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India

Report on Observance of Standards and Codes (ROSC) — Accounting and Auditing

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ABBREVIATIONS AND ACRONYMS

AAS	Auditing and Assurance Standards (issued by ICAI)
AASB	Auditing and Assurance Standards Board (of ICAI)
AS	Accounting Standards (issued by ICAI)
ASB	Accounting Standards Board of ICAI
BSE	Bombay Stock Exchange
CPE	Continuing professional education
DCA	Department of Company Affairs
FRRB	Financial Reporting Review Board
GDP	Gross domestic product
IAS	International Accounting Standard
IASC	International Accounting Standards Board
IASC	International Accounting Standards Committee
ICAEW	Institute of Chartered Accountants in England and Wales
ICAI	Institute of Chartered Accountants of India
ICSI	Institute of Company Secretaries of India
ICWAI	Institute of Cost and Works Accountants of India
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IRDA	Insurance Regulatory and Development Authority
ISA	International Standard on Auditing
NACAS	National Advisory Committee on Accounting Standards
NSE	National Stock Exchange
RBI	Reserve Bank of India
ROC	Registrar of Companies
ROSC	Report on Observance of Standards and Codes
SEBI	Securities and Exchange Board of India
SME	Small- and medium-size enterprises

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INDIA

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^a This report has been discussed extensively with Government of India; clearance has been obtained for publication, but does not necessarily bear their approval for the entire content including opinions, conclusions, and policy recommendations.

EXECUTIVE SUMMARY

This report provides an assessment of accounting and auditing practices in India within the broader context of institutional capacity available for ensuring high-quality financial reporting. India's accounting profession was among the earliest to develop historically when the Indian Companies Act was enacted in the mid-1800s, giving the accounting profession its start. Since then, considerable efforts have been made to align India's accounting and auditing standards and practices with the internationally accepted standards and codes. However, there is room for improvement.

Indian accounting and auditing standards are developed on the basis of international standards; and the country has many accountants and auditors who are highly skilled and capable of providing international-standard services. However, in order to further improve the quality of corporate financial reporting in India, there is a need to improve the institutional framework and take steps for enhancing compliance with the applicable standards and rules.

Enhanced by significant inputs from stakeholders, this report provides some principles-based policy recommendations aimed at strengthening the corporate financial reporting regime in India. These recommendations specifically focus on strengthening the monitoring and enforcement arrangements. Moreover, suggestions have been made on some important elements of an independent oversight body for the auditing profession, from a public interest perspective. The objectives of the recommendations are to build on the existing system and promote a gradual process of improvement.

I. INTRODUCTION AND BACKGROUND

1. This report is based on a review of the strengths and weaknesses of corporate accounting and auditing practices in India. It forms part of a joint initiative between the World Bank and the International Monetary Fund (IMF) on Reports on the Observance of Standards and Codes (ROSC), which covers a set of twelve internationally recognized core standards and codes relevant to economic stability and private and financial sector development.¹ The review involved the assessment of actual practices and an analysis of the effectiveness of monitoring and enforcement mechanisms. International Financial Reporting Standards (IFRS)² and International Standards on Auditing (ISA) served as benchmarks for evaluating comparability of locally applicable accounting and auditing requirements. The review used a diagnostic template developed by the World Bank to facilitate collection of information. This information was complemented by the findings of a due diligence exercise based on a series of meetings with key stakeholders conducted by World Bank staff.

2. India is the largest democracy and second most populous country in the world with a population of approximately 1.1 billion and a geographical area of about 3.3 million square-kilometers. India has made progress in increasing incomes and improving living standards over the past decade. After the setback associated with the 1991 balance of payments crisis, economic growth picked up; poverty continued to decline; and many social indicators, particularly in literacy, continued to improve.³ These developments were supported by the wide-ranging reforms launched in 1991 to open and deregulate the economy.

3. India's economic growth during 2003-04 has been reported at over 8 percent. More sectors have been opened to private activity; trade policy and the exchange rate regime have been further liberalized; and capital markets have been reformed, leading to an improved investment climate. Today India has one of the fastest growing economies in the world with a compounded average growth of 5.7 percent over the last two decades. The country's total gross domestic product (GDP) at US\$3 trillion makes it the fourth largest in the world in purchase price parity terms, yet its per capita income at US\$2,880 remains one of the lowest in the world. A large number of Indians work abroad, sending back to the country about US\$18.3 billion a year in inward remittances, which is the highest in the world.⁴

¹ Within the ROSC initiative, the World Bank and the IMF assist member countries in implementing international standards and codes; the first step in this regard is to carry out assessments and prepare reports in a modular form in each of the following areas: accounting and auditing, anti-money laundering and combating the financing of terrorism, banking supervision, corporate governance, data dissemination, fiscal transparency, insolvency and creditor rights, insurance supervision, monetary and financial policy transparency, payments systems, and securities regulation.

² Within this report, IFRS refers to all standards and related interpretations issued by the International Accounting Standards Board (IASB) and its predecessor, the International Accounting Standards Committee (IASC). IASC-issued standards are known as International Accounting Standards (IAS).

³ *India: Sustaining Reform, Reducing Poverty*, PREM, South Asia Region, World Bank, July 2003.

⁴ This report uses the rate of US\$1 equals approximately Rupees (Rs) 46.

4. More recently foreign direct investors and foreign portfolio investors have shown considerable interest due to initiatives, such as economic reforms, further liberalization of the Indian economy, and promise of government disinvestment from several state-owned enterprises. In 2003, there were over 9,500 listed companies⁵ and 23 registered stock exchanges in India. Since 1999, total market capitalization has ranged between 22 and 25 percent of GDP. The Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) are the two main competing exchanges.⁶ In May 2003, there were 5,650 companies listed on the BSE and 1,471 on the NSE;⁷ from these totals, less than 1,000 companies are actively traded. The top 100 BSE companies represent nearly 86 percent of BSE market capitalization. State-owned enterprises account for approximately 32 percent of BSE market capitalization.

5. India's economic performance has been aided by the structural reforms introduced over the past decade. However, it also seems clear that higher levels of private investment and productivity will be needed to raise the growth rate of GDP to more than 8 percent per annum, as targeted in the country's Tenth Five-Year Plan. This would require sustained injection of high levels of investments in the near future. India's private sector faces a tough challenge in tackling this issue. International comparisons indicate that India has intrinsic advantages that should allow the country to emerge as a major hub for manufacturing and labor-intensive service industries, including accounting-related services. These advantages include relative macroeconomic stability, one of the world's largest local markets; a large and relatively low-cost labor force; and a large well-educated English-speaking population. It is accepted that India would do better by focusing on further strengthening the investment climate in order to capitalize on its intrinsic advantages. This would require building on the existing initiatives and further strengthening of the corporate financial reporting regime; and improving comparability, transparency, and accountability.

⁵ This figure, from the Department of Company Affairs, represents less than 2 percent of the total number of registered companies.

⁶ Under the Securities Contracts Regulation Act (1956), all Indian stock exchanges have a self-regulatory role, but they may differ in organizational form.

⁷ In the BSE, 2,650 out of the 5,650 companies are suspended from trading. Since multiple listings are permitted, there is some overlap between the companies listed on the NSE and the BSE.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

6. **The Companies Act (1956) provides the basic requirements relating to financial reporting of all companies incorporated in India.** The Companies Act requires the preparation, presentation, publication, and disclosure of financial statements; and an audit of all companies by a member-in-practice certified by the Institute of Chartered Accountants of India (ICAI). Schedule VI to the Act prescribes the form, content, and minimum disclosure requirements of financial statements.

7. **The Central Government enforces the Companies Act through the Department of Company Affairs (DCA),⁸ the Company Law Board,⁹ the Regional Directors, and the Registrars of Companies (ROC).** Every Regional Director's office has a special unit for inspection of companies' accounts. While in some cases Regional Directors have taken action against erring auditors under the Companies Act, generally they refer such cases to the ICAI.¹⁰ The ROC is expected to scrutinize the records of registered companies for compliance with provisions of the Act.¹¹ This function is hampered by severe lack of capacity in terms of trained manpower, thus restricting oversight to listed companies.¹² The Company Law Board is an independent quasi-judicial body that receives petitions of complaint from the general public concerning the functioning and management of a company. The Company Law Board also receives applications for waivers from companies with regard to application of some of the provisions of the Act.¹³ The powers to implement penalties, notices, and sanctions are delegated among DCA, Regional Directors, and ROC.

8. **The Companies Act (1956) has been amended on numerous occasions.** Some major changes have been made through the Companies (Amendment) Acts 1999, 2001, and 2002. The amendment of the Companies Act (1999) requires all companies to comply with (Indian) Accounting Standards, disclose any deviation, give reasons for such deviation, and state the impact of the deviation on the financial statements. The amendment also requires the auditor to specifically state in the audit report whether the financial statements comply with these

⁸ The Department of Company Affairs, which was previously under the Ministry of Finance, became the Ministry of Company Affairs in May 2004. Within this report, DCA continues to be used to refer to the new Ministry of Company Affairs.

⁹ The Companies (Amendment) Act (2001) proposed to dissolve the Company Law Board and form a National Company Law Tribunal. Within this report, the Company Law Board is used to mean the new National Company Law Tribunal.

¹⁰ During this inspection, instances of potential professional auditor misconduct are passed on by DCA to the ICAI for its disciplinary proceedings, which usually take a long time to conclude due to extensive procedures prescribed in the ICAI regulations.

¹¹ The registry of records is available for inspection by the public for a nominal fee.

¹² The ROC Mumbai (which is the largest ROC) has over 150,000 registered companies (including 1,800 listed companies), out of which approximately 50 percent file their documents. Over 5,000 new companies are incorporated at the ROC Mumbai each year. ROC Mumbai has 4 staff who are employed to scrutinize these filings, none of whom are chartered accountants or company secretaries.

¹³ In the fiscal year ending March 31, 2002, the Company Law Board received 21,011 petitions and applications (10,080 new and 10,931 pending from the previous year) and disposed of 10,397.

Accounting Standards. Provisions in the Companies Act (1956) with respect to financial reporting are in the process of being revised.¹⁴

9. Directors and management of a company are required to ensure compliance with provisions of the Companies Act. Also, a company's auditor has an obligation to bring to the attention of the shareholders any noncompliance with provisions of the Act with respect to the financial reporting and associated legal aspects. The Act provides guidelines or limits for related party transactions involving directors.¹⁵ Every company must hold an annual general meeting in each calendar year within six months of the financial year-end when the company's board of directors is required to present to its shareholders financial statements for a financial period not exceeding 15 months. Requirements state that financial statements along with the annual return of the company should be filed with the Registrar of Companies within one month of holding the annual general meeting. The directors' report must include several disclosures over and above those generally seen internationally.¹⁶ Moreover, there is a requirement on inclusion of a "directors' responsibility statement."¹⁷

10. The Companies (Amendment) Act (2000) accorded mandatory status for the first time to the concept of an audit committee. Every public company that has a paid-up share capital exceeding Rupees (Rs) 50 million is required to constitute an audit committee. The audit committee can make recommendations on any matter relating to financial management, including the audit report; and the board of directors is bound to uphold these recommendations.

11. The Chartered Accountants Act (1949) governs the accountancy profession in India. A broad revision of the legislative framework relating to the accountancy profession has been under consideration for a couple of years. The Chartered Accountants (Amendment) Bill 2003 has been prepared to revise the Chartered Accountants Act. This bill proposes to reconfigure the current regulatory regime and the disciplinary arrangements in relation to the accounting profession. The ICAI has indicated to the Government their concerns about several areas where the proposed amendment falls short of their expectation.¹⁸ The bill has been referred by the Indian parliament to a special committee for discussion and deliberation. Important key amendments proposed in the bill include:

- **Formation of a Quality Review Board.** The Quality Review Board would be an independent body mandated to fix the standards for audit services, guide members to improve the quality of services, and review the quality of services provided by

¹⁴ For purposes of public debate and consultation, the Government released a Companies Act concept paper containing a model codified Company Law that would consolidate existing provisions of the Law. Based on the feedback, the Government would introduce the Company Bill for parliamentary approval.

¹⁵ Sec. 295, *Loans to directors*; Sec. 297, *Board/Government approval for contracts where directors are interested*; Sec. 299, *Disclosure of interest by Directors*; Sec. 314, *Directors not to hold office of profit*.

¹⁶ These disclosures include conservation of energy, technology absorption, foreign exchange earnings and outgo. A statement must also show details for each employee who draws an annual remuneration exceeding a prescribed amount (currently Rs.2.4 million).

¹⁷ This statement represents that accounting standards have been complied with; accounting policies adopted are consistent and prudent and give a true and fair view; they have taken adequate measures for maintenance of the books of account of the company for safe-guarding the assets and preventing and detecting fraud and other irregularities; and, the financial statements are prepared on a going concern basis.

