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Taxsutra Greentick World Congress Special - Compliance: A Collective Responsibility

Part 1 - ICAI: A Robust Regulator

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Compliance: A Collective Responsibility
Part 1 - ICAI: A Robust Regulator

Background

Increasing business needs, cross border transactions and investments calls for quality financial reporting to help build confidence among investors and disseminate accurate information. However, due to past experiences of manipulated accounting information, reporting has recently been under enhanced scrutiny of regulators. Good regulation is essential to the fairness, efficiency, and effectiveness of an economy. Though the regulatory role is entrusted to merely a handful of entities in every jurisdiction, ensuring compliance should be a collective responsibility of entities, auditors and regulators in general.

Specifically, w.r.t India, in recent times, regulators such as the 'National Financial Reporting Authority (NFRA)' and the 'Securities and Exchange Board of India (SEBI)' have also become extremely vigilant w.r.t ensuring compliances with accounting and auditing principles and practices.

Against this backdrop, based on the broader theme - '**Building Trust Enabling Sustainability**' of the **'21st World Congress of Accountants'** to be held in November 2022, **Taxsutra Greentick** brings to you an incisive article-series titled '**Compliance: A Collective Responsibility**' which emphasizes upon India's redefined regulatory framework, viz. how different oversight bodies perform their regulatory roles in India w.r.t accounting, reporting and auditing; major non-compliances pin-pointed by them; expectations of investors/ stakeholders and the need for quality reporting.

Part 1 of the aforesaid article-series, titled '**ICAI: A Robust Regulator**' elaborates upon how ICAI observes its regulatory role in India by performing different regulatory activities.

Introduction

We are well aware that over a period of time, ICAI has achieved recognition as a premier accounting body globally, and the profession has grown leaps and bounds. Apart from formulation of Accounting Standards and prescription of Standard Auditing Procedures, one of the essential roles of ICAI is regulating the profession of accountancy by performing financial reporting reviews, audit quality reviews, monitoring quality through peer reviews, exercising disciplinary jurisdiction, etc.

1. Financial Reporting Review

Since 2002, the Financial Reporting Review Board (FRRB) of ICAI has been working towards improving and strengthening of financial reporting practices in the Country by way of conducting reviews of general purpose financial statements and auditor‘s report thereon, of various enterprises to determine the compliances with the generally accepted accounting principles, auditors reporting obligations, disclosure requirements of applicable rules and regulations relevant to the reporting enterprise, etc.

The compilation of the findings of the Board during the course of review of general-purpose financial statements are released by way of publications. Till now, FRRB has released five such publications. Recently, in October 2022, FRRB issued a 158-pager publication titled '**Study on Compliance of Financial Reporting Requirements (Ind AS Framework) – Volume II**', a compilation of instances of non-compliances with respect to financial reporting requirements such as Ind AS, Standards on Auditing, Schedule III to the Companies Act, 2013, CARO 2016 etc., observed by the FRRB during the course of review of general-purpose financial statements of various enterprises. Ind AS wise, majority of the non-compliances observed pertained to Ind AS 1 – Presentation of Financial Statements, Ind AS 109 – Financial Instruments and Ind AS 107 – Financial Instruments: Disclosures; and from the perspective of financial statements' elements, the majority of the non-compliances observed pertained to assets and components of profit and loss.

A few of the key non-compliances observed include:-

A. Ind-AS based non-compliances

1. Interest income was not recognised using effective interest rate method.
2. The Board viewed that the exemption of custom duty under Software Technology Parks of India scheme is a government grant and should be accounted for as per the provisions of Ind AS 20. However, the company had not disclosed the policy on accounting for Government Grant.
3. The company had not disclosed the reconciliation of opening and closing balances of plan assets as well as the significant actuarial assumption in line with the requirements of Ind AS 19.
4. The company had disclosed substantial amount of goodwill in its financial statements which was acquired goodwill. However, no accounting policy for goodwill and its impairment was disclosed in the financial statements, given that goodwill is mandatorily required to be tested for impairment annually.
5. The circumstances which led to the recognition of impairment loss on investment during the year were not disclosed anywhere in the financial statements.
6. Bonus shares issued by the company during the year were not considered for calculation of basic and diluted earnings per share of previous year.
7. The place of incorporation and the proportion of ownership interest in respect of investments in subsidiaries and joint ventures was not disclosed anywhere in the Notes to accounts.
8. It was noted from the Note on other equity read with the Note on other income that equity investments designated at FVOCI had been derecognized during the year. However, no disclosure as to reasons for derecognition, fair value of investments at the date of de-recognition and cumulative gains and loss on disposal was made by the company anywhere in the financial statements.
9. As per paragraph 10 of Ind AS 27, the company has a choice to opt either ‘cost’ or ‘fair value’, in line with the Ind AS 109, for recognition & measurement of investments in

subsidiaries. However, the company had not disclosed the accounting policy for investment in subsidiaries in line with Ind AS 27.

