THE CFO BOARD

REBUILDING TRUST IN THE FINANCIAL REPORTING SYSTEM

A WHITE PAPER

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INTRODUCTION

In recent times there have been several corporate collapses in India and across the world. In some cases, corporate failures have been sudden with no indicators of impending failures. The favorable financial position as per audited financial statements was supplemented by high ratings from the rating agencies. The collapse of the companies without warning signals have eroded the trust in the financial reporting system.

There is also a confusion between ' business failure' and ' financial reporting failure ' which affected the confidence/ credibility of the financial reporting system. If the credibility gap and the crisis of confidence in the financial reporting system are to be addressed, merely focusing on quality of audit will not solve the problem. We need to take corrective steps in all the components of the financial reporting ecosystem. This will also address the expectation gap which investors and regulators have on the audit function.

The financial reporting system has a number of components and players. These are:

a. Preparers i.e., the management
b. Those charged with governance - audit committee, independent directors, the Board
c. Those who provide assurance - internal auditors and external auditors
d. Rating agencies
e. Users - shareholders, stakeholders, potential investors, analysts and proxy advisors
f. Stock Exchanges
g. Regulators.

In response to corporate failures, the National Financial Reporting Authority (NFRA) was constituted on 1st October,2018 by the Government of India. The NFRA Rules provide that NFRA shall protect the public interest and the interests of investors, creditors and others associated with the companies or bodies corporate 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.** NFRA will play a critical role in strengthening the financial reporting ecosystem in the country. While the regulatory oversight of NFRA is a welcome step, their role should not be just to enforce compliance but also nurture the growth of the accounting and audit profession. In this context, the following recommendations are made:

NODAL REGULATOR FOR OVERSIGHT OF CORPORATE FINANCIAL REPORTING AND AUDITORS

Nodal regulator for oversight of corporate financial reporting and auditors Currently, the auditors and preparers are subjected to oversight as well as various regulatory reviews by bodies such as NFRA, RBI, SEBI, ICAI (Peer review), FRRB and other sectoral regulators. Overlap of regulators should be addressed by identifying a single nodal regulator for a class of companies. Other authorities need to work in tandem with this nodal regulator while assessing the quality of reporting by a company and the auditor performance and contemplating any action. Considering that the composition of NFRA already envisages representation of various regulators, measures should be taken by MCA/ NFRA to collaborate with other regulators and have NFRA as a nodal regulator. There will need to be a greater clarity on the roles of each of these multiple regulators and timing of actions, which may also require alignment of some legal provisions.

STRENGTHENING THE AUDIT COMMITTEE

Audit committees (AC) form an integral part of the financial ecosystem. Revamping the financial reporting without empowering audit committees would not be effective. Some of the key responsibilities of AC include ensuring transparency and accuracy of financial reporting and disclosures and effectiveness of anti-fraud, ethics and compliance systems. Corporates look to the AC to provide an 'independent' reassurance to the board through its oversight and monitoring role. In this context the following recommendations can be considered:

- Regulatory oversight of the audit committee
- Mechanism for the independent director/ AC members to put their dissent to proposed board resolutions on record- these can be presented to the shareholders/ intimated to SEBI to make them a matter of public record.
- One can also take a cue from the 2018 UK Corporate Governance Code (the 2018 Code) published by FRC to strengthen the AC such as:
  - More explicit requirements in tendering process for appointing external and internal auditors and in approving non-audit services (specifically 'considering the impact this may have on independence'), besides developing and implementing the non-audit services policy
  - Rigorous annual evaluation of the performance of the Board, Audit Committee, the chair and individual directors including regular external evaluation- at least every three years

RELATED PARTY TRANSACTIONS

In recent years, there has been a significant oversight to related party transactions through changes in regulations under the Companies Act, 2013 and SEBI regulations. The rules may be circumvented by entering transactions with persons/entities which in form may not meet the definition of related party. The definition of related parties and the disclosure requirements should consider complex structures, that have been used by companies to avoid reporting as related parties. Further, the rules for defining related party may also include principles such as financial dependence, material transactions or other possible relationships that may create a real or perceived conflict of interest.

ENCOURAGE MULTI-DISCIPLINARY FIRMS AND LOCAL AND GLOBAL NETWORKING OF AUDIT FIRMS

There is a strong need to develop a forward looking and developmental approach to nurture the progress and growth of the audit profession in India. Enhanced audit quality should be at the center of such reforms. Multi-disciplinary firms with specialist skills like tax, technology, analytics, and forensics expertise are essential to the execution of audits today. The quality of audits is enhanced when a firm can bring depth of expertise in other disciplines to their audits. We recognize the need for auditor independence and that is addressed in a separate recommendation in this paper. In view of cross border capital markets activity, inbound and outbound mergers and acquisitions and companies accessing international markets it is an imperative to have firms that have networks in key geographies. The use of brand names of an international network should be permitted for better recognition of the auditor’s network.