¹⁸ Examples include a fast-track disciplinary mechanism, creation of multi disciplinary partnerships, and encouragement for consolidation of firms.

auditors. The Board would comprise 11 members, 5 nominated by the Government and 5 by ICAI, and 1 chairperson appointed by the Government. The ICAI would provide funding to the Quality Review Board.¹⁹

- ***Council of the Institute of Chartered Accountants of India.*** The amendment would increase the proportion of Government representation on the ICAI Council from the current 20 percent to 25 percent; allow for appointment of a Government nominee on every standing committee of the Council; and give the Government the power to dissolve the Council.
- ***Revision of the disciplinary action procedure against ICAI member.*** A broad revision of the current disciplinary procedure has been proposed.

12. **The Department of Company Affairs appointed the Naresh Chandra Committee to recommend initiatives to strengthen the institutional framework and legislative environment relating to the accounting and auditing profession.** In view of the local circumstances and following a large number of corporate failures in many industrialized countries, the DCA appointed the Naresh Chandra Committee in August 2002 to examine issues such as auditor-company relationship, certification of the financial statements by directors, and setting up an independent regulator along the lines of the Public Company Accounting Oversight Board established under the Sarbanes-Oxley Act of the United States. The Naresh Chandra Committee considered instituting certification of financial statements by chief executive officers and chief financial officers in line with the requirements of the Sarbanes-Oxley Act. However, instead of instituting criminal liability for misstatements as prescribed by Sarbanes-Oxley, the Naresh Chandra Committee favored enhancing penalties to act as effective deterrents. The proposed Chartered Accountant (Amendment) Bill and Companies Act concept paper include some recommendations of the Committee.

13. **There are two main pieces of legislation governing the securities market.** The Securities Contracts (Regulation) Act of 1956 provides for regulation of transactions in securities and aims to prevent undesirable transactions in securities. And the Securities and Exchange Board of India (SEBI) Act of 1992 protects investors and develops and regulates the securities market. Listed companies in India are required to comply with SEBI requirements as outlined in the SEBI Act and the Securities Contracts (Regulation) Act. To protect investor interests, SEBI-issued listing requirements specify disclosures applicable to listed companies in addition to other applicable auditing and accounting requirements. SEBI, through Listing Agreement, requires compliance with the ICAI-issued accounting standards.

14. **Under Section 619 of the Companies Act, the auditor of a corporatized state-owned enterprise is appointed and re-appointed by the Comptroller and Auditor General of India.** The Comptroller and Auditor General of India maintains and updates annually a panel of private sector firms qualified to undertake audits of state-owned enterprises.²⁰ Allocation of audit work among these audit firms is based on a points system that gives credit based on

¹⁹ Under the proposed governance and funding arrangements, it is difficult to view the Quality Review Board as an independent body.

²⁰ Corporatized state-owned enterprises include about 1,400 public commercial and noncommercial enterprises controlled by union and state governments.

information self-disclosed by the audit firms,²¹ which includes the number of partners in the firm, number of employees and trainees, experience of the firm, and term of association of the partners with the firm.²² The board of directors of the state-owned enterprise determines the professional fee of the auditor on the basis of guidelines issued by the Comptroller and Auditor General of India and subsequently approved by the shareholders of the company. The Comptroller and Auditor General of India conducts a supplementary/test audit of all such companies on a regular basis. The state-owned enterprises that are incorporated under specific acts have associated rules with respect to accounting and auditing. Depending upon the audit arrangements, as specified by these rules, the audit may be performed either by a private sector auditor or a state-appointed auditor, which may include the Office of the Comptroller and Auditor General of India or its appointee.

15. The Banking Regulation Act (1949) empowers the Reserve Bank of India (RBI) to regulate financial reporting of the financial sector, including banks and financial institutions.²³ The Third Schedule to the Banking Regulation Act prescribes formats for general purpose financial statements (balance sheet, and profit and loss account), including other disclosure requirements. Banking companies are also required to comply with requirements of the Companies Act provided they are consistent with the Banking Regulation Act. The RBI has issued circulars requiring compliance with the ICAI-issued accounting standards. All banks must publish audited financial statements within three months of the financial year-end.²⁴ Effective 2002-03, all banks are required to prepare consolidated financial statements; during 2001-02, consolidation was mandatory for listed banks only. The private sector and foreign banks are required to receive prior approval from RBI before appointing their auditors. The public sector banks appoint their statutory auditors (principal auditors and branch auditors)²⁵ on the basis of recommendations of RBI (except for State Bank of India where the principal auditors are appointed directly by RBI as per State Bank of India Act); this recommendation is made from the list of RBI-empanelled auditors. A statutory principal auditor relies on branch auditors' reports for issuing audit opinion on the bank's annual financial statements. The list of RBI-empanelled auditors is compiled from a self-disclosure form completed annually by interested auditors. Bank statutory auditor appointment, re-appointment, or removal requires RBI approval. All state-owned banks must have a minimum of four (joint) statutory auditors. Bank auditors must be replaced at least once in four years. No audit firm is allowed to audit more than 4 private-sector banks and 1 state-owned bank during any single year.

16. The Reserve Bank appointed a working group in 2001 to evaluate and recommend improvements to the auditor appointment process. The working group submitted its

²¹ The audit firms have to provide the required information in standard questionnaires, which is reviewed on a limited basis by the Office of Comptroller and Auditor General of India.

²² Most of these firms are small with about 70% of the firms, empanelled for 2004-05, having 2 partners or less and only about 10 percent having 6 partners or more.

²³ There are approximately 60 Indian banks, including 27 state-owned banks (19 nationalized banks and the State Bank of India and its 7 subsidiaries) and over 30 private banks.

²⁴ The Reserve Bank can extend the period not exceeding three months (i.e., total of six months).

²⁵ The lists include statutory principal and branch auditors. The empanelled list of branch auditors (about 25,000 eligible audit firms) is submitted by ICAI to the Reserve Bank. The statutory principal auditor list (482 eligible audit firms with a minimum of seven full-time chartered accountants, of whom five should be full-time partners, effective 2005-06) is obtained from the Comptroller and Audit General of India's empanelment data. In addition, banks also directly appoint concurrent auditors, who conduct internal audit. Statutory principal auditor appointment is based on 5 criteria: number of partners, number of qualified chartered accountants, previous bank experience, previous experience with state-owned enterprises, and number of years in practice. Total audit units in the banking sector are estimated at over 40,000.

recommendations in late 2002 and the RBI has provisionally accepted the recommendations, which are expected to be implemented in 2005. Among the recommendations is that the empanelment exercise will now be conducted bi-annually for the appointment of branch auditors.

17. The RBI formed a committee in 2000 to study observance of international standards and codes in India. In this connection, ten advisory groups were formed to study and report on the individual areas of the overall financial system. The Malegam Committee Report, issued in January 2001, compared the Indian accounting and auditing standards and relevant statutes with the international standards and made recommendations for reducing the standards gap. The Institute of Chartered Accountants of India has since issued several new accounting standards, which have substantially reduced this gap.

18. Urban Cooperative Banks fall under the supervision of the Reserve Bank of India, whereas Rural Cooperative Banks are supervised by the National Bank for Agriculture and Rural Development. Urban Cooperative Banks comprise approximately 7 percent of the total national banking deposits and hence form a small yet significant part of the Indian financial market.²⁶ Cooperative banks are incorporated as societies and hence are not required to follow the accounting standards mandated for companies; and the auditors of such societies are usually not ICAI members but state auditors. The Registrar of Societies appoints external auditors of all cooperative banks.²⁷ The Banking Regulation Act has certain sections dedicated to cooperative banks, though these do not extend to appointment and monitoring of auditors. There have been a few cases of big cooperative banks failing in the recent past, raising issues over the supervision of such banks. The Reserve Bank of India has requested that the Government transfer regulatory arrangements for the urban cooperative banks to the Reserve Bank, including power to appoint auditors.

19. The Insurance Regulatory and Development Authority (IRDA) regulates the financial reporting practices of insurance companies under the IRDA Act. The Indian insurance industry is dominated by state-owned enterprises since private sector participation has only been recent.²⁸ Limits on foreign ownership exist. Insurance companies and their auditors are required to comply with the requirements of the IRDA Regulations (*Preparation of Financial Statements and Auditor's Report of the Insurance Companies*) in preparing and presenting their financial statements and the format and content of the audit report. The IRDA requires compliance with ICAI-issued accounting standards. All insurance companies appoint two firms of auditors for a period of four years. The firms are selected from the list of approved auditors maintained by IRDA.²⁹ Appointment of joint auditors and audit firm rotation are mandatory for insurance companies.

²⁶ Total Indian banking deposits are approximately Rs 1,100 billion (US\$24.45 billion). Of the total 2,104 cooperative banks, 55 are scheduled and 2,049 are unscheduled.

²⁷ Except in case of cooperative banks, registered under the Multi State Cooperative Societies Act (2002), where the statutory auditors are appointed by the banks on their own at the annual general meeting.

²⁸ Based on its size, the insurance sector does not create a systemic risk for the financial sector, as compared with the banking sector. There are 26 (13 life and 13 general) insurance companies with total earned premiums of about US\$7 billion. The ratio of premiums to GDP, a measure of the insurance sector penetration rate, was less than 2 percent, well behind the worldwide average of 7.8 percent.

²⁹ In case of a government-owned insurance company, the Comptroller and Auditor General of India appoints the auditors.

20. The Stock Exchange Listing Agreement requires all listed companies to publish unaudited quarterly financial results. The Stock Exchange Listing Agreement (Clause 41) requires all listed companies to publish unaudited quarterly financial results, according to a prescribed format, in a national English daily and a local regional language daily newspaper within one month from the quarter-end. As of June 30, 2003, the quarterly results have been subject to limited review by the company's statutory auditors (or any chartered accountant in case of state-owned enterprises).³⁰ The limited review report must be submitted to the Stock Exchange within two months of the end of the quarter. In case of any deviation of more than 20 percent in any line item between the published amount and the limited review amount, a statement approved by the board of directors explaining the reasons for the difference needs to be submitted to the Stock Exchange. However, in practice, not many cases of deviations are reported. As observed in other developed economies, releasing unaudited financial results could lead to potential problems of influence over subsequent audits. From the quarter ending September 30, 2001, segmental information needs to be published along with the unaudited quarterly results. For the final quarter, publication and limited review of quarterly results are not required if annual audited financial statements are made available within three months of the quarter-end.

21. The Income Tax Act empowers Central Government to notify accounting standards for taxation purposes. In this context, the Central Board of Direct Taxes has notified two Indian Accounting Standards (AS) for taxation purposes without modifying ICAI-issued standards: AS 1, *Disclosure of Accounting Policies*; and AS 5, *Net Profit or Loss for the Period, Prior Items and Changes in Accounting Policies*. The Central Board of Direct Taxes has established a committee to examine all other accounting standards issued by the ICAI to consider their applicability in the context of tax laws and regulations. This committee is currently examining nine accounting standards for notification purposes. At the present time, accounting standards being used are generally the same for both tax reporting and general purpose financial reporting. However, this may change if the Central Board's accounting standard committee issues accounting standards different from those issued by the ICAI. The Income Tax Act also makes an annual tax audit compulsory for all taxable assesses, including companies with an annual turnover exceeding Rs 4 million (service entities with a turnover exceeding Rs 1 million). For a financial year (which for tax purposes has to necessarily end on March 31), the tax auditor is required to provide information on approximately 100 items relating to various provisions of the Income Tax Act and certify that this information is "true and correct."

B. The Profession

22. The Indian accounting profession began its history with the enactment of the Indian Companies Act in 1857 that introduced for the first time the concept of preparing company balance sheet on a voluntary basis. The Indian Companies Act of 1866 introduced legal requirements regarding the maintenance of accounts and auditor's qualification. Auditor's certification from the local government started after the enactment of a new Companies Act in 1913. Following India's independence in 1947, an expert committee was formed to examine the

³⁰ Previously half yearly results (from half year ending March 31, 2000) were subject to limited review by auditors.

scheme of an autonomous association of accountants in India, which led to the enactment of the Chartered Accountants Act (1949) and establishment of the Institute of Chartered Accountants of India the same year. The ICAI regulates the accountancy profession and, in line with India's imperial history, was initially modeled on the Institute of Chartered Accountants in England and Wales (ICAEW). The ICAI acts as both an examining body for granting chartered accountancy qualifications and licensing, and disciplinary authority for its members. ICAI has been a founding member of the International Federation of Accountants since IFAC's inception in 1977. With a reputation for excellence, ICAI has been the institution of choice for business graduates and aspiring business advisers, and today ICAI has a highly skilled membership of over 110,000, which makes it one of the largest professional accountancy bodies in the world.³¹

23. The Chartered Accountants Act (1949) provides for a Council to manage the affairs of the ICAI. The Council's statutory functions include enrolling students, regulating their education and training, conducting examinations, providing professional development, maintaining professional and ethical standards, and taking disciplinary action against erring members. The Council comprises 24 members elected from across the country and representing 5 regional constituencies, based on the number of members in each region; in addition to 6 persons nominated by the Central Government.³²

24. Other professional bodies include the Institute of Cost and Works Accountants of India (ICWAI), and the Institute of Company Secretaries of India (ICSI). These professional bodies have governance structures and powers similar to the ICAI. The ICWAI has approximately 22,000 members and ICSI has approximately 16,000 members as of April 2004. The ICWAI members provide cost audit services to companies falling within certain manufacturing industry sectors as mandated by Section 233B of the Companies Act. The ICSI members act as company secretaries and provide corporate secretarial services to the companies.³³

25. Smaller firms dominate the Indian auditing marketplace, even though the Indian affiliates of large international firm networks audit approximately 47 percent of the top 100 listed companies.³⁴ The ICAI reports about 53,245 audit firms operate in India, including members/affiliates of most of the international networks of accounting firms. About 1,000 firms audit at least one economically significant enterprise; and about 15 of the largest firms audit more than 70 percent of the top 100 listed companies. Government-owned companies, unlisted companies, public sector banks, and insurance companies are generally audited by small- and medium-size firms apparently due to the unremunerative fee scales prescribed for these

³¹ Based on the April 2004 numbers, 65,088 held a full-time ICAI certificate of practice and 12,302 held a part-time certificate of practice. Many of these practice certificate holders are not actively involved in public practice.

