Financial Reporting and Audit Ecosystem in India: Poised for a paradigm shift

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1. Introduction

In the recent past, there have been several large corporate failures, many of which have happened without any indicators of the impending failures. Apart from business failures, many of these collapses have been triggered by corporate fraud, loan defaults, misconduct, and regulatory noncompliance. Fraudulent conduct by companies and / or their shareholders has involved misappropriation of assets, financial misstatement, ever-greening of loans, bribery and corruption, and abuse of related party relationships. However, in most of these cases, the latest audited financial statements of these companies provided no signals of stress. Further, the financial position as per these audited financial statements was supplemented by high ratings provided by the Rating Agencies.

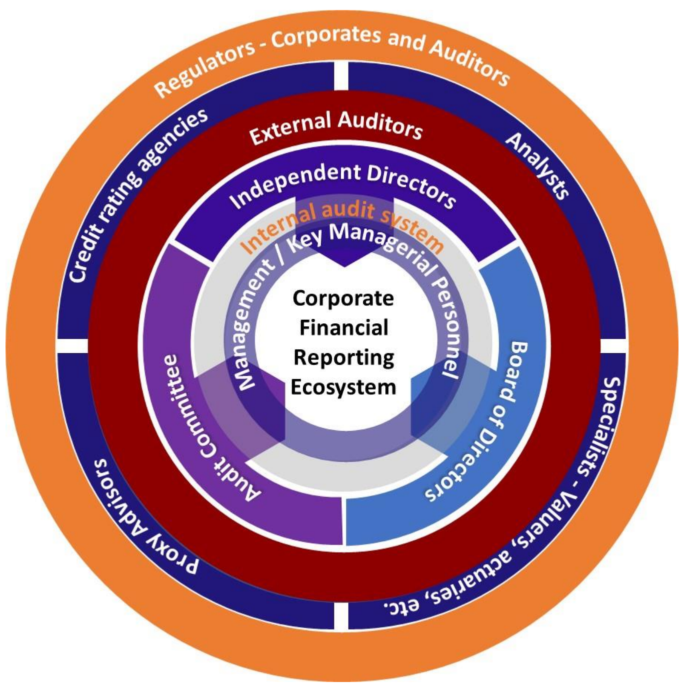
The recent glaring failure of managements, boards and auditors to perform their reasonable duties has created a trust deficit and put a lot of stress on the financial system. The effect of these corporate failures also spread to other companies, including those in the banking and financial services sector shaking market confidence due to this contagion. Investors, lenders and other stakeholders were impacted by these failures. The collapse of the companies without warning signals from either the financial statements or the credit ratings has raised questions on the reliability and usefulness of this information. Further, the lack of distinction in the eyes of the affected stakeholders and regulators, between 'business failure' and 'governance or financial reporting failure' has affected their confidence/credibility in the whole financial reporting system.

2. Financial reporting and audit ecosystem

The financial reporting and audit ecosystem comprise of many participants, each having a very distinct role in ensuring the veracity of financial information and ultimately the efficient functioning of the capital markets.

These participants (see graphic below) include:

1. Preparers of financial information – **Management**, including **key managerial personnel**
2. Internal monitoring mechanism – **internal auditors**
3. Corporate governance – **audit committee**, **independent directors**, **board of directors**
4. **External auditors**
5. Other stakeholders – **credit rating agencies**, **analysts**, **proxy advisors**, **specialists** such as valuers and actuaries
6. **Regulators**
7. And last, but not the least, the **users** of financial reports – **shareholders**, **lenders**, other stakeholders, potential investors, etc.



A dilution in the effectiveness of the role played by any one or more of these participants could lead to a complete breakdown in the entire ecosystem.

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.

3. Need 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 financial reporting ecosystem and that the trust in this ecosystem is restored once again.

In addition to the components and participants in financial reporting ecosystem there are also influences on the financial reporting ecosystem 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.

3.1 Economic rationale for change

Apart from the benefits associated with restoring trust in the financial reporting ecosystem, any move towards enhancing the quality of financial reporting in the country, has a direct impact on making the capital markets more attractive. Convergence with International Financial Reporting Standards was the first step in enhancing international comparability of financial information reported by Indian companies. The next logical step is to ensure that the information reported meet the highest quality standards. This will not only make the Indian capital markets more attractive but also reduce cost of capital and also facilitate international fund raising by Indian companies.

Several global studies have shown the impact of adoption of IFRS on reducing the cost of equity capital. While the adoption of / convergence with IFRS is one step in the right direction, when accompanied by other changes in the ecosystem, including the efficient functioning of a strong regulatory monitoring and enforcement mechanism and other elements of a high-quality corporate governance framework, will lead to a greater realisation of these benefits for Indian companies.

This whitepaper looks at a 360^o view of the issues and the changes that are warranted across the entire ecosystem covering the primary participants – the company and its management, the internal auditors, those charged with governance, the external auditors and the regulators.

4. Expectations from the corporates and the governance framework

4.1 Preparers: Management and key managerial personnel

Many of current requirements relating to financial reporting for Indian companies are comparable with the best in the world. The financial reporting standards are converged to International Reporting Standards (IFRS) and applicable to not just listed companies but many privately-owned companies as well. The requirements on internal financial controls are in some ways stricter than similar norms prevailing in other jurisdictions (such as Section 404 of the Sarbanes-Oxley Act in the United States), as the Indian requirements cover not just controls over financial reporting but extends to operational areas as well. CEOs and CFOs of listed companies are also required to periodically provide a certification on the internal controls and financial reporting. The management and the Board also periodically certify compliance with all laws and regulations applicable to the company.

However, despite these requirements being in place, there have been numerous instances where the standards have not been followed, or the controls have not been in place or the lapses not identified in time. This essentially requires the rigour of implementation to be significantly enhanced. This would also require a significant enhancement of in-house capabilities of companies and a focus on equipping the CFO and the finance teams with the skills of the future.

Further, the current reporting requirements may need to be augmented with additional disclosures and reporting requirements by companies, a lot of which is now possible with greater and faster availability of data and enhanced transparency.

Lastly, the recent collapses have also shown that the abusive nature related party transactions continue to plague the Indian corporates and there needs to be a further strengthening of the approval and disclosures requirements in this area.

