NFRA-Will it make a difference?

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Background:

The Union Cabinet on March 1, 2018 has approved the proposal for setting up of National Financial Reporting Authority (NFRA), a big step forward in regulating the financial audit of large companies. The NFRA will be an independent regulator overseeing the auditing profession. The setting up of NFRA signalled the end of voluntary self-regulation of the auditing profession and the beginning of formal, mandatory oversight.

The National Financial Reporting Authority shall consist of a chairperson, three full time members and nine part-time members. The part-time members will be one each to represent the Ministry of Corporate Affairs (MCA), the Comptroller and Auditor-General of India, the Reserve Bank of India, and the Securities and Exchange Board of India, three from the Institute of Chartered Accountants of India (ICAI) — president, chairperson of Accounting Standards Board and chairperson, Auditing and Assurance Standards Board — and two experts from the field of accountancy, auditing, finance or law.

The concept of establishing NFRA has travelled a long way. It was first proposed as an independent regulator of accounting and auditing in the wake of the Satyam scandal which went undetected for many years by the Company's auditors. There was a public outcry and call for a complete overhaul of the regulation of the accounting and auditing profession in India.

Companies Act 2013 (the 'Act') included Section 132 which relates to setting up of NFRA. This was one of the key changes brought about by the Companies Act 2013 but provisions of Section 132 were not notified by MCA for the last five years. The decision to set up NFRA perhaps is coming at a time when the role of auditors has come under further scanner for alleged lapses in various corporate scams, including one of the biggest banking sector fraud to the tune of Rs 12,700 crore at Punjab National Bank.

NFRA may be regarded as comparable to Public Company Accounting Oversight Board (PCAOB) in the United States or Financial Reporting Council (FRC) in United Kingdom or Accounting and Corporate Regulatory Authority (ACRA) in Singapore. Interestingly, PCAOB was in fact set up by Securities and Exchange Commission in the wake of Enron, WorldCom, Tyco and a series of other financial reporting scandals that rocked the securities markets in the United States and shook public confidence during those years.

These regulators not only act as an independent oversight body but also provide suggestions to the audit firms to improve the audit quality.

Need for NFRA:

Need for NFRA is primarily to move away from self-regulation system to statutory-based oversight that is independent of profession. In view of the critical nature of the responsibilities of auditors wherein alleged lapses have been seen to cause serious repercussions, the need for an independent body to oversee the profession became a requirement of the day.

It's not that the Institute of Chartered Accountants of India (ICAI) does not have a review mechanism to ensure that the process does not result in self-regulation. A Quality Review Board already exists, which consists of a chairperson and ten other members which are represented equally by the central government and the ICAI.

A legitimate question then arises, that what is it that is lacking in the current review mechanism set up by the ICAI which has led to the creation of NFRA. Why not strengthen or streamline the present system rather than creating another layer of red tape through NFRA?

Perhaps answers to these questions rest with the perception of the people at large. People arguing in the favour of the NFRA regard the self-regulation system as a flawed principle whereby the regulated elect the regulators. Uncovering number of frauds in the recent times has sowed the seed of doubt in the minds of the people that members or their elected representatives will not and may not be expected to take action against themselves.

It creates an ab-initio conflict of interest and therefore implicated the existing self-regulatory system and led to the inescapable conclusion that independent oversight bodies are indispensable elements of a strong financial reporting and auditing system.

People have a perceived trust and ability to rely more on an independent regulator. This perceived trust is also due to the existence of similar oversight bodies existing in other countries, for example Public Company Accounting Oversight Board (PCAOB) in the United States of America. With the formation of PCAOB, began a cultural change that triggered a profound shift in auditors' attitudes toward their accountability and built substantial public confidence in the countries' market.

World over, the number of independent audit regulators have increased over a period. This can be observed from the membership of International Forum of Independent Audit Regulators (IFIAR) which was established in 2006 by independent audit regulators from 18 jurisdictions and now covers 52 jurisdictions. IFIAR, inter alia, promotes international collaboration between the regulators. The oversight structure of auditors within ICAI has not been recognized as independent by IFIAR and India is not represented on this body.

Further, there has also been an increasing recognition of having an independent oversight /regulation over professionals and the deficiencies in the self-regulation model have also been taken note of in other legislations and sectors. An example for this is the Insolvency & Bankruptcy Code, 2016 that provides for the Insolvency & Bankruptcy Board of India to provide oversight over the Insolvency Professionals over and above the role of self-regulatory bodies. This is true in case some of the other bodies such the Securities Board of India (SEBI), the Telecom Regulatory Authority of India (TRAI) and the Competition Commission of India (CCI).

Certainly, there are benefits that can be anticipated in the coming future on setting up of NFRA. Some of the key benefits includes: functioning of the body as an independent authority, accountability of the NFRA to the Parliament (this has also been provided through the laying of report on its functioning in the Parliament every year), meeting international business standards and ultimately helping in bringing discipline in the auditing profession, being the most important watchdog for economic frauds thereby restoring confidence of the investors which will attract more Foreign Direct Investment (FDI) and Foreign Institutional Investment (FII) into the country.

Whilst the benefits can be discussed, the real success will be making sure that this regulatory body has qualified professionals who understand the profession and associated responsibilities to make sure that they perform duties as contemplated.

Way forward:

While people saw the change that PCAOB has brought to auditing profession in United States, it is worth mentioning that the annual budget of PCAOB for fiscal 2017 was $ 268.5 million and is enabled by 750 audit staff. This primarily gets funded through accounting support fees which is assessed on public companies, based on their relative average monthly market capitalization and on broker-dealers, based on their relative average quarterly tentative net capital.

The challenges of availability of trained and qualified audit staff and the cost thereof should therefore be appreciated to achieve the intended objective of setting up NFRA. Like PCAOB, MCA may also consider adopting a similar mechanism whereby NFRA can be funded based on the market cap of large companies falling under the certain criterion to support functioning of the body.

NFRA may also face challenges in keeping up with the reality that auditing is an activity that occurs across borders. Even in the case of consolidated audit reports signed by an Indian firm, an audit failure (by foreign firm) in other countries can affect Indian investors of large Indian business which have international operations. The NFRA needs to make sure that it is addressing that risk.

It would also be incumbent on NFRA to make their findings of oversight activities public. By doing this, investors can expect better practices. It will enhance the investors' perception that somebody is closely supervising the way audit firms are performing its attestation function.

Government of India has taken a positive step in strengthening the overall existing system of financial reporting, auditing and compliance. It is good to have and showcase the introduction of an independent regulator but a lot is to be seen in terms of operationalization in the right direction and making this successful by reinstating the confidence of stakeholders and various other regulators.

Finally, there must be a line between regulation and over regulation as monitoring and overlooking by too many regulators such as SEBI, MCA, RBI, and various other regulators may lead to overlapping. Reserve Bank of India

(RBI) has issued a press release on June 29, 2018 wherein it has been decided to put in place an enforcement action framework to enable appropriate action by the RBI in respect of the banks' statutory auditors for any lapses.

Such overlapping of regulation may create chaos and will go against the spirit of 'ease of doing business, as widely propagated by the current regime.

To conclude, people may argue that the current review mechanism set up by ICAI is self-sufficient to act as a deterrent for errant auditors but the perception of the public that establishing regulators independent from those it regulates would strengthen the independence of audit firms, quality of audits, enhance investor and public confidence in financial disclosures of companies cannot be ignored.