³² Nominations are made from various government departments and institutions, including the Central Board of Direct Taxes, Comptroller and Auditor General of India, and Department of Company Affairs.

³³ Companies with a paid up capital exceeding Rs 20 million are required to employ a full-time company secretary who issues a certificate of compliance with provisions of certain sections of the Companies Act. Companies with paid up share capital of more than Rs 1 million but less than Rs 20 million also require a company secretary who may be employed on a part-time basis.

³⁴ Local affiliates of large international networks audit 11 out of the top 50 Indian companies and jointly audit 6 other companies in the top 50 with another medium-size firm (for 34 percent of the top 50). They also audit 25 out of the top 51-100 companies and jointly audit 5 other companies in that bracket with another medium-size firm (for 60 percent).

engagements.³⁵ In most cases, the regulator or the Office of the Comptroller and Auditor General of India mandates joint auditors for state-owned enterprises,³⁶ public sector banks, and insurance companies.

26. Members of the ICAI are required to follow a detailed code of ethics as prescribed under the Chartered Accountants Act. The ICAI Council is entrusted with disciplinary powers that are exercised through its Disciplinary Committee. In matters concerning public interest, the awards of punishment require confirmation by a High Court. Some unique legal restrictions on auditors include these examples:

- (a) The name of any firm that wants to register for ICAI membership must have a combination of the names of the partners or a name in being, that is a name in use before this rule was introduced.³⁷
- (b) Post-1995 the display of any association with any firm, domestic or international, including logos, was banned.
- (c) The number of partners in an audit firm is limited to a maximum of 20. Companies, limited liability partnerships, and multidisciplinary partnerships are not permitted in the profession. ICAI proposals to permit conduct of nonattest functions through limited liability companies and to increase the limit on the number of partners have not yet been legislated.
- (d) The Companies Act restricts the number of public limited (not necessarily listed) audit clients to 20 per partner.
- (e) The Companies Act prohibits indebtedness of audit partner to audit clients in excess of Rs 1,000, which includes any arms-length transactions (for example, a credit card with a banking client).
- (f) Advertising and publicity is prohibited.

27. India has not yet experienced large-scale litigation against audit practitioners. Audit reports are signed in the name of a partner, although all partners have joint, several, and unlimited liability under the Indian Partnership Act. Professional indemnity insurance is not compulsory. ICAI does not specifically require or recommend that auditors take out such insurance.

28. Practicing auditors sit on the boards of directors for some listed companies, banks, and insurance companies. Although the audit firms of these respective partners do not perform audit services for these companies, they are not barred from taking up nonaudit service engagements. Even though these directors are required to disclose their interests under the Companies Act, these non-audit service engagements may create potential conflicts of interest.

³⁵ Recently revised audit fee scales for banks prescribe a progressive fee arrangement. Based on total asset size, the maximum fee is set at US\$13,000 for banks with assets exceeding US\$20 billion, and the minimum fee is set at US\$9,500 for banks with total assets less than US\$2.5 billion.

³⁶ The largest state-owned enterprise, Oil and Natural Gas Corporation Limited, had 5 joint statutory auditors in 2002-03. The largest Indian bank, State Bank of India, had 14 joint statutory auditors in 2002-03.

³⁷ Because of this 1988 regulation, 2 Indian affiliates of the Big 4 international network firms operate using their pre-1988 registered brand names. The other 2 did not have any firms registered with the ICAI pre-1988 and hence use completely unconnected Indian member firm brand names. Also, all 4 firms and some other larger international networks have private limited companies registered in India that use the global brand and actively sell all the firms services, other than those restricted to be provided by ICAI members. These private limited companies are not required to follow the strict code of ethics and are not subject to other ICAI rules and regulations.

29. In the Companies Amendment Act (2000), individuals who held securities carrying voting rights in a company were barred from auditing that company, effective one year after passage of the amendment.³⁸ No regulation currently bars an auditor from having family or other close relationship with the audited company or its key management personnel. Also, there is no cooling-off period prescribed for audit partners/staff joining their audit clients in a senior management position or client personnel joining the audit firm.

30. An audit practitioner is allowed to act as a company's statutory auditor, as well as provider of such nonaudit services that might threaten auditor independence. A cap on nonaudit fees was introduced for appointments made after April 2002 in order that nonaudit fees do not exceed the total audit fees from the same client (restricted to listed companies and other public companies having a turnover exceeding Rs 500 million). However, statutory auditors are not specifically prohibited from providing some nonaudit services, including tax restructuring, tax planning, tax advocacy and representation before tax authorities, recruitment, due diligence, mergers and acquisitions, and actuarial services. The Naresh Chandra Committee Report has recommended disallowing statutory auditors from providing certain other nonaudit services.³⁹

31. Mandatory audit firm rotation, after serving as auditor for 4 to 5 years, exists for government-owned companies, banks, and insurance companies. Audit partner rotation has never been mandatory and hence is not widely followed across the profession. In considering auditor independence, the Naresh Chandra Committee recommended adoption of audit partner rotation. The ICAI has recently put forward a resolution that will make mandatory audit firm rotations and joint audits for all listed companies. The ICAI has not made a final decision on this issue, which has been referred to a high-level committee for further deliberation.

C. Professional Education and Training

32. The ICAI has been conducting periodic review of its education and training schemes. Effective October 1, 2001, chartered accountancy students follow a new program of study and supervised training. The curriculum for ICAI membership includes Professional Education I (PE-I previously called Foundation),⁴⁰ Professional Education II (PE-II previously called Intermediate),⁴¹ a three-month compulsory computer training program prior to practical training, three years of practical training, general management and communication skills (two-week course after completing practical training), and final examination.⁴² The bachelor's degree holders, with a defined minimum score, are exempt from PE-I qualification. The three years of

³⁸ Prior to this amendment, disqualification occurred only when the auditor held over 5 percent of shares.

³⁹ Including financial information systems design and implementation; actuarial services; broker, dealer, investment advisor or investment banking services; outsourced financial services; management functions; staff recruitment; valuation services; and fairness opinions.

⁴⁰ PE-I level requires papers in the following subjects: (a) fundamentals of accounting, (b) mathematics and statistics, (c) economics, and (d) business communication and organization and management.

⁴¹ PE-II level requires papers in the following subjects: Group I, (a) accounting, (b) fundamentals of financial management and costing, and (c) auditing; and Group II, (a) business and corporate laws, (b) income tax and central sales tax, and (c) information technology.

⁴² Group I, final professional examination papers are (a) advanced accounting (b) advanced financial management, (c) advanced auditing, and (d) corporate laws and secretarial practice. Group II, final professional examination papers are (a) cost management, (b) direct taxes, (c) indirect taxes, and (d) management information and control systems.

practical training requirements start after passing the PE-II level⁴³ and must be under the guidance of an eligible chartered accountant. During the last year of practical training, a student has the option to undergo ICAI-approved industrial training instead of professional practice training. There is no limit on the number of attempts to pass the final examination.

33. Many students are attracted to the chartered accountancy program. The number of candidates taking professional examinations has steadily increased over the years. About 10 to 12 percent of the students pass when attempting all PE-II levels and final examination papers. The ICAI claims that in an effort to improve the assessment system it has been increasing emphasis on case studies in their professional examinations.

34. The range and depth of practical knowledge gained by the trainee accountants significantly vary with the diversity in nature and size of accountancy firms that act as practical training providers in India. The number of training vacancies with audit firms far exceeds the number of students seeking training contracts. Audit firms have limits on how many trainees they can accept based on the number of partners and their experience. The ICAI has, in the past, examined the prospect of moving to criteria based on “quantum of work,” in lieu of the current “efflux of time” to determine the entitlement to train. This matter is still being considered. Moreover, the absence of monitoring the quality and ability of practical training providers seriously impacts practical knowledge of the trainees. An ICAI review committee noted in 1992 that some students who prefer to train with small firms felt the main objective was passing the exams and the quality of training was secondary.

35. A Board of Studies was set up by the ICAI in 1954 to provide theoretical education to accountancy students. The Board of Studies is primarily engaged in imparting distance learning for students taking the professional chartered accountancy course. The Board provides a comprehensive academic package to students including all prescribed study materials. Students in India mostly rely on self-paced study using the material provided by the Board, or they enroll for private tutorials. Most students must also bear costs of the exams, the ICAI enrollment fees, and tuition fees.⁴⁴ In most cases their stipend from practical training is not sufficient to cover these costs.

36. The stipend for trainee accountants is not commensurate with the current cost of living. The stipend is calculated on a minimum scale prescribed by the ICAI, based on the population of the city where the trainee is employed. Minimum monthly stipends prescribed by ICAI are Rs 450 (US\$10), Rs 600 (US\$13), and Rs 800 (US\$15),⁴⁵ respectively, in the first, second, and third years of training.⁴⁶ In comparison, a newly qualified chartered accountant's salary ranges from US\$200 to US\$700 per month across the country.

37. University courses in accountancy focus on the Indian Standards and do not cover International Financial Reporting Standards and International Standards on Auditing.

⁴³ The minimum training for each year requires 1,250 hours. Trainee students are required to sign agreements with training providers and submit their training records for ICAI review.

⁴⁴ The cost curriculum of the Chartered Accountancy course is Rs.10,500 (US\$210) for a period of more than 4.5 years, which is fairly low in comparison to other professional courses in the country.

⁴⁵ Larger firms sometimes pay monthly stipend in excess of the minimum prescribed, in order to attract talented students.

⁴⁶ A revised schedule of stipend, recommended by the ICAI, is currently under consideration of DCA.

These courses also do not enable the students to gain exposure to the international dimensions of accounting and auditing practices. The curricula are restricted to teaching only Indian standards. In addition, accounting course books, as well as examinations, lack adequate focus on the practical application of standards.

38. The Chartered Accountancy curriculum includes professional ethics as a topic in a subject, and not as a separate subject. The IFAC Education Committee recommends that professional ethics be taught separately in the prequalifying education of professional accountants.⁴⁷ Professional and ethical issues have been incorporated into one topic to comprise 20 percent of advanced auditing subject in the final examination curriculum.

39. ICAI introduced a mandatory requirement for continuing professional education (CPE), effective January 1, 2003. Monitoring and enforcement of this requirement is yet to be put in place. Many qualified professional accountants require updating on recent developments in financial reporting, auditing, and other related subjects. Minimum requirements for members in professional practice are 15 CPE hours in 2004 and 20 CPE hours in 2005. For the members who are in industry or engaged outside professional practice, the ICAI has recommended (not made mandatory) 15 CPE hours in 2004, and mandated 10 CPE hours in 2005.

D. Setting Accounting and Auditing Standards

40. The Accounting Standards Board (ASB) and the Auditing and Assurance Standards Board (AASB), are responsible for assisting the ICAI in setting standards. Due process is followed to promulgate Accounting Standards, and Auditing and Assurance Standards (AAS). Based on the draft regulations prepared by the ASB and the AASB, the ICAI Council approves and issues new standards under its authority and prescribes a deadline for adoption.

41. ICAI uses IFRS and ISA extensively in developing the national standards. The ICAI duly considers the IFRS and ISA in the standardsetting process and may depart from these standards if justified, keeping in mind the local environment and practices.

42. The Central Government makes official notification of accounting standards applicable to companies. Exercising powers conferred by subsection (1) of section 210A of the Companies Act (1956, amendment of 1999), the Department of Company Affairs constituted in August 2001 the National Advisory Committee on Accounting Standards (NACAS) to advise the Central Government on the prescription of accounting standards for observance by companies registered under that Companies Act. However, the Chartered Accountants Act (1949) regulates the accounting profession in India and accordingly mandates the ICAI to issue Accounting Standards and Auditing and Assurance Standards. The NACAS reviews the applicability of the ICAI-issued Accounting Standards to companies and, if necessary, may recommend modification of the ICAI-issued standards.

