

## Regulatory Mechanism of Audit Profession in India: A Brief Study

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**ABSTRACT:** *Quality of audit may be characterized to provide reasonable assurance to the concerned regulatory authorities for better legal and regulatory compliances to improve systems and procedures for the business as a whole including the subject matter of audit, to act as a guide to successors, to a better information presentation and to offer reasonable professional satisfaction to the auditor. A sound quality control system should be maintained for conducting audit in conformity with prevailing law, verification of the positive/negative assertions as required under relevant laws, compliance with ICAI's pronouncements and finally confirming timely completion of audit. There are numerous provisions introduced in Companies Act 2013 effective from 1<sup>st</sup> April 2014 dealing with internal financial control[section 134(3) & (5) ], business relationship of the auditor(section 141),other services of the auditor (section 144),rotation of auditor and audit committee recommendation (section 139), complying with auditing standards, audit report and fraud reporting (section 143) , National Financial Reporting Authority(NFRA) with extended authority for maintaining quality of audit practices (section 132), punishment for contravention (section 147),fraud (section 447) which are directly or indirectly guiding audit functioning towards improvement of audit quality. Regulatory measures as the setting up of Audit Committee, Peer Review, Continuing Professional Education and Financial Reporting review Board, Serious Fraud Investigation Office etc to regulate functioning of audit professionals are discussed. Against this backdrop, the objective of the study is confined to deal with regulatory mechanism of audit functioning in India.*

**Key Words:** *Audit Quality, Internal Financial Control, Audit Committee, ICAI, NFRA*

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## **1. INTRODUCTION**

Regulation begins with making and implementing the rules to control the behavior of a person or group of persons being regulated. It is important to address the role of the profession in the evolution of its regulation. In most developed countries, initially, the professional public accountants were given the license to regulate the accounting profession. They set the minimum requirements for the same. 'Historically, leading professional practitioners then established a code of professional conduct and, eventually, accounting, auditing and other practice standards' (Sylph Jim, 2005) that are acknowledged as the self regulatory measures of the profession.

Through the 20<sup>th</sup> century onwards, the professional accountants have been gaining knowledge of professional practice standards. These standards, needless to say, consist of some techniques, procedures that the public accountants are used to in examining the financial statements so that investors' interests are properly protected. In course of time, professional practitioners founded professional associations to promote their profession and its standards leading to the government regulations that had the legal authority to mandate compliance with the standards, to adopt the standards for reference or as acceptable interpretation. Over the years in many countries including United States this approach of government sanctioned self regulatory mechanism has proved to be an adequate, efficient and investor friendly system (Ward Graham, 2005). In more recent years the total scenario has changed with the impact of globalization. There are numerous new provisions introduced in Companies Act 2013 effective from 1<sup>st</sup> April 2014 dealing with internal financial control (section 134(3) & (5)), business relationship of the auditor (section 141), other services of the auditor (section 144), rotation of auditor and audit committee recommendation (section 139), complying with auditing standards, audit report and fraud reporting (section 143), National Financial Reporting Authority (NFRA) with extended authority for maintaining quality of audit practices (section 132), punishment for contravention (section 147), fraud (section 447) which are directly or indirectly influencing audit functioning for improvement of audit quality. It is noteworthy that audit failure is practically meant for failure on the part of auditor of the company only. There may be 'fraud perpetrated by managers or employees, and particularly, dominant owner managers' (ICAEW 2006) which will not claim poor audit quality. Regulatory measures as the setting up of Audit Committee, Peer Review, Continuing Professional Education and Financial Reporting review Board, Serious Fraud Investigation Office etc to regulate functioning of audit professionals are discussed. Against this backdrop, the objective of the study is confined to deal with regulatory mechanism of audit functioning in India.

