BOMBAY CHAMBER
Bombay Chamber
of Commerce & Industry

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Mr. Ajay Tyagi
Chairman
Securities and Exchange Board of India (SEBI)
SEBI Bhavan, BKC, Plot No. C4-A, G Block
Bandra Kurla Complex, Bandra (East)
Mumbai – 400051

Subject: Requirement of pre-intimation of forensic audit and sharing of final forensic audit report on conclusion of the audit

Dear Sir,

Greetings from the Bombay Chamber of Commerce and Industry.

During the last couple of months, Securities and Exchange Board of India ("**SEBI**") has taken several important steps including the seven decisions taken on September 29, 2020 in the SEBI Board Meeting, which were taken with an aim to bring transparency and preventing the scope of misuse or dissipation in the market. One of the decisions taken on September 29, 2020 in the SEBI Board Meeting was regarding *'disclosure of information related to forensic audit of listed entities'* which was subsequently brought into effect by amending the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**Listing Regulations**") *vide* SEBI (Listing Obligations and Disclosure Requirements) (Third Amendment) Regulations, 2020 with effect from October 08, 2020. We write to you with reference to the recent amendment regarding *'disclosure of information related to forensic audit of listed* entities' brought in by the afore-said amendment to include *inter alia* the following in Part A of Schedule III of the Listing Regulations:

"17. Initiation of Forensic audit: In case of initiation of forensic audit, (by whatever name called), the following disclosures shall be made to the stock exchanges by listed entities:

a) The fact of initiation of forensic audit along-with name of entity initiating the audit and reasons for the same, if available.

b) Final forensic audit report (other than for forensic audit initiated by regulatory / enforcement agencies) on receipt by the listed entity along with comments of the management, if any."

Pursuant to the above amendment, listed companies are now required to make disclosures to stock exchanges, within 24 hours, of: (A) initiation of 'forensic audits', and (B) receipt of final 'forensic audit' report, in terms of Regulation 30(6) of the Listing Regulations (the "**Forensic Audit Disclosure Norm**").

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Under Part A of Schedule III of the Listing Regulations, listed companies are required to disclose certain events or information upon occurrence without any application of the guidelines for materiality. Pursuant to the amendment, companies are required to disclose to stock exchanges about the forensic audit initiated along with the details of the fact of initiation, name of entity initiating the audit and reasons for audit, if available.

This mandate of '*disclosure of information related to forensic audit of listed entities*' will prove to be and is capable of providing an impetus to Indian companies to focus on investing in fraud prevention mechanisms, which in turn can reduce the need for undertaking a full-fledged forensic audit and limit disclosure obligations. However, the mandate in its current form may also discourage companies to initiate forensic audits of small matters, fearing adverse publicity and market sentiments.

We understand that market participants have raised several concerns in respect of the Forensic Audit Disclosure Norm on account of:

i. the adverse impacts that a premature disclosure without adequate factual backing may cause;

ii. the absence of a materiality standard under the Forensic Audit Disclosure Norm; and

iii. the possibility that listed companies may hesitate to initiate a 'forensic audit' though appropriate in certain facts and circumstances, to avoid triggering the Forensic Audit Disclosure Norm.

These concerns have been placed before SEBI for their consideration.

We, as one of the oldest Chamber of Commerce & Industry in the country, strongly believe that it is necessary to bring to your notice about the apprehension of the corporates on its consequences. We would like to base our representation on the basis of three reasons that have stirred a debate around the amendment with a severe trepidation in the market:

i. The unprecedented nature of the requirement of pre-intimation of forensic audit and sharing the report on conclusion of the audit. We humbly submit that such a step is not recommended under any major regulatory regime in national or international jurisdiction;

ii. Such a requirement gives a sense of the boards' inability to discharge their duties and could be viewed as dilution of the independent conduct of companies' board;

iii. The premature disclosure leading to significant erosion of shareholders' value, which in turn will have an adverse impact on the company's reputation.

