THE ROLE OF THE NATIONAL FINANCIAL REPORTING AUTHORITY IN INDEPENDENT AUDITOR REGULATION[1]

1. I deem it a great privilege to participate in the conference of the WIRC of the ICAI. I understand that the WIRC is the largest Regional Council of the ICAI, and that it has been consistently adjudged as the Best Regional Council of the ICAI. It counts many of the country's most distinguished CAs amongst its Members, including several Presidents of the Institute. NFRA's mandate and purpose is focused on continuous improvement in corporate financial reporting. This task is to be achieved in significant measure through the work of CAs, both as preparers, and as auditors, of financial statements. I understand that around 2500 delegates are taking part in this conference. This conference is, therefore, a tremendous opportunity for me to share with the CA community an idea of what NFRA is about, what we have done so far, and what our approach is to the task of improving the quality of corporate financial reporting.
2. 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 recommendation of the ICAI, in consultation with and after examination of the recommendations of the NFRA;
    b) Monitoring and enforcing compliance with the accounting and auditing standards;
    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 of R. Sridharan, Chairperson, NFRA, as Chief Guest at the 35th Regional Conference of the Western India Regional Council of The Institute of Chartered Accountants of India on Dec. 24, 2020

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

3. The Central Government has notified the NFRA Rules 2018 using its powers under this Section. The Rules specify what classes of companies would fall under the purview of the NFRA, what procedures should be followed in discharging the functions specified in the Act, some details about the internal administration of the NFRA etc.
4. NFRA's jurisdiction covers what may be called 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, subsidiaries of these entities of a certain size etc. The total number of these companies is quite large. We estimate that over 6000 companies would fall under NFRA's purview.
5. NFRA is 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, WorldCom, and Arthur Andersen 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. This Act is described as "An Act To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes". SOX provided for the setting up of the Public Company Accounting Oversight Board, PCAOB for short, Strengthening Auditor Independence, 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.

6. In a recent speech[2] 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[3] and inspections were conducted by peer audit firms, a practice subject to extensive criticism.[4]
7. "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.[5] In setting standards, conducting inspections, and imposing disciplinary sanctions, the explicit objective was and is to act in the public interest".
8. Since then, many countries all over the world have 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.
9. IFIAR has drafted and adopted 7 Core Principles[3] 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:
    1. 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.
    2. Audit regulators should be operationally independent. The audit regulator should be operationally independent from external political interference and from commercial, or

[2] 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.
[3] https://www.ifiar.org/?wpdmdl=2113, accessed on 16 Dec 2020.

other sectoral interests, in the exercise of its functions and powers, including not being controlled in its governance by audit practitioners.

3. 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.

4. 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.

5. Audit regulators should ensure that their staff is independent from the profession and should have sufficient staff of appropriate competence.

6. Audit regulators should be objective, free from conflicts of interest, and maintain appropriate confidentiality arrangements.

7. Audit regulators should make appropriate arrangements for cooperation with other audit regulators and, where relevant, other third parties.

10. NFRA was notified on 1st October, 2018. Under the Act, the Secretary and other employees required for the efficient functioning of the NFRA are to be appointed by the Central Government on such terms and conditions as may be prescribed. This process has been initiated and the building up of organisational capacity and competence is on going.

11. NFRA has taken up Audit Quality Reviews, or AQRs in short, in the first phase of its functioning. NFRA has described the AQRs[4] as having the objective of verifying compliance with the requirements of the Standards on Auditing, or SAs in short, relevant to the performance of an Engagement by an Audit Firm. 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. The AQR is undertaken in terms of Rule 8 of the NFRA

[4] For this, and subsequent paras dealing with the AQRs, please refer to https://nfra.gov.in/sites/default/files/AQRR%20BSR_3.pdf as an example.

Rules which provides that for the purpose of monitoring and enforcing compliance with auditing standards under the Act, NFRA may:

(a) Review working papers (including audit plan and other documents) and communications related to the audit;

(b) Evaluate the sufficiency of the quality control system of the auditor and the manner of documentation of the system by the auditor; and

(c) Perform such other testing of the audit, supervisory and quality control procedures of the auditor as may be considered necessary or appropriate

12. NFRA has clarified that the AQR is designed to identify and highlight non-compliance with the requirements of the SAs and to bring out insufficiencies in the Quality Control System of the Audit Firm and the shortcomings in the documentation of the audit process. The AQR also evaluates the quality and adequacy of the supervisory procedures of the Audit Firm. The AQR, NFRA explains, is, therefore, not to be treated as an overall rating tool.

