National Financial Reporting Authority: Six years on

The NFRA's primary objective is to strengthen the financial ecosystem and ensure the credibility of financial statements. Its success is essential for restoring confidence in financial reporting.

Next week will mark six years since the National Financial Regulatory Authority (NFRA) was constituted – a long enough period for it to find its feet, but not sufficient for institutional sclerosis to set in.

But first, it is worth recalling that the genesis NFRA. It lay in the Satyam Computer Systems fraud – one of the biggest in India. Satyam's founder and chairman, B Ramalinga Raju, confessed to manipulating the company's accounts over several years. He admitted to inflating the company's cash and bank balances, understating liabilities, and overstating debtors' positions. The loss of credibility in the audited financial statements and the resultant erosion of investor and stakeholder confidence, risked taking down not just Satyam but the entire IT sector. The 21st Standing Committee on Finance noted that "in light of recent experiences in corporate mis-governance, the process of audit and the functioning of auditors to be made more independent and effective; stringent joint and individual liability prescribed; setting up of oversight body to set standards and supervise quality of audit recommended."

The Companies Act, 2013, provided the regulatory framework for the NFRA, but the Union Cabinet approved the proposal for its establishment only in March 2018, with the NFRA coming into existence on October 1, 2018. This delay was mainly on account of the Institute of Chartered Accountants of India (ICAI) unwilling to cede ground, as it was also formed through an Act of Parliament. The Supreme Court intervened, urging the government to "consider appropriate legislation and mechanisms for oversight of the auditing profession, similar to the Sarbanes-Oxley Act, 2002, and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010, in the US." It was only after the Supreme Courts intervention that the NFRA was constituted in 2018.

As a primary objective of the NFRA has been to strengthen the financial ecosystem and ensure the credibility of financial statements. It is tasked with regulating both listed and unlisted companies, and their audit. Consequently, it has focused on a variety of issues related to the quality of financial reporting and practices, as well as adherence to standards. So far, it has issued numerous orders, and some of its observations are listed below.

The NFRA observed that auditors often face challenges in adhering to prescribed accounting standards (Ind-AS), which has led to inaccurate or misleading financial statements. Another common issue is the failure to adequately test and report weaknesses in internal control systems, contributing to potential financial misstatements. Also, inadequate audit documentation is a persistent problem; the NFRA has frequently noted gaps such as missing work papers, insufficient evidence, and poor documentation for key judgments. Auditors are also expected to identify fraud risks, but the NFRA has highlighted instances where critical fraud indicators have been overlooked or ignored, and fraud risk was not effectively communicated.

Another area of concern is the improper use of external confirmations, where auditors either fail to obtain sufficient confirmations or inadequately follow up on responses. Weaknesses in audit planning and risk assessment further compromise the effectiveness of audits. Moreover, auditors often exhibit an overreliance on management representations without independent verification, failing to exercise the necessary professional scepticism.

The NFRA has also observed lapses in evaluating the going concern assumption, with auditors not properly assessing whether companies can continue their operations, leading to inadequate disclosures about financial uncertainties. Instances of unethical practices, such as conflicts of interest and a lack of auditor independence, have also been noted. Inaccurate or misleading audit opinions are another issue, where clean opinions were issued despite significant misstatements, or audit opinions were not modified in light of identified issues. Finally, auditors sometimes struggle with complex accounting areas, such as derivatives, fair value assessments, and multi-component revenue recognition, leading to further lapses in audit quality.

Each of these observations leads to loss of credibility, causes reputational damage, erodes investor confidence, and has legal repercussions.

What about the future? The NFRA has a busy agenda ahead. From continuing its work on audit quality to encouraging the use of technology and AI in audits, as well as sustainability reporting and alignment with global standards, it has much more ground to cover.

NFRA has begun engaging with a wider set of stakeholders, and accelerating this, with a closer interaction with the audit committees, will strengthen its understanding of issues and how companies are approaching these. Its regulatory architecture will need to include settlement mechanism. And as the institution matures, the need for an appellate body needs to be debated. Going ahead, only if the NFRA can build organisational credibility, will the ecosystem and public markets have confidence in the financial reports that are presented.