We understand that as on date, SEBI is yet to prescribe the format for disclosure under the Forensic Audit Disclosure Norm. The term 'forensic audit' has neither been defined in the Listing Regulations nor under Securities and Exchange Board of India Act, 1992, the Companies Act, 2013, the Securities Contracts (Regulation) Act, 1956, the Depositories Act, 1996 and/or the rules and regulations made

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thereunder, or any other legislation/regulation, on which reliance may be placed for definitive interpretation of the term. Given the absence of guidance under related legislations on the term "*forensic audit*", to determine the appropriate trigger for the Forensic Audit Disclosure Norm, it is important to first understand the intent of the SEBI, while considering the amendment to the Listing Regulations, in this regard. For this purpose, reliance may be placed on the Agenda titled "*Disclosure of information related to forensic audit of listed entities*" ("**Agenda**") placed before the SEBI Board for its meeting held on September 29, 2020. The Agenda was a part of the SEBI press release that announced SEBI's decision to amend the Listing Regulations to provide for Forensic Audit Disclosure

Norm. The relevant extracts of Agenda, which capture the importance and need for disclosure of information regarding forensic audits, are reproduced below:

"3.1. Forensic audits of listed entities are generally initiated by lenders, management of a listed entity or regulatory / enforcement agencies. Lenders or the management of a listed entity generally initiate forensic audits when something appears to be amiss with the ***entity's financial statements*** *pointing to misstatement, misappropriation and perhaps, siphoning of funds; it is thus designed to uncover a fraud / mis-utilization, which underlines the seriousness of such audit. On the other hand, in cases where regulatory / enforcement agencies initiate audits, the objective of the audit may be specific to the mandate of the agency and may be part of a broader investigation. If the investigation of the regulatory / enforcement agency results in any material regulatory action against the listed entity, the action along with its impact, is required to be disclosed as per the existing disclosure requirements specified in the LODR.*

3.2 In the recent past, there have been cases where forensic audit of listed entities has been initiated by lenders or the management but the fact of initiation of the forensic audit and the complete report of the forensic audit, has mostly not been disclosed by listed entities to stock exchanges.

3.3. In such cases, the information ***on possible financial distress*** *of the listed entity is available only with certain parties such as the promoters or key managerial personnel (KMPs) of the listed entity, third parties such as lenders; whereas other concerned regulators and minority shareholders are not informed of the potentially negative information. Non-disclosure of such information creates information asymmetry in the market and results in unequal access to disclosures. Further, in few cases, there have been instances of leakages of forensic audit reports in the media, thereby exacerbating concerns on information availability with only few persons / entities.*

3.4. Considering that the findings of these audits may have a significant bearing on decision making by investors, it is important that complete disclosures are made by listed entities in this regard. Further, in order to get a perspective of the management of the listed entity, such disclosures may be accompanied by the comments of the management, if any."

In terms of the Agenda, the proposal placed before the SEBI Board was to make it mandatory for listed companies to disclose initiation and conclusion of forensic audit, other than those initiated by regulatory/ enforcement agencies. However, in SEBI's decision on the matter, the Forensic Audit Disclosure Norm was expanded to include initiation of forensic audit even by regulatory/ enforcement agencies.

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The rationale behind introducing Forensic Audit Disclosure Norm is that the information on possible financial distress of the listed entity was available only with certain parties such as the promoters or KMPs of the listed entity, because of which shareholders and investors had to face significant bearings. Since listed entities have huge public money at stake, disclosure in compliance of Forensic Audit Disclosure Norm will help disclose potential financial mismanagement to the stock market which will assist in timely detection and regulation of corporate frauds. However, in absence of definition of the term 'forensic audit', various companies are finding it difficult to ascertain what constitutes "forensic audit". Whether audit of non-financial matters of the company would also constitute "forensic audit"? As an illustration, whether background examination and disk imaging of an employee of a company to assess if he/she were involved in vendor favoritism in lieu of personal gains would also fall within the ambit of "forensic audit"? The absence of guidance on what constitutes "forensic audit" is a point of hindrance and hesitation faced by the companies to give effect to the rationale behind the Forensic Audit Disclosure Norm. In this regard, we may request SEBI to come up with a definition or legislative guidance as to what constitutes "forensic audit" so that the rationale to assist the company in making timely detection of corporate frauds is not defeated.