## 2. CONCEPTUAL FRAMEWORK

Businesses have become increasingly more complex and there is more expanded scope of business operation. The scope for professional accounting firms becomes wider and to meet the expanded market demand, the professional accountants and their firms have extended the range and types of business services beyond the traditional attest and assurance and taxation advises. These changes together with 'major public company failures involving inadequate corporate governance and perceived and adequate shortcomings in auditor performance' (Ward Graham, 2005) draw attention of accounting community to the need for re examination of accounting regulation and standard setting structures. As part of overall regulation of accounting profession, the following areas of the auditing profession need to be addressed.

- Education and admission standards
- Audit Standards
- Ethical Standards
- Disciplinary action

There are two primary ways of the regulation of professional accountants. These are Self regulation and External (Direct) regulation.

In the Self regulation of the profession, 'the government has delegated the responsibility to the regulation of the profession and the profession regulates itself within that framework and reports on its activities. There can be a greater or lesser degree of government monitoring and oversight' (Jim Sylph, 2005, p.5).

In the External regulation of the profession government establishes audit oversight body to directly regulate part or, rarely, all the profession. Like self regulation, direct regulation has been processed through kind of roles, responsibilities and reporting arrangements that the government has enforced by legislation. 'A combination of self regulation and external regulation is often used to regulate the profession. Self regulation and external regulation reinforce each other, they should be acting in way that is complementary to each other, not competing' ([www.ifac.org](http://www.ifac.org)). There should be a periodic evaluation of the effectiveness of the methods and their combination. In a number of ways self regulation and external regulation may create an efficient and effective regulatory mix (Bhadra, M.S, 2011, p 157). One combination may be self regulation with oversight by an independent agency. Another combination may be such that some aspects are to be regulated by professional body and other aspects being regulated by a government or independent agency.

For example, setting education or admission standards, audit standards, ethical standards, disciplinary actions are those areas where accounting profession may have significant expertise

to regulate them. However, there are a number of factors including financial reporting failures, performance of the professional body, performance of the governments, general political orientation to regulation, development path of the economy, nature and characteristics of market failures etc for an appropriate mix of the regulation for a particular country concerned. It goes no saying that regulation becomes successful if both types of regulations work in tandem over time as market demands for accountancy services change. Of late, the auditing profession has witnessed the need for increasing oversight of the performance of the auditors and/or the performance of the professional accountancy bodies. So, there are now two more additional areas of regulations (Ward Graham, 2005, pp 2-3), namely,

- Monitoring the audit quality, for example, audit inspections.
- Monitoring the Self regulatory activities of the professional accountancy bodies.

In recent years, two clear trends have become apparent in the regulation of the audit profession: a move towards direct regulation and regulatory convergence of the audit profession in the international level (Ward Graham, 2005, pp 2-3).

### **3. AUDIT REGULATORS IN INDIA**

In India, so far as accounting and auditing regulation is concerned the Institute of Chartered Accountants of India (ICAI) is , perhaps , the most powerful of the regulators including the Companies Act 1956, Securities and Exchange Board of India(SEBI), Institute of Company Secretaries of India(ICSI), Institute of Cost and Works Accountants of India(ICWAI) etc . The Companies Act 1956 has authorized the ICAI as per Section 227(4A) to the Act to issue Statement on the Companies (Auditor's Report) Order2003. The members of the Institute are required to comply with the requirements of the Companies (Auditor's Report) Order (CARO) 2003 issued by the Central Government in June 2003 and revised and again issued in August 2005. The revised edition (2005) of the Statement on CARO 2003, however, provides detailed clause by clause guidance on all the reporting requirements under the Companies (Auditor's Report-Amendment) Order, 2004.

In India, Companies Act 2013 lays down provision under section 132 to constitute National Financial Reporting Authority (NFRA) in place of earlier National Advisory Committee on Accounting Standards (NACAS) with more authority for issue and implementation of companies rules, accounting and auditing standards in India. It has power of civil court, investigate professional or other misconduct. ICAI can't initiate/continue any proceedings where NFRA initiates action. A brief study over audit regulators of India is as follows.