13. NFRA very strictly adheres to the principle of basing its findings only on the evidence of the Audit file. The AQR process starts with obtaining the Audit File, as defined in para 6(b) of SA 230, in respect of the specific audit engagement chosen for review. This is followed by the issue of a questionnaire to the audit firm, seeking details of the relevant documents in the audit file where answers to the questions may be found. The replies received are then examined with reference to the supporting evidence in the audit file and the prima facie conclusions of the NFRA, along with the reasoning in support thereof, are provided to the audit firm. A response from the audit firm to these conclusions is obtained, and this is then further examined in detail before preparing a Draft AQR Report. This draft AQRR is then shared with the audit firm so as to provide one more opportunity for the audit firm to respond to the NFRA. The audit firm is also invited to make an oral presentation to the NFRA, if it so desires. On detailed examination of the response of the audit firm, the AQRR is finalised, and further action is processed thereon in terms of the Rules.

14. As per the directives of the Central Government, NFRA has first taken up AQRs of the ILFS Group pertaining to the period immediately before the take-over of its management by the

Government. So far, three AQRs relating to ILFS Financial Services have been published. Orders in three professional misconduct cases arising out of these AQRs have also been passed. All these are available on the website of the NFRA[5].

15. NFRA has adopted the following charter for itself. This can be seen on the NFRA website[6].

THE NFRA CHARTER

- The objective of the National Financial Reporting Authority (NFRA) is to continuously improve the quality of all corporate financial reporting in India.
- 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.
- Corporate financial reporting would have to be continuously improved 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 would have to 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 should be 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.

[5] https://nfra.gov.in/
[6] https://nfra.gov.in/charter-national-financial-reporting-authority

- 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 and lying within its legal mandate.

16. Enron was not the last occasion where a business failure was accompanied by accounting and auditing failure. Arthur Andersen's conflicts of interests leading to loss of independence were significant. It is said[7] 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 Enron's management and permitted the company to defer recognizing the charges. Internal controls at Andersen, designed to protect against conflicted incentives of local

[7] 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.

partners, failed"[8] . According to a UNCTAD paper authored by Andrew Cornford, the Powers Committee appointed to look into the firm's accounting concluded that "The evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal contracts over the related-party transactions"[9]. Cornford goes on to further record that "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"[10].

17. WorldCom was another case where Arthur Andersen were the auditors. I am mentioning this at length since the practices that led to audit failure at Enron are not entirely absent or forgotten even today. Very recently, GE agreed to pay 200 million dollars as penalty to the SEC to settle violations of the "the antifraud, reporting, disclosure controls, and accounting controls provisions of the securities laws"[11].

18. The financial crisis of 2007-08 led to serious introspection about the state of financial reporting across the world. The Financial Crisis Advisory Group that reported in 2009[12] was of the opinion that it seemed clear that accounting standards were not a root cause of the financial crisis. At the same time, the FCAG concluded, it was clear that the crisis had exposed weaknesses in accounting standards and their application. These weaknesses had reduced the credibility of financial reporting, which in part contributed to the general loss of confidence in the financial system. The weaknesses primarily involved (1) the difficulty of applying fair value ("mark-to-market") accounting in illiquid markets; (2) the delayed recognition of losses associated with loans, structured credit products, and other financial instruments by banks,

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[8] Ibid, p. 15
[9] 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
[10] Ibid, p 9.
[11] https://www.sec.gov/news/press-release/2020-312. Accessed 16 Dec 2020.
[12] https://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176156365880&d=&pagename=FASB%2FDocument_C%2FDocumentPage

insurance companies and other financial institutions; (3) issues surrounding the broad range of off-balance sheet financing structures, especially in the US; and (4) the extraordinary complexity of accounting standards for financial instruments, including multiple approaches to recognizing asset impairment.

19. One of the 4 recommendations of the FCAG was the need to progress towards convergence of accounting standards. The FCAG said that “Because of the global nature of the financial markets, it is critically important to achieve a single set of high quality, globally converged financial reporting standards that provide consistent, unbiased, transparent and relevant information, regardless of the geographical location of the reporting entity[13]”. They further emphasised that “effective financial reporting depends not only on high quality accounting standards, but also on the consistent and faithful application and rigorous independent audit and enforcement of those standards. Accordingly, even if accounting standards are converged, differences in financial reporting may arise as a result of differences in national or regional auditing standards or differences in enforcement. We believe that convergence in these areas is ultimately as important as convergence in the accounting standards themselves”[14].