Some of the recent corporate collapses have been analysed to provide a view on the prevalence of these issues despite having a plethora of standards and regulations governing corporate financial reporting.

Analysis of companies referred by RBI to IBC process

The Reserve Bank of India (RBI) identified 12 companies constituting 25% of India's total Non-Performing Assets (NPAs) to be resolved through the Insolvency and Bankruptcy Code (IBC) on 13 June 2017.

An analysis of the annual reports of these 12 companies to identify if the previously audited financial statements had any disclosures of an impending failure / stress revealed several indicators, but not consistently across the 12 companies. The indicators identified were categorized in the following 8 categories:

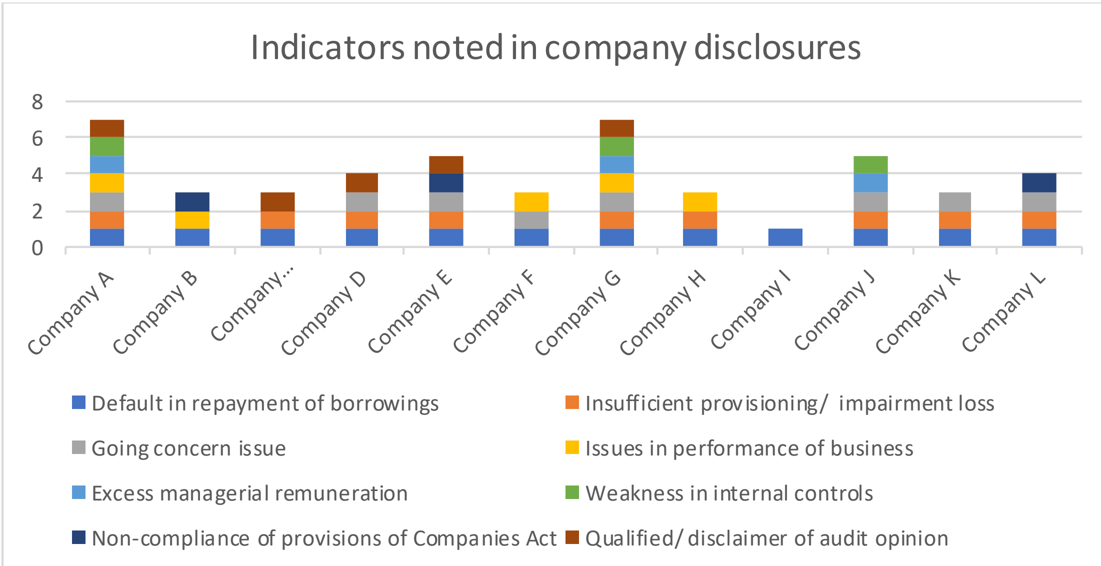
Leading indicators

Issues in performance of business	Weakness in internal controls	Non-compliance of provisions of Companies Act	Qualified/Disclaimer of audit opinion	Excess managerial remuneration
▪ Severe pressure on company's operational cash flow ▪ Decline in turnover and operating margin ▪ Non adherence to contractual obligation ▪ Non-reconciled/mismatch in bank accounts.	▪ Material weakness in internal controls ▪ No internal audit department ▪ Manual intervention in operations.	▪ Issues raised under secretarial audit relating to non-compliance of provision of Companies Act (2013), Rules, Regulations and Guidelines	▪ Qualified opinion in the audit report ▪ Disclaimer of opinion due to inability to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion	▪ Default in repayment of loans (principal and interest) to banks, financial institutions and debenture holders ▪ Loans classified as NPA by the lenders.

Lagging indicators

Default in repayment of borrowings	Insufficient provisioning/impairment loss	Going concern issue
▪ Default in repayment of loans (principal and interest) to banks, financial institutions and debenture holders ▪ Loans classified as NPA by the lenders.	No/insufficient provisioning for : ▪ Recoverability of loans/ corporate guarantee extended to related parties ▪ Recoverability of investments made in related parties ▪ Lack of balance confirmation from debtors ▪ Long outstanding loans and advances.	▪ Accumulated losses resulting in erosion of net worth ▪ Current liabilities in excess of current assets ▪ Recurring losses/Cash losses ▪ Negative net worth ▪ Suspension of primary business activity.

As can be seen from the graph below, of these 12 companies, 2 of them had disclosures relating to 7 of these 8 indicators, 1 of them had just 1 indicator disclosed with most others having 3 to 4 of these indicators disclosed. These disclosures were made either in the financial statements or the auditor's report, or the other sections of the annual report such as the directors report, MD&A, etc..



Default in repayment of borrowings to banks/financial institutions/debenture holders was noted in all the 12 companies recommended under IBC, whereas, insufficient provisioning or non-recording of impairment loss for the investments made in related parties was identified in 9 out of the 12 companies analyzed. Concerns on the ability of the companies to continue as a going concern was another major issue noted in 8 out of the 12 companies.

Analysis of top 100 bank frauds

Over the last few years the Indian banking industry has seen a rising trend in bank frauds. The money involved and the complexity of bank frauds has raised concerns for both, banks and regulators, such as RBI, Enforcement directorate and central bureau of Investigations (CBI), Department of Financial services (DOFS)

To address these concerns, Central Vigilance Commission (CVC) had undertaken a review and analysis of top 100 Bank frauds as on March 31, 2017. In their report "**Analysis of Top 100 Banks Frauds**" (http://www.cvc.nic.in/sites/default/files/new1111.pdf), CVC has provided a perspective on the recent trends in bank frauds which could help banks and regulators to understand trends in bank frauds.

CVC has presented the analysis of their review. In its analysis, for each sector, CVC has mainly focused on (i) modus operandi of the frauds identified; and (ii) suggested systemic improvements to address the loopholes/lapses identified.

Below is the summary of the modus operandi and suggested systemic improvements.