**3(a).National Financial Reporting Authority (NFRA)**

The National Financial Reporting Authority (NFRA) was set up on 1st October, 2018 by the Government of India as per section 132(1) of the companies act, 2013. NFRA is authorized to recommend accounting and auditing policies and standards in India under section 132(2) of the companies act, 2013. It has to the power to supervise the audit professional to enforce compliance with accounting and auditing standards and suggest measures for improvement of audit quality. As per Sub Rule (1) of Rule 4 of the NFRA Rules, 2018 , provides that the Authority on behalf of the government should establish high quality accounting and auditing standards and exercise effective oversight over financial reporting of the companies and bodies corporate and auditing functions performed by auditors.

As a quasi judicial body NFRA exercises power of civil court to oversee professional misconduct of auditors. It has constituted three committees – Committee on AS, Committee on SA and Committee for Enforcement Power to conduct investigations or quality reviews against audit firms which conducts audit of 200 companies or more in a year or audit of 20 or more listed companies or company or companies (including listed company or companies), having net worth more than 500 crores or paid up capital more than 500 crores or annual turnover less than 1,000 crores as on 31st March of immediately preceding financial year or company or companies having securities listed outside India CNK 70. Auditing Standards are to be followed as formulated by ICAI and notified by NFRA which is empowered with Suo-moto action against firm or member with penalty – for individuals 1 lakh to 10 times fees received, for firms – 10 lakhs to 10 times fees received and debarring member or firm from practice for 6 months to 10 years.

**3(b).Institute of Chartered Accountants of India (ICAI)**

The ICAI Act 1949 clearly mandates that a chartered accountant registered with ICAI must obtain a certificate of practice prior to joining the profession (Indian Chartered Accountants Act, 1949, Section6 (1)).The chartered accountants must also renew their certificate of practice every year by paying an annual fee (Indian Chartered Accountants Act, 1949, Sections 6, 20). In India, ICAI is the apex regulatory body to regulate all the auditors in the country through a good deal of measures incorporating formulation of auditing standards, statements and guidance notes etc in one hand and constitution of Peer Review Board, Continuing Professional Education for the members and Financial Reporting Review Board etc for implementation of the standards, statements and guidance notes on the other. These regulatory measures are said to be Self-Regulatory measures. The ICAI as the self regulatory authority of audit profession

has become overburdened both in formulating and implementing auditing standards by its members. The oversight function of the ICAI has slackened following some corporate collapses due to auditor's failures. There is lack of consolidated control (Vittal N, 2007). 'For instance, soon after the Satyam episode came to light, the ICAI which regulates all the auditors in the country and lays down all accounting rules and audit norms –tried deflecting the blame by pointing fingers at certain firms and individuals, instead of introspecting about the quality of accounting and reporting norms that it endorses' (Rajrishi Singhal, 2009, p.6). Most regulators and some professionals have agreed to the need for creating an independent oversight arrangement for the auditing profession in line with the recent development in many developed and emerging market economies.

Regulatory bodies similar to Public Company Accounting Oversight Board (PCAOB) should be set up. As per Sarbanes Oxley (SOX), majority of PCAOB members are non CPA and the chairman of the Board may not be practising public accounting for at least five years prior to the appointment [Sarbanes Oxley Act, section 101 (e) (2)].

Members of Indian regulatory bodies are desired to enjoy similar status. Regarding disciplinary action against the auditor, India needs Sarbanes Oxley Act (SOX) type penal provisions as well as adequate enforcement of such provisions. The PCAOB in United States can deregister or suspend a member or impose upon him penalty up to \$15,000,000 whereas in India, a chartered accountant can be reprimanded or deregistered for a period not exceeding five years. Again, there is also the need of a fully independent audit committee as provided for in the SOX. Many professional and business leaders have shared the view that full adoption of International Financial Reporting Standard (IFRS) and International Standard on Auditing (ISA) with respect to financial reporting by banks and other financial institutions, listed companies and other large size business enterprises would provide incentive to the profession to keep pace with international best practices and the latest worldwide developments in the field of accounting and auditing. Another view that has come on the forefront is the regulatory convergence throughout the world and that would definitely strengthen regulatory oversight over global audit profession. Amongst views of participating stake holders some regulators and corporate accountants and analysts have, however, expected some improvement in the case of monitoring, integrity, objectivity, independence, and standards compliance by auditors. A minority of auditors and corporate accountants have felt that Indian members of the profession were fiercely independent and completely compliant with the standards.

