

National Foundation for Corporate Governance

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

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Plenary Session: Trends in Accounting and Audit Disclosure Practices

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The Indian economy with the growth rate estimated at about 9% has been established as one of the fastest growing economies in the world. This coupled with the unprecedented growth of India Inc. is contributing to the transformation of the business environment. Growth of corporations is leading to complicated business models, cross border and indigenous movement of capital, increased business risks etc. This in turn has augmented the need for financial disclosures as per Internationally accepted accounting principles and standards ensuring greater transparency and providing high quality financial and operating results to shareholders and to other stakeholders is now one of the major responsibilities of the board of directors.

In this regard the initiatives taken by the Ministry of Corporate Affairs, desire to be mention once again three most important to my mind are: accounting standards formulated with a view to harmonizing different accounting policies and practices in order to ensure comparability of financial statements of different enterprises, constitution of National Advisory committee on accounting standards to (2) examine the recommendations of the institute of chartered accountants of India before recommending them to central government for prescribing them under the Companies Act 1956 (3) Notification No. GSR 739 E of 7th December 2006 which prescribes 29 accounting standards corresponding to international accounting and financial reporting standards with a view to ensuring proper compliance. Along with these are the latest trends and I would like to mention some here before making one specific comment. These latest trends include delegation of the

internal audit function to outside organizations to embrace global internal audit methodology and to ensure a higher degree of objectivity and independence in the activities since the effectiveness of the audit committee depends on the quality of the internal audit report. Considerable importance to the internal control systems, definition of appraisal linked department and management roles, focused audit committees that are extensively prepared and well informed for deliberations at meetings, meticulously following up on implementation of agreed improvements and internal control, focus on elements of risk assessments, planning, execution and reporting, constitution of risk management committee and introduction of corporate risk officers to deal with business risks including project risks, delivery risk, reputation risks, geographical risks, foreign exchange risks etc. Finally, management of the audit plan by introducing mechanisms such as audit calendars to understand what is happening, what kind of issues that are likely to surface, what kind of systematic changes are required, etc. and seek external assistance whenever and wherever required.

Having preached the coir, brings me to the Sorbans Oxley Act. Because this is specially relevant today because something just happen this week and I will collaborate on that couple of weeks ago I had the privilege of listening to the CFO of Intel at another function organized by CII where Prof. Rao was also present. He talked quite in detail about the Sorbans Oxley Act. This week the U.S. government announced a watering down of the Sorbans Oxley Act. You know the government regulation is seriously out of rack when even the Securities and Exchange Commission begins to back fiddle. That is the case with Sorbans Oxley Act. The corporate governance Act has placed an extraordinary financial burden on small to medium electronic firms thinking of going public. The SEC recently issued new auditing standards Sorbans Oxley Act intended to reduce unnecessary costs especially for smaller public companies, according to SEC chairman Chris Cox. Unfortunately, I understand that experts who are closely with electronic startups see the standard as more of a band-aid than a panacea when it comes to encouraging industry-wide innovation. This is where I think it is quite relevant to us. The new standard that the SEC has announced aims to encourage companies and auditors alike to move away from the checklist approach to Sorbans Oxley audits, a methodology that drives auditors delve into each financial element in fine detail. Mr Cox himself admits that the checklist approach forces small companies to overcome the same hurdles as multi billion dollar enterprises

resulting in disproportionately higher costs. With the new standard SEC is recommending a risk based approach that will encourage executives, auditors, directors and audit committee members to focus on the material risks that investors care about – according to SEC announcement. This risk based approach attempts to transfer some of the responsibilities for auditing corporate governance to a firm’s own management and internal auditing teams counting on them to determine and check what is really important. Management and audit committees now can engage in a more meaningful dialogue with the auditors to ensure that auditors are focused on what matters risk and materiality and not on rout compliance with the rule book – admits Mr Cox. However, while the new standards appear to be good for electronic firms experts agree that the new standards aren’t likely to make it any easier for smaller firms who would benefit from infusion of capital resulting from a public offering.

Part of the problem seems to be that risk based approach runs counter to the interest of the public accounting firms tasked with conforming compliance. Most external auditors, no offence meant here, use billable hours to charge fees, an approach that makes the checklist approach lucrative than any approach that involves more participation of internal resources. External auditors have goaled on finding things that internal auditors missed. Many people feel that public accounting firms have corporate cultures that make them alternatively suspicious and dismissive of the internal auditing process. Even without the financial incentives external auditors have a major incentive to be overly thorough. The survival of the entire company hinges on not making a big mistake. One of the by-products of Enron debacle was Sorbanes Oxley but the other was the demise of Enron’s auditors. – Arthur Anderson. Under the circumstances it is no surprise that public accounting firms don’t want to get too cozy too credulous when it comes to the management of the companies that they audit. In addition, I understand that over 6000 public companies still are not required in the US to provide the audited disclosures required by Sorbanes Oxley because they have more than 75 million dollars in public equity. That threshold apparently creates a door net hole (As I am told because I am not an auditing expert) of companies that if they went public would be too big to qualify for exemption but too small to afford the expense of compliance.

A rule of thumb therefore seems to be gaining ground that you shouldn't go public if you cannot generate immediate market capitalization of over 200 million dollars and unless the post IPO market capitalization is at least 500 million dollars. For that to happen there will need to be a shift in public opinion about the reliability of business owners. These cycles of severity and flexibility of regulation have occurred in the past and will occur in the future no doubt just as the public opinion of the business community is cyclical. It may be sometimes before the cycle moves far enough to allow true regulatory relief. When the public opinion was outraged with shenanigans of the 1990s that became apparent with that 2001 market collapse the US congress acted with Sorbanes Oxley we all know and the SEC reacted with further implementation of the Sox Act. The real importance of the new guidelines lies in the fact that they reflect the beginnings of such a shift in the public opinion. SEC is a politically appointed body but is sensitive to public opinion as any other politically appointed body. Now that the impact of strict interpretation and implementation is becoming more clear it seems that SEC is reacting with more flexibility. Who knows, while the situation is clearly not ideal the new flexibility may actually lighten the burden somewhat. However there are those questions – whether the new guidelines or the small company exemption likely to provide much needed relief to electronics firms hoping to go public and feel that what is needed is changes to the law that allow accounting firms to treat smaller firms differently from their larger brethren because small firms simply don't need the same level of internal controls. Unfortunately, even with the new flexibility is Sorbanes Oxley is closing of the strategic business option that has been instrumental in fueling innovation in the electronic business. There are reports that many micro cap publicly held companies seem to be considering means of ending their public company status in large part because of the expense imposed by the Sorbanes Oxley.

Even worse Companies in markets such as Electronic Design Automation where the traditional exit strategy involved being acquired are now unable to come under the same purchase price without taking into account Sorbanes Oxley. Acquiring firms are demanding basic compliance inside the companies that they acquire if only because the acquired operations will need to pass an external audit during the first year after the merger. The consensus, therefore, appears to be that unless the law is substantially changed the burden of Sorbanes Oxley will continue to be a major factor in strategic business decisions within small to medium sized electronic firms.

As our economy in India grows further innovation would be a critical element in sustaining our growth. It is well accepted that 80% of innovation comes from the small and medium sector. The very segment Sorbanes Oxley Act revisions attempt to address. Therefore, I believe we in India need to learn from the experience in the U.S. as well as elsewhere, of course and formulate policies and regulations appropriate to our needs so that we do not make mistakes that have already happen elsewhere.

Thank you
