Forum of Firms: Audit Quality Event

Friday, 17 November 2022, Hotel Sofitel, Mumbai, India

Remarks delivered by NFRA, India Chairperson Dr. Ajay Bhushan Prasad Pandey, at Panel II: Regulatory expectations from the Professions in India

Good afternoon every one

I would like to thank Forum of Firms for inviting me to deliberations on Regulatory expectations from the Profession in India. I understand, the deliberations will be focused on **Audit Quality and Independence and Future of Audit Profession.** All three are closely related to each other.

Then a forward looking area of relevance to the Accountancy Profession. That is **Non-financial Reporting Frameworks like ESG, Sustainability**.

'Audit Quality', 'Independence' and 'Future of Audit Profession'.

I am addressing the three topics together as they are highly interdependent and are driven by a moot question whether the audits performed today meet the expectation of stakeholders?

In my view, Audit Quality will be achieved when the expectations of stakeholders are met. However, this moot question is not being rightly addressed, as the solution to the underlying cause is getting postponed or wished away by excessive dissection of something called as Audit Expectation Gap. As mentioned in Brydon Review Report[1] in the aftermath of Carillon failure, varieties of gaps such as Performance gap, Knowledge gap, Hindsight gap, Quality gap, Mis-perception gap, Evolution gap have come to surface. In fact, I tend to agree with a view mentioned in that report that the problem is not one of expectations, rather we have a grave 'delivery gap' when it comes to audit.

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[1] Brydon Review (Dec 2019)- REPORT OF THE INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT

Now, in order to address this delivery gap so that a good audit is performed keeping in mind the stakeholders' expectations, I have a few suggestions for the consideration of the Audit Profession.

Identification and Reporting on Frauds

A recent report of ACCA (the Association of Chartered Certified Accountants)[2] based on survey of 11K members of public in 11 countries, brings to fore the paradigm shift in the public expectation of audit as far as detection and reporting of fraud is concerned.

The survey results show c.35% want the audit to always detect frauds and another 25 to 40% want detection of material frauds. This is an area which has been agitating the public since decades. In this context, it would be relevant to note the views of CA. Y H Malegam, Past President, ICAI, nearly 25 years ago in 1998[3] "The public wants protection against fraud and it cannot understand how companies for which an auditor has given an unqualified audit report could suddenly collapse later on because of certain management fraud." He had also said we need to abandon our traditional approach where we put primary responsibility in this regard on the Management and also auditor looks at internal control only from his audit risk perspective. In fact, he has again reminded in his recent article in ICAI journal[4] that finding fraud can well become a major element of future audit reform. There is a growing expectation in the investing public and the regulators that the onus should be on the auditor to detect material fraud in all reasonable ways.

Preventing Corporate Failures

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[2] Closing the Expectation Gap, ACCA

[3] The Role of Accounting Professionals, CA. Y H Malegam, The Chartered Accountant January 1998

[4] Building Excellence with Integrity, Trust and Transparency, CA. Y H Malegam, The Chartered Accountant July 2022

In the ACCA survey report mentioned earlier, in respect of auditors' role in preventing company failures, a whopping 70% said yes. The report says these results show that there is a global demand from the public for a wider audit scope.'

I may draw your attention to the recommendation in the Brydon Review Report[5] to redefine the audit as "The purpose of an audit is to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements."

This definition, if accepted, in my view is going to expand the scope and objective of audit in the future especially, in the area of Going Concern to Viability of the Audited Company. In this regard, it may be pertinent to note that latest amendments to Schedule III of Indian Companies Act require disclosures of many financial ratios by the management which will strengthen the auditors' ability to comment upon the going concern status of the company.

Identification of business risks and understanding the entity's business and operating environment

This is another area where the scope and extent of auditing need to undergo paradigm shift. The existing Standards on Auditing, SA 300, SA 315 etc. cast a duty on the auditor to understand the entity's industry environment, its strategies, business model and business risks.

SA 315[6] also says that an understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements.

However, the auditors' work in this area is primarily focused towards assessing risk of material misstatement. This scope may need to be broadened to look at from the perspective of viability or survival of the entity at least in the foreseeable

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5 REPORT OF THE INDEPENDENT REVIEW INTO THE QUALITY AND EFFECTIVENESS OF AUDIT, SIR DONALD BRYDON CBE, Dec 2019

6 Para A37 of SA 315 IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT

future. Once again here, it may be relevant to remember what CA. Y H Malegam had alluded to the broader role of auditor in 1998 when he said the audit profession has to move away from the concept of control of audit risk to the concept of control of business risk which is a much wider situation.

In this context, independence of auditor is also very critical. The Code of Ethics for Professional Accountants, issued by the International Federation of Accountants (IFAC) and the ICAI define the term 'Independence' from two angles viz. Independence of mind and Independence in appearance.

In India, the Auditors are required to comply with the general requirements of the Code of Ethics issued by the ICAI as well as with the prescriptions of the section 141 and 144 of the Act. The Code of Ethics also lays down a requirement for the auditor to evaluate certain threats to compliance with fundamental principles e.g., Self-interest threat, Self-review threat, Advocacy threat, Familiarity threat and Intimidation threat. All cases involving the provision of any non-audit service to an audit client must be passed through the tests of these threats even if they may pass Section 141 and Section 144. **In a situation of even the slightest doubt, how before taking a position, the auditing profession must consider what the stakeholders will perceive as independence.**

Here, I am tempted to remind you all about the forewarning that was given by CA. Y H Malegam,[7] way back in 1998, just a couple of years before the Arthur Andersen and Enron catastrophic event "..we will, therefore, have to have very effective standards to ensure that audit independence is not sacrificed at the altar of business expediency. If we are unable to do this, I am afraid we will destroy the audit profession." Independence not only has to be there but it should also seem to be there.