On the other hand, there was widely held views among accountants both in the audit profession and in the corporate sector that the government should not interfere in the regulation

of the profession.

However, it is needless to say that auditing principles are universally applied to all types of clients irrespective of big or small in size, but high quality and stringent principle based engagement standards may, sometimes, pose certain challenges to audit of small clients. Implementation of auditing standards has become a burning issue over the years (Bhadra, M.S, 2011, pp.155, 177, Appendix I).

ICAI has adopted several measures including introduction of Peer Review, Continuing Professional Education of members, the setting up of Financial Reporting Review Board, Audit Committee and even Ethical Standards for the members of the Institute. In the following part these regulatory measures are discussed.

### **3.(b)(i) Peer Review**

‘Peer Review is a system whereby professional practices, procedures, attestation engagement records and related financial /other data of an auditor are examined by another professional of similar standing (the peer)’ (Gupta Kamal, 2005, p.104). The objective of peer review is to review if the auditor complies with technical standards and maintains proper quality control systems and procedures (including documentation)( Bhadra, M.S,2011, .pp.156,177).

‘The system may alert the accounting firm in general and the role of the auditor in particular , not to do such jobs that may appear as lack of transparency in the profession’(Basu, Dr.B.K. 2004, pp.8-18).

In a peer review process, a practice unit, usually a large audit firm is selected to review its attestation engagement records immediately preceding three completed years. The attestation service includes audit services and excludes compilation procedures and tax advisory services etc. The ICAI has constituted the Peer Review Board to regulate the peer review mechanism. The Board consists of a maximum eleven members of whom six would be from the council of ICAI and the remaining individuals from regulatory authorities, industry, public offices or from other walks of life with high repute. The tenure of membership in the Board is generally one year or as decided by the council of the ICAI. However, independence and transparency are two deserving factors in the functioning of the board. The peer review goes through planning, execution and reporting processes. In the planning process, the practice unit is notified about peer review. A questionnaire is sent to the Practice Unit (PU) which is given three suggested names of reviewers out of which it can select one. Within one month of receipt, the questionnaire is completed and returned along with a complete list of attestation services clients.



The reviewers then select an appropriate sample on random basis, representative of PU's client portfolio and settle the review dates by mutual consent so as to complete the review within four months of initial notification.

In the execution process, there is an onsite review which is completed within one to seven working days. The reviewer conducts initial meeting and then reviews audit manuals (in case of large PU). He concentrates on five moot areas of general control, viz, independence, professional skills and standards, outside consultation, staff supervision and development and office administration. He also reviews control procedures and records of selected audit engagements and working papers.

In the reporting stage, the reviewer prepares a preliminary report and asks for a written response from the PU within 21 days. After considering them, if the reviewer is satisfied submits final report to the Board. If the reviewer is not satisfied he makes his interim report to the Peer Review Board.

Regarding compliance with technical standards, if there is any weakness in application of technical standards; Board makes recommendation to PU and issues instruction for further review after six months when the reviewer, if satisfied, will issue final report to the Board. If he will not be satisfied submit final report showing reasons for dissatisfaction. Board shall consider the reviewer's final report and PU's submissions. Board shall issue recommendation to PU and instruct the reviewer to follow-up action. After that, if the reviewer is satisfied, issues Peer Review Certificate and if not, no certificate will be issued. Again, if there is no weakness regarding application of technical standards, Board recommends to PU for improvement of internal quality control and follow-up in done after 12 months to enquire about implementation. If the Board is satisfied, it will issue Peer Review Certificate. If the Board is not, the reviewer proceeds for follow-up review and subsequently submit his report.