BRIDGING THE EXPECTATION GAP

A key aspect of the ‘expectation gap’ is the auditor’s responsibility towards detection of fraud. The ‘watchdog’ justification is no longer a good defense in the face of material frauds. It is important that auditing standards are upgraded to mandating greater substantive procedures with use of analytics and digital tools and more reliance on external evidence in the audit process for high-risk areas. India can take the lead in developing such standards.

USE OF FAIR VALUE IN FINANCIAL REPORTING, INVOLVEMENT OF EXPERTS AND GOODWILL AMORTISATION

The adoption of Ind AS for financial reporting has brought in extensive use of fair values in the financial statements, both for measurement as well as disclosure purposes. Some of the important areas are impairment assessments and valuation of investments and financial instruments. While the use of fair values provides information to users that is considered relevant for making economic decisions, it is also an area that involves significant judgement and potential for abuse. Therefore, there is a need to bring in greater consistency in how fair values are determined, including the methodologies, approaches and assumptions used and require the involvement of relevant experts in determining these fair values. Further, considering the importance of fair values in the determination of financial position and financial performance and the reliance placed on them by the auditors of this financial information, the experts involved in the determination of fair values should be brought under the regulatory ambit.

It is recognized that the Indian Accounting Standards (IndAS) have been formulated to converge with IFRS. The accounting standard on intangible assets may be amended to require amortization of goodwill on acquisitions. This will reduce the accounting arbitrage that arises on allocation of purchase consideration between goodwill and other assets. It will also reduce the risk of exceptional impairment charges. Although this will be a carve-out from IFRS it can be justified on being a conservative approach.

NON-AUDIT SERVICES TO AUDIT CLIENTS

The Companies Act, 2013 has prescribed safeguards to address the issue of conflict of interest and threats to independence when non-audit services are rendered by auditors. There should be clarity on what services, if any, are permissible for auditors to provide their audit clients. The MCA should issue clarifications or amend regulation to eliminate interpretative issues in this matter. It is also suggested that these restrictions may apply to public interest entities. Small and medium enterprises often find it more cost effective to engage their auditors particularly on compliance matters such as income tax returns filing and preparation.

JOINT AUDITS

Joint audits should not be made mandatory because of issues on cost of compliance as well as dilution of responsibility. It also creates a burden of co-ordination on corporates. There is no evidence that joint audits improve audit quality.

INSPECTIONS AND OUTCOMES

NFRA has recently issued Audit Quality Inspection Guidelines. NFRA can work towards adoption of certain practices from Public Companies Accounting Oversight Board (PCAOB). PCAOB makes only certain parts of audit inspection reports public. The non-public parts of inspection reports, which contain quality control criticisms, are also made public if the firm fails to address such criticisms within 12 months. Further, the names of the auditee companies should not be disclosed if the deficiency is limited to auditing procedures.

NFRA should organize structured dissemination of learnings from inspections through various industry and professional forums. This will enable the preparers and auditors to improve their systems and processes, as required.

ENFORCEMENT ACTIONS AND SANCTIONS:

There is a need for a consistent approach for enforcement/ penal actions against auditors, directors, and others in case of corporate failures. The overall oversight and enforcement regime should be proportionate to the roles of the individuals, and improvement based. The overall environment should not result in it being a deterrent for individuals to take on senior management, director or auditor roles.

Where the auditors are found guilty in a case, it would be appropriate to penalize only the concerned partners and the other staff members of the audit firm who were performing the audit assignment. Only in situations of repeated failures resulting from systemic deficiencies with the firm, should broader action be considered. Debarring the entire firm of auditors impacts many professionals employed with the firm, who are unnecessarily penalized for no involvement on their part in the case.

While considering sanctions against audit firms, the relevant regulator should consider a range of possible sanctions, rather than just looking at deregistration. Other measures such as the following may be considered:

- Requiring firms to perform enhanced quality control reviews;
- Requiring firms to implement corrective actions;
- Temporary bans on tendering for new audit clients
- More close regulatory oversight on quality control

NFRA may consider a settlement mechanism for auditors and preparers to reduce protracted litigation.

WHISTLEBLOWER MECHANISM

A whistle blower mechanism should be in place for auditors. It is difficult for auditors to "blow the whistle" as this may have grave repercussions on investors and the market. Auditors should therefore have access to the regulator to alert them about suspect matters with protection of anonymity and not being subject to 'breach of confidentiality' for such actions.

SUMMARY

To be effective and sustainable, measures to strengthen financial reporting should focus on all constituents of the financial reporting eco-system, including Corporates, Board of Directors, Audit Committees, Auditors and Regulators. The regulators need to support an environment that attracts good talent into accounting and auditing, as the quality of talent will impact the quality of financial reporting, which is a vital feature in providing confidence to the capital markets and stakeholders.

This white paper has been prepared by The CFO Board, under the guidance of Mr. P K Ghose, Former Executive Director and CFO Tata Chemicals along with other members of The CFO Board.

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