10. The Board viewed that the 'rent deposit' is a financial asset, therefore, it should have been disclosed under the head 'Other Financial Asset' in line with the requirements of Ind AS 32, rather than 'Other Non-current Assets'.

B. Non-compliances related to presentation of financial statements

11. Director's sitting fees should have been disclosed under the head 'employee benefit expenses', rather than in the note on 'Other Expenses'.
12. The note on current financial assets included 'Loans to Related Parties', however, the same was not classified into secured or unsecured and considered good or doubtful.
13. The Board noted from the financial statements that investments had not been categorized as "quoted" or "unquoted". Further, "market value" of investments has also not been disclosed.
14. The purpose for which loans granted to subsidiary companies were given was not disclosed by the company anywhere in the financial statements.
15. The year-end balance of cash and cash equivalents included fixed deposit which had been held as margin money or security against guarantees, letter of credits and other commitments. It was viewed that fixed deposits held with banks as margin money should not be classified as cash and cash equivalents in Cash Flow Statement.
16. Capital advances fall in the category of investing activity, and therefore, should be disclosed as such while determining cash flows from investing activities. However, in the given case, the movement in capital advances was adjusted as working capital changes under the head 'cash flow from operating activity'.

C. Non-compliance in CARO 2016 report

17. In CARO 2016 report, it was noted from the paragraph (xiii) that the auditor had stated that transactions with related parties are in compliance with the section 177 and 188 of the Companies Act, 2013, however, he had not reported as to whether these transactions with

the related parties were disclosed in the financial statement in compliance with the applicable accounting standards i.e., Ind AS 24.

2. Audit Quality Review

The Quality Review Board (QRB), established by the Government of India under Section 28A of the Chartered Accountants Act, 1949, reviews all aspects of how an audit is performed in entities selected for review. QRB can initiate reviews of quality of audit services provided by members of ICAI only in respect of entities other than those specified under Rule 3(1) of NFRA Rules, 2018, namely, private limited companies, unlisted public companies below the thresholds specified under Rule 3(1) of NFRA Rules, 2018 and other entities not specified under Rule 3(1) of NFRA Rules, 2018; and those referred to QRB by NFRA under Rule 9(4) of NFRA Rules, 2018.

QRB's reviews involve assessment of the work of statutory auditors while carrying out their statutory audit function so that QRB is able to assess (a) quality of audit and reporting by the statutory auditors; and (b) quality control framework adopted by the audit firms in conducting audit. The major focus of the reviews is on compliance with technical standards, relevant laws & regulations, quality of reporting, ethical standards and firm's quality control framework. Since past few years, the QRB issues an audit quality review report every year based on the reviews performed during that year.

Recently, in November 2022, QRB issued a 42-pager 'Report on Audit Quality Review (2021-22)' which highlights the key findings observed in the audit quality reviews conducted during financial year 2021-22 indicating QRB's approach for review, key trends, its expectations and other focus areas; along with an overall trend of audit engagements reviewed from FY 2012-13 to FY 2021-22. The report also mentions key takeaways for audit firms, and an analysis of the observations vis-à-vis number and % of audit firms. Observations are made on a wide range of topics viz. independence, engagement quality control review, risk assessment procedures, external confirmations, comparative information, financial instruments disclosures, revenue from contracts with customers, statement of cash flows, income taxes, related party disclosures, employee benefits, Schedule III of Companies Act, 2013, Companies Auditor's Report Order (CARO), 2016, etc.

3. Peer Review

The Peer Review Board of ICAI was established with an objective to enhance the quality of assurance services rendered by the members and to ensure adherence of various technical, professional and ethical Standards by them. In April 2022, the Peer Review Board rolled out a four-stage Revised Peer Review Mandate for certain categories of firms rendering assurance services to specific classes of entities, starting from 1st April 2022; and clarified that at each phase, before undertaking statutory audit the concerned Practice Unit should possess Peer Review Certificate. With the roll out of this mandate it is expected that more Practice Units will be Peer Reviewed which will go a long way in enhancing the audit quality. Further, in November 2022, the Board issued 'Peer Review Guidelines 2022', w.e.f **1st October, 2022,** to consolidate and prescribe Guidelines relating to requirement, procedure and administrative aspects of Peer Review of Chartered Accountant firms in practice. The said guidelines introduced the concept of new practice unit i.e. firms in existence for less than twelve months immediately preceding the date of application for Peer Review as well as firms in existence for a period exceeding twelve months but not rendering any assurance services getting a Peer Review Certificate.

