Governance Failure Before Audit Failure

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When NFRA passes an order against an auditor, the public narrative is almost always the same. An auditor failed. Standards were not met. Action was taken. That narrative is accurate as far as it goes. But it stops too early. In a significant proportion of NFRA enforcement cases involving listed companies, the audit failure did not occur in isolation. It occurred within a governance environment that had already weakened — sometimes dramatically — before the audit itself went wrong. The auditor is visible. The governance failure that preceded it rarely is.

What NFRA Findings Actually Reveal About Governance

NFRA's inspection reports and enforcement orders are detailed documents. Most commentary focuses on what they say about auditors. Less attention is paid to what they reveal, often by implication, about the governance structures surrounding those audits.

The patterns are consistent. Revenue recognition anomalies of extraordinary scale — in one documented instance, a 1,026% increase in reported revenue from one year to the next — were apparently approved by boards and adopted without the audit committee meaningfully interrogating the underlying basis. Related party transactions involving diversion of funds, understatement of loans, and evergreening arrangements passed through governance structures without the scrutiny those structures were specifically designed to provide. Auditors appointed without adequate assessment of firm capacity, independence, or quality systems — with remuneration levels that raised obvious questions about whether a thorough audit was even commercially viable.

In each of these situations, the question is not only what the auditor did or failed to do. The question is equally what the audit committee did, or failed to do, before, during, and after the audit.

> ***"The auditor is visible. The governance failure that preceded it rarely is."***

The Legal Architecture Is Not the Problem

India's governance framework for listed companies is substantively sound. Section 177 of the Companies Act 2013 establishes clear audit committee responsibilities. The SEBI LODR Regulations 2015 specify composition requirements, financial literacy standards, and terms of reference in considerable detail. SA 260(R) mandates structured two-way communication between auditors and those charged with governance.

The architecture exists. The question is whether it functions.

In several companies where NFRA has taken enforcement action, the majority of audit committee members were apparently not financially literate in any meaningful sense — not in the way the regulations intend. One documented case involved independent directors whose educational backgrounds bore no relationship to financial oversight. They may have met technical eligibility criteria. They were not equipped to ask the questions the role requires.

Financial literacy on paper and financial oversight in practice are not the same thing.

The Room Where Governance Fails

The Kuru court in the Mahabharata was not absent of governance. It was full of it. Elders of unimpeachable seniority were present. Rules were acknowledged by all parties. The setting was formal. Procedural legitimacy was visible at every step. And yet, round after round, loss after escalating loss — everyone watched in silence.

The institution did not fail because governance was missing. It failed because governance was performing — and performance is not the same as function.

The parallel to the modern audit committee is precise. Papers are circulated. The agenda is followed. Management presents with confidence. Questions are asked — carefully, collegially, without friction. The meeting concludes. The minutes reflect a productive session. Concerns may exist. They are visible to anyone paying attention. But the threshold for escalation feels high. The relationship feels fragile. The moment feels premature. So the concern is noted. The file is closed. The governance record shows that oversight occurred.

> ***"The Kuru court also had productive sessions."***

What Was Actually Missing

The Kuru court had seniority. It lacked courage. It had process. It lacked the willingness to interrupt process when process was being used against the institution's own purpose.

1

The Revenue Question

When revenue grows by 35% while collections slow materially, the audit committee question is not: Has this been disclosed? It is: What caused the auditor to conclude that the slowdown in collections does not indicate a revenue recognition problem?

2

The Fee Question

When an auditor is appointed at a fee level that experienced practitioners would immediately recognise as inadequate, the question is not: Was the appointment process followed? It is: Is this fee sufficient for the audit this company actually requires?

3

The Related Party Question

When a related party transaction is presented for approval, the question is not: Does it meet the arm's length criteria as documented? It is: Does this transaction serve the company's interests, and has management been required to demonstrate that convincingly?

4

The Structural Standard

These questions are not hostile. They are structural. The audit committee that institutionalises them builds durability. The one that avoids them builds the appearance of governance.

> ***"What makes a good audit committee question? Not a technically correct one. A question that creates genuine discomfort — because the matter under discussion deserves it."***

Governance Fails Before Audit Fails

The sequence matters. Audit failure is visible. It produces enforcement orders, penalties, and debarments. It generates commentary. It is recorded. Governance failure is quieter. It accumulates through deferred questions, accepted explanations, and meetings that conclude without friction. It does not produce enforcement orders of its own — yet it creates the environment in which audit failure becomes possible, sometimes inevitable.

This is not an argument that auditors bear reduced responsibility when governance is weak. The auditor's obligations exist independently of what the audit committee does or fails to do. Nothing prevents an auditor from issuing a modified opinion when the evidence demands it, regardless of governance quality.

But audit quality cannot be fully understood — or fully improved — by focusing on auditors alone. The governance architecture surrounding the audit either strengthens or weakens the conditions in which audit judgement is exercised.

> ***"An audit committee that asks the right questions, at the right moments, with the right degree of persistence, creates an environment in which audit quality is more likely to be maintained. An audit committee that defers, approves, and records creates an environment in which the gradual erosion of quality passes unnoticed until inspection reveals the pattern."***

The Practical Question

For boards and audit committees, the relevant question is not: Have we complied with our governance obligations? It is: If our decisions and our questions were examined independently, would they withstand scrutiny?

That distinction — between compliance and defensibility — is the same distinction that separates audit files that pass inspection from those that fail it. It applies equally to the governance layer above the audit.

Institutions Are Not Tested Daily

They are tested episodically. The governance architecture that determines how that test is met is built — or not built — in the quiet periods before pressure arrives.

The Sequence Is Not Simultaneous

Governance failure and audit failure do not occur together. Governance fails first — quietly, incrementally, with everyone present. The audit failure that follows is the visible consequence of an invisible prior collapse.

The Standard Is the Same

The question regulators ask of auditors — can you demonstrate that judgement was exercised with depth and scepticism? — is the same question that should be asked of every audit committee. The standard does not stop at the engagement partner.

> ***"By the time the audit fails, the governance failure is usually already complete."***

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This article is part of Anveshana's Audit Quality Insights series.