Modus Operandi		***Suggested improvements***
▪ Fabricated/forged documents. ▪ Diversion/Siphoning of funds ▪ Frauds related to collaterals.		▪ Improving existing processes ▪ Enhanced due diligence ▪ Improving transaction monitoring though robust systemic rules and alert generation mechanism

Modus Operandi		*Suggested improvements*
▪ Fabricated debtors and inventory statements. ▪ Frauds involving staff members		▪ Creating awareness/ trainings to staff ▪ Independent investigation and forensic audits on periodic basis

Modus operandi observed by CVC

Fund diversion - mediums	Frauds with respect to collaterals	Fabricated debtors/ inventory statements	Fabricated/ forged submissions	Frauds perpetrated by Employees
▪ Routing of funds through non consortium bank accounts ▪ Use of shell companies and non operational companies ▪ Transactions with group companies/ related parties ▪ Fictitious vendor payments	Frauds due to bankers lacking information on the following: ▪ Prior charge on the asset ▪ Information on depletion/ sale/ disposal of collateral	▪ Fabricated monthly debtor and inventory statements to inflate the drawing power of the entity and obtain higher loans ▪ Fictitious valuation reports showing higher valuations ▪ Misrepresentation of insurance details / documents for inventory ▪ Forged registration details	▪ Fake import-export documents for remitting funds abroad - Forged shipping bills, suppliers and vendors information ▪ Misrepresentation of Company's performance – Forged end use certificates from Chartered accountants, ▪ Incorrect representation in the financial statements and improbable predictions of future cash flows.	▪ Fraudulently conveying messages through SWIFT without proper authorisation ▪ Transactions carried out in customer accounts by employees without customer knowledge ▪ Transactions approved in the system by staff in violation of Anti-Money Laundering guidelines

CVC has classified the frauds as per the industries affected. We have classified the frauds into five categories and assessed the impact on the sectors, which is summarized below:

Sector and Modus	Frauds with respect to collaterals	Funds diversion	Fabricated/ forged submissions	Fabricated debtors/ inventory statements	Frauds involving staff members
Gems & Jewellery	✔	✔	✔	✔	
Manufacturing	✔	✔	✔	✔	
Agro	✔	✔	✔	✔	

Sector and Modus	Frauds with respect to collaterals	Funds diversion	Fabricated/ forged submissions	Fabricated debtors/ inventory statements	Frauds involving staff members
Media	✔	✔	✔		
Aviation		✔	✔		
Service/Project		✔	✔		✔
Discounting of cheques and other issues			✔		
Trading		✔		✔	
Information Technology		✔	✔		
Export Business	✔	✔	✔	✔	
Fixed Deposit Fraud			✔		
Demand Loan			✔		✔
Sectors affected	5/12	10/12	11/12	3/12	2/12

Analysis of other corporate failures

Based on a review of several recent corporate failures which have ultimately been referred to the insolvency process, we note that corporates tend to channelize the funds by diverting through group companies and potential non-operational/ shell companies. It has been recently observed by the government investigating agencies that corporates float potential non-operative companies for siphoning of funds granted by the creditors and also for the purpose of tax evasion.

Transactions used to funnel assets and funds out of the company

Loans and advances including capital advances	Inter-corporate deposits	Fictitious purchases/ expenses
Transfer of interest in a asset for the benefit of	Use of bank accounts not reported in the books of	Transfer of assets at a value less than its

Channels used to enter into the above transactions

Potential related parties (PRP)	Potential non- operating companies (PNOC)
Apart from the definition of related party under section 5(24) of IBC, the following could also classify as Potential Related Parties: ▪ Common registered email ID ▪ Common registered address ▪ Directors being employees of CD ▪ Common signatories noted on documentary evidences obtained	Non-operating companies have not been expressly defined under any statute, however following are potential indicators of PNOC: ▪ No operational revenue ▪ Bare minimum or no employee costs ▪ More than 90 per cent of assets contributed by debtors, loans and advances ▪ No fixed assets in the company based on nature of business

Resultant misstatement in financial statements

Transaction	Summary of transaction	Misstatement and impact on financial statements
Loans and advances including capital advances	Money is advanced to related parties or non operative entities for under the pretext of creation of capital assets	▪ As there is no actual receipt of any capital asset for a long period, the advances stand outstanding in the books of accounts. The proposed capital expansion project experience delay in completion and the advances are kept long outstanding. ▪ After significant time has elapsed, the advances are either written off in books or adjusted against other third party ledgers ▪ In certain cases, the parties recorded in the books of accounts were different than the actual beneficiaries of the transfers.
Inter-corporate deposits (ICD's)	Money is advanced to related parties as an Inter Corporate Deposit. Inter corporate deposits are generally used when a company has surplus funds.	▪ Inter corporate deposits are advanced to related parties as a part of secured loans. ▪ Interest payments are serviced for some years after the ICD's are advanced. However, subsequently there are no interest payments and the ICD is kept in the books of accounts as a non-moving asset for a long time
Fictitious purchases/ expenses	Purchases are booked against payments made to non-operating entities/ vendors without actual movements of goods.	▪ Fictitious documents (Invoices, transport receipts) are prepared in order to create a document trail. ▪ In order to showcase the purchases to be a genuine, fictitious sales are recorded with no corresponding realisations. ▪ Circular transactions are recorded between inter-related non-operational debtors and creditors to show business operations for a period of time before turning NPA.
Transfer of interest in a asset for the benefit of another entity	Certain assets such as fixed deposit or fixed assets of the company are offered as collateral securities for the loans obtained by related parties	▪ Often contingent liabilities with regard to related parties are concealed in the financial statements. ▪ While offering assets as a collateral, the position of loans in the sister concern are not disclosed in the financial statements.
Use of bank accounts not reported in the books of accounts	Bank accounts are opened outside the consortium bank accounts without obtaining no objection certificates.	▪ Entities in certain cases were observed to have opened bank accounts outside consortium accounts to route transactions. At times such bank accounts are not disclosed as a separate line item in the financial statements. ▪ At times consolidated bank balances are noted in the financial statements without revealing the number of bank accounts with different banks. ▪ Sales proceeds in the bank accounts are routed through bank accounts outside the consortium from where funds are diverted for use other than the loan purpose which delays the process of detection
Transfer of assets at a value less than its market price	Assets of the company are sold at a loss to related parties or non	▪ Assets are sold to related party or non operational company without conducting proper due diligence. The actual market price of the asset sold is not disclosed in the financial statements.