Over the years, Peer Review, a self-regulatory mechanism, is continuously working to assure stakeholders at large, that the profession is aware of its responsibilities and strives its best to ensure that all the practicing members rendering service adhere to the highest standards. The importance of Peer Review process is apparent from the fact that in India the Peer Review auditors have been recognised by the Regulators. The Securities & Exchange Board of India (SEBI) has made mandatory with effect from April 1, 2010 that the limited review/statutory audit reports submitted to the concerned stock exchanges by the listed entities shall be given only by those auditors who have subjected themselves to peer review process and holds a valid certificate issued by the 'Peer Review Board' of the ICAI. Further, the Comptroller & Auditor General of India (C&AG) has recognized Peer Review Board's work as it has decided to allocate substantial points to the Peer Reviewed firms in the application form for allotment of audit for Public Sector Undertakings.

4. Audit Quality Maturity Model

In July 2021, ICAI issued the Audit Quality Maturity Model -Version 1.0 (AQMM v1.0), which is a capacity building measure, and the objective of this evaluation matrix is for sole proprietors and audit firms to be able to self-evaluate their current level of audit maturity, identify areas where competencies are good or lacking and then develop a road map for upgrading to a higher level of maturity. Further, in September 2022, ICAI issued the revised version of AQMM and required mandatory evaluation of the audit quality maturity to be undertaken by the firms auditing the following types of entities: (a) A listed entity; or (b) Bank other than co-operative bank (except multi-state co-operative banks); or (c) Insurance Company; and excluded the firms conducting only branch audits. It mentioned that the scores and the level arrived at shall be subject to review by a peer reviewer alongside the peer review cycle which falls anytime on or after 1st of April 2023.

W.r.t the above, the then President of ICAI and current Vice-President of ICAI, quoted that "*Even though the bird's eye view of an audit firm's overall audit quality is important, what is relevant is the worm's eye view of the quality of the engagement. The Audit Quality Maturity Model (AQMM) is an amalgamation of a well-researched set of Audit Quality Indicators (AQIs), which will not only help firms to arrive at their current maturity level but will also provide a mechanism to help and guide the members to specifically improve upon their audit quality… Audit Quality Indicators (AQIs) are quantitative and qualitative measures of audit quality, including both inputs and outputs. They indicate the firm's historical, present and future ability to perform quality audits, as well as providing insights into audit quality when read with other AQIs and relevant context*"… *The AQMM v1.0 released will provide a model that will help in creating demand for audit quality and protect the interests of all stakeholders… Improving audit quality is highly imperative in the times when new age technologies such as Data Analytics and Robotics Process Automation have come into being.*"

Way Ahead

With changing times, an entity's relationship with the environment has become increasingly important. Climate change presents significant risks for all entities, their activities and their economic sectors. Similarly, an entity's ability to remain resilient will depend on a range of resources and relationships. Such resources and relationships include its workforce, any specialised knowledge it has developed and its relationships with local communities and natural resources. Investors, lenders and other creditors, therefore, seek information about the significant sustainability-related risks and opportunities facing an entity to inform their decisions about providing resources to the entity.

In this regard, in September 2022, the Sustainability Reporting Standards Board (SRSB) of the ICAI, issued an Exposure Draft of the Standard on Sustainability Assurance Engagements (SSAE) 3000 "Assurance Engagements on Sustainability Information", applicable to all assurance engagements, which pertains to providing reasonable or limited assurance, on sustainability information.

Further, in August 2022, SRSB of the ICAI issued a 214-pager Exposure Draft of Compendium of Social Audit Standards on sixteen thematic areas (viz. eradicating hunger, poverty, malnutrition and inequality; promoting health care including mental healthcare, sanitation and making available safe drinking water; promoting education, employability and livelihoods; promoting gender equality, empowerment of women and LGBTQIA+ communities; ensuring environmental sustainability, addressing climate change including mitigation and adaptation, forest and wildlife conservation; etc.); pursuant to SEBI's notification with regard to formation of Social Stock Exchange, wherein ICAI has been entrusted with the responsibility of being self-regulatory organization for regulating the profession of social auditors.

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Thank you!