20. India has also taken a decision to converge our accounting standards with the IFRS. Auditing standards have also been harmonized with globally recognised International standards issued by the IAASB of IFAC. Indian Standards, both accounting and auditing, are part of company law. Implementation of the new accounting standards is, in a sense, still work in progress, especially since these standards are not yet applicable to the banking and insurance sectors. It bears recollection that the 4 weaknesses in accounting standards, especially relating to the financial sector that the FCAG identified in 2009, are still largely relevant. As far as the Standards on Auditing are concerned, our Standards have also been redrafted under the Clarity Project. The New Format, which has been made applicable from 1st April, 2008, incorporates the fundamental principles of the Standards of Auditing (SAs) in the Requirements section of each SA, and these are represented by the use of “**shall**”, whereas prior to the new standards,

[13] Ibid, p.11.
[14] Ibid, p.12.

the word used for this purpose was "**should**". In this context, the very important practical difference that this change in language has made is best understood through the Rules of the Public Company Accounting Oversight Board (PCAOB). Rule 3101 (a) of the PCAOB Rules[15] states as follows:

> (1) Unconditional Responsibility: The words "must," "shall," and "is required" indicate unconditional responsibilities. The auditor must fulfill responsibilities of this type in all cases in which the circumstances exist to which the requirement applies. Failure to discharge an unconditional responsibility is a violation of the relevant standard and Rule 3100.
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> (2) Presumptively Mandatory Responsibility: The word "should" indicates responsibilities that are presumptively mandatory. The auditor must comply with requirements of this type specified in the Board's standards unless the auditor demonstrates that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard. Failure to discharge a presumptively mandatory responsibility is a violation of the relevant standard and Rule 3100 unless the auditor demonstrates that, in the circumstances, compliance with the specified responsibility was not necessary to achieve the objectives of the standard.

Clearly, the change in language now brought about, when read also in the context of the explanation in the PCAOB Rules, which is admittedly of high persuasive value, has cast a mandatory duty on the auditor to comply with the SAs, in an unconditional manner, unlike earlier, when the use of the word "should" provided some discretion to the auditor to show that alternative methods of compliance were possible.

21. 2009 also saw the Satyam issue. In its essentials, the audit failure in Satyam was not caused by a "rocket science" kind of problem. At the heart of the audit failure in this case were the non-performance of the most elementary of audit checks. The auditors were subject to penal action both in India and the USA. The PCAOB noted as follows in its penalty order[16]: "In the most

[15] https://pcaobus.org/about/rules-rulemaking/rules/section_3
[16] https://pcaobus.org/Enforcement/Decisions/Documents/PW_India.pdf

recent audit year, 2008, Satyam represented to the engagement team that the cash on deposit at these six banks exceeded $1 billion, which constituted approximately half of Satyam's total reported assets………In order to test the cash balance during the 2005, 2006, 2007, and 2008 Satyam audits, the engagement team planned to confirm cash with third parties. The audit procedures that the Satyam engagement team actually performed, however, failed to test the existence and valuation of this asset and, moreover, did not comply with PCAOB standards governing the confirmation process. The engagement team did not make direct contact with the six banks to confirm the bank balances that Satyam reported in its financial statements. Instead, and in violation of PCAOB auditing standards related to confirming cash, the engagement team relied exclusively on information provided by Satyam management. Indeed, the engagement team relied on Satyam management to mail out confirmation requests to Satyam's banks, and to return purported confirmation responses to the engagement team."

22. It is interesting to note that Enron had a star-studded cast of independent directors, including the former Dean of the Stanford University Business School. Satyam directors were equally distinguished, including a Professor, this time from the Harvard Business School, who ironically was the co-author of a paper on "The Fall of Enron" published in a very reputed economics journal.
23. The recently reported case of Wirecard produces a strong sense of déjà vu. 1.9 Billion euros said to be held in banks was found to be non-existent. According to the Financial Times (FT), Wirecard's auditors "failed for at least three years to request crucial account information from a Singapore bank where Wirecard claimed it had up to €1bn in cash, a routine audit procedure that could have uncovered the fraud"[17]. FT has also reported that "James Freis, Wirecard's new chief executive, has in recent days told supervisory board members that basic checks should have been enough to spot the scandal. Mr Freis told the board he did not understand how the fraud could have remained undetected for so long"[18]. The auditor's version of what led to these