⁴⁷ IFAC Educational Guideline No. 10, *Professional Ethics for Accountants: The Educational Challenge and Practical Application*.

43. The standards prepared by the Auditing and Assurance Standards Board lay down the principles governing an independent audit. It is mandatory for ICAI members to ensure that Auditing and Assurance Standards are followed in the audit of financial information covered by their audit reports.⁴⁸

44. Guidance notes on accounting and auditing practices are issued by ICAI, particularly in areas where standards do not exist. Certain guidance notes are replaced by the issuance of standards. Certain guidance notes deal with implementation of some existing accounting and auditing standards. The guidance notes are primarily designed to provide assistance to members on matters that may arise in the course of their professional work, including assurance-related engagements.

E. Ensuring Compliance with Accounting and Auditing Standards

45. Regulators primarily focus on compliance with requirements on “special purpose” regulatory reporting. The governmental regulatory agencies include the DCA, SEBI, RBI, and IRDA. These regulators enforce regulatory norms and act decisively against any noncompliance. The DCA has the mandate to monitor general purpose financial reporting, which is exercised primarily through the statutory audit. The DCA may further examine cases, when it is felt that the regular mechanism has not worked effectively, under section 233A (special audit) and Section 209A (inspection of books of accounts) of the Companies Act. Enforcement by the DCA is largely restricted to the levy of fines, which are usually not a credible deterrent.⁴⁹

46. The SEBI does not proactively monitor compliance with financial reporting requirements, which is unlike many other international securities market regulators. The SEBI only looks at financial statements contained in the prospectus at the time of a public offering or in the case of a complaint against a listed company. The SEBI refers cases of noncompliance that come to its attention to the Stock Exchange, ICAI, and DCA, as applicable.⁵⁰

47. The Bombay and National Stock Exchanges rely on external auditors to monitor compliance with the accounting and disclosure requirements. Listed companies are required to submit their financial statements to the Stock Exchange. The Stock Exchanges closely monitor compliance with requirements of their Listing Agreement and promptly act on publishing of any information that could mislead investors. The Stock Exchanges in India are generally satisfied if a publicly traded company issues audited financial statements on a timely basis, and such statements are accompanied by an unqualified audit opinion. The Corporate Relations Department of the Stock Exchange pursues any qualification by the auditors with the

⁴⁸ Part I of the Second Schedule to the Chartered Accountants Act specifies that an ICAI member's failure to bring attention to any material departure from AAS shall be grounds for professional misconduct.

⁴⁹ Prescribed fine can be compounded for all noncompliance, including repeat offenses, within provisions of the Companies Act. The sanctions for noncompliance with financial disclosures range from a maximum fine of Rs 10,000 up to six-months imprisonment. In practice, there have been no instances of imprisonment. Moreover, judicial delays diminish the deterrence factor of such penalties.

⁵⁰ In July 2004, SEBI used the provision under the 1995 SEBI Regulations (*Prohibition of fraudulent and unfair trade practices relating to securities market*) to investigate inappropriate accounting practice of a listed company.

company and requires corrections by the following year-end. The Stock Exchanges lack sufficient number of qualified professionals and financial resources to systematically carry out monitoring of compliance with accounting and financial reporting requirements.

48. The RBI relies on banks' statutory auditors to ensure compliance with the general purpose financial reporting requirements. The RBI officials conduct both offsite and onsite supervision of banks to ensure compliance with prescribed RBI norms and guidelines. In cases when differences arise between the findings of a bank's statutory auditor and RBI's onsite supervision team, RBI appoints an independent auditor for resolution. A bank's statutory auditor must report to RBI any violations of established standards, rules, regulations, and laws and submit a long-form audit report in addition to the prescribed audit opinion. In the course of monitoring compliance with prudential regulations, RBI officials identify and require corrections of departures from established accounting requirements and also pursue auditor's qualified opinions with the bank and the auditor. RBI's role with respect to the general purpose financial reporting by banks includes reviewing financial statements, approving appointments of statutory auditors, reviewing long-form audit reports/management letters directly from the statutory auditors, holding meetings with banking supervision staff and a bank's statutory auditors, and reviewing feedback from bank management on the performance of statutory auditors. The RBI refers to the ICAI any apparent issues regarding professional misconduct of bank auditors. The RBI supervision staff comprises experienced bankers who have generally passed the examination of the Institute of Bankers, which includes accountancy as a subject. In recent years, there have been some cases of bank failures allegedly associated with misleading financial reporting⁵¹ indicating a need to take steps for further strengthening RBI's capacity with regard to monitoring and enforcement of financial reporting requirements.⁵²

49. The public sector insurance companies have been facing problems in meeting the requirements under the new regulatory regime. The power to regulate the financial reporting of insurance companies was given to IRDA in the financial year 2000-01 when new private insurers entered the Indian insurance market. While the private insurance companies have set up systems to meet the various requirements under the IRDA Act and the related rules, the public sector insurance companies have been facing practical problems in meeting the requirements under the new regulatory regime. The IRDA has the authority to impose sanctions for noncompliance. However, in practice, this power has rarely been exercised.

50. The Electricity Act influences financial reporting by power sector companies. Electricity companies in India are required to follow the Electricity Act (2003) that has an overriding effect in cases of any inconsistency with the Companies Act. The Electricity Act does not provide guidance on computation of depreciation taking into account economic life of assets; this has created significant confusion in power sector accounting and reporting. Different

⁵¹ In one case, a private bank that failed in July 2004 was accused by RBI of misreporting its net worth and assets in 2001/2 and 2002/3. The RBI accused the auditor of providing an inappropriate auditor's report and referred the case to the ICAI disciplinary committee.

⁵² An RBI working group, chaired by a former ICAI president, identified banks' compliance gaps with Indian Accounting Standards and recommended steps to eliminate or reduce them. Four standards were identified where noncompliance was found: *Prior period items*, *Revenue recognition*, *Effects of changes in foreign exchange rates*, and *Retirement benefits*. Banks also had difficulty in applying 4 recently issued accounting standards: *Segment reporting*, *Related party disclosures*, *Consolidated financial statements*, and *Deferred taxation*. An RBI-issued circular has provided further guidance on application of 7 of these standards.

power sector companies (primarily state owned) engaged in the same business and using similar types of assets apply different rates of depreciation resulting in variations in profit statements.⁵³ The office of Comptroller and Auditor General of India took note of this issue and asked the Ministry of Power to provide necessary clarification to ensure consistency in the financial statements of the power sector companies.

51. The ICAI requires its members to ensure compliance with all applicable accounting and auditing standards in the performance of assurance engagements. The ICAI members must also report any departure from the applicable standards. There is no robust arrangement for monitoring and enforcing compliance with these requirements. The ICAI relies on its disciplinary mechanism for ensuring that its members comply with the applicable accounting and auditing standards, including code of professional ethics. This disciplinary mechanism is widely regarded as being very slow and requiring improvement.⁵⁴ The Chartered Accountants (Amendment) Bill, which proposes revisions in the disciplinary mechanism of the ICAI, is currently under consideration of the Parliament.

52. The ICAI has made a modest beginning as a self-regulator by introducing peer review of audit firms. There is a need for strengthening and implementing an effective mechanism for an independent review of the quality assurance arrangements of audit firms dealing with economically significant enterprises. The ICAI still lacks an adequate proactive arrangement for monitoring and ensuring compliance with auditing standards and code of ethics for professional accountants. In compliance with IFAC requirements, a country should develop and enforce quality control arrangements, which require audit firms to put in place the necessary policies that conform to professional performance standards. An independent review mechanism can ensure that audit firms have effective quality control arrangements. The ICAI established an 11-member Peer Review Board in March 2002.⁵⁵ The Peer Review Board provides guidance to enhance the quality of services provided by ICAI members. In the first phase, peer review focuses on the review of firms that audit major enterprises at least once in a three-year block. The peer review does not lead to any disciplinary or regulatory mechanism. Peer review certification is either given or not given based on the findings of the review. Peer reviewers are members currently in practice with at least 15 years of audit experience.

53. The Financial Reporting Review Board (FRRB), constituted by ICAI in July 2002, has a mandate to review the financial statements of certain major enterprises. The objective of the FRRB review is to determine apparent noncompliance with standards and regulations.⁵⁶ Unlike the Peer Review Board process that helps build capacity, FRRB findings have disciplinary implications for ICAI members if they fail to discharge their attest functions

⁵³ In one case, in its accounts for 2004 a state-owned central public sector company applied the rates of depreciation for tariff purposes as pronounced by the electricity regulator. In another case, a central public sector company applied the rates of depreciation as prescribed under the Companies Act, Schedule XIV, which are substantially higher than the first case. In the former case, the profit impact (overstatement) was over US\$100 million for FY2004.

⁵⁴ The Naresh Chandra Committee reported that “procedures framed under the Chartered Accountants Act have not been able to cope with the changed scenario” and “ICAI, despite best intentions, seems to have been unable to adjudicate disciplinary cases within reasonable time.”

⁵⁵ Peer Review Board comprises 6 ICAI members and 5 members from industry and several other government bodies and users of financial statements, like the office of Comptroller and Auditor General of India, DCA, and IRDA.

⁵⁶ FRRB’s mandate includes review of published financial statements of enterprises that can make the public interest susceptible due to bad financial reporting. Initially, it proposes to restrict its review to the top 500 listed companies in the country by turnover and any company referred to ICAI.

in accordance with the standards. While a positive step in the monitoring process, the FRRB does not have sufficient resources and required coverage to achieve its objectives. FRRB has, during the first year of its operation, reviewed only 20 public interest entity financial statements, which represents a small fraction of the total “public interest” entities in India where there are over 5,500 listed companies.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

54. The ICAI has issued and revised several accounting standards over the last couple of years, significantly reducing the gap between the Indian Accounting Standards and IASB-issued international standards. Appendix A summarizes Indian Accounting Standards, their equivalent international standard, and their applicability to large and small enterprises.⁵⁷ Since April 1, 2001, large companies, including listed companies, need to disclose related party transactions, disclose segmental information, and account for deferred tax assets and liabilities.⁵⁸ Since April 1, 2003, large companies need to apply a new accounting standard with respect to intangible assets. Since April 1, 2004, large companies are also required to disclose information related to discontinuing operations and account for impairment of assets.

55. Financial reporting requirements for small- and medium-size enterprises (SMEs) have been simplified. A recent revision in ICAI-issued accounting standards with regard to the applicability framework of these standards has seen several exemptions being granted to small- and medium-size enterprises concerning disclosure requirements of certain standards.⁵⁹

56. It is mandatory only for listed companies and banks to prepare consolidated financial statements. The requirements with respect to presentation of consolidated financial statements are prescribed under the Stock Exchange Listing Agreement and RBI regulations. This requirement is not mandated either by the Companies Act or Indian Accounting Standards. Even after SEBI introduced the requirement to present consolidated financial statements for a listed company in the Listing Agreement, the current Companies Act still requires annexing the single company audited financial statements of all subsidiary undertakings (including overseas subsidiaries) prepared under Indian laws and regulations. The companies, which prepare consolidated financial statements, usually seek an exemption in this respect.

57. Although Indian Accounting Standards are largely aligned with IFRS, differences do exist. Differences exist because certain IFRS and IFRS- concepts are yet to be adopted, less detailed disclosures are required in some Indian Accounting Standards, and certain Indian Accounting Standards are narrower in scope than equivalent IFRS. The following international standards do not have equivalent Indian Accounting Standards: IAS 1, *Presentation of Financial Statements*; IAS 26, *Accounting and Reporting by Retirement Benefit Plans*; IAS 29 *Financial Reporting in Hyperinflationary Economies*; IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*; IAS 32, *Financial Instruments: Disclosure and Presentation*; IAS 39, *Financial Instruments: Recognition and Measurement*; IAS 40, *Investment Property*;⁶⁰ and IAS 41, *Agriculture*. The banking regulator (RBI) currently prescribes rules and norms relating to topics covered by IAS 30, 32, and 39, which are generally narrower in concept. And the Companies Act prescribes the presentation of financial statements

⁵⁷ New Indian standards correspond to the following international standards: IAS 12, *Income Taxes*; IAS 14, *Segment Reporting*; IAS 24, *Related Party Disclosures*; IAS 17, *Leases*; IAS 28, *Investments in Associates*; IAS 31, *Interests in Joint Ventures*; IAS 34, *Interim Financial Reporting*; IAS 38, *Intangible Assets*; IAS 35, *Discontinuing Operations*; IAS 36, *Impairment of Assets* and IAS 37; *Provisions, Contingent Liabilities and Contingent Assets*. Recently revised standards include local equivalents of IAS 11, *Construction Contracts*; and IAS 21, *The Effects of Changes in Foreign Exchange Rates*.

