as the body for doing this[24]. I do not agree with this recommendation. A regulator who appoints an auditor cannot sit in judgement on the performance of the very same auditor. I am sure industry and the profession will get together to provide satisfactory answers.
58. To provide some perspective, I will share some data about this matter. Our standard cost estimate for a proper statutory audit, in accordance with the auditing standards, , is around Rs 1.5 lakhs even assuming a Tier 3 town location. We examined the audit fees paid by a sample of 3,91,021 unlisted companies who have filed audit fees paid data. Around 30 % of them paid less than Rs 10,000 as audit fees and another 30 % paid between Rs. 10,000 and Rs 25,000. It is hard to believe that any CA would sign an auditor's report that carries significant professional and legal responsibilities for such low amounts. Unless, of course, there is virtually zero likelihood of being held liable for bad work.

The Financial Reporting Ecosystem

59. I wish to talk specifically about two important components of this ecosystem. They are the judicial system and the investor/user community.

[23] UK's Big Four accounting firms told to outline plans for audit split by October. Financial Times, 6 July, 2020. https://www.ft.com/content/4464e0a3-9ba2-47d2-9f85-3f2912a22f25. Accessed 20 Dec, 2020.
[24] Kingman. Op Cit. p1

60. One suggestion made by several respondents to NFRA's recent Consultation Paper[25] is that NFRA should introduce a Settlement Mechanism[26]. SEBI's example is also given in this regard. One obvious difficulty is that the law does not now provide for such a mechanism for NFRA. Even in the case of SEBI, the jury is out on whether the existence of legal backing has made for any great effectiveness of the settlement system.

61. The answer is to be found in the speed and the effectiveness of the judicial system. For reasons known to everyone, cases in our courts take a long period of time to reach a finality. The incentive to accept a settlement offer is directly proportional to the speed and rigour of the judicial process. It is here that the US system seems to score much better. Even such a person as Rajat Gupta found himself in jail within a very short period after proceedings had started against him. This system generated pressure is clearly reflected in the enforcement orders of the PCAOB. Out of 357 orders passed from 2003 to 2021, 310 were settlement orders, and only 47 were adjudicated orders. The contrast could not be starker than in the case of Satyam. Satyam's auditors were quick to settle with PCAOB. The scandal broke out in Jan 2009. PCAOB launched a formal investigation soon after. The auditors settled with the PCAOB, accepting the penalties, and paying a fine of USD 1.5 million in April 2011. On the same day, the auditors also accepted the SEC's cease-and-desist orders and paid a penalty of USD 6 million. In addition, PwC India and PwC International agreed to settle a shareholder class-action suit in April 2011 by paying $25.5 million.[27] As far as my information goes, the matter has, however, not yet reached finality in India.

62. The apathy of the investor/user community seems to be a problem even in countries like the UK. The US has traditionally been known as a society with a high propensity to litigate. The potential liability arising out of certifying misleading financial statements has been identified as a source of the pressure for high audit quality. Prof Suraj Srinivasan of the Harvard Business School, explains the matter in the following words: "Auditors' incentive to do a good job is to maintain their reputation……The complement to reputational incentives is the litigation system. The US is somewhat unique in having a strong class-action litigation system through which investors can hold companies accountable after the fact when there is a problem. For investors, this is how they can partly remedy the harm". But even in the US, recent research has shown that lawsuits against auditors for accounting violations have fallen

[25] https://nfra.gov.in/consultation_papers

[26] In a Settlement Mechanism the party charged with a failure to act in accordance with a legal requirement agrees with the regulator to pay an agreed amount without admitting or denying the charge. Generally, the matter ends there. In an Adjudication Mechanism the regulator passes an order recording a finding of failure and specifying the amount of monetary and other penalties. In this case, the party has the right to go on appeal against the regulator's order in accordance with the law.

[27] https://amlawdaily.typepad.com/satyampwcsettlementstip.pdf

over the past 20 years[28]. The researchers, of whom Prof Srinivasan is one, attribute this to two decisions of the US Supreme Court in 2007 and 2011 that effectively narrowed liability standards by requiring plaintiffs such as institutional investors to prove that auditors knew, or should have known, that their clients' financial statements contained errors.

63. The Companies Act, 2013, has introduced a provision for members or depositors of a company to claim damages or compensation from the auditor for any improper or misleading statement of particulars made in his audit report or for any fraudulent, unlawful or wrongful act or conduct. (Sec 245(1)(g)(ii)). We are yet to see the results of action either under this section or under Sec 447.