Transaction	Summary of transaction	Misstatement and impact on financial statements
	operational companies to strip cash rich assets of the company	▪ Assets are also transferred pursuant to an agreement between the related parties which are not disclosed to the financial creditors or disclosed in the financial statements.

In this context, the following recommendations are being made:

Recommendation 1: Enhance rigour of implementation of existing standards and requirements
Companies should enhance the rigour of implementation and application of existing requirements on financial reporting, internal financial controls, compliance with laws and regulations, and CEO/CFO certification. Companies should be able to demonstrate how they have complied with the spirit of these requirements. The Ministry of Corporate Affairs (MCA) can consider issuing additional implementation guidance to enable companies to consistently apply the requirements.

This should be accompanied by enhanced focus by the auditors on these areas as well as regulatory monitoring and related enforcement. A combination of these will help in enhancing the rigour of implementation of these standards.

Recommendation 2: Enhance skills and talent within the finance organisation
Companies should seek to upskill their finance team covering not just the technical domains of finance, accounting, reporting and compliance, but also focussing on the skills of the future in finance, such as data and technology skills, including automation, cognitive technologies and analytics. This would fully enable them to fully leverage emerging technology capabilities while also focusing on the compliance and reporting requirements.

Recommendation 3: Enhance disclosures to provide more timely information to users
Companies should enhance the disclosures that they provide to the users of financial information, that can significantly enhance the usefulness and relevance of the information on the company's financial health. These could be a combination of event based disclosures (such as changes in credit rating, defaults in payments of interest/principal, changes in assessment of company's ability to continue as a going concern etc) and periodic disclosures (such as key trends in ratios relating to financial health of the company, non-cash transactions, use of fair values and key assumptions etc).

Recommendation 4: Enhance rules governing related party transactions
While the regulations relating to related party transactions are strict in India, there are still certain areas where these could be strengthened, including the following:

- Enhance the focus and approval mechanisms of related party transactions to the consolidated group coverage to Group through relevant amendments in Listing Regulations as well as Companies Act.
- Audit Committee should be mandated to seek independent reviews / valuation / fairness assessments of transactions meeting certain thresholds. Further, acquisitions, divestments, etc. where promoters are interested should backed by a valuation report and a fairness opinion. There should be a requirement on audit committees to evaluate the competence and credibility of such valuers.

- For transactions beyond a threshold (say 5% of revenues), company should disclose the pricing methodology used to arrive arm's length.
- The approval requirements, as applicable to the initial related party transactions, should be applied to any subsequent modifications to such related party transactions.
- All dues from related parties / contractual obligations (such as advance for properties, etc.), outstanding beyond a specified period, say two years from the date of transaction, should be disclosed in the financial statements along with purpose of the transaction, date when the amount will be collected / obligations settled and reasons for delay, if any.
- The definition of related parties and the disclosure requirements should be suitably modified to consider complex structures that have been used by companies to avoid reporting as related parties (commonly referred to as 'box structures' and 'diamond structures'.

4.2 Monitoring mechanism: Internal auditors

While the Board of Directors are ultimately responsible for the effective governance of a company, the internal audit function plays an important role in assisting the board in providing assurance on the effectiveness and efficiency of the risk management, internal control and governance processes in the company. Therefore, internal audit is one of the critical components of an effective corporate governance framework.

Considering the criticality of its monitoring role, it is important to ensure that the function is robust and providing the necessary support in enhancing the effectiveness of the financial reporting ecosystem. In this context, the following recommendations are made to enhance the effectiveness of the internal audit system:

Recommendation 5: Strengthening the internal audit process
Internal audit process within companies, whether run through an internal team, outsourced to an external firm or co-sourced should consider the following aspects in greater detail:

By the Audit Committee:

- Process of selecting and appointment of internal auditors to be strengthened with the Audit Committee playing the lead role in determining the capacity and capability of the internal audit team
- Scope of internal audit and reporting to be decided by the Audit Committee and should complete coverage of all relevant activities every year
- Oversight of internal auditors should be done by the Audit Committee
- Ensure that the internal audit is not just limited to finance processes but instead multi-disciplinary audit including cyber security, fraud prevention and detection, apart from business, operational, financial and technology areas.
- Ensure the team is adequately equipped with skills in areas of cyber security, forensics, data and technology, apart from core skills in the business operational, financial and technology areas. Where the skills aren't available with the team, the internal audit team should consider the need for involvement of external experts to support the internal audit team
- Consider mandating forensics audit of high-risk areas with the use of digital tools to comb through the volumes of transactions to identify exceptions/ frauds
- Use of risk-based approach combined with additional substantive procedures, including forensic type procedures, should be mandated on all internal audit engagements

By the relevant regulators

- Where internal audit is outsourced to professional firms – whether the internal audit should be subject to regulation and oversight just as statutory audit
- Prescribing minimum qualifications for internal auditor – e.g. membership of a professional body or the Institute of Internal Auditors
- Accountability of internal auditors
- Education and training needs of internal auditors, including continuing professional education requirements, as well as focus on skills of the future

4.3 Corporate governance: Audit Committee, Independent Directors and Board of Directors

Audit committees form an integral part of the financial eco system. Revamping the financial reporting without empowering audit committees would not be effective. Corporate boards need strong leadership from their ACs in steering companies through today's complex business and financial reporting 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.

In this context the following recommendations can be considered:

Recommendation 6: Strengthening the audit committee

What empowers the auditors is a strong and independent AC and one can consider bringing in certain reforms to empower it:

- 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

5. Expectations from auditors – need for structural reforms in the audit profession

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.

5.1 Capacity and capability building of audit firms/ professionals:

Adequate investment required in capacity building at individual firm level and at a broader professional level is required 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 only. Further, all of 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 7: 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 8: 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 9: 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.

5.2 Foundation for Audit Quality

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 10: 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.

5.3 Introduction of Audit Quality Indicators (AQIs):

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 11: Implementation of AQIs 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.

5.4 Audits of Group Financial Statements (Including the Work of Component Auditors)

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 12: Convergence with ISA 600

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

5.5 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 13: 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.

5.6 Multi-disciplinary firms

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. Policies such as mandatory audit firm rotation, strict rules on provision of non-audit services and an effective supervisory mechanism like NFRA, are among the most effective solutions to derive the maximum advantages while minimizing the perceived risks of a multi-disciplinary practice model.

