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The National Financial Reporting Authority(NFRA) – A Case Of New Audit Governance In India

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The implementation of the NFRA has impacted the powers of the ICAI drastically, especially with respect to the disciplinary powers of the ICAI

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The Standing Committee on Finance's 21st Report on the Companies Bill, 2009, recommended the need for an independent body to monitor the quality of audit undertaken across the corporate sector in India. Following the recommendation and in consonance with the global best practices, the National Financial Reporting Authority was first provided recognition under section 132 of the Companies Act, 2013 (Act). This provision had remained idle for almost 5 (Five) years only until when the Hon'ble Supreme Court of India in its judgment dated February 23, 2018, gave a nudge to the formation of the NFRA. The Apex Court, in the matter of S. Sukumar v/s The Secretary, Institute of Chartered Accountants of India, ordered the Government of India to constitute a committee (Committee) to look and deliberate into the aspects of audit system in India. The Committee was formed in April 2018 and the terms of reference of the Committee included the need for an appropriate legislation on the pattern of the Sarbanes Oxley Act, 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 in the USA or any other appropriate mechanism for oversight of the profession of the auditors.

The Committee thereafter submitted its report on October 25, 2018 (Report), wherein it has considered several issues and has made various recommendations to strengthen the regulatory regime of auditors and promote the development of the audit profession in the country. Within a span of a little over two weeks from the submission of the Report, the Ministry of Corporate Affairs, on November 13, 2018, notified the National Financial Reporting Authority Rules, 2018 (Rules) to lay down the powers, jurisdiction, roles, and duties of the NFRA.

The Report records that the Institute of Chartered Accountants of India (ICAI) had raised continuous objections with respect to the formation of the NFRA and the ICAI was of the opinion that there was no need for a new regulator and, instead, the existing mechanism needed to be strengthened. As a middle path, the ICAI also recommended setting up an independent quality review board under the Chartered Accountants Act, 1949 to refine the quality of attestation of audits. The prolonged debate with respect to the need for the NFRA had delayed the implementation of this critical reform.

On one hand, the implementation of the NFRA has impacted the powers of the ICAI drastically, especially with respect to the disciplinary powers of the ICAI. On the other hand, the ICAI as a governing body continues to exist with respect to all entities that do not fall within the ambit of the NFRA. This might act as counter-productive in this long road to ensuring effective implementation of the NFRA.

Following the IL&FS crisis, as per the recent news reports, it is proposed that the Securities and Exchange Board of India (SEBI) is also planning to tighten up rules around audit of subsidiary companies of the listed companies. As a result of this, the auditor

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audit reports prepared by different auditors of subsidiary companies. What it will also do is to require the parent companies to adopt a unified structure of the same audit firm being responsible to audit all the subsidiary entities in the group. It will be interesting to see if the move will also bring within its folds the associate companies whose financial statements are also required to be consolidated with the parent's as per the Companies Act, 2013.

In the aforementioned scheme of things, too many regulators governing the audit governance of companies, i.e. NFRA, ICAI, MCA, SEBI, could result in creating ambiguities around the proposal to clean up the audit governance in India, and it will be imperative if the different regulators aim to streamline the process by having internal consultations and portraying a unified audit regime.

In the aforementioned backdrop, we have analyzed below, how the NFRA is being touted as the regulator to curb the audit mishaps and to bring in stronger audit framework in India.

Non obstante and penalizing powers of the NFRA

The Act has given the NFRA the over-riding powers to establish its supremacy over other laws, with respect to its various functions and powers, viz., recommendations for accounting and auditing standards, enforcement of compliance with accounting and auditing standards, overseeing of professionals engaged in ensuring compliance with accounting and auditing standards, investigation into professional misconducts by chartered accountants, empowered with powers of civil court similar to trying a suit, and for imposing penalties and debarment. The non-obstante powers given to the NFRA do seem to indicate that there is an intent to overhaul the regulatory regime in India for the audit and auditors.

With the introduction of the NFRA, one of the key aspects to understand is how the ICAI will be visualized as compared to the powers given to the NFRA. Though the NFRA has been given the non-obstante powers, the ICAI will continue as the primary body for the auditors. In fact, the Rules require the NFRA to receive recommendations from the ICAI on proposals for new accounting standards or auditing standards or their amendments, however, at the same time, the NFRA is given the liberty to consider the recommendations in such manner as it deems fit, thus making the recommendations made by the ICAI not binding in nature.

The NFRA is also empowered to impose heavy monetary penalties. In case professional or other misconduct has been proven with respect to a person/entity falling within its ambit, the NFRA is given the power:

1. to impose a penalty of not less than INR 1,00,000 (Indian Rupees One Lakh), but which may extend to 5 (Five) times of the fees received, in case of individuals; and
2. to impose a penalty of not less than INR 5,00,000 (Indian Rupees Five Lakh), but which may extend to 10 (Ten) times of the fees received, in case of firms.

