Current affairs in auditing

The need for confidence in financial reporting in India

Introduction

This month's Current Affairs in Auditing is taken from a survey by CPA Australia (2004a) entitled 'Confidence in Financial Reporting 2004' published in October 2004. This survey was broad-based and covered 'a wide range of topics including investment decision making, business leader integrity, use of annual reports, the annual general meeting, perceptions of auditor independence and confidence in Australia and overseas share markets and major corporations' (p.2).

From this month, we will examine the need for confidence in financial reporting for several Asian countries where a significant number of students studying business in Australia were drawn. In this and next month's edition we will look at India. In this month's edition we look at how globalisation and the need for foreign investment and trade necessitated India to introduce reforms to auditing and corporate governance. We shall also examine why corporate governance systems adopted by companies in India is the basis of regulatory reforms. Finally, we shall briefly examine the documents issued in the reform process and the need for regulations contained in these documents not to constrain wealth production.

In next month's edition of Current Affairs in Auditing we shall examine the reforms suggested to improve India's corporate governance and auditing. We will find these reforms bear a striking similarity to those reforms discussed or introduced in Australia.

CPA Australia survey on confidence in financial reporting

The major conclusions of the survey was that the majority of respondents had the same confidence in major corporations in Australia, more confidence in the Australian share market and less confidence in overseas share markets (CPA Australia, 2004b, p.1).

An article by Lee (2004) commenting upon the survey noted a significant number of investors and financial analyst stated that 'investor confidence would improve if shareholders have more influence over what executives were paid' and that two-thirds of those surveyed said that executive remuneration should be performance based. The article seemed to interpret this as meaning that investor confidence in Australia is remaining the same. The article noted a comment from the CEO of CPA Australia where he expected confidence levels to 'rise after the newly implemented reforms such as CLERP 9 corporate law package have had time to settle in' (Lee, 2004).

The part of the survey that related to auditing dealt with auditor independence. Here 62% of the public who have an interest in the sharemarket and 74% of financial analysts were very confident and quite confident about the independence of the auditor (CPA Australia, 2004a, p.6)

Although the results of the 2004 survey do not reveal any significant trends, the survey highlights the importance of the issue of confidence in various aspects associated with business. For this column the most relevant factors are confidence in financial reporting and auditing. In prior columns we have previously noted that confidence in financial reporting is important for economic success. The downturn of the American economy after the revelations of various corporate collapses and accounting scandals is evidence of this point. For example, Paul Sarbanes (2002), one of the architects of the Sarbanes-Oxley Act noted that associated with the scandals, market capitalisation of US companies declined by an estimated $6 to $7 trillion (p.7). Home et al. (2002) notes that

> 'Enronitis' threatens to stunt foreign investment if enough international investors conclude that U.S. corporate management and accounting cannot be trusted. Given the magnitude of our borrowing requirement, a relatively small reduction of voluntary capital inflows suffices, at the margin, to depress the dollar. Its decline since February is evidence that foreign investors are already reacting to dramatic losses in their U.S. equity holdings (Home et al., 2002).

Confidence in financial reporting in selected Asian countries

This column has been primarily devoted to the collapses and accounting scandals in Australia and United States. There are many students studying in Australia that are from Asia and they may wonder if the information presented in this column is relevant to their countries. It would be suggested that as all counties desire increased international investment and trade that discussions on increasing the reliability of financial statement data would be relevant for their own country.

At present we are witnessing a change in the mix of countries from where Australian overseas students come from. In 2004 the number of commencing students for studies at Australian Universities from Malaysia, Hong Kong, Singapore, Indonesia and Thailand fell. But this loss of students was more than compensated by increased number of students coming from China and India (Dodd, 2004, p.16). In the first semester 2004, students from China who enrolled in full time degree courses rose by 47.3 per cent to 9265 students compared to semester one of the previous year. Students from India rose by 51.9 per cent to 5059 students in first semester 2004 (p.16).

It is the intention of this month's and future month's columns to investigate how various countries who provide many students who study at Australian Universities have reacted to the problem of ensuring confidence exists in the financial reporting system of that country. This and next month's column will discuss India and future months will discuss other relevant Asian countries.

Confidence in Indian financial statements

Levitt's general comments

Arthur Levitt, 1999, the former Chairman of the Securities and Exchange Commission in United States, in a speech to the American Council on Germany made some general comments about confidence in financial reporting that are applicable to India. He stated:

> If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All companies in that country – regardless of how steadfast a particular company's practices may be – suffer the consequences (p.2).