If the Board is satisfied, will issue the Certificate, otherwise, shall issue recommendation to PU and instruct the reviewer to follow-up action and if again is dissatisfied, no certificate is issued (Bhargava Sunil, 2003, pp.852-64). Peer review is the most confidential system for the benefit of the PU and the cost of review is to be borne by the PU itself. It is worthy to mention in this context that Securities and Exchange Board of India (SEBI) has decided to bear the cost of 'peer review' of the accounting statements of all Nifty and Sensex companies to avoid a Satyam like financial scandal and also to dispel a slight conflict of interest in the minds of investors if companies pay the peer review fees (Bhave C B, 2009). The most special feature of peer review in India is a strong, efficient independent Peer Review Board. The Peer Reviewers concentrate on the quality of audit and do not examine the opinion or sit on judgement of opinion. It also



provides comprehensive redressal forum for aggrieved parties. The purpose of review is to enhance the quality of professional work. It has no relationship with any disciplinary or any other regulatory mechanism as clearly enunciated in the preface of Peer Review Manual.

### **3.(b)(ii) Continuing Professional Education**

The ICAI issued a Statement on Continuing Professional Education with effect from January 1, 2003. The Statement intends to motivate the members (i.e. practicing chartered accountants) to maintain high standards of professional competence in the wake of increased complexity and specialization in the changing business environment (Nolan Ronan J, 2009) and makes it mandatory for them to continue professional education with minimum number of hours on an ongoing basis. Members of the Institute working in Practising firms, either as principals or as employees, are required to devote a minimum average of 20 hours structured Continuing Professional Development (CPD) and 50 hours unstructured CPD in each year.

The annual hours above need not necessarily be achieved every year, but members should ensure that they comply on a rolling three year average basis. Such education can be had through courses/seminars/workshops etc conducted by the Institute and its organs. It is needless to say that there were some prominent efforts by the Institute (ICAI) to upgrade Education and Training curriculum in the year 2000 benchmarked internationally. 'The Council of the Institute has constituted a Committee for Review of Education and Training recently to further benchmark it with the imperatives of globalisation' (Bhupathy R, 2003).

### **3.(b)(iii) The Financial Reporting Review Board**

The ICAI constituted the Financial Reporting Review Board (FRRB) in July, 2002 to review the financial statements of certain major enterprises covering listed companies, banks, financial institutions and other significant enterprises with annual turnover of Rs50 crore or more or those which are otherwise significant for the interest of general public. The Board consists of Technical Reviewers. 'The Criteria and Form for Empanelment of Technical Reviewers has been revised to enable the empanelment of members of the Institute working in industry also as Technical Reviewers who are involved in the finalisation of accounts of enterprises that are under the purview of the Board' and of practicing chartered accountants with experience of more than 10 years. The Institute conducts various workshops, seminars, training programmes etc to 'guide the Technical Reviewers on further enhancing their review skills of the General Purpose Financial Statements and to acquaint them with major non-compliances observed by the Board during the review of general-purpose financial statements of various companies'.

This standing committee of the Council of ICAI (Gupta Kamal, 2005, p.107)(i.e.FRRB) examines if the entities comply with Indian GAAP and regulatory disclosure requirements. Its findings can form the basis for disciplinary action against the auditor. The committee can also communicate irregularity, if any, found by it, to the regulatory authority or body concerned (e.g. Registrar of Companies) and to the management of the enterprise.

### **3(b)(iv).Professional Ethics Requirement**

Professional ethics and auditing standards (AASs) have different scope of operation but are overlapping in nature. Auditing standards (AASs) are technical procedures auditors apply in the conduct of audit of financial statements whereas professional ethics is broader in sense to incorporate even the technical standards and guide the auditors to stick at basic principles of morality, integrity, credibility, objectivity and independence for the interest of general public and of society at large. Professional ethics may be noted to refer to the DO and DO NOT of the profession.