Not only can it impose monetary penalties, but it can also debar the member or the firm from engaging himself or itself from practice as member of the ICAI for a minimum period of 6 (Six) months or for such higher period not exceeding 10 (Ten) years in case a professional or other misconduct has been proven with respect to itself.

Absence of network liability in the Rules

While the Rules have been notified, however, there is one key aspect that the Committee had considered has gone missing in the current form of Rules. In the Report, the Committee has acknowledged the concept of auditor and audit firm operating in India as a member/part of an international network, and in view of the same, it made two noteworthy recommendations, as listed below, however, these recommendations have not found any place in the Rules:

Monetary penalties on international network / entity: The Committee recommended imposition of civil liability in the form of monetary penalties on the international network/entity with whom / which the Indian audit firm has entered into networking/membership, if any audit failure or fraud is found to have been caused due to any faulty methodology being followed by that particular network. The penalty could be up to 5 (Five) times the amount of penalty imposed on the audit firm; and

Annual Transparency Report to the NFRA: Another recommendation from the Committee was that every auditor and audit firm which is operating in India as a member/part of an international network, must submit an annual transparency report to the NFRA. The rationale behind seeking such a report is to gather information which will help the NFRA keep track of the auditors and audit firms operating in India as part of the same network so that in case any legal liability needs to be imposed on that particular network for an audit failure or fraud. Few examples of what should form part of the annual transparency report are: (i) description of the network, its legal and structural arrangement, including payment of any fees, costs, grants, between the Indian audit firm and its network firms and affiliates, directly or indirectly; (ii) details of ownership and management structure of the outside entities constituting the network; (iii) central administration or principal place of business of each network member (including their affiliates) operating in India; and (iv) total turnover achieved by network members (including their affiliates) operating in India.

The network liability is definitely an important element to strengthen audit governance, especially in light of various international networks operating in India, however, failure of consideration of the same in the Rules as on date,

Jurisdiction of the NFRA: Private companies ousted, extra-territorial applicability

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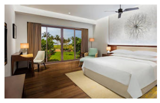
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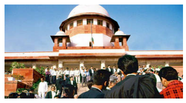

irrespective of their turnover, or net worth or income, have been left outside the jurisdiction of the NFRA along with public unlisted companies below the prescribed thresholds, the Central Government seems to have been given the discretion to make a referral to the NFRA of even private companies or such unlisted public companies, in public interest. It is not unusual where a private company is the eventual controller of a complex multi-layered structure, and in spite of the same, exclusion of private companies from the NFRA regime looks odd.

In a nutshell, as provided by the Rules, the NFRA will regulate accounting, audit standards and quality of service of auditors of:

Listed companies	Certain unlisted public companies	Companies governed by other regulators	Entities referred by Central Government
Companies whose securities are listed on any stock exchange in India or outside India	Unlisted public companies having: • paid-up capital of not less than INR 500,00,00,000 (Indian Rupees Five Hundred Crores); or • an annual turnover of not less than INR 1000,00,00,000 (Indian Rupees One Thousand Crores); or • in aggregate, outstanding loans, debentures and deposits of not less than INR 500,00,00,000 (Indian Rupees Five Hundred Crores) as on the March 31st of immediately preceding financial year;	Insurance companies, banking companies, companies engaged in the generation or supply of electricity, companies governed by any special statute for the time being in force or bodies corporate incorporated by other statutes to which the provisions of the Act apply	The Central Government is empowered to refer any body corporate or company or person, or any class of bodies corporate or companies or persons, in public interest
Offshore associate or subsidiaries of the aforementioned entities			
Any body corporate incorporated or registered outside India, which is a subsidiary or associate company of any of the aforementioned entities if the income or net worth of such subsidiary or associate company exceeds 20 % (Twenty percent) of the consolidated income or consolidated net worth of the relevant aforementioned entities			

Publication of findings of non-compliances with accounting and auditing standards in public domain

The "name shame" approach has found its way in the Rules. This is one of the key powers given to the NFRA to publish its findings on its website which are available in public domain regarding the non-compliances with accounting and auditing standards where it has conducted investigations or initiated actions under the Rules. This power is in line with the powers of independent audit regulators in other jurisdictions to publish the results of an audit inspection. For instance, the Sarbanes Oxley Act, 2002 authorizes the Public Company Accounting Oversight Board to inspect registered firms and publish the results of the same. This move will ensure transparency in actions taken by the NFRA. However, the Rules also give the discretion to the NFRA to not publish its findings if it has reasons not to do so in public interest and it records the reasons in writing. In such cases, it may not be ruled out, where a member of an international network, it finds itself looped into this, will not proceed for defamation.