⁵⁸ Large companies include those with a turnover exceeding Rs 500 million and/or borrowings exceeding Rs 100 million.

⁵⁹ SMEs include companies with a turnover of less than Rs 500 million and borrowings of less than Rs 100 million.

⁶⁰ The Indian Accounting Standard, AS 13, *Accounting for Investments*, covers parts of IAS 39 and IAS 40.

in a way that is not fully consistent with the requirements of IAS 1.⁶¹ Further, an Accounting Standard exists that covers the Disclosure of Accounting Policy requirement of IAS 1. Disclosure requirements are not as detailed in some standards as IFRS and more detailed than IFRS in other cases. The ICAI is currently reviewing all these international standards for adoption, except IAS 29, which they consider not applicable in Indian circumstances. With their adoption, the standards gap will be further reduced.

58. And more differences between Indian AS and IFRS. The degree of application of fair value varies across national standards as compared to IFRS requirements. The dividend proposed after balance sheet date is provided for as an “adjusting event” because of Companies Act requirement, which is contrary to the requirements of IAS 10. Indian AS defines “control” narrowly by restricting it to more than 50 percent of the voting power or control of the composition of the board, because of Companies Act requirement (See Appendix C for definition of control). A period of non-coterminous year-end of subsidiaries permitted under Indian Accounting Standards is six months, whereas IAS 27 allows a period of three months. The rebuttable presumption under IFRS for the useful life of intangible assets is twenty years, whereas under Indian Accounting Standards this presumption is ten years.

59. Evidence of compliance gaps exists despite substantial overall improvement in the corporate financial reporting practices in India over the past decade. A ROSC-led review was conducted of 50 sets of published financial statements of selected major enterprises, including 4 banking companies, 1 financial institution, 2 nonbanking finance companies, 2 power companies, and 1 insurance company.⁶² In addition to the sample reviews, interviews conducted with experienced senior corporate accountants, financial analysts, practicing auditors, academics, and regulators revealed several instances of compliance gaps.⁶³ Issues noted during the review indicated noncompliance with certain accounting standards and applicable statutes. In several companies, application or disclosure of the standard with respect to segment reporting was inadequate. Similarly, in many companies, earnings per share disclosure was not appropriately calculated or not appropriately disclosed. In many companies, problems were noted with respect to profit calculation for the purposes of directors/management remuneration or nonprovision of management commentary on significant cash balances that is not available for use by the entity as required under the Companies Act. Some companies failed to provide for other than temporary diminution in the value of investments, apply the standard on foreign exchange appropriately, make the disclosures necessary with respect to investments, properly classify items within their cash flow statements, and provide for certain retirement benefits on the basis of an actuarial valuation.

60. A significant proportion of sampled banks and financial institutions failed to fully apply the requirements of the Indian Accounting Standard on “related party transactions” and on “segment reporting.” Further, disclosure with respect to “credit exposure for borrowings” was found to be inadequate in many reviewed banks’ financial statements. In 2001, RBI formed a working group to study the reported noncompliances with

⁶¹ Schedule VI of the Companies Act lays down the format for presentation of the financial statements.

⁶² For the sample, 23 companies were selected from the top 50 listed companies by market capitalization, and the balance were selected from other larger listed companies, giving a representative cross-section of audit firms. State-owned enterprises audited by private sector auditors represented 16 percent of the sample.

⁶³ Compliance gap refers to the deviation of actual practice from the applicable accounting standards.

recently issued Accounting Standards by banks.⁶⁴ This working group identified noncompliance with respect to certain disclosure requirements of some Accounting Standards for banks, including those on related party transactions and segment reporting.

61. **Vague statements were noticed in some reviewed financial statements that raise a question on the validity of the auditor's opinion on "true and fair view."** There was a nonstandard disclosure in one company's notes to accounts that "the debtors, advances and creditors were subject to reconciliation/confirmation." Another set of financial statements said that the information provided by the company as required under Indian Accounting Standards on segment reporting was unaudited. The auditor remarked that the present accounting system of corporations does not give the requisite information for preparation of segment accounts.

⁶⁴ See footnote 52 for details

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

62. Indian Auditing and Assurance Standards are broadly in line with ISA. The text of AAS generally replicates the text of the equivalent ISA with modifications that adapt to local circumstances when considered necessary. India has not issued equivalent AAS for ISA 100, *Assurance Engagements*; ISA 501, *Audit Evidence—Additional Consideration for Specific Items*; ISA 720, *Other Information in Documents Containing Audited Financial Statements*; and ISA 910, *Engagements to Review Financial Statements*, although a guidance note currently covers the subject matter of ISA 501 and ISA 910. The Indian AAS, *Responsibilities of Joint Auditors*, does not have an equivalent ISA mainly due to the prevalence of the concept of joint audits in state-owned enterprises, banks, and insurance companies. Appendix B shows Indian Auditing and Assurance Standards, including equivalent international standards.

63. The gap between AAS and ISA is significant in its material affect on assurance engagements, except in a few areas. In these exceptions, the modifications made to ISA when adapting to Indian AAS appear to allow a less flexible audit approach, perhaps in order to reduce the extent of auditor judgment required to properly apply sophisticated auditing standards and procedures. Several Indian AAS have modified ISA requirements when the ISA prescribes a review of another auditor's work or a judgment of their professional competence.⁶⁵ In reality, a new (incoming) auditor's inability to access former (outgoing) auditor's working papers may affect the quality of audit, departing from international best practice. The standard on "audit sampling and other selective testing procedures," both as written and as practiced in the country, significantly differs from ISA. Few auditors use sampling techniques prescribed by ISA. Moreover, the requirements of Indian AAS on "management representations," "planning," "quality control for audit work," and "using the work of another auditor" have gaps that need to be aligned with corresponding ISAs.

64. Auditors often issue "subject to/except for" audit opinions with a list of observations in apparent violation of national standards. Some audit reports often contain a "subject to/except for" audit opinion with a long list of audit observations, which may either appear in the audit report or in notes to accounts or in an annex, the cumulative effect of which may be material enough to warrant issuance of "an adverse or disclaimer" opinion. The auditors of such enterprises often give an appearance of trying to convey a message to the reader without necessarily appropriately qualifying their audit opinion. The AASB Statement on Qualifications in Auditor's Report requires the auditor to consider the collective effect of all the qualifications taken together in preparing an audit opinion on "true and fair view," such as a case that might substantially affect profit or loss of the company. However, adverse or disclaimer opinions are rare in India, in both private and public sector enterprises. Rather than apparently positive opinions, subject to the various material observations, disclaimers or adverse opinions would help the readers to get a clearer understanding of financial statements of the enterprises (mostly in the public sector) in appropriate circumstances that call for so severe an indictment.

65. The quality of audit practice differs significantly among audit firms. This is mainly due because of inadequacy of quality control arrangements in most of the smaller audit firms.

⁶⁵ For example, AAS 24, *Audit Considerations Relating to Entities Using Service Organizations*; AAS 22, *Initial Engagements—Opening Balances*; and AAS 10, *Using the Work of Another Auditor*.

To assess actual auditing practices, the ROSC team interviewed senior practicing auditors and experienced corporate accountants. Facilitated discussions were conducted with professionals representing a cross section of audit firms. Most of these specialists were of the opinion that a majority of auditors use a traditional vouching-based audit approach focusing on transactions, as opposed to the modern risk-based approach focusing on critical assertions. In addition, most auditors focus their audit effort on financial reporting and compliance with provisions of statutes.

66. Improvements in audit quality can be achieved by the development and dissemination of practical guidelines on the implementation of auditing standards. A small proportion of audit firms use high-quality audit practice manuals. In the absence of proper guidance, auditors generally find it difficult to address important concepts, such as audit risk, audit planning, internal control, materiality, documentation, and quality control. Many stakeholders expressed their concern about close relationships between some auditors and their clients. In cases when auditors are defending the majority owners' interests as opposed to protecting the minority shareholder, this may cause undue influence on auditors, resulting in noncompliance with applicable auditing requirements.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

67. A general perception is that financial reporting practices have improved over the past 5 years; however, significantly strengthened enforcement mechanisms are needed to further improve the quality of corporate financial reporting. Interviews and discussions with stakeholders—foreign and local investors, investment bankers, financial analysts, and regulators—reveal that financial reporting practices in India have experienced a substantial improvement with enhancement in good corporate governance practices and the introduction of several new accounting standards that aim to harmonize Indian Accounting Standards with International Financial Reporting Standards. Despite these improvements, many stakeholders also expressed concern about the independence of many practicing auditors.⁶⁶ The peculiar form and layout of Indian financial statements and lack of comfort with the quality of audits sometimes discourage foreign investors from relying on published financial statements. Most interviewees agreed that a majority of the qualified accountants in India are capable of providing internationally comparable professional services, and improvement of the quality of financial reporting requires an effective monitoring and enforcement mechanism for ensuring compliance with accounting and auditing standards, auditors' independence, and adherence to the professional code of ethics.

68. Most stakeholders praised ICAI's efforts in the last 5 years for issuing new accounting and auditing standards, introducing CPE requirements, initiating a process of peer review, and constituting the Financial Reporting Review Board. However, most stakeholders were also absolute in recognizing the need for an effective monitoring and regulatory regime. There was a widely held view among accountants, both in the audit profession and in the corporate sector, that the government should not interfere in the regulation of the profession. Most regulators and some professionals agreed to the need for creating an independent oversight arrangement for the auditing profession in line with recent developments in many developed and emerging market economies. Many professionals and business leaders share the view that full adoption of IFRS and ISA—with respect to financial reporting by banks and other financial institutions, listed companies, and other large-size business enterprises—would provide an incentive to the profession for keeping pace with international best practices and the latest worldwide developments in accounting and auditing. Among views of the participating stakeholders,⁶⁷ some regulators and corporate accountants and analysts expected improvement in the monitoring of the integrity, objectivity, independence, and standards compliance by auditors. A minority of auditors and corporate accountants felt that Indian members of the profession were fiercely independent and completely compliant with standards. During ROSC-facilitated discussion with a sample of audit firms, there was a consensus that adherence to audit standards and code of ethics varied across the levels of profession.

⁶⁶ In this regard, some stakeholders pointed to issues of conflict of interest; in one instance, involving a large audit firm in the country, one of the senior members of the external audit team resigned from the audit firm and joined as a senior financial management position of the client, which is a public interest entity.

⁶⁷ Stakeholders include representatives and senior partners of professional accounting firms; chief financial officers of listed and large Indian companies; university accountancy professors; credit analysts; financial analysts; investment bankers; and regulators (from Registrar of Companies, Regional Directors in the office of Department of Company Affairs, ICAI, SEBI, ICWAI, governing council members and standard setters, and RBI's Department of Banking Supervision and Department of Banking Operations and Development).

VI. POLICY RECOMMENDATIONS

69. During the course of carrying out the ROSC accounting and auditing review in India, representatives of stakeholder groups suggested that it would be useful to prepare “principles-based” policy recommendations based on findings from the ROSC exercise. It was further suggested that a high-level working group use these policy recommendations as inputs for preparing a comprehensive action plan aimed at strengthening the institutional framework of accounting, auditing, and corporate financial reporting. From this perspective, the following policy recommendations have been prepared with significant inputs from leaders of the accounting profession, experienced practitioners, regulators, academics, investment analysts, top management personnel of major corporations and financial institutions, local and foreign investors, and various other stakeholders. The objectives of these recommendations are twofold:

- ***Build on the existing system.*** Recommendations should not jeopardize the achievements of the current framework and systems in place.
- ***Promote a gradual process of improvement.*** Listed companies and other public interest entities should lead the reform process.⁶⁸

70. **Strengthening the monitoring and enforcement mechanism.** High-quality financial reporting depends not only on having appropriate accounting and auditing standards, but also on a proper monitoring and enforcement mechanism. There are three links in the enforcement chain:

- (a) Top management needs to make necessary arrangements for ensuring that corporate financial statements are prepared in compliance with the applicable accounting and financial reporting requirements.
- (b) Auditors need to be independent and competent for ensuring that auditing is conducted in compliance with the applicable auditing standards, and to determine the extent to which the preparers of financial statements have complied with the applicable accounting and reporting standards.
- (c) Regulators need to protect public interest through monitoring and enforcement activities aimed at preventing noncompliance with accounting and auditing requirements.