In India, the chartered accountants are regulated by the code of conduct in accordance with ICAI Act 1949. The First and Second Schedules to the Act prescribe a list of circumstances under which a chartered accountant is deemed to be guilty of professional misconduct. The Council of ICAI is empowered to enquire in to the conducts of chartered accountants in other circumstances also. For application of code of conduct of all chartered accountants is referred to in Part III of First Schedule to the Chartered Accountants Act 1949. Part I of the First Schedule is applied for professional misconduct in relation to chartered accountants in practice. Part II of the First Schedule applies to chartered accountants in employment. The Second Schedule deals with misconduct which requires action by the High Courts.

### **3(c). Audit Committee**

Apart from regulating the auditor through auditing standards where ICAI is the apex regulatory body, the capital market is monitored by two most powerful regulators, namely, Securities and Exchange Board of India( SEBI), Companies Act 1956 which are, however, indirectly involved in overseeing auditor's compliance with audit standards( Bhadra .M.S. pp.157-177 , Chapter 6.). Audit Committee is the most effective measure of the regulatory bodies in this regard. Section 292A of the Companies Act 1956 provides for the setting up of Audit Committee by every public company having paid up capital of Rs5crore or more. Again, SEBI guideline of Clause 49 of listing agreement lays down that all entities listed on stock exchange have to set up audit committee in compliance with Clause 49 of listing agreement. The committee is an

independent body consisting of mostly non-executive directors. It acts as coordinator between the auditor and the management to search for remedial measures to stop company failures (Basu, B.K. P, 4.3).

‘With the setting up of audit committee, there has been an improvement in the financial reporting process and audit function ; particularly because the auditors now have an opportunity to discuss various audit related issues at a forum where non executive directors or independent directors are in majority’(( Gupta Kamal, 2005, p.497). The responsibility of audit committee is immense in that it owes a fiduciary duty to the shareholders rather than to the management (Sharma Aparna, 2007) for the purpose of presenting true and fair financial position of the business. Further, audit committee may play crucial role to monitor the performance of both the management and the statutory auditor towards the achievement of financial reporting objectives. So, indirectly, the committee insists the auditor to offer best performance in audit service.

### **3(d). Serious Fraud Investigation Office (SFIO)**

Serious Fraud Investigation Office (SFIO) has been given Statutory Recognition through section 211 of companies act 2013. SFIO is vested with requisite legal authority to conduct investigation into the affairs of a company on receipt of a report of the Registrar or inspector under section 208 of the Companies Act, 2013, on intimation of a special resolution passed by a company that its affairs are required to be investigated in the public interest and on request from any department of the Central Government or a State Government.

## **4. CONCLUSION**

Regulation of audit profession has become a major issue particularly in consequence of Satyam scam in 2010. Corporate regulation attempts to liberalize law to make it more user-friendly. However, Satyam Scam had shifted the orientation to introduce a more stringent regulation in corporate financial reporting practice. Generally in India principle based rather than rule based regulation prevailed over the years in formulation and execution of the standards but Companies Act, 2013 highlights considerably rule-based law that provides the government scope for retaining power to amend by Ministry of Corporate Affairs itself rather than going to the doors of the Parliament. As rules can be made by the Ministry itself and amended as and when required. An oversight mechanism with more power like the Public Company Accounting Oversight Board (PCAOB) in USA is constituted of NFRA in India to ensure a more effective accounting and auditing regulation. As there are a number of regulatory

measures introduced from time to time in corporate affairs to maintain transparency in accounting and audit regulation but ICAI in India, it is needless to say, played very important role in the regulation of audit profession in India prior to the introduction of Companies Act 2013. Now, NFRA supersedes the authority of ICAI while conducting an independent oversight of accounting and auditing profession in India.

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