Disciplinary proceedings against auditors and audit firms: Responsibilities of partners/ employees

One of the differentiating powers given to the NFRA is its power to initiate disciplinary proceedings not just against individual auditors but also against audit firms. This was one of the critical limitations under the Chartered Accountants Act, 1949, where the ICAI had the inability to penalize the audit firms for professional or other misconducts, and it could only penalize the members with a monetary penalty up to INR 5,00,000 (Indian Rupees Five Lakhs).

The Rules have empowered the NFRA to initiate disciplinary proceedings against individual auditors and audit firms based on the reference received from the Central Government or findings of its monitoring or enforcement or oversight activities, or on the basis of material otherwise available on record.

Interestingly, in case the action is initiated against an audit firm, the relevant audit firm is required to disclose the names of the partners concerned who shall be responsible for answering the allegations. if no partner, whether erstwhile or present, own responsibility for the allegations made against the audit firm, then the audit firm as a whole, will be responsible for responding to the allegations, and all the partners and even employees of that audit firm as on the date of occurrence of alleged misconduct, will be responsible for answering the allegations.

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Investigative powers: ICAI and NFRA's powers to take disciplinary actions

The NFRA is given the power to investigate if it has received any reference from the Central Government for investigation into any matter of professional or other misconduct, or if it has decided to undertake investigation into any matter on the basis of its compliance or oversight activities, or if it has decided to undertake suo motu investigation into any matter of professional or other misconduct. These powers appear very wide and will require clear parameters for their exercise. The NFRA has the power to investigate all cases of professional or other misconduct against auditors of all companies who fall within the purview of the NFRA and no other institute or body can initiate or continue any proceedings in such matters of misconduct where the NFRA has initiated an investigation. Whereas, all cases of professional or other misconduct against auditors of companies or body corporates who do not fall within the ambit of the NFRA shall be dealt with ICAI unless a specific reference is made to the NFRA by the Central Government.

In a recent ruling by the Supreme Court of India, in the matter of the Council of the Institute of Chartered Accountants of India v/s Shri Gurvinder Singh & Anr. Vide, dated November 16, 2018, the Apex Court held that the disciplinary committee of the ICAI as per the Chartered Accountants Act, 1949 has the powers to conduct disciplinary proceedings and met out punishments against a member of the ICAI if it is of the opinion that the act done by such a person brings disrepute to the profession whether or not related to his personal work. The ruling seems to have strengthened the ICAI's powers to conduct the disciplinary proceedings, however, after the commencement of the Rules and in light of the NFRA's powers under the Act, it will be interesting to see as to how powers such as these which have been given to the NFRA as well as the ICAI, fall in place.

Suo moto review of financial statements

The NFRA is empowered to review the financial statements of the companies or body corporate falling within its jurisdiction for the purpose of monitoring and enforcing compliance with accounting standards. It can also direct such companies or body corporates or even their auditors to provide further information or explanation or any relevant documents relating to such company or body corporate. The NFRA is empowered to direct auditors to take measures for improvement of audit quality including changes in their audit processes, quality control, and audit reports and specify a detailed plan with time-limits.

Database of information vis-à-vis auditors

The Rules have also asked the companies and the body corporate to file a return with the NFRA providing details of auditors. Additionally, it has imposed obligations on an auditor of every company/corporate which falls within the purview of the NFRA, to file an annual return in the prescribed form. The format of this form is not provided in the Rules, however, it may contain details about the remuneration (audit as well as non-audit fees), conflict of interest, the international network to which the auditor belongs to, number of entities for which the auditor is acting as auditor, etc.

CONCLUDING REMARKS

Whilst the aforementioned efforts look commendable, they are delayed in their introduction. As an independent audit regulator, it will be expected that the NFRA enhances an investor's confidence and bring more transparency and accountability in the auditing profession. With the roles and responsibilities extending to even employees of the audit firms, they need to be wary of their accountability in the audit firms. The publication of the name of audit firms, especially those which belong to international network will clearly cause reputational damage. Although the NFRA is mandated to not publish proprietary or confidential information, however, at the same time, it is given the power to do so in the public interest if it has reasons for the same. It is a power that will need to be exercised with great caution.

As we see more complex and multi-layered structures and increased corporate governance, it will be interesting to see the implementation and effectiveness of the NFRA vis-à-vis the increased roles and responsibilities of auditors, and whether the NFRA will be able to act as the watchdog to protect the public interest and the interests of investors, creditors and others associated with the companies or bodies corporate falling within its purview.

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