

National Foundation for Corporate Governance

National Conclave on Corporate Governance in India : *Disclosure Practices – Accounting and Audit*

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One has been on various forums discuss corporate governance and we keep hearing about Sox and Enron. The real story is very little different while Enron happened and why Sox came along. I am not getting into because this is not the forum to speak. The question I want to ask this audience is if Sox was there would Enron not have happened? That is an important question we all need to answer. If Sox was there would Enron have happened. Enron was the management fraud of the highest order and I don't think any amount of regulation could have or any amount of auditors could have actually stopped it. As very rightly said that the U.S. has realized that Sox has actually driven the economy. The financial market is no more New York today. It has moved to London and there was a huge competition whether it is going to be Frankfurt or London and now we hear that the three 'T's are going to take over the world financial market and that is Mumbai, shanghai and Dubai. Those are the three places were now London is worried.

India has actually arrived there and it is no more story and it is no more hype. It is heartening to hear that the kind of changes that the government is trying to make, the regulatory changes they are trying to keep pace with the growth of the economy. The Ambani brothers are the richest family in the world. India has got the richest families sitting, even richer then Wal-Mart, the Walton family which was the richest till now. India has come a long way, ten

years back would not have dreamt about it. The topic that was given was what was in the last decade and what is going to be in the next decade. One cannot foresee the future but one can predict something from what we have now.

Earlier the institute of chartered accountants actually prescribed all the accounting standards and I used to be auditing some a few years back and I used to get into our clients debate that this is your institute has recommended we are not bound by this. The government has taken a great step now by coming and making it a part of the regulation, as part of the law and that is something that everybody needs to follow. It is part of the regulation and actually the national advisory committee on accounting standards is the great move because this is what is actually happening in the western countries.

The Institute of Chartered Accountants is there to regulate the members, regulate their own bodies and getting there people trained. You have an independent accounting standards board now which will actually develop these accounting standards. They have taken the work of the institute, all the accounting standards made, they have made some modifications in that, few structural changes in that. Like we heard that they are trying to make it in compliance with IFRS. There is still a lot of work to be done there but it is moving in the right direction. They have also changed the classification of companies from level 1, 2, 3 basically to two types of companies small and medium and the other companies which are basically the large companies. Of course all the hard work put in by the institute on interpretations, they have taken those as foot notes.

As we know that when IFRS came in actually went on what international accounting standards were developed and they took that as the base and from that they moved on. We have also had increase in directors' responsibility. While we hear the auditors pushing the blame on to the company, the company believes that the auditors have to make the accounts and ordered the accounts. These regulations which have recently come like clause 49 etc. which have very clearly brought out that it is the director who takes the primary responsibility that the accounting standards have been complied with

and all the accounting judgments and estimates are reasonable and prudent. Let me tell you the things which impact are where you go into judgments and estimates. Totaling 1+1 everybody knows it is 2, though we heard earlier saying that 1+1 could be anything but it is always judgments and estimates which go wrong and that's where it is important that the company takes the responsibility, just not leave it to the auditors.

SEBI introduced the quarterly reporting, there is mixed feelings around it, quarter by quarter you have to a report and there is a pressure on management but this has done a lot of change. Earlier only the technology companies were losing nearly. Now everybody has geared up their accounting systems to actually match them to be able to do timely reporting. Now managements don't wait for three months to get data to take management decisions because you are living in the past earlier now you have timely immediate information available to you take decisions which are going to impact your company.

We are living in the very very competitive world. If you live in the competitive world it is important that they information available to us is timely, accurate and reliable. This is what actually the quarterly reporting has achieved to a great extent. It has got companies geared up to match up to this. Offcourse we discussed schedule VI under review. We discussed the limitations of Schedule VI. It was formulated in 1956 with a few changes. There are a lot of contradictions between current assets and current liabilities there is non-current and current and the whole thing is blurred. It has not actually kept pace with the new companies that have come up. If we take the 30 new companies they will be completely different from the 20 companies twenty years back. These companies are all knowledge companies. They don't have assets on their balance sheet. If you want to call their assets what will their assets be? These companies' market caps are huge. So actually schedule VI has not kept pace with that to understand what it is the information they need to disclose. For example, for technology company human capital is very important. If all your assets which go in the evening do not come back the next today there is nothing left in the company. Scheduled VI needs to change keeping this in mind. When we have these amalgamation

and mergers we have codes which come out how accounting needs to be done. At that point of time, many times they don't look at the accounting standards. They just prescribe what is to be done and that overrides accounting standards. This will need to change. You can't have codes coming with judgments which are against basic accounting standards. Then the companies will need to follow whatever the codes say at that time. Indian accounting standards need some kind of improvements which I will discuss.

IFRS has been spoken out since morning, a number of times it has been mentioned.

IFRS has now been adopted by more than 100 countries across the world. SEC has accepted that from next year all foreign filers have the option to either use US GAP or IFRS. I was talking to some of my U.S. partners and they were saying that in the U.S. also there is a move now where even U.S. companies in the next two to three years may be allowed to use IFRS instead of USGAP. They say that US GAP is on its way out in a way. As rightly said by Mr. Khosla it is very prescriptive in nature, it is very rule based, while IFRS basically gets into fair value accounting.

