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Date: 13 March 2020

To,
The Ministry of Corporate Affairs
Government of India

Sub: Comments on the consultation paper to examine the existing provisions of law and make suitable amendments therein to enhance audit independence and accountability

Dear Sir,

The CFO Board is a group of senior finance professionals in the country which contributes to knowledge sharing amongst finance professionals and to deliberate on various regulatory developments affecting the industry. The Board acts as a sounding board between the government and industry to highlight the concerns and suggestions to improve the regulatory framework for advancement of industry and commerce.

The Ministry of Corporate Affairs, Government of India (MCA) released a Consultation Paper, dated 06 February 2020, to examine the existing provisions of law and make suitable amendments therein to enhance audit independence and accountability. Through the Consultation Paper, MCA has sought inputs on several recommendations with an objective to improve the quality of auditing in India.

While this is a welcome step from MCA with respect to making amendments to enhance audit quality in India, there are certain areas which need to be reviewed for improvement. In this context, The CFO Board has made suggestions which are attached in this paper.

It is our humble request that the suggestions made in this whitepaper be considered favourably. We would be glad to present our views in person if an opportunity of such meeting is granted by your office.

Warm regards,
The CFO Board

Table of Contents

Audit Ecosystem in India: Poised for a paradigm shift

The recent instances of corporate failures and the subsequent actions from various stakeholders including, regulators, investors, lenders, auditors, independent directors and so on, and the way each of them now engages with the others in the ecosystem is a clear indication that the rules of the game are changing. There is a heightened awareness of the changing regulatory and governance environment as well as the risks and opportunities that this presents.

While this changed environment could lead to better adherence to the laid down laws, regulations and standards, it also presents an opportunity to evaluate what needs to be done additionally to truly step up the role of the each of the participants to raise the standards to ensure that we have a high quality audit ecosystem and that the trust in this ecosystem is restored once again.

In the context of the recent corporate collapses, while there has been significant focus on the role of the external auditors, it is equally or more important to reflect on the role played by the other participants, starting with the management of the company and its board on the one end to the role of the regulators on the other end, and covering all other participants in between. There are also influences which have an effect both positive and negative as they drive behaviour of the participants. These too need to be reviewed and, if necessary, re-calibrated to produce the desire effect. Some of these are:

- Provisions of various laws which deal with the roles, responsibilities and accountability of the participants in the ecosystem
- Penalty and prosecution provisions in the various laws
- Role and process of investigative agencies
- Multiplicity and overlapping investigative/regulatory agencies
- Whistle blower mechanisms
- Standards – accounting standards, auditing standards, secretarial standards, internal audit standards, etc.

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. Structural reforms in the audit profession is an important component of proposed paradigm shift in the overall ecosystem and enhanced audit quality should be at the centre of such reforms.

Recommendations on enhancing the independence and accountability of auditors

What empowers auditors is a strong and independent Audit Committee (AC). Corporate boards need strong leadership from their Audit Committees (ACs) in steering companies through today's complex business environment. 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.

However, the awkward question being asked today is – are these 'Independent Directors (IDs) who constitute the audit committee - truly independent? A director can be independent in form but not in spirit because of his or her social relationships, donations, jobs or contracts for friends, director interlocks, supplier or customer relations or other perks such as vacations, office use, excessive tenure and high compensation.

Recommendation 01: Strengthening the audit committee

- Code of conduct/ guiding principles for the IDs and ACs to follow - regulatory oversight of the AC may help this cause
- Mechanism for the IDs / 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. This will act as a deterrent for other directors who try to overpower/ influence the IDs.
- Some form of annual assurance meeting can be introduced which should require the direct participation of AC chair, external auditor as well as the internal auditor.
- 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
    - Formal and rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors including regular external evaluation- at least every three years. The external evaluator to be identified in the annual report and a statement made about other connection it has with the company or individual directors.
    - Annual report to include:
        - Significant issues that the AC considered relating to the financial statements and how these issues were addressed;
        - If the external auditor provides non-audit services, an explanation of how it has assessed the independence and effectiveness of the external audit process and an explanation of how auditor independence and objectivity are safeguarded
        - Approach taken to the appointment or reappointment of the external auditor – if the AC's recommendation on external auditor appointment was not accepted by the Board- reasons for the same

Recommendations on the need to build capacity of home-grown Indian audit firms

Adequate investment required in capacity building at individual firm level and at a broader professional level: Adequate investment is required in capacity building at individual firm level and at a broader professional level to ensure development of requisite skill set and experience for audit firms and professionals. As per the data available on the website of the Institute of Chartered Accountants of India (ICAI), out of around 71,000 CA firms in the country, around 50,000 are sole-proprietorships. Further, all these firms do not necessarily provide audit services, with many choosing to specialize in provision of tax or other advisory services.