Furthermore Levit, 1999, discusses a global market where the quality of information provided to investors and the market is of vital concern (p.2). He notes that

> capital investments are crossing borders, transcending oceans, and traversing continents – almost instantaneously. An explosion of

> information sources, real-time news feeds and on-line resources has reinvented how we gather and disseminate information. Information is the
>
> lifeblood of markets. But unless investors trust this information, investor confidence dies. … Capital dries up. … The promise of a global marketplace, like never before, depends on it (pp.1-2).

Obviously accounting data is a very important piece of information given to investors and markets. Levitt, 1999, envisages the development of a global reporting system where individual countries reporting systems produce reliable accounting data. Levitt notes that this is feasible when individual counties provide the infrastructure that means accounting standards

> are interpreted and applied rigorously. This means high quality auditing standards, strong international audit firms with effective quality controls, profession wide quality assurance and active, meaningful regulatory oversight (p.5).

Levitt, 1999, further notes that '(f)or some countries, this will mean a major commitment of capital and resources to secure this infrastructure. For others, it will require revamping current oversight procedures to accommodate new international demands' (p.5).

Foreign Investment and trade in India and the need for regulation

A firm of consultants, ATKearney, 2004, surveyed Chief Executive Officers (CEOs) and Chief Finance Officers (CFOs) and other top executives of 1000 global companies about various aspects of foreign direct investment. In 2004 the survey showed that India was considered the third favoured destination for foreign direct investment in the world. China was listed first with United States of America second. India's rose from sixth to third placing; this being its highest placing since the inception of the survey (p.1). Investment in activities that could be off-shored to India included IT, business processing and R&D investments, with the desirable characteristics of India being its 'highly-educated workforce, management talent, rule of law, transparency, cultural affinity and regulatory environment' (p.2). Other relevant findings of the survey are that India was considered the second most favoured destination for manufacturing investments, moving from fifth to second place for telecom and utility investments (p.2). India's high ranking in manufacturing and telecom and utility investments was caused by a 'desire to make productivity-enhancing investments in IT, business process outsourcing, research and development and knowledge management activities' (p.2). Huang and Khanna, 2003, suggest that because of these investment trends 'China has won the race to be the world's factory. With the help of its diaspora, India could become the world's technology lab' (p.4). If China wishes to continue its dominance in manufacturing and India to obtain would dominance in technology, companies

associated with these activities shall have to produce reliable financial statements.

Presently, we live in a global economy where a country's prosperity is dependent upon economic conditions in other counties. For example, the state of Australia's economy is dependent on the boom in China that has led to an increased demand for Australia's mineral resources. It seemed the downturn in the US economy in 2001 and its subsequent impact on trade with India created economic gloom in India (*The Hindu Business Line*, 2 October 2001, p.1) It was envisaged that the economic problems in US would cause less demand for goods produced in India with the decreased demand causing greater competition in goods that India would supply, leading to lowering of profit margins (p.1). This shows India's prosperity is dependent upon continuance of supplying goods to other countries. Customers would wish to have some guarantees about continuance of supplies and would demand reliable financial information to enable them to evaluate whether the Indian companies shall continue to exist and thus able to continue to supply goods and services.

Investment and regulation in India

The relationship between foreign investment and credible regulatory systems is clearly demonstrated when India's Prime Minister, Dr Manmohan Singh stated that over the next decade India needed $150 billion foreign investment in infrastructure sectors that included airports, railways and telecom sectors (The Hindu Business Line, 20th October, 2004, p.2). The Prime Minister stated that

> we are working towards creation of a regulatory framework in infrastructure sectors that would be independent and based upon international best practices (p.2).

He added that the government desired to achieve growth rates of between 7-8 per cent over the next decade. He wished 'to promote investment by creating a climate conducive to investors' (p.2).

Evidence of the relationship between foreign investment and the adoption of good corporate governance lies in Mukherjee's (2004) comments in finding an explanation why Indian software companies adopted good corporate governance practices, but government adopted poor corporate governance practices (p.2). He stated:

> The answer is: global focus.
> …

> While Indian companies have been forced to leave the protectionist cocoon of isolationist policies of he 1960s and 1970s, the Indian state remains inward-looking even today.
>
> …
>
> If the government made even a modest beginning by tapping commercial lenders overseas … it could gradually find itself under more pressure to improve governance (p.2).

As previously noted India's telecom industries need foreign investment to finance the necessary growth for survival. It seems that to obtain these funds Indian Telecoms will be competing with other telecoms in other Asian countries. Phandis (2002) notes a comment from a partner in Telecom Group in India stating that 'corporate governance is for everybody of course, but Indian telecom companies need it most at this point of time' (p.1).