To be effective, a regulatory body must have sufficient capacity, authority, and independence. Regulatory oversight covers a range of very sophisticated and complicated activities, requiring adequate human and financial resources. It should have staff with the same skill and competence as the industry it is meant to regulate. For the economy as a whole, and financial sector in particular, it can turn out to be a very costly exercise if auditing activities and regulatory oversight of auditors are not carried out properly. The regulatory authority should also have adequate power, granted by law, to carry out its functions, which would include its ability to conduct on-site examinations; impose effective sanctions; revoke audit practice

⁶⁸ In India, public interest entities could include all listed companies (equity/debt), banks, financial institutions, mutual funds, insurance enterprises, companies with turnover in excess of Rs500 million per year, companies with borrowings in excess of Rs100 million and all holding/ subsidiary companies of the above. The ICAI Council has enunciated a similar definition for Level-I enterprises in connection with prescribing simplified accounting and reporting requirements for small- and medium-size enterprises.

license; and, when needed, start criminal proceedings. Regulatory actions are often politically unpopular with the professional accounting bodies, and therefore the regulator must be independent and have the right to act against a practicing accountant and auditor without seeking approval from the professional accounting body or any other interest groups.

71. Strengthening the regulatory arrangements for monitoring and enforcing accounting and auditing requirements in regard to public interest entities. The composition, functions, and powers of the body responsible for monitoring and enforcing these requirements need to be configured in line with the emerging international trends to ensure independence and effectiveness in regulating general purpose financial reporting.⁶⁹ This body should be empowered with oversight to assess whether the auditing profession is appropriately serving the interests of users of audited financial statements and of the wider public. It should adjust the scope of its work in coordination with the monitoring and enforcement activities of other regulators, including professional self-regulatory organizations. Other regulators (RBI, SEBI, and IRDA) could strengthen their capacities to complement the role of this body. The top management of this body should comprise eminent persons from various fields, with sufficient exposure to financial reporting and the auditing profession. Above all, it should be independent and therefore should be funded in the same way as in the case of other regulatory agencies (e.g., SEBI, IRDA, and Telecom Regulatory Authority of India). Practicing accountants and auditors (including those associated with entities affiliated to auditors or audit firms) would not be normally eligible for inclusion on the governing board of the oversight body. This oversight body should maintain a list of authorized audit firms that are eligible to be appointed statutory auditors of public interest entities. The oversight body should also have power to disqualify an audit firm from carrying out audits of public interest entities. And, it should have powers to prescribe penalties, restrictions, and ethical standards. In order to execute the above mandate, the oversight body could set up subsidiary units with fulltime staff. While the main board will act as the overall policymaker, these subsidiary units will monitor general purpose financial reporting by the public interest entities and their auditors:

- ***Practice Review Unit.*** With responsibility for conducting practice reviews of the auditors of public interest entities and ensuring each firm is reviewed at a reasonably regular interval, this unit should decide and impose effective sanctions on audit firms for preventing noncompliance with auditing requirements.
- ***Financial Reporting Review Unit.*** With responsibility for reviewing published financial statements for compliance with standards of the public interest entities on a proactive basis, this unit should decide and impose effective sanctions on corporate management for preventing noncompliance with accounting and financial reporting requirements. The individual regulators could continue to monitor for compliance with their regulatory pronouncements (for example, RBI will monitor prudential norms and the Stock Exchanges will continue to monitor compliance with the Listing Agreement). The external auditors might also be mandated to report directly

⁶⁹ This could either be done through separate legislation or by revising the proposed Chartered Accountants Amendment Act by enhancing the role of the proposed Quality Review Board. The composition, functions, and powers of the proposed arrangement need to focus on protecting public interest. In developing such an arrangement, lessons/principles may be drawn from similar arrangements in other countries—some examples of the evolving regulatory structures are: United Kingdom's Financial Reporting Council, Australia's Financial Reporting Council, and the United States' Public Company Accounting Oversight Board.

to this unit any material unresolved noncompliances observed when auditing financial statements of their clients.

72. **Rationalizing the Companies Act.** Simplify Schedule VI to the Companies Act with an arrangement in line with IAS 1, *Presentation of Financial Statements*. Legislated disclosure requirements have not kept pace with changes in standards, disclosures, and relevant international practices because amendments to the Companies Act are cumbersome and difficult to implement on a timely basis.⁷⁰ Regulatory information can still continue to be submitted under the current requirements (RBI guidelines, IRDA guidelines, Banking Regulation Act) and the general purpose financial statement should follow the national equivalent of IAS 1. In addition, there is a need to amend the Companies Act to delete the requirement to annex subsidiary company financial statements with parent company's financial statements. The Schedule of the Companies Act that prescribes minimum rates of depreciation for financial reporting purposes needs to be discontinued in favor of the accounting standard recommending computation on the basis of estimated useful life of each asset; depreciation rates for tax purposes can continue to be prescribed by tax legislation.

73. **Bridging the gap between IFRS and Indian Accounting Standards.** Immediate steps should be taken to issue IFRS-equivalent national standards that are not yet adopted.⁷¹ Disclosure-related requirements should be reinstated through adoption of IAS 1. Requirements for preparing consolidated financial statements should be made mandatory for all public interest entities. Certain existing differences need to be re-examined to bring them in line with IFRS. As a future step, the Indian authorities could also explore possibility of full compliance with IFRS for the public interest entities.

74. **Bridging the gap between ISA and the equivalent Indian AAS.** India should prepare and issue the national equivalent of ISA 100, *Assurance Engagements*; ISA 501, *Audit Evidence—Additional Consideration for Specific Items*; ISA 720, *Other Information in Documents Containing Audited Financial Statements*; and ISA 910, *Engagements to Review Financial Statements*. Any differences still existing between ISA and any comparable AAS that have already been adopted need to be corrected. Certain narrowly conceived concepts in local AAS need to be re-examined in the light of international experience. The following specific actions could also be considered:

- ICAI could reference the example of quality control for audit work as provided by the equivalent ISA in order to guide firms on how to implement the requirements of this standard.
- ICAI could consider permitting the review of audit working papers on a “hold-harmless” basis and hence suitably modify AAS 24, *Audit considerations relating to entities using service organizations*; AAS 22, *Initial engagements--Opening balances*; and AAS 10, *Using the work of another auditor*.

⁷⁰ The presentation and layout of financial statements is defined in Schedule VI of the Companies Act, Schedule III of the Banking Regulation Act and RBI guidelines (for banks), and IRDA regulations (for insurance companies).

⁷¹ International standards without an equivalent AS are IAS 26, *Accounting and Reporting by Retirement Benefit Plans*; IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*; IAS 32, *Financial Instruments: Disclosure and Presentation*; IAS 39, *Financial Instruments: Recognition and Measurement*; and IAS 41, *Agriculture*.

- ICAI could consider defining a minimum proportion of major financial statement captions that must be audited by the primary auditor, while leaving up to the auditor to determine whether that proportion is sufficient or not in order to issue the overall opinion.
- The AAS on *Audit sampling and other selective testing procedures* needs to be brought in line with the latest ISA.

75. Facilitating coordination among multiple accounting standard committees set up by regulators. The function of preparing and recommending accounting standards needs to be primarily vested with the Accounting Standards Board of ICAI. The Accounting Standards Board should be fully supported by the other accounting standards committees of SEBI, RBI, and the Central Board of Direct Taxes. The Central Government through NACAS could continue to notify the accounting standards for companies as required under the prevalent law. The other standards committees should pool resources with ICAI and provide inputs at the standard setting stage for due consideration.

76. Recognizing affiliates of audit firms as part of one economic entity for purposes of regulatory restrictions and independence considerations. This recommendation would assist in addressing issues related to independence/conflict of interest as described in paragraph 26 and footnote 37. At present, separate legal entities belonging to the same network of firms provide various professional services. One or more of such a network members are licensed by ICAI to provide auditing services. The other members of the same network provide various professional services other than audits; they are not required to follow the ICAI's code of ethics, and they are not treated as a part of one economic entity. Although these firms are separate legal entities, in reality they share the same resources, infrastructure, and methodologies, and are rarely independent of each other in true spirit. Applicable laws do not currently recognize an audit firm's affiliated entities as part of an economic entity, which leads to legal requirements being followed in appearance rather than in substance.⁷² Recognizing affiliates of an audit firm as part of an economic entity would help in better addressing conflict of interest issues and other related regulatory requirements.

77. Revisiting the policy on publishing unaudited quarterly results by the listed companies. As described in paragraph 20, in cases of listed companies, publishing unaudited quarterly results in the press before a limited audit review needs to be re-examined. Furthermore, the deadline for submission of audited annual financial statements could be shortened to a maximum of 90 days from the balance sheet date for the listed companies.

78. Bringing the regulation and monitoring of financial reporting practices by all cooperative banks under purview of the Reserve Bank of India. As described in paragraph 18, the regulation, auditor appointment, and monitoring of cooperative banks (both urban and rural) should be brought under the purview of the Reserve Bank of India. Cooperative banks should be subject to the same accounting/auditing standards and regulatory monitoring as the rest of the banking sector.

⁷² For example, recently some private banks changed their auditor to meet the RBI guideline on mandatory auditor rotation every 4 years, where the incoming audit firm was a close affiliate (part of the same international network of firms) of the incumbent audit firm.

79. Introducing practices to ensure compliance with code of ethics by the auditors of public interest entities. For example, ICAI-member auditors could provide a standard annual letter of representation that would be an annual certificate of compliance with the code of ethics, including disclosure of any infractions. In case any representation is found to be incorrect, the member could be suitably dealt with, including permanent loss of ICAI membership.

80. Scaling up structured training programs for ICAI members. ICAI should make arrangements for scaling up the delivery of training programs to provide guidance on (a) implementation of new accounting and auditing standards; (b) new concepts like fair value, true and fair override, materiality, and division of work; (c) best practice audit report disclosures and report writing and evolving risk-based audit methodologies; and (d) implementation of quality control procedures and code of ethics in small and medium audit firms.

81. Revising the ICAI Code of Ethics and Chartered Accountants Regulations to bring in line with the IFAC Code of Professional Ethics. Some restrictions prescribed under the current ICAI Code of Ethics need immediate revision in order to increase the competitiveness of Indian audit firms. Other restrictions need to be introduced through the Code in order to enhance auditor independence. The Naresh Chandra Committee has made several commendable recommendations in this regard that should be legislated. The ICAI Code of Ethics defines several rules; these rules may appear to be stricter than those defined by the IFAC Code, which can be complied with to the letter but circumvented in substance. Therefore it is recommended that a broad revision of the ICAI Code and the Chartered Accountants Regulations be undertaken to insert a principle-based conceptual framework while retaining some of the rules.⁷³ The ROSC team advocates a framework approach that (a) sets out fundamental ethical principles, (b) provides a reasoned analysis of the possible threats to these principles, and (c) gives guidance on the safeguards that may be necessary to mitigate these threats. The following issues could be considered:

- ***Remove restriction on number of partners permitted in an audit firm;*** permit audit firms to be limited liability partnerships while prescribing a minimum professional liability insurance cover based on the quantum of revenues of an audit firm.
- ***Address undue dependence on an audit client.*** Maximum fee from one client compared to total firm fee needs to be brought down from the currently permissible 40 percent of total fees to a level that would not compromise audit firms' independence.
- ***Prohibit personal/business relationships with audit clients*** for audit firms, its partners, and their relatives, as opposed to current regulations that only require disclosure of such relationship in the audit report.
- ***Prescribe a “cooling-off” period.*** Situations where audit partners join clients or vice-versa are not uncommon. It is recommended that a three-year “cooling- off”

⁷³ The IFAC Code of Ethics for Professional Accountants states, “A conceptual framework that requires firms and members of assurance teams to identify, evaluate, and address threats to independence, rather than merely comply with a set of specific rules which may be arbitrary, is, therefore, in the public interest. Independence is potentially affected by self-interest, self-review, advocacy, familiarity, and intimidation threats.” ICAEW states, “The most effective way to ensure the reality of independence is to provide guidance centered around a framework of principles rather than a detailed set of rules that can be complied with to the letter but circumvented in substance.”

period be prescribed. This requirement should extend to the audit firm partners, managers, and any management-grade employee of the client.

82. Taking steps for improving professional education and training arrangements. Continuing professional education requirements prescribed by ICAI need to be brought in line with those prescribed by the IFAC-issued pronouncement on Continuing Professional Education and Development. Although India has a highly reputed education system, the following steps should be taken with regard to professional education and training in accountancy:

- ***Introduce an elective course on international standards***, including topics on practical application of IFRS and ISA, and detailed discussions on the differences between these international standards and Indian standards, as part of the undergraduate business/accounting programs.
- ***Teach business ethics*** as a separate subject in undergraduate business/accounting programs, and test candidates' knowledge about the practical aspects of professional ethics in the professional qualification examinations.
- ***Further improve the professional examinations of ICAI*** by undertaking a detailed and independent review of the current assessment methodology. ICAI could consider including objective-type questions, introducing case studies that test the students' practical training and application of standards as opposed to theoretical questions, and examining students on the differences between Indian and international standards.
- ***Put in place an arrangement for licensing authorized training providers.*** The ICAI should screen audit firms before allowing them to accept any trainees. In order to be an authorized training provider, a firm should be involved in providing auditing services to at least one major business enterprise in the region,⁷⁴ and it should have sufficient capacity to enable the trainee-auditors to gain exposure to the practical aspects of all the applicable standards and codes. The ICAI should maintain a list of authorized practical training providers. The list should be updated on the basis of periodic assessment of the capabilities of the existing and potential training providers.