STATISTICS OF FIRMS
AS ON 01-04-2018

	Head Office			Branch Office			Grand
	Prop.	Part.	Total	Prop.	Part.	Total	Total
REGION -1 : WESTERN REGION	20041	6449	26490	87	4440	4527	31017
REGION -2 : SOUTHERN REGION	7115	3891	11006	58	3330	3388	14394
REGION -3 : EASTERN REGION	4252	1988	6240	17	1428	1445	7685
REGION -4 : CENTRAL REGION	8377	4865	13242	46	5500	5546	18788
REGION -5 : NORTHERN REGION	9607	4638	14245	56	4611	4667	18912
TOTAL	49392	21831	71223	264	19309	19573	90796

As compared to the growing needs of the Indian corporate sector, the capacity available in the Indian market may not be adequate.

In this context, the following recommendations are being made.

Recommendation 02: Facilitate consolidation of accounting firms to build capacity depth and competitiveness

Encouragement, including through eased or new legislation, should be provided to help the consolidation of accounting firms to build professional capacity, scale, depth of expertise and global competitiveness (for e.g., this approach was followed in China).

Recommendation 03: Development of skills and capabilities in the profession

Addressing the talent and relearning gap in the profession is perhaps the need of the hour. Capacity building of audit professionals by way of structured trainings and awareness of best practices would go a long way in enhancing audit quality. Use of skills relating to analytics, technology, forensics and valuation are essential for better audit outcomes. This will make them ready for the rigor of inspections.

Recommendation 04: Encourage local and global networking of firms

Global and local networking should be encouraged. The observations of the Committee of Experts (COE) appointed by the Honourable Supreme Court of India may be considered in this connection. The COE commented on the distinction between networking and reciprocity arrangements and recommended the removal of restriction on brand names with appropriate safeguards. It also recognised the need for multi-disciplinary audit firms.

Recommendations on restriction of non-audit services

Currently auditors are allowed to provide certain non-audit services to their audit clients. It is important to address the perceived ‘conflict of interest’, when non-audit services are rendered by auditors.

There are sufficient safeguards to address this risk- The Companies Act, ICAI Code, IESBA Code provide guidance on permissible and non-permissible non-audit services- usually services that pose a threat of “self-review” of work and “stepping into management role and decision making” are prohibited. The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) also cautions against other threats to independence such as advocacy threat, self-interest threat, familiarity and intimidation threat. If the audit firms follow these guidelines in spirit, the independence can be maintained in both fact and appearance.

Recommendation 05: In the context of non-audit services to be rendered to audit clients:

- mandate the assessment of conflict across all the member firms of the network, using the internal conflict check processes implemented by all network firms before rendering non-audit services
- mandate that the remuneration of audit partners is based on the revenues earned only from assurance services; no incentives to be paid on cross-selling of non-audit services.
- mandate the disclosure by all entities of nature of non-audit services provided by the auditor and its network entities and related fees, with a view to increase transparency
- mandate that the audit committee approves all audit and non-audit services- so even audit committees need to play a diligent role in assessing auditors’ independence

Recommendations on whether Joint audits be made mandatory

In a joint audit, it happens that two or more audit firms split the amount of work assigned and are responsible for their respective areas which generally results in high cost of compliance and there is no significant effect on the quality of the audit. The caution to be implemented in this is to ensure that the joint auditors appointed are relatively of the same size or else the purpose of a ‘joint’ audit would be defeated.

Recommendation 06: Joint audits may not be a solution as the cost of compliance and risk of dilution of responsibility, outweighs the benefit. Joint audits should be an option available to companies but should not be mandatory.

Recommendations on holding Company auditor reviewing working paper of Subsidiary Company Auditor and commenting on account of subsidiary companies

While the Indian auditing standards have been converged with their corresponding international standards, ISA 600 - Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors) has not been incorporated into Indian auditing standards framework. Globally, the trend is to get the principal auditor to take responsibility for work done across the entire group rather than divide the responsibility with component auditors.