Recommendation 14: Encourage building multi-disciplinary firms

Multi-disciplinary firm 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.

5.7 Auditors expectation gap

Investors recently have begun to question the role of auditors in not being able to highlight financial dis-connects, which post-facto seemed obvious in some cases. The overall sentiment is that auditors have limited themselves to form, rather than the substance in audit reports. Higher level of assurance is expected from auditors extending to areas such as company's risk management, future outlook, identification and action on frauds, compliance of all laws and regulations etc. The argument relating to the role of an auditor being 'watch dog' or a 'blood hound' continues to be open. In short, there is a huge gap between what the role of an auditor is under the auditing standards and what the expectations in this regard are for the larger stakeholder community.

Recommendation 15: Bridge the expectations gap

The relevant regulator should take measures to bridge gap between auditors' responsibility and stakeholders' expectations. This may require various measures, including review of the prevailing auditing standards and the need to enhance or amend them, educating stakeholders about the cost versus benefit of addressing the expectation in relation to the level of assurance, providing clarity about role and responsibilities of auditors, providing clarity about auditors' liability, particularly, in case of corporate frauds and business failures etc

Recommendation 16: Mandatory use of specialists in audits

Mandatory involvement of specialists such as valuers, actuaries in financial reporting of public interest entities needs to be considered. Further, there should be mechanism for oversight and accountability of specialists such as valuers, actuaries.

5.8 Restrictions on 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 Cos 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 in to 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. As long as the audit firms follows these guidelines in spirit, the independence can be maintained in both fact and appearance.
In this regard, the following recommendations can be considered:

Recommendation 18: Non-audit services to audit clients

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

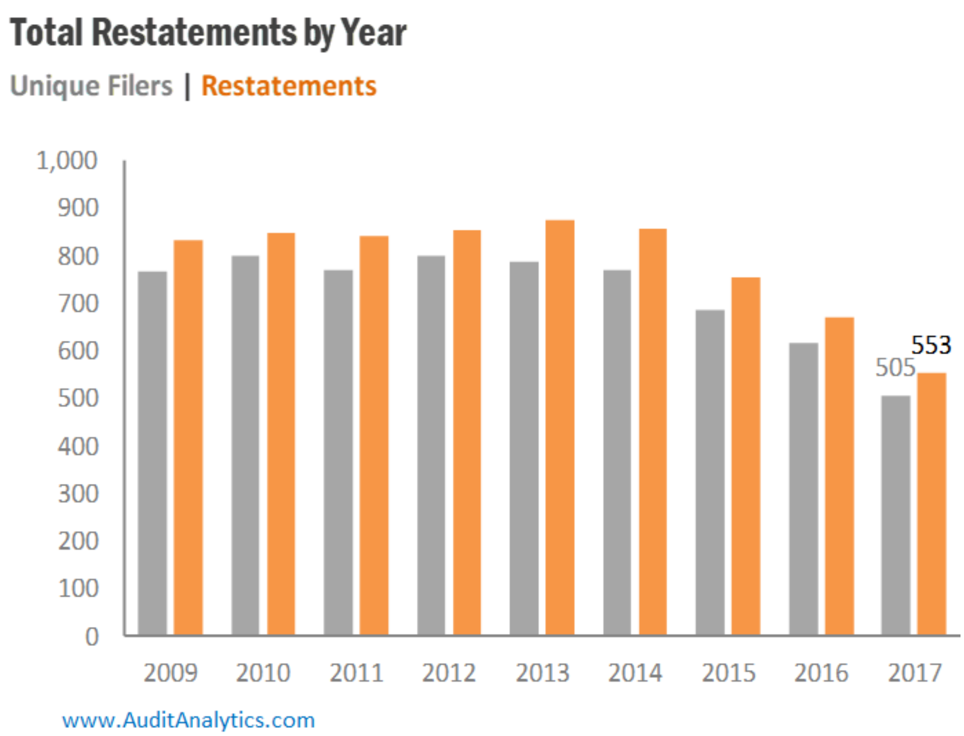
- mandate the assessment of conflict across all the member firms of the network, using the internal conflict check processes implemented by all network firms before rendering non-audit services
- mandate that the remuneration of audit partners is based on the revenues earned only from assurance services; 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

6. Overhaul of the financial reporting regulatory framework

Based on the letter of the law and related regulations, Indian standards on corporate governance and financial reporting are amongst the best in the world, in many cases stricter than those applicable in many of the more mature markets. However, where India has been found lacking is in the rigour of implementation on the part of the companies, and the lack of an effective monitoring and enforcement mechanism on the part of the regulators, combined with the lack of consistency within the audit profession in India, including the availability of relevant skills and capabilities within the firms operating in India.

Further, global experience has also shown that when there is an increased regulatory focus on monitoring of financial reporting, it leads to better quality of reporting over a period of time. Looking at the experience in the United States in particular, there was an increased regulatory focus on quality of financial reporting following the collapse of Enron and other large corporations in the early 2000s, followed by the passage of the Sarbanes-Oxley Act. This led to a spate of financial statement restatements in the following years. However, after reaching an all-time high in 2006, the restatements have consistently shown a decreasing trend with 2017 showing the lowest in 17 years.

[Insert graph on trends in restatements in the US from 2002 to 2018– to replace the graph below]



A quick look at regulatory capacity as it relates to oversight of listed companies indicates that there is a significant gap between what may be required vis-à-vis the capacity that's available.

The latest annual report of the US Securities and Exchange Commission (SEC) highlights that the SEC employed more than 4500 employees in 2018. In contrast SEBI employed fewer than 800. This is for a market with more than 5500 listed companies and 55,200 registered market intermediaries. While the

SEC has almost one employee for each company, SEBI has one for six companies. This makes it hard for officers to monitor trading activities and detect frauds.