[17]*EY failed to check Wirecard bank statements for 3 years*. Financial Times, 26 June, 2020. https://www.ft.com/content/a9deb987-df70-4a72-bd41-47ed8942e83b. Accessed on 18 Dec, 2020.
[18] *EY prepares for backlash over Wirecard scandal.* Financial Times, 29 June, 2020. https://www.ft.com/content/ae73160b-fd9a-4313-89f9-8fd70183158e Accessed 18 Dec, 2020.

happenings is said to be contained in a letter written to its clients by its global CEO[19]. FT has also reported that "The audit firm advised its partners to tell their clients: "There are indications that this was an elaborate and sophisticated fraud with the deliberate aim of deceiving our audit team in Germany. The CEO is accused of having inflated the balance sheet total and sales volume of Wirecard, likely in co-operation with other perpetrators, by feigning income . . . to make the company more financially powerful and more attractive for investors and customers.[20]" In a wry comment, FT further went on to say that "It seems rich to dismiss detection of a €1.9bn cash hole as something that "even the most robust audit procedures may not uncover" and added that it was "Rich, but predictable"[21].

24. The point that needs emphasis is that good audit quality starts from getting the very elementary basics right. If this is not taken care of, any talk of nuanced professional judgements in arcane business and financial matters would have to be regarded only as smokescreens meant to mislead.

25. The foundation of good audit quality is independence.

26. The Guidance Note on Independence of the Auditors issued by the ICAI states as follows[22]:

    "It is not possible to define "independence" precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence**. Independence is a condition of mind as well as personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered**. (Emphasis supplied)

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[19] *EY chairman admits 'regret' over Wirecard failures in letter to clients*. Financial Times, 15 Sep, 2020. https://www.ft.com/content/5d4dd451-e1b3-46de-b37e-c50b7b15ed6a. Accessed 18 Dec, 2020.
[20] Ibid.
[21] *EY/Wirecard: accounting for fraud*. Financial Times, 30 June, 2020. https://www.ft.com/content/f0e1faa7-ff9f-4c7e-bdfd-386fae1f5c45. Accessed 18 Dec, 2020.
[22] Institute of Chartered Accountants of India. (2005) Guidance Note on Independence of Auditors (Revised). p 6.

There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance.

The Code of Ethics for Professional Accountants, issued by International Federation of Accountants (IFAC) defines the term ‘Independence’ as follows:

“Independence is:

(a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; and

(b) Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm’s, or a member of the assurance team’s, integrity, objectivity or professional scepticism had been compromised.”

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly, he is himself satisfied about his independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors’ independence.

27. The Companies Act, 2013, has built in several provisions to give statutory backbone to the above lofty idealism. 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 the following five modalities would attract the ban:

    1. Through a parent.
    2. Through a subsidiary entity.
    3. Through an associate entity.

4. Through any other entity whatsoever in which the firm, or any partner of the firm has significant influence or control; or
5. Through any other entity whatsoever whose name or trademark or brand is used by the firm or any of its partners.

Para A16 of SA 200 refers to the need to comply with these sections.

28. 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[23]. They have 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[24]. 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.
29. Auditor independence is only a necessary condition for audit quality. To move towards sufficiency, it has to be accompanied by professional scepticism, the attitude of a questioning mind, that is always alert to conditions that may indicate possible misstatement due to error or fraud, and always critically evaluates evidence. This is an attitude that is required not only or even specially in auditing. This scepticism is the very foundation of all rational decision making. When we ignore this requirement, we fall into the logical trap that Daniel Kahneman, the Nobel Prize winning psychologist calls the WYSIATI fallacy, standing for What You See is All There Is. The FRC has recently stated that in more than 80% of the audits they reviewed over the past two years, and that were assessed as "improvements required" or "significant improvements required" identified ineffective challenge of management as a key driver of our

[23] 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.
[24] 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.

overall assessment of that audit. Problems cited in the FRC's latest report included an overreliance on letters from management without further audit checks, and a tendency to give information from a client company more weight than external data when testing assumptions[25]. NFRA's experience so far has not been different.