Capacity Building of the NFRA, especially administrative and financial autonomy.

64. NFRA operates on the basis of a single section in the Companies Act, 2013. This section does not provide a comprehensive coverage of all the functions and powers that are required to constitute the NFRA as a Corporate Financial Reporting Regulator. Besides, the statute treats the NFRA essentially as a subordinate office of the Ministry of Corporate Affairs with only such administrative and financial powers as the Ministry may choose to delegate. In the interests of the functional, financial, and administrative autonomy of the NFRA, there is a compelling need for a stand-alone legislation. This will be the key also to build up the regulatory capacity of the NFRA. The Technical Advisory Committee of the NFRA has been entrusted with the task of developing a draft law.

Future of Accounting and Audit

66. I now come to the Future of Audit. In significant measure, audit will continue to follow accounting, which, in turn, should follow developments in business and industry. Given the diversity amongst corporate entities in the country, it appears to me that it would be more appropriate to speak instead about the several Futures of Accounting and Audit.
67. At one end, we have companies at the cutting edge of technology and innovation, funded largely by the early stages of venture capital. Every day, we hear of one or the other company having achieved unicorn status.
68. At the other end, we have a huge number of companies whose turnover, profits, and market cap in the case of listed companies, are very small in absolute terms. Questions that would naturally arise, seeing this diversity, are whether uniform accounting and auditing standards

[28] https://hbswk.hbs.edu/item/investor-lawsuits-against-auditors-are-falling-and-that-s-bad-news-for-capital-markets. Accessed on 12 Sep, 2021.

are the way to go, and even whether even compulsory statutory audit of general purpose financial statements is desirable in the case of the vast majority of companies who do not seem to be able to afford the same. These companies, which would be largely micro, small, and medium enterprises (MSMEs) are essentially family-owned enterprises formed as companies for the sake of limited liability, or to get bank loans, bus route permits, mining licences, and the like. They are effectively glorified proprietorships or partnerships. There is no public interest in foisting external audit on them. In any event, it is clear that such audit as is being carried out cannot boast of any quality at all. Banks can direct them to have an audit as a condition for giving them loans, but that would be a private matter. Exempting small companies from mandatory audit would result in furthering ease of doing business for MSMEs and reducing the compliance burden and costs on such enterprises. A recent example is the increase in the turnover threshold for mandatory tax audit from Rs 5 crore to Rs 10 crore in the Finance Act, 2021. Similar considerations would seem to apply in the case of most small cap listed companies also. Perhaps, the minimum eligibility criteria for stock exchange listing have to be reviewed.

69. As far as high tech companies go, there is the view of Baruch Lev and Feng Gu, backed by extensive research, that the poor quality of even "honest" financial reports, legitimately disclosed under the current, universally used accounting system, seriously harms capital allocation and economic growth[29]. Lev and Feng conclude that corporate quarterly and annual reports contribute only 5 to 6 % of the total information used by investors. They say that what is instead required is a Strategic Resources and Consequences Report that would overcome the three causes for the loss of relevance of accounting. These causes, according to them, are the accounting for intangibles in a manner that does not reflect their real importance, the piling up of estimates in the financial statements, and the non-recording of the events that affect corporate value, given that accounting operates only if there are transactions between entities. There is much in what they say that should stimulate thinking, not the least of which would be the role, methodology, and significance of accounting and auditing, as traditionally understood, in the case of these companies.
70. In any discussion on the future of audit, it is de rigeur to speak of blockchain, AI, Machine Learning, ESG etc. I will not go there because there are others who are better experts at this than me.

Summing Up

[29] Lev, Baruch and Feng Gu. *The End of Accounting and the Path Forward for Investors and Managers*. 2016. John Wiley and Sons Inc.

71. Company Financial Statements and their audit are examples of regulation of companies. The design of this regulation has to be clear about its objectives, be grounded in precise data about the regulated entities and their characteristics, and differentiated in a manner that acknowledges their heterogeneity. At every stage, the design of regulation has to be conscious of available regulatory capacity, and the real costs thereof versus the hoped for benefits.
72. Given some of the facts described above, it would appear that there is great need, and scope, for serious examination of the present system.
73. As far as NFRA itself is concerned, our focus will be clearly concentrated, in the manner described above in detail, on companies with the greatest external impact. Our aim will be to create conditions that would reassure those who have to deal with such companies about the basic reliability of their financial statements.

Thank you.