However, in India, the principal auditor (i.e., auditor of the parent company) can place reliance on the work done by other auditors and divide the responsibility on the overall audit of the consolidated financial statements. This poses risks, as there is a possibility of things falling in between the cracks and the risk of the principal auditor not being able to see the complete picture on certain important matters/transactions, etc.

Recommendation 07: Convergence with ISA 600

Convergence of SA600 with corresponding international standard ISA 600 into Indian auditing standards framework.

Internal controls reporting on Indian entities vs entire group:

India had adopted Internal Financial Control (IFC) reporting requirements for all companies. Interestingly, when reporting on the consolidated financial statements, the auditors of Companies in India are required to report on the IFC for Indian companies only and their foreign subsidiaries are exempt. This is quite unlike the requirement in the international markets, where the requirement applies to the entire group.

For an investor, they are keen on the well-being of the whole group and the control environment that is prevalent across the entire group rather than just the Indian operations. This is particularly relevant as many large Indian companies now have significant foreign operations.

Recommendation 08: Internal financial controls reporting at group level

IFC reporting requirements to be made applicable to the entire operations of the group and not just to their Indian operations. Companies can be given some transition time to adopt these additional requirements.

Recommendations on development of a 'Composite Audit Quality Index' to improve accountability

With the goal of enhancing audit quality and capacity in the country, sharing of knowledge and best practices is essential amongst those in the profession. In other markets, bodies such as the Center for Audit Quality in the US have helped bring together large audit firms and co-opted them to be part of the solution of creating additional capacity and raising audit quality. Similar approach could be considered in India by the formation of a capacity building body.

Recommendation 09: Setting up a foundation for audit quality

Encourage large firms to help in capacity building for the audit profession in India, e.g. by creating a Foundation for Audit Quality. This will promote best practices for enhanced quality, support in identifying and propagating best practices to enhance governance and optimize controls and provide current professional practice letters for all practitioners to consult.

Users and other stakeholders involved in the selection of audits need to have clear visibility on the capability of auditors and their ability to perform a high-quality audit in relation to the size, scale and complexity of the company. Such an assessment can be done through an assessment of indicators such as workforce metrics, skill-development and training of audit team, quality metrics such as audit restatements, trends in audit metrics such as billable hours and audit fines, legal actions and fines against the firm, independence metrics such as client and group concentration, use of technology, etc.

Recommendation 10: Implementation of Audit Quality Indicators as recommended by Kotak Committee Report

Periodically disclosing such Audit Quality Indicators will enable transparency and comparison of the audit quality of different auditors. For this purpose, the discussion paper issued by PCAOB may be evaluated in the Indian context.

Recommendation 11: Encourage building multi-disciplinary firms (MDF)

Multi-disciplinary firms (MDF) 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. MDF model should be encouraged for higher assurance in audit. To address any concerns regarding independence and conflicts, MDF firms need to operate within the construct of effective oversight, strong systems of quality control, and a multi-layered regulatory environment that places checks on the firm through robust inspections and enforcement programs.

Key takeaways

1. Capacity and capability building in the profession is a must and an urgent need to build depth and competitiveness. A foundation for audit quality could be established to nurture audit quality.
2. Like for corporates, the skills of audit professionals also need to evolve considering the data and technology skills, valuation and forensic skills as well as other broader business and risk management considerations
3. Disclosure of Audit Quality Indicators will provide users with relevant information on the capacity, capability and quality parameters of an auditor in a more transparent manner
4. Group auditors should be required to take responsibility for the audit of the entire group.
5. The audit process and the audit product both need to evolve – any reform in the audit mechanism should be focused on improving the overall quality - present audit product does not meet expectations and radical regulatory and legislative changes in financial reporting, auditing standards and technology infrastructure are required to upgrade the audit mechanism
6. Joint audits should be an option available to companies but should not be mandatory
7. Bring further restrictions and enhance disclosures relating to non-audit services

List of Abbreviations

FRC	Financial Reporting Council, UK
ICAI	Institute of Chartered Accountants of India
PCAOB	Public Companies Accounting Oversight Board
RBI	Reserve Bank of India
SEBI	Securities and Exchange Board of India

Acknowledgement

The recommendations submitted in this paper are a part of The CFO Board's submissions on 'Financial Reporting and Audit Ecosystem in India: Poised for a paradigm shift' to the Chief Economic Adviser, Government of India for the Economic Survey 2019-20.

For further queries, please contact secretariat@cfoboard.com or log in to www.cfoboard.com.