30. The FRC's report says that "Changes to audit procedures are likely to be part of the solution. We do not, however, think procedures alone can fix the problem. More processes and templates can also be a distraction, reducing time for and stifling the required critical thinking and robust, evidence-based, judgement that is an essential component of effective challenge"[26]. Mechanical filling up of forms, often based on computerised templates are rituals that NFRA has also encountered. The FRC adds that "Developing the right ***mind set*** and ***professional behaviour*** is critical. Both of these attributes are heavily influenced and reinforced by a strong ***audit culture of scepticism and challenge***. In such a culture, auditors will feel confident that they have the support of senior management of the firm when they challenge management, even if it might in the extreme lead to delays or modifications of audit reports, or a breakdown in the relationship with the management of the audited entity; members of audit teams will be encouraged to ask questions and raise concerns; and auditors will be open to new information and challenge from members of the audit team, specialists and peers"[27]. The FRC states that such a culture of scepticism and challenge develops and gets reinforced where the focus of the firm is on the delivery of consistently high quality work. It is this factor that has been described by the FRC as being the motivation for the operational separation of the audit practice. The UK BEIS Committee Report on the Future of Audit says very aptly that "The culture of advisory services does not sit easily with the culture of challenge required by audit"[28].

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[25] Challenge of Management. Financial Reporting Council letter dated 8 Dec 2020. https://www.frc.org.uk/getattachment/e297b54c-8d11-4ff7-b6c2-772b06b00c15/Challenge-of-management-Letter-Final.pdf. Accessed on 20 Dec 2020.
[26] Ibid, p.2.
[27] Ibid, p.2.
[28] The Future of Audit. Report of the House of Commons Business, Energy and Industrial Strategy Committee. p.3. https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/171802.htm. Accessed on 20 Dec 2020.

31. For us in India, where very effective provisions against conflicts of interest have already been substantially incorporated into the law, the takeaway would be that such provisions should be interpreted and enforced in such a manner as to promote this culture of scepticism and challenge in the overall interests of audit quality.

32. Auditors always need to keep in mind that their ultimate accountability is to the shareholders of a company. It is never to the management. As a means of practically giving effect to this important distinction, the Standards on Auditing have developed the concept of Those Charged With Governance, or TCWG. An entire separate Standard deals with the Auditor's responsibility for communicating to TCWG all important matters arising in the course of the audit. TCWG is identified by 3 key aspects of the role they perform: first, overseeing the strategic direction of the entity; second, overseeing the obligations related to the accountability of the entity; and third, overseeing the financial reporting process. Given this, it is clear that the management will not be TCWG; it will not be the Audit Committee also. A key identifier would be whether the group has the authority to take corrective action in any matter in question, and whether it can control, or if necessary, penalise management. NFRA has seen that the proper identification of TCWG, and compliance with SA 260 in communication with TCWG, is a very neglected area in audits. Equally, this is one area of audit failure that has had the effect of not bringing out potential business failure to light even at an incipient stage. As mentioned by me earlier, this deficiency seems to have occurred in the Enron case also. The problem gets somewhat complicated where component auditors of subsidiaries have to deal with actual control being exercised by persons who are not even on the boards of the auditee companies.

33. One serious misconception that we need to exorcise from our minds is the much-venerated description of the auditor being only a watchdog and not a bloodhound. This misconception has very far-reaching consequences. I am not a lawyer by training, so what I am now going to say on this subject is largely derived from a scholarly article published by R. Baxt in *The Modern*

Law Review in 1970 titled "The Modern Company Auditor. A Nineteenth-Century Watchdog?"[29].

34. Baxt describes the 1896 "watchdog" formulation by Lopes L.J. in the *Kingston Cotton Mill Co.* case as an expansion of the general theme propounded by Lindley L.J. in the *London and General Bank* case of 1895. In London and General Bank, Lindley noted that the " auditors are to be appointed by the shareholders, and are to report to them directly, and not to or through the directors." The object was to ensure that the shareholders received "independent and reliable information respecting the true financial position of the company at the time of the audit." After rejecting the notion that the auditor was however an insurer who guaranteed the absolute "correctness" of the accounts Lindley continued: "Such I take to be the duty of the auditor: he must be honest-i.e. he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient, and in practice I believe business men select a few cases at haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary; but still an auditor is not bound to exercise more than reasonable care and skill, even in **a** case of suspicion, and he is perfectly justified in acting on the opinion of an expert where special knowledge is required."
35. In the Kingston Cotton Mills case, Lopes L.J. added to this evaluation saying "It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound. He is

[29] R. Baxt. **The Modern Company Auditor. A Nineteenth-Century Watchdog?** The Modern Law Review. Vol. 33, No. 4 (Jul., 1970), pp. 413-431. https://www.jstor.org/stable/1094298. Accessed 20 Dec 2020.

justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful". His Lordship however repeated the warning that to place too severe an onus on auditors was unjustified.