SEC			SEBI Equivalent		
Division	**Responsibility**	**Man-power**	**Division**	**Responsibility**	**Man-power**
Corporate Finance	Ensures that investors are provided with material information in order to make informed investment decisions, both during initial offering and on an ongoing basis	477	Corporation Finance Department	Issuance & listing of securities including initial and continuous listing requirements. Also, handles complaints pertaining to non-compliance with LODR & falsification of accounts	
Enforcement	Conducts investigations into possible violations of the federal securities laws, and prosecutes the Commission's civil suits in the federal courts as well as its administrative proceedings	1,380	Integrated Surveillance Department Enforcement Department	Responsible for market surveillance of all segments of Securities market Responsible for handling appeals against SEBI orders filed before SAT, appeals filed against SAT in Supreme Court, Criminal complaints filed by SEBI in courts and settlement proceedings	
Investment Management	Regulates investment companies, variable insurance products, and federally registered investment advisers including mutual funds, closed-end funds, unit investment trusts, and exchange-traded funds	183	Investment Management Department	Responsible for registering and regulating mutual funds, VC funds, foreign VC funds, collective investment schemes including FIIs, Portfolio managers and custodians	
Economic Analysis and Risk	Assists in the Commission's efforts to identify, analyze, and respond to risks and trends, including those associated with new financial products and strategies	151	Department of Economic and Policy Analysis (DEPA)	Policy framing, research and analysis of trends and specific data	
Trading and Markets	Establishes and maintains standards for fair, orderly, and efficient markets. The Division regulates the major securities market participants, including broker-dealers, self-regulatory organizations (such as stock exchanges, FINRA, and clearing agencies), and transfer agents	258	Market Intermediaries Regulation and Supervision Department (MIRSD)	Responsible for registration, supervision, compliance monitoring and inspections of market intermediaries across all markets. Also handles work related to regulatory violations.	
			Market Regulation Department (MRD)	Responsible for formulation of policy and supervision of Stock exchanges, depositories and clearing corporations	
Others	General Counsel, Administration, Public Affairs etc.	2,105	Others	Commodity derivatives Market Regulation Department (CDMRD), Integrated Surveillance Department, International Affairs etc.	
Total		**4,554**			**788**

To address these challenges, the regulators need to focus on the following:

1. Build regulatory capacity including data analytics and cognitive capabilities
2. Build effective monitoring and enforcement capabilities
3. Enhance cooperation between agencies and identify a nodal regulator
4. Structural changes to address short termism in the market

Accordingly, the following recommendations are being made for an effective overhaul of the regulatory framework.

6.1 Strengthening of National Financial Reporting Authority (NFRA)

It is imperative that NFRA is adequately staffed with appropriate skill-set and experience, both in terms of technical and administrative activities. It is important that the personnel responsible for inspection and other audit quality related activities should have relevant industry and professional experience. NFRA should ensure that the reviewers are equipped to handle different sized audit firms. They should undergo various trainings like on industry specific matters (to develop ability to deal with complex sector issues), rapidly changing technology (to develop understanding of data analytic tools that may be used by various audit firms) etc. Further, the personnel with specialized skills, such as valuation, IT, banking, should also form part of NFRA considering greater involvement of specialists in large and complex audits.

In this context, it may be noted that internationally, all major oversight bodies have made significant investments in capacity building (e.g. PCAOB has 900+ resources and FRC UK has 250+ resources) to discharge their functions effectively, including setting up teams with not just accounting and auditing expertise, but also significant industry and sectoral expertise.

NFRA can work towards adoption of best practices from PCOAB to empower NFRA such as:

- While we have witnessed penalisation and de-barring of auditors, we are yet to see any regulator in India prescribing remedial measures. The PCAOB inspections result in not only finding deficiencies but also enforcing remedial measures to help audit firms address quality control issues.
- PCAOB makes certain parts of audit inspection reports public to expose negligent audit firms. 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- this has a significant impact on audit quality, auditors' reputation, and client retention.

The following suggestions may be considered in this regard:

Recommendation 19: Need enforcement and capacity building to ensure quality of inspections.
Recruit more senior staff (including at partner-equivalent level) with relevant experience and sector expertise and enhance the involvement of personnel with specialized skill-sets (IT, Forensic, Valuation, etc.). NFRA should also be provided requisite financial resources as well as staffed with adequate full-time personnel (along the lines of the US PCAOB, UK FRC or other similar global bodies) to be able to effectively carry out its mandate without any active support from the profession.

Recommendation 20: Clarity about process for inspection, remediation measures and publication of findings
With a view to ensure transparent and effective functioning of NFRA, its processes should be clearly laid out. This would include clarity on periodicity of inspections, publication of findings on the web-site, process of appeal etc. Specifically, the following two suggestions deserve consideration:

1. 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.
2. Publication of findings should be an anonymized and be in a summarized report form.

Recommendation 21: Efforts to make NFRA a member of International Forum of Independent Audit Regulators (IFIAR).
Most major economies in the world have implemented systems of independent oversight for the auditors of listed companies that provide confidence to shareholders and stakeholders. The International Forum of Independent Audit Regulators (IFIAR) is an international body established in 2006 that comprises independent audit regulators from 52 jurisdictions representing Africa, North America, South America, Asia, Oceania, and Europe. IFIAR's mission is to serve the public interest and enhance investor protection by improving audit quality globally.

In India, the NFRA is mandated to conduct such reviews and is currently operationalising the process of reviews of audits performed by various auditors. NFRA should be further strengthened to meet the independence criteria laid down by IFIAR and become a member of IFIAR within a defined timeframe.

6.2 Other capacity building initiatives within the regulatory system

Recommendation 22: Bridging the human resources gap and building new capabilities
Today there are over 11 lakh companies registered in India that are considered active, out of a total of over 17 lakh companies. Further, there are over 5,000 listed companies in India. Monitoring companies at this scale, with companies operating across the spectrum from Fortune 500 companies on the one hand to small shell companies on the other requires significant capabilities, both human resources as well as technology capabilities.

Currently SEBI has approximately 1 staff for every six companies monitored, as compared to a 1:1 ratio for markets such as the United States which has a similar number of listed companies. The efforts to monitor smaller companies often tends to be disproportionate to their size, especially considering the experience in India dealing with shell companies and the like, and therefore requires a good combination of human resources and technology capabilities. The challenge is even larger for the MCA as they look at the entire unlisted company universe, with many of them qualifying as public interest entities.