When we talk of fair value accounting I will tell you the challenges that is going to pose to the companies in India or the professionals the way we are trained presently. The way the redeemable preference share is looked at, it is not looked at share capital. In the Indian accounting standards preference share is looked as share capital. This is going to be looked as a current liability. Similarly convertible debentures taken as a loan but the convertible debentures that is going to form part of equity will move into equity accounting. It will form part of change in equity. That way it is going to change. The way the long term loans is going to be evaluated – today long term loans are not in that sense discounted but you will have to see what is the maturity period, what is the repayment etc, the valuation has to be done. Valuation of investments, long term and short term – long term investments unless it is a permanent impairment you don't provide for it. IFRS says that you value the investment and you provide for it. Treatment of prior period items- today the accounting standard says that you take the prior period item

and show in a separate line item in very very extraordinary cases you can show below the line but IFRS says that you will need to make recast the account of the previous year. The impact will need to be made back at that time.

The question comes up if we declare dividend in the previous year, what happens then? Did we declare dividend out of capital? When we talk of fair value accounting the question comes up if we start valuing assets and liabilities at current value what happens with the unearned income? Will that be subject to tax? These are questions that need to be answered. Can we declare dividend on unearned income? Because you have done your fair value accounting, you have actually accounted for that income will this be subject to tax? Can you declare dividend on those incomes? These are some challenges which we would need to look at. Then the format of disclosures, the schedule VI has a very prescribed format of disclosures. IFRS has no prescribed form. They go basically by disclosures more on function, the year in which the type of expenditure you could decide how you want to disclose it and there is no rigidity of how you want to disclose. Maybe over a period of time IFRS may also come with some standards around that. So the challenges for this IFRS conversion for us is going to the amendment to Companies Act which of course, is already on but we will have to amend it to keep in tune with if we are going to have adopt IFRS by 2011 it is good if we start it now.

In India, some of the regulators, the Indian Banking Regulation Act is there, the insurance governments are there, different accounting principles with gets followed. It is just not one Company's Act - all these will need to get amended. You will not be able to have the accounts tribunals and courts actually dictating how accounts need to be made. Amendments in taxation laws will have to follow. You will have to understand how you are going to tax this income, which is going to get accrued in company's accounts. The development of techniques for fair valuation. The Institute of Chartered Accountants will have to work hard on training the professionals because today when you talk of fair value accounting you talk of judgment and estimates. People will need to get trained how they will take the valuation and make these judgments and estimates.

Let me tell you that globally there is a big challenge happening because when these 100 countries move to IFRS they also had a huge amount of effort on getting these valuation experts who would come and say this is okay, lot of subjectiveness is coming in. There is lot of subjectiveness in that. There needs to be techniques and methods which you will need to follow and say that this is what I need to do. Of course, creation of IFRS resource. I think India can become a good talent pool. For more countries are going to adopt IFRS. India can become a source and we can actually do the IFRS conversion. Lot of economies around the world other than the 100 countries have done it are still on the verge of converting.

What is going to happen in the next decade? We heard earlier that technology has overtaken all of us, business models have become very complex. With ERPs coming in audit cannot be a tick and brush approach anymore. One will use technology will have a greater role to play in order to get quality audit done. I think people would need to use technology in auditing completely.

Take the case of a retail company, which is completely dominated by technology. The traditional auditor cannot add value to the retail company audit. It is technology driven it will have to be going into the system because all those numerous amount of transactions actually run through the system. Without the technology you can't be doing audit in a bank. In fair value accounting there would be lot of judgments and estimates, lot of training would be required, lot of understanding around this.

Now with this clause 49 there is a real growing importance of auditors committees, independent directors, independence of auditors. This has become a norm of the day. This is creating awareness amongst people. To be fair as this new regulation come in I think we need to move away from the check list kind of technique to say that whether we want to adopt this in spirit.

Corporate governance does not begin and end in the board room. It may begin in the boardroom but it has to be cascade down to the last employee in the organization because they see how the leadership behaves, how the top

management behaves and that is the way the organization will actually behave. If we can get corporate governance into the organization at its grass root levels one would have made significant change in the way companies actually function. There will have to be a lot more quality review procedures because as these new regulations come in what kind of the quality review and how the auditors are actually auditing as we keep hearing lot on the profession that this profession is not doing this, there will have to be a much more rigorous kind of quality review procedures put in.

One could look at having an autonomous self regulatory overseeing body like the U.S. has PCOIB which comes. The PCOIB is for people who don't know, they actually regulate the auditors. They don't only regulate the way you audit they regulate the way the firm is structured, they see how the partners are paid, how the compensations are paid, they look at what kind of risk management procedures are in place, what is the behavior of people to etc. They just don't come an interview. They come there they come and do audit, they meet the employees understand how employees get recruited in the organization. They look at the entire quality of the auditors. Then they will come out, and they whether this auditor is fulfilling what he is asked to do. I think this kind of self regulation maybe important to bring into India. As these organizations grow we kept hearing 100 MNCs of India what we wanted even the audit will need to up its skill sets in understanding businesses. We heard about it are we leveraging technology. Do we have knowledge and database available to us with we can use actually in helping us improve the quality of audit and actually going to the next level.

Thank you