36. Writing in 1970, Baxt says that these formulations have been continually accepted by the courts since 1896 as the norm. Indeed, he adds, there have been very few cases where the courts have been prepared to depart in any way from these standards.

37. Baxt then asks the question of just how far the standards which were applicable in 1895 and 1896 should continue to be accepted. In 1896 there was in fact no statutory obligation on the part of a trading company to file annual accounts. Furthermore, there was no legal obligation on the part of companies to appoint an auditor until 1900. Baxt goes on to say that the introduction of legislation requiring accounts to be prepared, filed and distributed, together with the requirement that these be audited, and the very substantial development of the statutory law in relation to the information that companies were to supply to the company registry and to their own shareholders has been regarded by authorities as one of the landmarks in the development of modern company law. Clearly, what was a common law understanding of the auditor's duty in the absence of any statute to govern the same would not at all be applicable today. The Companies Act, 2013, has built in substantive provisions regarding audit and auditors into the statute. All accounting and auditing standards are now part of subordinate legislation. The auditor's duties are now comprehensively detailed in the law. This includes responsibilities to obtain reasonable assurance (defined as a high, but not absolute, level of assurance) that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error (Para 5 of SA 240). Para 8 of SA 240 says that when obtaining reasonable assurance, the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be

effective in detecting fraud. Para 12 again talks about the need for professional scepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and TCWG. The law on the fraud related responsibilities of the auditor has moved far ahead of what it was in the 1890s. We need to forget the watchdog and not bloodhound description.

38. This movement in the law is continuing to take place in the UK also. The Brydon review recommended that ARGA amends ISA (UK) 240 to make clear that it is the obligation of an auditor to endeavour to detect material fraud in all reasonable ways. The consultation process for the amendments in SA 240 this will require is now on going[30].

39. For those who would nevertheless recall the watchdog metaphor with something like nostalgia, I would only recommend a read of the Sherlock Holmes short story Silver Blaze. Holmes draws attention to the curious incident of the dog in the night time, a dog that did nothing, because of the identity of the criminal.

40. There is just one more matter that I wish to deal with, and then I would have done. This is what is termed the "expectations gap", the name given to the gap between what the public expects of the auditors and what the auditors themselves recognise as falling within their responsibility. The BEIS Report on the Future of Audit says that "In their written and oral evidence, most audit firms told us that the public misunderstands audit. As we outline below, they said that audit does not look at the future, does not look for fraud and does not look at compliance with the law, besides accounting standards"[31]. As far as the future is concerned, the Report was dismissive of the stand of the auditors. It said "The public is right. Audits are and should be forward-looking, under the "going concern" assumption. Accounts are almost always prepared under the assumption that the business is a going concern, i.e. that the company will in all

[30] Financial Reporting Council. Consultation Paper And Impact Assessment Proposal to revise ISA (UK) 240 (Updated January 2020) *The Auditor's responsibilities Relating to Fraud in an Audit of Financial Statements.* https://www.frc.org.uk/getattachment/e05a922a-4a99-40d3-8713-c4dd7a24e623/ISA-(UK)-240-Consultation-Paper-and-Impact-Assessment-(final)-(002).pdf. Accessed on 20 Dec 2020.
[31] The Future of Audit. Op cit. p.14.

likelihood continue to trade for at least a year from the date of approval of the financial statements. The auditor must form an opinion on the appropriateness of the going concern assumption, and report on it if there are material risks to the business"[32]. After examining the matter in detail, the Report concluded, in words that auditors would do well to reflect and ponder upon, that "***the expectation gap must not be allowed to mask the serious failure of audit to deliver on its own current terms. If auditors delivered on the existing regime reliably and well, the expectation gap would shrink greatly. The delivery gap is far wider than the expectation gap and that is what must be fixed as soon as possible*"[33]*.**

41. Good audit quality requires much more resources being devoted to the audit product. The resources should be used for sincere and meticulous compliance with the law, an important part of which are the accounting and auditing standards. Companies are sure to find that the expenditure would be well rewarded.

42. I wish to conclude by once again thanking the WIRC for having given me this opportunity to share with you our understanding of the NFRA's mandate, and how we propose to carry it out. I thank all delegates for the patient hearing you have given me. NFRA looks forward to active collaboration with the CA profession in the endeavour of achieving continuous improvement in corporate financial reporting in India.

[32] The Future of Audit. Op cit. p. 16.
[33] The Future of Audit. Op cit. p. 85.