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CHARGED WITH GOVERNANCE

This is the 120th edition of our monthly newsletter. Excellence Enablers wishes to thank our readers for their continuing encouragement over 10 years.

With a major corporate governance related development in one of India's largest private sector banks, it would normally have been appropriate for this newsletter, being a commentary on governance, to address issues arising from that development. However, with the plethora of pundits having pronounced judgement in the absence of evidence, we consciously decided to reserve our comments and our observations until such time as more information was available in the public domain. We therefore turned to another matter which has been occupying mindspace in several boardrooms over the last few months.

On January 7, 2026, National Financial Reporting Authority (NFRA) put out a circular (hereinafter called the Circular) requiring Boards, Audit Committees (ACs), Auditors and Those Charged With Governance (TCWG) to address aspects of the audit process in order to minimise any slip ups that might have taken place as a result of lack of clarity of roles and responsibilities. The subject of the Circular is "Effective Communication Between Statutory Auditors and Those Charged with Governance, Including Audit Committees". It will be seen therefrom that the primary concern of NFRA is on the adequacy and effectiveness of communication between Auditors and TCWG, in other words, the Auditees.

The Circular refers to provisions of the Companies Act, 2013 and sets out the responsibilities of the Board of Directors, the Independent Directors (IDs), the AC and the Auditors. It does not increase the regulatory load, but emphasises that there are responsibilities, which, presumably in NFRA's opinion, require reiteration and reinforcement. The Chairman, NFRA has, in a public statement, mentioned that ACs are not doing all of what is expected of them, and it is perhaps this concern that has led to this comprehensive Circular.

Central to the Circular is the group referred to as TCWG. This term had been safely tucked away in the Auditing Standards, but has suddenly become centrestage in conversations on audit quality and Auditing Standards.

What is the TCWG, and who determines its composition? In paragraph 3.1 of the Circular, NFRA refers to paragraph 10(a) of SA 260 (revised), and defines TCWG as those with responsibility for overseeing the strategic direction of the company, and obligations relating to the accountability of the company. Paragraph 11 of SA 260 lays down that it shall be mandatory for the Auditor to determine appropriate persons as TCWG within the governance structure. It acknowledges, seemingly grudgingly, that as per the Companies Act, 2013, the Board of Directors has overall responsibilities for the governance of the company, and it will qualify for being considered as TCWG. Given the primacy of the Board, as derived from

statute, in matters relating to governance, it seems somewhat condescending to state that it qualifies for being considered as TCWG. In the same breath, the Circular states that the TCWG could also be a sub-group of the Board, which could be the AC plus some of the Board members. Having made these seeming concessions, the Circular states that “in any case, it is necessary for the Auditor to determine TCWG at the start of the audit”.

Section 134 of the Companies Act, 2013 and the related Rules thereunder require that the financial statements, including the consolidated financial statements, if any, shall be approved by the Board of Directors. Section 134(5) of the Companies Act, 2013 provides that the Directors Responsibility Statement referred to earlier in the Section should disclose the Board’s assertions on some critical aspects such as adherence to applicable Accounting Standards, selection and application of accounting policies, and making of judgements/ estimates on reasonable and prudent basis. The implementation of adequate Internal Financial Controls (IFC), and ensuring their operating effectiveness is a responsibility of the Board, as mandated by the statute. Therefore, the constitution of the TCWG cannot detract from the statutory responsibility of the Board.

Some comment is necessary on why NFRA was set up. Section 132 of the Companies Act, 2013 tasks NFRA with improving the overall auditing structure. Its broad functions include protecting the interests of investors, setting Auditing and Accounting Standards, conducting quality review of Auditors and audit firms, investigation, inspections and monitoring compliance. It will be noticed that the thrust of Section 132 is on ensuring improvement of auditing quality. Prior to the coming into being of NFRA, only the Institute of Chartered Accountants of India (ICAI) had the responsibility of regulating audit professionals, setting Accounting Standards, and ensuring strong audit quality. ICAI being a membership body, which also had a regulatory component, it was felt that the regulatory function was, in some sense, being circumscribed by the membership function. This inherent weakness of self-regulatory organisations (SROs) manifested in creating the feeling that even when transgressions were noticed, disciplinary proceedings were tardy and ineffective. Following a dispute between ICAI and NFRA, which had to be judicially determined, NFRA emerged with the powers and the responsibility to lay down Accounting Standards. In the course of its inspections of major audit firms, it found significant deficiencies, including, but not limited to, independence and professionalism. In NFRA’s view, it seemed inadequate to deal with Auditors alone, and therefore NFRA started communicating with ACs, both directly and through the Auditors. In a series of papers, referred to as “NFRA Auditor-Audit Committee Interaction Series”, NFRA advised the ACs, through the Auditors, on the questions the committee members ought to raise in regard to the auditing process and the findings of audit. The Circular travels a little further, and specifically refers to the responsibilities of IDs under Schedule IV of the Companies Act, 2013. Whether this is an overreach, or a legitimate implied extension of its remit, is a matter that needs to be separately addressed.