⁷⁴ ICAI's regional body will be responsible for determining whether a particular client of an authorized training provider meets the previously established threshold of a major business enterprise.

APPENDIX A.
INDIAN ACCOUNTING STANDARDS AND THEIR APPLICABILITY TO ENTERPRISES

<i>IAS equivalent</i>	<i>Indian Accounting Standards (AS)</i>	<i>Mandatory date</i>	<i>Mandatory only for Level I *** enterprises</i>	<i>Mandatory for all other enterprises from</i>
IAS 1	AS 1 Disclosure of Accounting Policies <i>(Under preparation- Revised AS 1- Presentation of Financial Statements)</i>	1/4/1991		APPLICABLE TO ALL ENTITIES
IAS 2	AS 2 (Revised) Valuation of Inventories	1/4/1999		APPLICABLE TO ALL ENTITIES
IAS 7	AS 3 (Revised) Cash Flow Statements	1/4/2001	✓	No Date
IAS 10	AS 4 (Revised) Contingencies and Events Occurring after the Balance Sheet Date <i>(Under preparation- Revised AS 4- Events after Balance Sheet Date)</i>	1/4/1995		APPLICABLE TO ALL ENTITIES
IAS 8	AS 5 (Revised) Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies <i>(Under preparation- Revised AS 5- same title)</i>	1/4/1996		APPLICABLE TO ALL ENTITIES
IAS 16	AS 6 (Revised) Depreciation Accounting **	1/4/1995		APPLICABLE TO ALL ENTITIES
IAS 11	AS 7 (Revised) Construction Contracts	1/4/2003		APPLICABLE TO ALL ENTITIES
	AS 8 Accounting for Research and Development <i>(AS-8 was withdrawn from the date AS-26 became mandatory)</i>			
IAS 18	AS 9 Revenue Recognition <i>(Under preparation- Revised AS 9- same title)</i>	1/4/1991		APPLICABLE TO ALL ENTITIES
IAS 16	AS 10 Accounting for Fixed Assets <i>(Under preparation- Revised AS 10- Tangible Fixed Assets)</i>	1/4/1991		APPLICABLE TO ALL ENTITIES
IAS 21	AS 11 (Revised) The effects of Changes in Foreign Exchange Rates	1/4/2004		APPLICABLE TO ALL ENTITIES
IAS 20	AS - 12 Accounting for Government Grants <i>(Under preparation- Revised AS 12- same title)</i>	1/4/1994		APPLICABLE TO ALL ENTITIES
IAS 39; 40	AS 13 Accounting for Investments	1/4/1995		APPLICABLE TO ALL ENTITIES
IAS 22	AS 14 Accounting for Amalgamations <i>(Under preparation- Revised AS 14- same title)</i>	1/4/1995		APPLICABLE TO ALL ENTITIES
IAS 19	AS 15 Accounting for Retirement Benefits in the Financial Statements of Employers <i>(Under preparation- Revised AS 15- Employee Benefits)</i>	1/4/1995		APPLICABLE TO ALL ENTITIES
IAS 23	AS 16 Borrowing Costs	1/4/2000		APPLICABLE TO ALL ENTITIES
IAS 14	AS 17 Segment Reporting	1/4/2001	✓	No Date

<i>IAS equivalent</i>	<i>Indian Accounting Standards (AS)</i>	<i>Mandatory date</i>	<i>Mandatory only for Level I *** enterprises</i>	<i>Mandatory for all other enterprises from</i>
IAS 24	AS 18 Related Party Disclosures	1/4/2001	✓	No Date
IAS 17	AS 19 Leases	1/4/2001		APPLICABLE TO ALL ENTITIES [∞]
IAS 33	AS 20 Earnings Per Share	1/4/2001		Mandatory for all companies and other enterprises that presents EPS [∞]
IAS 27	AS -21 Consolidated Financial Statements	1/4/2001	✓ Only for listed companies and banks	Mandatory for enterprises that present consolidated financial statements.
IAS 12	AS 22 Accounting for Taxes on Income	1/4/2001		Applicable to certain public interest enterprises from 01.04.2001 and to companies from 01.04.2002 (All entities from 01.04.2006)
IAS 28	AS 23 Accounting for Investments in Associates in Consolidated Financial Statements	1/4/2002	✓ Only for listed companies and Banks	Mandatory for enterprises that present consolidated financial statements.
IAS 35	AS 24 Discontinuing Operations	1/4/2004	✓	No date
IAS 34	AS 25 Interim Financial Reporting	1/4/2002		Recognition and measurement requirements are applicable to listed enterprises and other enterprises that present interim financial results; fully applicable if an enterprise is required or elects to prepare and present an interim financial report as defined in the standard.
IAS 38	AS 26 Intangible Assets	1/4/2003		APPLICABLE TO CERTAIN PUBLIC INTEREST ENTERPRISES FROM 01.04.2003, FOR ALL OTHER ENTITIES FROM 01.04.2004
IAS 31	AS 27 Financial Reporting of Interests in Joint Ventures	1/4/2002	✓ Δ	Δ
IAS 36	AS 28 Impairment of Assets	1/4/2004	✓ from 01.04.2004	Level II **** enterprises from - 01.04.2006 Level III ***** enterprises from - 01.04.2008
IAS 37	AS 29 Provisions, Contingent Liabilities and Contingent Assets	1/4/2004		APPLICABLE TO ALL ENTITIES [∞]

[∞] Certain disclosure requirements of these standards are exempted for Level II and Level III enterprises (collectively referred to as SMEs).

Δ Requirements relating to separate financial statements are mandatory; for consolidated financial statements, mandatory only if presented.

** From date AS 26 is mandatory (1/4/03), the provisions relating to the amortization of intangible assets contained in AS 6 stand withdrawn.

*** Large & Listed Enterprises or "Level I" Enterprises-

- i) Listed enterprises/ enterprises in the process of being listed (equity or debt)
- ii) Banks (including Cooperative Banks), Financial Institutions and Insurance Companies
- iii) Enterprises whose turnover (excluding Other Income) exceeds Rs 500 million in the previous year
- iv) Entities with Borrowings including Public Deposits exceeding Rs 100 million at any time during period
- v) Holding and Subsidiary Companies of the above entity anytime during the period

**** Level II Enterprises-

- i) Enterprises whose turnover (excluding Other Income) exceeds Rs 4 million in the previous year but does not exceed Rs 500 million.
- ii) Entities with Borrowings including Public Deposits exceeding Rs 10 million at any time during period but not exceeding Rs 100 million.
- iii) Holding and Subsidiary Companies of the above entity anytime during the period

***** Level III Enterprises-

All entities that do not qualify as Level I or Level II

APPENDIX B.
INDIAN AUDITING AND ASSURANCE STANDARDS (AAS)

ISA equivalent	Indian Auditing and Assurance Standards (AAS)	Title of the Indian AAS	Effective date² (dd/mm/yy)
200	1	Basic Principles Governing an Audit	1/4/1985
200	2	Objective and Scope of an Audit of Financial Statements	1/4/1985
230	3	Documentation	1/7/1985
240	4 (Revised)	The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements <i>Revised AAS issued in January 2003. Original AAS issued in June 1987</i>	1/4/2003
500	5	Audit Evidence	1/1/1989
400	6 (Revised)	Risk Assessments and Internal Control <i>Revised AAS issued in June 2002. Original AAS issued in May 1988</i>	1/4/2002
610	7	Relying Upon the Work of an Internal Auditor	1/4/1989
300	8	Audit Planning	1/4/1989
620	9	Using the Work of an Expert	1/4/1991
600	10 (Revised)	Using the Work of Another Auditor <i>Revised AAS issued in September 2002. Original AAS issued in April 1995</i>	1/4/2002
580	11	Representations by Management	1/4/1995
No corresponding ISA	12	Responsibility of Joint Auditors	1/4/1996
320	13	Audit Materiality	1/4/1996
520	14	Analytical Procedures	1/4/1997
530	15	Audit Sampling	1/4/1998
570	16	Going Concern	1/4/1999
220	17	Quality Control for Audit Work	1/4/1999
540	18	Audit of Accounting Estimates	1/4/2000 ³

<i>ISA equivalent</i>	<i>Indian Auditing and Assurance Standards (AAS)</i>	<i>Title of the Indian AAS</i>	<i>Effective date^a (dd/mm/yy)</i>
560	19	Subsequent Events	1/4/2000 ^b
310	20	Knowledge of the Business	1/4/2000 ^b
250	21	Consideration of Laws and Regulations in an Audit of Financial Statements	1/4/2001
510	22	Initial Engagements – Opening Balances	1/7/2001
550	23	Related Parties	1/4/2001
402	24	Audit Considerations relating to Entities Using Service Organisations	1/4/2003
710	25	Comparatives	1/4/2003
210	26	Terms of Audit Engagement	1/4/2003
260	27	Communications of Audit Matters with Those Charged with Governance	1/4/2003
700	28	The Auditor's Report on Financial Statements	1/4/2003
401	29	Auditing in a Computer Information Systems Environment	1/4/2003
505	30	External Confirmations	1/4/2003
930	31	Engagements to Compile Financial Information	1/4/2004 ^c
920	32	Engagements to Perform Agreed upon Procedures regarding Financial Information	1/4/2004 ^c

^a The Auditing and Assurance Standards are effective for all audits commencing on or after the dates specified in the respective cells in column 4.

^b Applicable to all compilation engagements beginning on or after the date specified in the respective cell in column 4.

^c Applicable to all agreed upon procedures engagements beginning on or after the date specified in the respective cell in column 4.

APPENDIX C.
PROPOSED DEFINITION OF “CONTROL” FOR PURPOSES OF CONSOLIDATING

The definition of “control” in the Indian Accounting Standards—more than 50 percent of the voting power either directly or indirectly or control of the composition of board—is narrower than that prescribed in IAS 27—a more principles-based definition, “the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.”

In rare situations, Indian groups could take advantage of the “rule-based” nature of the definition of control under Indian Accounting Standards (as opposed to the “principle-based” nature of the IAS) whereby they can reduce the voting power to just under 50 percent and ensure that they do not control the board on paper to get out of consolidating a subsidiary they do not want to consolidate.

Therefore the definition of “control” should be amended in line with the IAS 27 definition (see below) to also include control over the financial and operating decisions of the entity as part of a 3-way test:

- **51 percent ownership or voting, or**
- **Control over governing board, or**
- **Control over financial and/ or operating decisions.**

As per IAS 27, control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than 50 percent of the voting power of an enterprise unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control.

Control also exists even when the parent owns 50 percent or less of the voting power of an enterprise when there is:

- power over more than one half of the voting rights by virtue of an agreement with other investors,
- power to govern the financial and operating policies of the enterprise under a statute or an agreement,
- power to appoint or remove the majority of the members of the board of directors or equivalent governing body, or
- power to cast the majority of votes at meetings of the board of directors or equivalent governing body.

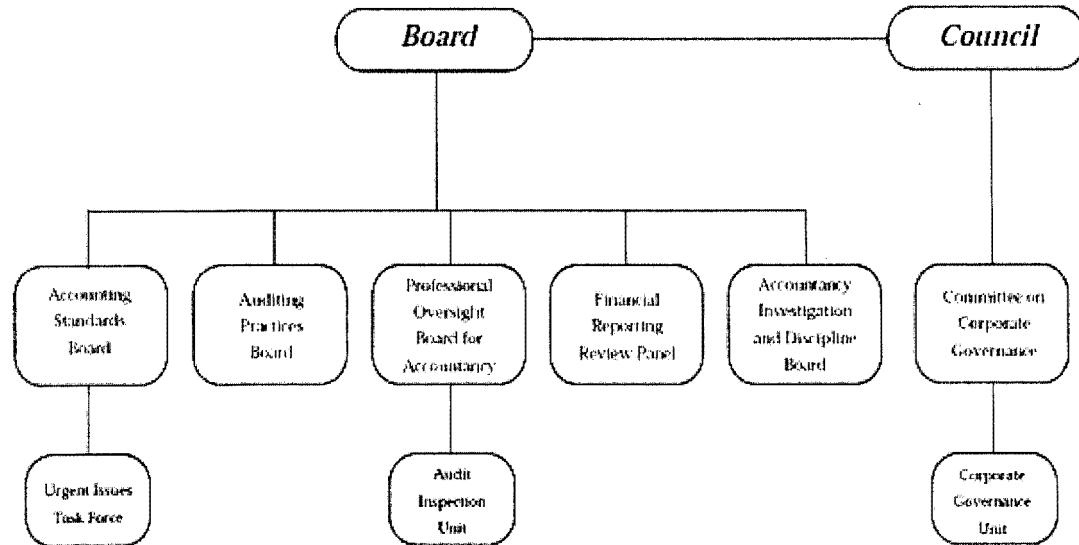
APPENDIX D.
INTERNATIONAL DEVELOPMENTS IN REGULATORY FRAMEWORK
OF ACCOUNTING AND AUDITING

This note describes salient features of regulatory structures in three countries, for example. For more details, refer to (a) www.frc.org.uk for the United Kingdom's Financial Reporting Council, (b) www.frc.gov.au for Australia's Financial Reporting Council, and (c) www.pcaobus.org for the United States' Public Company Accounting Oversight Board.