Moreover, we also propose to suggest that it would be better if the amendment with regard to Forensic Audit Disclosure Norm is brought out of Para A of Schedule III of the Listing Regulations. Para A of Schedule III of the Listing Regulations provides for events which shall be disclosed without any application of the guidelines for materiality as specified in Regulation 30(4) of the Listing Regulations. Regulation 30(4) of the Listing Regulations requires the company to frame a policy for determination of materiality of events or information for disclosure, based on the criteria specified therein. In this regard, it must be pointed out that keeping the Forensic Audit Disclosure Norm within the purview of the materiality threshold will help and assist companies in better compliance of the Forensic Audit Disclosure Norm. In absence of any materiality, companies may find it difficult and cumbersome to disclose any small or non-material examination or audit to the stock exchange which may have no nexus with the rationale behind Forensic Audit Disclosure Norm.

Regulation 4(1)(c) of the Listing Regulations provides that the listed entity shall refrain from misrepresentation and ensure that the information provided to recognised stock exchange(s) and investors is not misleading. Any premature disclosure may lead to significant erosion of shareholders' value, and adverse impact on the company's reputation. In fact, such disclosure may be counter-productive to the interest of minority shareholders, whose interest is sought to be protected by the Forensic Audit Disclosure Norm. furthermore, such disclosure may result in compromising the witness testimonies and confidential deliberations during the investigation process. This may also have an adverse effect on the trust the employees and other stakeholders have on the investigation process, which is an effective tool for detecting misconduct and/or potential violation. The real intent of SEBI behind introducing the Forensic Audit Disclosure Norm appears to ensure prompt dissemination of information regarding material adverse developments in a company, which if not disclosed, may create a false market of the securities of the company.

It is pertinent to note at this juncture that a premature disclosure of initiation of forensic audit, without waiting for conclusion thereof, will definitely mislead investors, resulting into an undesirable fluctuation in the company's stock price. Nonetheless, such a disclosure may act counterproductive

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to the interest of minority shareholders, whose interest is sought to be protected by this disclosure requirement.

Over and above the aforementioned factors, there are high chances of this mandate rendering itself for misuse. There could be a situation, where the requirement to disclose relevant information during the course of audit may tempt any person to collude with a competitor to make an unsubstantiated whistle-blower complaint and exploit such information to the detriment of company's interest.

We may suggest that with respect to the contents of the disclosure of a forensic audit report, the disclosure should be limited to the conclusion of the audit, in case any wrong doings are found. There are two major safeguards that should be considered – (i) to ensure the audit is conducted in a holistic manner and the information revealed should not fall in the hands of unauthorized individuals; and (ii) privacy of individuals may be maintained who may be named in the audit report.

We would like to point out that the captioned mandate of forensic investigation has an important positive aspect too, which is overlooked by the current amendment. Forensic audit when coupled with the fact that the managements and boards have a larger responsibility for reviewing internal records, has become adjunct to the internal audit process. Many companies conduct forensic audit to test the compliance of their internal systems & processes to establish the thoroughness within their own organization, and thereby send out a salutary signal. Wherein, the current amendment overlooks the positive aspect and, on the contrary, might end up discouraging such a good- and forward-looking practice.

SEBI's intention of circulating information regarding material adverse developments in a company, that might create a false market of the securities of the company can be achieved through alternative ways. For illustration, it is proposed that SEBI may direct companies to disclose summary of the report of the forensic audit upon conclusion of the audit. Similarly, the forensic audit report may be disclosed to public at large only in case it is instituted pursuant to an order passed by a regulatory/enforcement agency. In such cases, it may be considered as unpublished price sensitive information from the SEBI (Prohibition of Insider Trading) Regulations, 2015 requiring closure of the trading window for insiders.

It is of utmost important to maintain a balance between privilege and disclosure of relevant information to the stock exchange in a timely fashion for detection of frauds at an early stage. As per practice any report created pursuant to an investigation undergoes multiple iteration and there is a possibility of sensitive and confidential information might get disclosed to public. To safeguard this issue, a final report that contains only the relevant facts and outcome of the audit may be submitted and disclosed to the stock exchange.

Considering the above-mentioned aspects, we sincerely request you to reassess and consider with hindsight about reviewing the Forensic Audit Disclosure Norm requirement as it would cause severe irreparable defacement of well-established companies which are more in number, compared to the handful of errant companies that are intended to be tracked. We are of the opinion that revaluating

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the mandate, while keeping in mind the apprehension of the corporate circle, would prove to be beneficial and also result into an amicable functioning of the regime whilst adequately taking care of the general functioning of the market.

We will be delighted to provide any additional clarification and/ or support required by the SEBI for considering our request.

Yours sincerely,

Sandeep Khosla