As earlier stated, the focus of the Circular is on effective communication. NFRA seems to have arrived at the conclusion that the communication between Auditors and AC (TCWG) was a one-way communication, in which the Auditors made presentations, at quarterly intervals, detailing their observations and the procedural and substantive deficiencies noticed. It was felt that the AC (TCWG) to whom the presentations were made did not, because of time pressure or otherwise, put the appropriate questions to the Auditors, and challenge, or seek clarity on, their findings. Stated differently, it would seem that the AC has been perceived as passive recipients of information put out by the Auditors.

What is presently contemplated by the Circular is effective two-way communication. The Auditors are expected to communicate to the TCWG all that is relevant to facilitate a clear understanding by the TCWG. The latter is expected to put its questions in writing to the Auditors, or supplement oral questions by subsequent written communications. It need hardly be stated that besides questioning the trust on which oral communication is based, this would place an extraordinary burden on the TCWG to raise all relevant matters in writing. Is this yet another case of over-prescriptive regulation turning out to be counterproductive, with TCWG going through the motions of asking a few questions in writing?

Earlier in this newsletter, the question was raised as to who decides the composition of the TCWG. The Auditors responsibility, derived from the Accounting Standards, cannot override the statutory responsibility given to the Board of Directors. It therefore stands to reason that the TCWG should be constituted by the Board of Directors, through an appropriate resolution of the Board.

The next question which arises is the membership of the TCWG. Clearly, all AC members should be members of the TWCG. In addition, there could be members of the Board, such as members of the Risk Management Committee, whose presence in the TCWG would add value to the deliberations. Should TCWG then be a body larger than the AC, but smaller than the Board? It is readily conceded that the entire Board might not have the time to interact at least twice a year with the Auditors.

The Circular also contemplates the existence of a Nodal Officer to communicate with the Auditors. Some Boards seem to have decided that the CFO would be best placed to be the Nodal Officer, having regard to his/her functions, and the continuing interactions with the AC. This raises a fundamental question. Managements, even at present, interact with the Auditors. Should TCWG's interaction not bring a Board perspective, as distinct from a management's perspective, into the conversation and the communication with the Auditors? If superintendence of the management's functioning is a responsibility of the Board, it follows that the TCWG's communication with Auditors cannot be left to a management functionary, such as the CFO. There is a supporting role that the CFO can perform in making information available, and clarifying the management's perspective. These however have to be inputs made available to the TCWG to enable a constructive conversation with the Auditors. Boards should keep this aspect in mind, while deciding both the composition of the TCWG and identification of the Nodal Officer.

It is also interesting to note that the communication with Statutory Auditors would involve aspects of strategic direction. Strategy is a matter that is finalised by the Board, with the assistance of management, and clearly at the time of finalising the strategy, including the determination of strategic direction, there cannot be a major role for Auditors. UPSI (unpublished price sensitive information) concerns cannot be brushed aside. Second guessing of strategic decisions by an entity that is not tasked with the determination of strategy is an unwise step.

It is no one's case that the quality of audit should not be significantly improved. However, the better approach will be to identify the existing shortcomings in the audit process, as already done by NFRA in a number of cases, and strengthening processes based on those observations and conclusions. Spreading the net wide, and looking at how ACs perform, and

whether IDs are measuring up, could be seen as getting into the domain of SEBI. It is interesting to note that the Public Company Accounting Oversight Board (PCAOB) in the USA, set up under the Sarbanes-Oxley Act, 2002, is under the aegis of the Securities and Exchange Commission (SEC), whereas NFRA is a creature of statute. It is easy to contemplate the possibility that turf battles lie ahead of us as different Regulators, with the right intentions, exercise the authority vested in them by statute.

Putting in place a pragmatic regulatory regime should necessarily be preceded by meaningful consultations with the relevant stakeholder community. Absent this, we could end up prescribing in haste, and amending at leisure.



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