SEBI and MCA, apart from increasing its manpower, should also look at bringing in people with strong technology and data analytics capabilities to be more effective in their monitoring and enforcement functions.

6.3 Periodic regulatory monitoring mechanisms

Recommendation 23: Review of periodic filings by companies
MCA and SEBI should set up a process for periodic review of filings made by unlisted public interest companies and listed companies respectively.

For listed companies, companies are required to comply with regulations pertaining to disclosure that must be made both at the time of an initial offering and then on a continuing and periodic basis. While SEBI currently carries out detailed reviews of filings made in connection with initial public and follow on offerings, SEBI should set up a process to annually review documents that listed companies are required to file with SEBI. A similar process for review of filings should also be set up by MCA for unlisted public interest entities.

The documents to be covered as part of this periodic review should include: (i) annual and quarterly filings (where applicable); (ii) annual reports to shareholders; (iii) notices and other accompanying materials sent to shareholders before general meetings; (iv) documents concerning open offers, qualified institutional placements, and buy backs; (v) filings related to mergers and acquisitions and other corporate reorganisations; (vi) ratings reports from the ratings agencies in situations where the firm's credit rating has suffered a downgrade; and (vii) adverse reports on the firm's business and/or corporate governance from analysts and/or proxy advisors.

Recommendation 24: Monitoring and enforcement of policies relating to financial reporting
MCA and SEBI should take on the responsibility for monitoring and enforcing policies on accounting and auditing matters to enhance the transparency and relevancy of financial reporting by public interest entities, and for improving the professional performance of public company auditors in order to ensure that financial statements used for investment decisions are presented fairly and have credibility. To take on this responsibility and achieve the stated objective, MCA and SEBI, either through the Corporation Finance Department of SEBI or a separate department in the MCA, should set up three groups; Accounting, Professional Practice and International Collaboration.

Recommendation 25: Use of data science and development of early warning systems: assessing the quality of financial reporting and risk prediction
MCA and SEBI should set up a data science department that will focus its efforts of review of the financial statements and filings to detect reporting, disclosure and audit failures. The principal goal of the department should be detection and prosecution of violations involving false or misleading financial statements and disclosures. The department should also focus on identifying and exploring areas susceptible to fraudulent financial reporting, including ongoing review of financial information and use of data analytics.

To complement the insights obtained using data analytics, the department personnel should review the results manually and apply their industry expertise and professional scepticism to finally conclude on the data that they are analysing. This would be essential to address the risk of false positives that data analytics may generate. Therefore, manual intervention and analysis is critical to review and conclude on the outcome of data analytics. The source of information can be from the financial statements and other financial data that are being filed with SEBI and the XBRL reports that are being filed with MCA. The XBRL tags could be used to identify financial data and the related note disclosures. Furthermore, all key parameters such as measures of earnings smoothing, revenue trends, key parameters, industry wise comparatives, tax treatments and so on should be readily accessible to the members of the department through intuitive dashboards that are customized for their use.

Recommendation 26: Institutionalise a whistle-blower program for all public interest companies
Currently the MCA does not have a whistle-blower program covering all public interest entities. SEBI has recently instituted a program. It is important for MCA to create such a policy in order to ensure that it is constantly provided with information which it cannot independently collect regarding the public interest entities in India. This would ensure greater transparency and accountability and improve the regulation systems. In fact, some of the recent instances that have put the spotlight on corporate governance, whistle-blowers have played an important role.

6.4 Cooperation between regulatory agencies and need for a nodal regulator

Recommendation 27: Enhance cooperation between regulatory agencies
There are multiple initiatives within the government departments on enhanced monitoring and data analytics. As MCA and SEBI start monitoring companies more effectively, there should also be a mechanism for real time exchange of information and cooperation between multiple regulators. This could cover MCA, SEBI, ICAI, Tax Departments, RBI and other regulatory agencies and professional bodies to enhance the coverage of the domain pertaining to white-collar crime in listed entities and public interest entities.

This should be further extended with a mechanism to share red flags with auditors as well on a timely basis. This could include results from analytics being performed by MCA and SEBI, whistle-blower complaints received by SEBI, frauds reported to MCA, credit defaults data reported to RBI, tax issues under the lens of CBDT and so on.

Recommendation 28: 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 nodal regulator that not only enacts regulations but also monitors the financial reporting and audit profession. There can be one nodal regulator for one class of companies (say listed companies) and another for another class of companies (say unlisted public interest entities), but for the same class of companies, there should be only nodal regulator. It is ideal that only such a nodal regulator that enforces the regulations, initiates disciplinary actions. Other Enforcement authorities needs 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. This will make the review process more cost effective and would also avoid overlap and multiple regulatory actions and litigations. For this purpose, NFRA which has already been set-up as an independent oversight body should be strengthened.

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.

6.5 Enforcement regime: Need for a balanced view

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, and improvement based rather than focusing on penalty provisions. The regulators should avoid undue focus on punishment. Further there is deferred prosecution. The overall environment should not result in it being a deterrent for individuals to take on senior management, director or auditor roles. It is important that regulatory measures do not result in unnecessary expense or burden making India markets unattractive for investments.

Following recommendations should be considered in this regard:

Recommendation 29: Constructive approach to sanctions:
A range of sanctions should be prescribed based on the severity of issues which will make the entire inspection process constructive rather than punitive. There should be adherence timeliness in implementation of actions.

While considering sanctions against audit firms, the relevant regulator should consider a range of possible sanctions, rather than just looking at deregistration. Sole action of deregistration of audit firm will decrease competition in market. Other measures such as the following should 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

Recommendation 30: Sanctions against individuals involved vs audit firms:
Where the auditors are found guilty in a case, it would be appropriate to penalise only the partners and the other staff members of the audit firm who were connected with the audit assignment. Only in situations of repeated failures resulting from systemic deficiencies with the firm, should any broader action be considered. Debarring the entire firm of auditors impacts a large number of population of professionals employed with the firm, who are unnecessarily penalized for no involvement on their part in the case.

