The National Financial Reporting Authority

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On the 1st of March, the Union Cabinet approved the creation of the National Financial Reporting Authority (NFRA), an independent regulator for the accountancy and auditing professions, as mandated by the 2013 Companies Act. The move is broadly in line with trends in other jurisdictions, including the United States and the UK, which have, in the wake of accounting scams, moved away from self-regulation to create independent audit regulators. (In the US, the Public Company Accounting Oversight Board (PCAOB) handles the task, while in the UK, it rests with the Financial Reporting Council (FRC).) Drawing on global experience, India has been toying with this idea for several years, but the recent PNB banking scandal may have – despite the ICAI's advice against setting up another oversight body – forced the government's hand. To better understand the 'whys', 'hows' and 'whats' of the NFRA, we recently hosted MP Vijay Kumar, CFO of Sify and a key member of the ICAI, who engages deeply with the government on behalf of the Institute.

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THE ORIGINS OF THE NFRA...

Until 1998, there was no formal requirement for preparers of financial statements to comply with any specific accounting standards. Resultantly, audit reports would contain numerous qualifications, which dented end-user confidence. A landmark 1998 amendment to the Companies Act changed this by mandating that the authors of such reports must comply with the relevant accounting standards. To that end, company Directors were now required to sign off on a Directors' Responsibility Statement that assured such compliance. An independent body, the National Advisory Committee on Accounting Standards (NACAS), was created specifically to advise the Central government on the formulation and implementation of accounting policies/standards that certain classes of companies would need to adopt. However, NACAS' role was purely advisory, and it had no regulatory powers. The 2011 draft amendment to the Companies Act proposed reconstituting NACAS as 'NACAAS' (National Advisory Committee on Accounting and Auditing Standards). The intent was to give similar statutory recognition to auditing standards as was earlier given to accounting standards. To everyone's surprise, however, the 2013 amendments to the Companies Act renamed NACAS as NFRA, and – without any public debate – granted the new body regulatory authority over auditing, accounting and financial reporting, as well as over the accountancy profession per se.

The draft rules recommend that the NFRA be a 13-member committee,

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with 9 part-time members that should include three ex-officio members of the ICAI, the Chairman of the Accounting Standards Board, and the Chairman of the Auditing Standards Board. The full-time members and Chairperson cannot be associated with any audit firm during their tenure, and for two years after demitting office. The NFRA is meant to complement the role of the ICAI, and its mandate will be wide, extending to both listed and large unlisted public companies. The Central government will also refer to the NFRA when an entity needs to be investigated on grounds of 'public interest'.

In its press release, the government states that the NFRA's establishment, is likely to push up both domestic and foreign investment, and support the 'globalisation' of Indian business. However, India's accounting standards are already based on international standards. In fact, while the global practice is to apply audit requirements mainly to 'public interest' entities, India requires even small businesses to comply with stringent audit standards. Moreover, while many jurisdictions have felt the need for an oversight authority, this was probably truer in the early 2000s, right after the dotcom burst, when scams such as Enron and WorldCom came to light. Back then, PCAOB was set up as an extended arm of the SEC – whereas India is only now getting around to the task, that too, using 'accounting scams' as the justification for doing so. This is perhaps inconsistent with the broad sweep of Indian corporate history: leaving aside stray cases like Satyam, auditing scandals here have been mainly about inappropriate accounting treatment, or auditors not properly exercising their judgment. Simply put, if what India seeks to prevent is management fraud rather than accounting scams, setting up a new body like the NFRA may not be the most appropriate answer.

THE WAY FORWARD: AREAS OF CONTENTION

Envisaged as an 'oversight' body, the NFRA will have the power to investigate professional and other misconduct that may have been committed by CA members or firms. In this regard, its jurisdiction, under Section 132 of the Act, will extend to listed and large unlisted public companies. This is contrary to global standards, according to which best-in-class oversight bodies engage mainly in 'inspection', and conduct 'investigations' only in a limited number of cases.

Since 2011, ICAI has contested the idea of vesting the NFRA, or any such independent body, with disciplinary and investigative powers on grounds that Sections 234 and 237 of the Companies Act already lend such powers to the government. Instead, ICAI proposes that its own powers to regulate not just professionals, but also audit firms, be enhanced, especially given the limitations in the current regulatory framework. For instance, according to the standard on quality control (SQC1), an audit firm is required to maintain quality, while the engagement partners (which are responsible for executing the task) are supposed to follow the prescribed quality procedures. Yet, when the engagement partner fails to adhere to these standards – which implies that the audit firm's quality procedures have also probably failed – no punitive action is taken against the auditor.

ICAI also maintains that there is no need to whittle down its own powers, which will inevitably happen under the new framework. Globally, policy formulation and investigative authority tend to rest with a single body: the PCAOB and FRC, for instance, perform both functions. According to the new guidelines, ICAI's regulatory remit will remain intact, but the NFRA's presence will have an 'over-ride effect' that may cause confusion. The biggest impact, however, will be seen on ICAI's QRB (Quality Review Board). In the last six years, the Board has reviewed the financial

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MISCONCEPTIONS ABOUT ICAI:

A TRIGGER FOR THE NFRA?

ICAI's track record – and certain misperceptions about its role and function – may have contributed to the hurried decision to roll out the NFRA. In a July 2017 speech, Prime Minister Modi pointed out that only 25 ICAI members have been removed from the profession in the last 11 years, while more than 1,400 cases drag on. While this is true, the fact is that another 600-700 professionals have received sanctions ranging from a few days to several months. This may not seem like much, but even a single day's ban on a CA is enough to taint his or her professional image for a lifetime, making it impossible to ever find large-scale audit work again. Another myth associated with ICAI is that it is self-regulated. In reality, it is a multifaceted body with 20 per cent of its total membership base represented by various government bodies, including the RBI, CBDT, and MCA. So far, there has never been an instance of disagreement between the core members of ICAI, and those appointed externally. Crucially, too, the institute is wrongly seen as 'just' an educational body, whereas the CA Act clearly states that the main reason for its existence is to regulate the accounting profession. As with other regulators, including SEBI, which both conducts exams and oversees capital market intermediaries, ICAI has multiple functions, but this undue focus on its 'educational' role may prove costly to the institution.

statements of about 85 per cent of all listed companies, building a vast ecosystem (~200 technical reviewers) in the process. Its penal provisions are actually stiffer than those proposed by the NFRA. While the NFRA could draw on all this expertise, clear guidelines will be required to ensure healthy collaboration. More seriously, under the new rules, the QRB's scope has been limited to conducting audit reviews of private limited companies, public unlisted companies, and certain sub-classes of listed companies that the NFRA may delegate to it. There could also be additional areas of conflict – for instance, if a firm registered under the CA Act gets prosecuted by the NFRA, then the ICAI will require additional powers (which it currently lacks), to be able to take disciplinary action.

Finally, there could be potential disruptions arising from regulatory overlap. This is because other regulators will have concurrent jurisdiction on issues related to listed companies: SEBI on matters of investor protection, and the RoC (Registrar of Companies) and SFIO (Serious Fraud Investigation Office) when it comes to fraud investigations. The law clearly states that once the NFRA begins an investigation, all other ongoing investigations must cease – which, at least in the short run, could prove disruptive. ■

This article is based on discussions of the India CFO Forum in Chennai and Mumbai with MP Vijay Kumar, CFO of Sify, in April 2018