The NFRA's establishment fits well into the shifting arc of governance. Expectations now extend beyond just the company; its entire leadership, particularly the board including its independent directors, to its auditors and its investors, all have a role in ensuring that companies are doing the right thing. The NFRA's role is critical to make this shift.

A modified version of this blog was published in Business Standard on 23 September 2024. The article is behind a paywall. The newspapers subscribers can access the original blog by clicking this link or typing the following url: https://www.business-standard.com/opinion/columns/six-years-on-nfra-remains-key-to-restoring-trust-in-financial-reporting-124092301249_1.html

Disclaimer

This document has been prepared by Institutional Investor Advisory Services India Limited (IiAS). The information contained herein is solely derived from publicly available data, but we do not represent that it is accurate or complete and it should not be relied on as such. IiAS shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. This document is provided for assistance only and is not intended to be and must not be taken as the basis for any voting or investment decision and/or construed as legal opinion/advice. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigation as it deems necessary to arrive at an independent evaluation of information referred to in this document (including the merits and risks involved) and exercise due diligence while using this report. The discussions or views expressed may not be suitable for all investors. The information given in this document is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. IiAS reserves the right to make modifications and alterations to this document as may be required from time to time; however, IiAS is under no obligation to update or keep the information current. Nevertheless, IiAS would be happy to provide any information in response to specific queries. No copyright infringement is intended in the preparation of this document. Neither IiAS nor any of its affiliates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of this information. This report may cover listed companies (the 'subject companies'); IiAS may hold a nominal number of shares in some of the subject companies to the extent disclosed on its website and/or these companies might have subscribed to IiAS' services or might be shareholders of IiAS. IiAS and its research analyst(s) do not have any financial interest in any of the subject companies except to the extent disclosed on its website.

Confidentiality

Other Disclosures

IiAS is a SEBI registered entity (proxy advisor registration number: INH000000024) dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions of 1000+ listed Indian companies (https://www.iiasadvisory.com/iias-coverage-list). Our products and services include voting advisory reports, standardized services under the Indian Corporate Governance Scorecard, and databases (www.iiasadrian.com and www.iiascompayre.com). There are no significant or material orders passed against the company by any of the Regulators or Courts/Tribunals.

This article is a commentary on general trends and developments in the securities market.

About IiAS

Institutional Investor Advisory Services India Limited (IiAS) is an advisory firm, dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions for over 1,000 companies that account for over 96% of market capitalization.

IiAS provides bespoke research and assists institutions in their engagement with company managements and their boards. It runs two cloud-based platforms, SMART to help investors with reporting on their stewardship activities and ADRIAN, a repository of resolutions and institutional voting pattern.

IiAS jointly with the International Finance Corporation (IFC) and BSE Limited, has developed a Corporate Governance Scorecard for India to evaluate company's governance practices and market benchmarks.

IiAS is a signatory to UN supported Principles of Responsible Investment (UNPRI). In January 2023, IiAS also became the first domestic firm to issue a Second Party Opinion when it carried out an assessment of the framework for sovereign green bonds issued by the Government of India.

IiAS Sustainability Solutions Private Limited (IiAS Sustain), a wholly owned subsidiary of Institutional Investor Advisory Services India Limited (IiAS) has received registration as a Category – II “ESG Rating Provider” from the Securities and Exchange of India (SEBI).

IiAS has equity participation by Aditya Birla Sunlife AMC Limited, Axis Bank Limited, Fitch Group Inc., HDFC Investments Limited, ICICI Prudential Life Insurance Company Limited, Kotak Mahindra Bank Limited, RBL Bank Limited, Tata Investment Corporation Limited, UTI Asset Management Company Limited and Yes Bank Limited.

IiAS is a SEBI registered entity (proxy advisor registration number: INH000000024).