1. UNITED KINGDOM: THE FINANCIAL REPORTING COUNCIL (FRC)

The Financial Reporting Council (FRC) of the UK is a unified, independent regulator which (a) sets, monitors and enforces accounting and auditing standards, (b) oversees the regulatory activities of the professional accountancy bodies, (c) regulates audit; and (d) promotes high standards of corporate governance. It was initially established in 1990 and the mandate was expanded in 2003. It has five subsidiary boards with a Management Board that co-ordinates the key policy and resource issues of the organization. The FRC is the parent of all the subsidiary boards, all of which are established as companies limited by guarantees.

Organization chart



The Council is headed by a chief executive and comprises of a chairman, a deputy chairman (both of whom are directors of FRC limited) and three additional directors (each representing a community of stakeholders, namely Confederation of British Industry (CBI), consultative committee of the Accountancy Bodies (CCAB) and, a representative of the investor community). The Council determine the strategic direction of the organization, oversee the delivery by each subsidiary Board of its functions, reviews and amends the combined code as necessary to secure and maintain observance of high standards of corporate governance; and manage the broad strategic relationship with key players domestically and

internationally. The FRC and its subsidiaries are currently supported and funded jointly¹ by the accountancy profession (through the Consultative Committee of the Accountancy Bodies [CCAB]), business (through a levy collected by the FSA) and the Government.

The Accounting Standards Board (ASB)

The role of the Accounting Standards Board (ASB) is to issue accounting standards under the Companies Act 1985, which took over the task of setting accounting standards from the Accounting Standards Committee (ASC) in 1990. The ASB has up to ten Board members, of whom two (the Chairman and the Technical Director) are full-time, and the remainder, who represent a variety of interests, are part-time. Under the ASB's constitution, votes of seven Board members (six when there are fewer than ten members) are required for any decision to adopt, revise or withdraw an accounting standard. Board members are appointed by a Nominations Committee comprising the chairman and fellow directors of the Financial Reporting Council (FRC).

The Auditing Practices Board (APB)

The new Auditing Practices Board (APB) was established in April 2002 which replaced the APB which had been in place since 1991. The APB establishes standards of auditing, meets the developing needs of users of financial information; and ensures public confidence in the auditing process.

The Public Oversight Board for Accountancy (The POBA)

The POBA provides (a) independent oversight of the regulation of the auditing profession by the recognized supervisory and qualifying bodies; (b) monitoring of the quality of the auditing function in relation to economically significant entities; and (c) independent oversight of the regulation of the accountancy profession by the professional accountancy bodies.

Audit Inspection Unit. The POBA includes an Audit Inspection Unit (AIU), which in the initial year (2004-05) is focusing on the audits of the FTSE 350 companies and the Big 4 firms of auditors, which audit 97% of those companies. Coverage will be extended over the following two years to other public interest entities, including listed companies with a minimum market capitalization of £100 million, major charities, major pension funds, mutual organizations and other public interest entities over the following two years. A sample of audits will be subject to review in any one year, the selection of audits will, in part be on a risk basis, and to provide coverage across the audit firms. The Professional Bodies own monitoring units will continue to be responsible for monitoring audits not falling within the scope of the AIU. The AIU will be supported by a Panel of very senior individuals with experience of audit who will be available to provide advice on inspections, and particularly on issues involving professional judgment. The AIU will present their reports with recommendations for action to the Audit Registration Committees (ARCs) of the accountancy bodies, who will then exercise their existing functions: taking appropriate regulatory action and/or referring the matter to the bodies' disciplinary procedures for action. The POBA will monitor the response of the Audit Registration Committees to AIU reports to ensure itself that appropriate action is being taken. In addition, the AIU can inform the AIDB if it identifies concerns, which might lead to disciplinary action. The AIU can also inform the FRRP of concerns it has with the audits of individual companies, so that the FRRP may take appropriate action in relation to the company accounts.

The Financial Reporting Review Panel (FRRP)

The FRRP (commonly referred to as "the Panel") considers whether the annual accounts of public companies and large private companies comply with the requirements of the Companies Act 1985

¹ The FRC has one-third government funding, one-third funding from the CCAB and the balance from listing companies and the banking and investment sector. Previously, the Accountancy Foundation had been funded solely by the CCAB, which was considered to risk the independence of the organization.

including applicable accounting standards. The Panel can ask directors to explain apparent departures from the accounting requirements. If the Panel is not satisfied by the directors' explanations it aims to persuade them to adopt a more appropriate accounting treatment. The directors may then voluntarily withdraw their accounts and replace them with revised accounts that correct the matters in error. Depending on the circumstances, the Panel may accept another form of remedial action—for example, correction of the comparative figures in the next set of annual financial statements. Failing voluntary correction, the Panel can exercise its powers to secure the necessary revision of the original accounts through a court order.

The Accountancy Investigation and Discipline Board (AIDB)

The AIDB is the independent investigative and disciplinary body for accountants in the UK. It has up to eight members and is responsible for operating and administering an independent disciplinary scheme ('the scheme') covering members of professional accountancy bodies under its purview. The AIDB deals with cases which raise or appear to raise important issues affecting the public interest in the UK and which need to be investigated to determine whether or not there has been any misconduct by an accountant or accountancy firm. The Scheme and Regulations contain the detailed rules setting out how cases are dealt with by the AIDB. In the first instance, complaints about accountants or accountancy firms would be made to the accountancy body of which the accountant or the firm is a member. Matters which raise serious issues affecting the public interest will be referred to the AIDB by the accountants' professional bodies. The AIDB will then decide whether to investigate the matter, in which case it will be referred to an Executive Counsel. The AIDB may also decide of its own accord to investigate a matter without it having been referred to it by one of the accountants' professional bodies. The Executive Counsel will conduct the investigation and decide whether or not any accountant or accountancy firm should be subject to disciplinary proceedings. If disciplinary proceedings are to be commenced, the Executive Counsel will file a complaint with the AIDB and the AIDB will appoint a Disciplinary Tribunal to hear the case.

2. AUSTRALIA: THE FINANCIAL REPORTING COUNCIL

The Financial Reporting Council (FRC) is a statutory body under the *Australian Securities and Investments Commission Act 2001* (ASIC Act), as amended by the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004. The FRC is responsible for providing broad oversight of the process for setting accounting and auditing standards as well as monitoring the effectiveness of auditor independence requirements in Australia and giving the Minister reports and advice on these matters.

Specific accounting and auditing standard setting functions for which the FRC is responsible include (a) appointing the members of the Australian Accounting Standards Board (AASB) and Australian Auditing Standards Board (AuASB), (b) determining, approving and monitoring the AASB's and AUASB's priorities & business plans, (c) giving the AASB and AUASB directions, advice or feedback on matters of general policy and on the AASB's and AUASB's procedures, (d) monitoring the development of international accounting and auditing standards and the accounting and auditing standards that apply in major international financial centers, (e) promoting the continued adoption of international best practice accounting and auditing standards in the Australian accounting and auditing standard setting processes, (f) monitoring – (i) the operation of accounting and auditing standards to assess their continued relevance and their effectiveness in achieving their objectives in respect of both the private and public sectors of the Australian economy; (ii) the effectiveness of the consultative arrangements used by the AASB and AUASB; and (iii) seeking contributions towards the costs of the Australian accounting and auditing standard setting processes;

Specific auditor independence functions for which the FRC is responsible include (a) monitoring and assessing the nature and overall adequacy of (i) the systems and processes used by Australian auditors to ensure compliance with auditor independence requirements; (ii) the systems and processes used by professional accounting bodies for planning and performing quality assurance reviews of audit work undertaken by Australian auditors to the extent to which those reviews relate to auditor independence requirements; (iii) the action that Australian auditors who have been subject to such quality assurance reviews have taken in response to the reports prepared as a result of those reviews; (iv) the action taken by professional accounting bodies to ensure that Australian auditors who have been subject to such quality assurance reviews respond appropriately to the reports prepared as a result of those reviews; and (v) the investigation and disciplinary procedures of professional accounting bodies as those procedures apply to Australian auditors, (b) monitoring the overall compliance by companies, registered schemes and disclosing entities with the audit-related disclosure requirements of the Corporations Act and the accounting and auditing standards, (c) giving the Minister and the professional accounting bodies reports and advice on the above matters, (d) monitoring international developments in auditor independence, assessing the adequacy of the Australian auditor independence requirements in the light of those developments and giving the Minister, and professional accounting bodies, reports and advice on any additional measures needed to enhance the independence of Australian auditors; and (e) promoting, and monitoring the adequacy of, the teaching of professional and business ethics by, or on behalf of, professional accounting bodies to the extent to which the teaching of those subjects relates to auditor independence.

The members of the FRC are appointed by the Treasurer and hold office on terms and conditions determined by the Treasurer. The FRC includes members appointed from nominations put forward by key stakeholder groups, as well as members appointed independently of stakeholder interests.

3. UNITED STATES: PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (USPCAOB)

Following are the most important accounting and auditing related requirements of the *Sarbanes-Oxley Act of 2002*. The Act includes provisions concerning various other matters affecting investor protection.

- ***Oversight of Public Company Audit.*** The Act establishes the Public Company Accounting Oversight Board (PCAOB); to be organized as a non-profit corporation, with SEC administration and oversight. The PCAOB's mission is to oversee the audits of public companies and related matters.
- ***Organization of PCAOB.*** The Securities and Exchange Commission appoints the chairman and members of the Public Company Accounting Oversight Board. The Board comprises five members—two can be professionally qualified accountants.
- ***Auditor registration.*** All auditors of public companies must register with the PCAOB, identify public audit clients, identify all accountants associated with those clients, list fees earned for audit and nonaudit services, explain their audit quality control procedures, and identify all criminal, civil, administrative, and disciplinary proceedings against the firm or any of its associated persons in connection with an audit.
- ***Inspection of CPA firms.*** The PCAOB must inspect all CPA firms that audit public companies to assess compliance with the law, SEC regulations, rules established by the PCAOB, and professional standards. Firms that audit more than 100 public companies will be inspected annually. Firms that audit 100 or fewer public companies must be inspected at least once every three years. If violations are found, the PCAOB must take disciplinary action.

- ***Audit committees.*** All audit committee members must be independent (non-executive) directors. Audit firms will be appointed by, and will report directly to, the audit committee. Audit committees must establish procedures to deal with complaints about accounting, auditing, and internal controls.
- ***Audit, quality control, ethics, and independence standards.*** The PCAOB must adopt audit, quality control, ethics, and independence standards. In doing so, the PCAOB may look to standards established by recognized professional organizations such as the AICPA.
- ***Quality control.*** The PCAOB's quality control standards must require that registered firms properly supervise all work, monitor compliance with ethics and independence rules, and establish internal systems for consultation, professional development, and client acceptance and retention.
- ***Restrictions on services to audit clients.*** The Act restricts consulting work auditors can do for their audit clients. Restricted services include (with certain exceptions) bookkeeping, financial systems design, appraisal and valuation, actuarial, internal audit, management functions, human resources, broker-dealer, investment banking, and legal. PCAOB may enumerate additional prohibited services. The registrant's audit committee must pre-approve engaging the auditor for other nonaudit services, including tax work.
- ***Partner rotation.*** The Act requires 5-year rotation of the audit partner and second reviewing partner.
- ***Accounting standards.*** The law permits the SEC to recognize standards established by a private-sector accounting standard-setter provided that the standard-setter is deemed acceptable by the SEC and considers international convergence in developing standards.
- ***Disclosures.*** The Act requires certain disclosures in financial reports, including information about off-balance sheet transactions, and orders the SEC to develop rules regarding pro forma disclosures.
- ***Principles-based standards.*** The SEC is required to study the “adoption by the United States financial reporting system of a principles-based accounting system” and, within one year, submit a report to specified committees of the US Senate and House of Representatives.
- ***Corporate and criminal fraud.*** The Act provides for criminal penalties for corporate fraud and document shredding.
- ***Restatements.*** The Act specifically prohibits improper influence on audits and requires forfeiture of executive bonuses and equity gains if financial statements must be restated.
- ***Compliance with SOX Section 404.*** Section 404 of the Sarbanes Oxley Act requires the management of a company registered with the SEC to assess and report on the effectiveness of the company's internal control over financial reporting, and requires auditors to attest to and report on management's assessment.