6.6 Measures to address short-termism in the market

Recommendation 31: Short term vs long term view on companies – removal of quarterly reporting
Companies and their managements are increasingly focused on compliance, quarterly reporting, chasing analyst expectations and striving to meet them. As a result, there is a lot of focus on short term performance, sometimes at the cost of long-term performance. The UK, European Union and certain other jurisdictions have done away with requirement to mandatorily publish quarterly results, wanting investors and companies to focus on long term performance and prospects as against the short-term performance of the company. The decision in the UK was triggered by the Kay Report of 2012 and subsequent studies carried out by the European Union.

India should consider making quarterly reporting voluntary, and instead encourage both companies and investors to focus on long term business results. Mandatory reporting should be restricted to half yearly and annual reporting. Companies should only be required to report any material developments in the interim period, rather than report their financial results on a quarterly basis. This will also help ease the pressure on the management caught in the reporting cycle.

6.7 Other measures to strengthen financial reporting in the country

All listed companies and large unlisted companies in India, except for banking companies, are currently following Indian Accounting Standards (Ind AS), which are aligned to the globally accepted International Financial Reporting Standards (IFRS). The adoption of Ind AS will enhance the quality of financial information reported by banks and the level transparency in their reported performance. However, the MCA and RBI have deferred the applicability of Ind AS to banks on multiple occasions citing the overall readiness of the banking companies to make this transition. There have also been concerns on the impact of adoption of Ind AS on the capital requirements of banks.

Recommendation 32: Implementation of Ind AS for banks

Ind AS should be implemented immediately so that capital impairment issues can come to light and capital requirements can be evaluated right now rather than later when corrective actions will be difficult to implement. Immediate Implementation of Ind AS will highlight the extent of the credit related stress, which once known can be used to draft action plans for remediation.

In this context, it is important to note that the Basel Committee confirms that there are several reasons why it may be appropriate for a jurisdiction to introduce a transitional arrangement for the impact of ECL accounting on regulatory capital. The Committee acknowledges that the transition to ECL accounting will generally result in an increase in the overall amount of loan loss provisions, which in many cases will reduce the capital ratios of banks as they transition to the ECL approach. Based on these considerations, the Committee believes that jurisdictions should have the option to choose whether to apply a transitional arrangement for the impact of ECL accounting on regulatory capital. The Committee stresses that a transitional arrangement must apply to only “new” provisions arising as a result of moving to ECL accounting. Transitional capital adjustments must not be made for provisions which would exist under accounting approaches used prior to the implementation of ECL accounting.

In view of the above, adopting Ind AS, and then using the transitional arrangement permitted by the Basel Committee for the impact of ECL on regulatory capital would be a prudent approach to deal with the current NPA situation and the need for meeting the regulatory capital requirements.

Recommendation 33: Use of fair value in financial reporting and the involvement of experts

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. 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 also 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 also 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.

7. Key takeaways

1. To be effective and sustainable, the reforms need to focus on the financial reporting eco-system as a whole, including corporates, audit committees and governance framework, the audit mechanism, financial reporting requirements and an overhaul of the regulatory framework.

Expectations from corporates and the governance framework

2. Enhance the rigour of implementation of existing standards and requirements on financial reporting, internal controls, compliance with laws and regulations and certifications by the CEO, CFO and the Board.
3. The talent and skills within the finance organization as well as within the Board and the Audit committee need to be strengthened and broad-based to align them with the skills of the future.
4. Companies should be mandated to provide more timely information, including on certain leading indicators of their financial health to users of financial information
5. Strengthen the processes and requirements to prevent or minimize abusive related party transactions
6. Strengthen the internal audit function
7. Focus on strengthening audit committees through regulatory oversight and mandating an increased focus on financial reporting, tendering process for auditors and recording of dissent with the Board, if any.

Expectations from auditors – need for structural reforms in the audit profession

8. Capacity and capability building in the profession is a must and an urgent need for them to build depth and competitiveness. A foundation for audit quality could be established to nurture audit quality
9. 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
10. 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
11. Measures need to be taken to bridge the gap between auditors' responsibility and stakeholders' expectations
12. Group auditors should be required to take responsibility for the audit of the entire group
13. 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
14. Banning an audit firm without proven wilful misconduct is not a solution - other options such as penalty, more close regulatory oversight on control, etc. should be considered
15. 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
16. Bring further restrictions and enhance disclosures relating to non-audit services

17. Today's corporate world has very large companies with a global footprint that need international network firms and multi-disciplinary firms to provide them with the seamless cross functional and sector expertise and their brand name to boost investor confidence

Overhaul of the regulatory framework

18. NFRA can strengthen the inspection mechanism. Its role should not be of just to enforcing compliance, it is should also to nurture the progress and growth of the audit profession. NFRA could consider membership with an international forum such IFIAR.
19. Overlap of regulators should be addressed by identifying a nodal regulator and taking a cue from the PCOAB model
20. Regulators also need to focus on capability building to effectively discharge their monitoring and enforcement functions, including setting up processes and groups to periodically review filings by companies
21. Regulators should develop early warning systems by mining data from periodic filings by companies and focusing on leading indicators of financial stress
22. The regulators should also leverage on a whistle-blower program
23. There should be greater collaboration between regulators and active sharing of information amongst themselves and with the auditors
24. Regulators should take a balanced and a constructive approach in bringing sanctions against auditors
25. SEBI should consider the removal of quarterly reporting, thereby easing the pressure on management to constantly endeavour to meet analyst expectations
26. Proposed changes, especially regulatory oversight, should enhance audit quality but not impair ease of doing business- distinction should be made between public interest entity and a non-public, so that different, stricter regulations apply to only public entities
27. The roadmap for implementation of Ind AS for banks should be expedited with appropriate transitional arrangements for considering the impact of ECL accounting on regulatory capital

8. List of Abbreviations

CMA	Competition and Markets Authority, UK
CBDT	Central Board of Direct Taxation
ECL	Expected Credit Losses
FRC	Financial Reporting Council, UK
ICAI	Institute of Chartered Accountants of India
IFIAR	International Forum of Independent Audit Regulators
IFRS	International Financial Reporting Standards
Ind AS	Indian Accounting Standards
MCA	Ministry of Corporate Affairs
NFRA	National Financial Reporting Authority
PCAOB	Public Companies Accounting Oversight Board
RBI	Reserve Bank of India
SEBI	Securities and Exchange Board of India
SEC	Securities Exchange Commission

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