Another question many stakeholders routinely pose is why are the auditors not able to identify frauds or risk of corporate failures? Are auditors alone responsible

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[7] The Role of Accounting Professionals – The Chartered Accountant January 1998

for detecting frauds or risks of corporate failures? My personal view is before passing a value judgement on this issue, all players which include governments, regulators, companies must appreciate the challenging environment in which the auditors operate. We must evaluate whether they have real freedom and independence or face practical constraints while doing audit in the manner they want and whether there are factors which limit their professional freedom, independence, and their scope.

Here, two things can be very useful. One the Engagement with Stakeholders and Gathering their Expectations by the issuers and the other by use of emerging technologies for data research, analytics, and third parties confirmation.

In the era of Internet and Social Media Platforms, there is a need to leverage them and evolve suitable mechanisms and means for the 'Two way" communication between the Stakeholders and Auditors, of course via the audit committees. While there has been a good reform in the Auditor's responsibility for reporting Key Audit Matters under SA 701, there is definitely a need for gathering the supply side of the expectations and risk related information from the stakeholders. Again, one may consider the suggestions in the Brydon Review Report. The suggestion there is to publish Directors' Risk Report prior to the Audit Committee where the scope of audit is discussed. Also, it suggests that Audit Committee may publish a formal invitation to shareholders to express any requests they have regarding the areas of emphasis they wish the auditor to incorporate in the audit plan. This innovative method of crowdsourcing of risk identification through the shareholders will not only help meet the expectation gap of the shareholders but also empower and strengthen the auditors to look into several areas which the conflicted management may not ideally want them to look into. This will also go a long way in establishing a transparent regime of corporate governance which we have been striving for decades.

The other area is use of technology and data analytics in audit. Today we as a country are proud to have solved many long standing vexed problems through technology and data analytics, like in Aadhaar and UPI, GST, Income Tax, faceless assessments and Annual Information Statement in Income Tax etc. We have used technology to minimize human interface or physical inspections and have been able to do external and third-party confirmation of information contained in more than 200 millions of tax returns and half a billion e-invoice every year in an automated manner and thereby improve compliance and tax collection significantly. We all need to put our minds together to see how technology can be used in the areas of audit too. We must be aware that the Stakeholders expectations and technology are going to change the nature of the audit in future.

Corporate Non-financial Reporting Initiatives and Frameworks

As we all know, since 1992 UN Conference on Conference on Environment and Development, many efforts in the area of sustainable developments have taken place internationally and nationally under various initiatives[8] of United Nations and other non-state organisations. e.g., 2030 Agenda for 17 Sustainable Development Goals of September 2015 UN Sustainable Development Summit. Etc.

In the above background of emphasis on sustainable development of the global community and economies, a number of corporate reporting frameworks have come up with variety of titles. A 2017 study by the World Business Council for Sustainable Development (WBCSD) indicated that the number of “reporting provisions” globally have increased tenfold in the 25 years since the 1992 Rio Earth Summit to about a thousand, indicating the complexity and need for such

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[8] https://sdgs.un.org/goals

reporting.[9] Also, Recent report[10] of IFAC indicates use of multiple frameworks/standards increased from 68% in 2019 to 80% in 2020.

Unlike Financial reporting structures, policies and practices the non-financial reporting frameworks suffer from lack of uniformity and acceptability across the globe and importantly, understandability among their users. Hence, there has been a need for consistency and comparability in sustainability reporting at a global level. There was a demand by the investors, central banks, market regulators, policy makers, corporate sector (preparers) and audit firms and request by G7 and G20 to IFRS Foundation for addressing the complex and fragmented sustainability disclosure landscape. Therefore, with the high-level objective of providing a global baseline, the IFRS Foundation, known for its success in establishing globally acceptable Financial Reporting Standards, has embarked on a global mission to provide a globally acceptable non-financial reporting framework since November 2021. A few critical milestones to note are (a) establishment of fully dedicated standard-setting board called International Sustainability Standards Board (ISSB) at UN Climate Change Conference (COP26) in November 2021 and issuance of two exposure drafts on Sustainability Disclosure Standards.

One of the positive aspects as I see today is that the ISSB has received overwhelming response, c.720 public comments, to the proposals in the above two exposure drafts; this reflects the extensive support and interest of stakeholders across the globe for a global baseline framework for non-financial reporting.

The way forward in my view are two folds.

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[9] Report of the Committee on Business Responsibility Reporting, MCA, GOI, May 2020

[10] The State of Play in Reporting and Assurance of Sustainability Information: Update 2019-2020 Data and Analysis

1) We need to gradually start develop global sustainability reporting standards in other areas of environmental and social risks to the business and industry.

2) Global baseline in respect of audit and/or assurance of the non-financial reporting should be developed on priority basis.

Finally, India is at critical juncture of development cycle and at the inflexion point of our economic growth in which the private corporate sector will have a major role. That is where we the regulators and the accounting and auditing profession bear a major responsibility to ensure good corporate governance and build trust in the system and I have no doubt that together we can meet that responsibility.

Thank you.