Impact of Enron and the necessity for introducing regulation

An Enron scandal or like has not occurred in India (Sukumar, 2004, p.2). However this does not mean that India can disregard the consequences of Enron. Through fear that their country is not seen to be adopting measures that are perceived to deal with an Enron situation, Enron and other collapses and accounting scandals in US triggered countries to evaluate their regulation and make the necessary reforms. In India these forces were recognised when in August 2002 The Ministry of Company Affairs established the Committee on Corporate Audit and Governance (Naresh Chandra) Committee who investigated and made recommendations on various corporate governance and auditing issues (para. 4 of Executive Summary). This committee was established a month after the Sarbanes-Oxley Act was passed (para. 4 of Executive Summary) and the Committee's report acknowledges the importance of this Act and the corporate collapses and accounting scandals in US that led to the formulation of the Act. The report stated:

> After the Enron debacle of 2001, came other scandals … and the auditing lacunae that eventually led to the collapse of Andersen. These scandals triggered another phase of reforms in corporate governance, accounting practices and disclosures — this time more comprehensive than ever before. In July 2002, less than a year from the date when Enron filed for bankruptcy, the Sarbanes-Oxley Bill (popularly called SOX) was enacted. The Act brought with it fundamental changes in virtually every area of corporate governance …. It is fair to predict that the SOX Act will do more to change the contours of board structure, auditing, financial reporting and

> corporate disclosure than any other previous law in US history (Para 3 of Executive Summary).

The report also recognises a ‘global movement for better corporate governance’ (Para 1.01). Following the publication of the recommendations of the Naresh Chandra Committee the President of the Confederation of Indian Industry (CII) noted that ‘corporate scandals in the US have highlighted the criticality of corporate governance and its importance in creating trust and confidence among investors’ (*The Hindu Business Line*, 25 December 2002, p.1). The concern over Enron type disasters spread to Chief Executive Officers with a PricewaterhouseCoopers partner stating in the Indian news media that ‘post Enron corporate governance has become the biggest concern for CEOs, taking precedence over even growth’ (Phadnis, 2002, p.1).

Regulatory problem facing India leading to a reliance on self-regulatory corporate governance systems

A Press Note dated 4 August 2004 from the Ministry of Company Affairs announcing the issuing of a Concept Paper on Company Law made the following statement.

> It is also increasingly being recognized that a new framework had to be placed in position in tune with the emerging scenario, encouraging good corporate governance and essentially including protection of the interests of investors and other stakeholders (p.1).

The term corporate governance has two meanings. It can refer to the range of external and internal mechanisms introduced to protect stakeholders. For example, the mechanisms could include ‘external and internal audit, the use of audit committees, … shareholder voting rights, including proxy voting and institutional investor involvement in corporate affairs’ (Lee, 1993, p.30). Alternatively, corporate governance can be taken to mean the practices adopted within a company to aid in control of the organisation. The mix of use of external regulations and internal self-regulation constitutes a problem to the regulator. The nature of the regulatory problem to deal with the requirements of India’s growing economy was summarised in the Press Note as follows.

> In the competitive and technology driven business environment, while corporates require greater autonomy of operation and opportunity for self-regulation with optimum compliance costs, this must be reciprocated by way of greater transparency through greater disclosure and greater responsibility for improved compliance and enforcement norms (p.1).

As a developing country, India is concerned about the wise allocation of its scarce resources and this poses problems in determining the optimum amount of regulation in India. Based upon the arguments noted in previous sections a

certain level of regulation is needed. However a developing country is wary of the costs of regulation and excessive regulation is to be avoided. This favours the use of self-regulatory measures such as companies adopting corporate governance systems where the company itself bears the costs of compliance. However Indian regulators cannot ignore the more costly to government external regulations imposed upon companies. Mr William H Witherell, Director of OECD financial fiscal and enterprise affairs stated that

> developing countries that want to attract foreign direct investment from the developed world will have to comply with OECD1 guidelines on corporate governance (The Hindu Business Line, 30 November 2002, p.2).

The objective of the OECD Principles of Corporate Governance (2004) is noted below and this shows Witherell is referring to the term corporate governance used in the wider context which includes internal and external mechanisms for control.

> The Principles are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing of good corporate governance (p.11).

In addition, the World Bank and International Monetary Fund (IMF) reviewed India's adherence to the OECD Principles of Corporate Governance and issued a report in April 2004.

While the above shows that government need to consider all types of regulation that comes under the umbrella of corporate governance, there does seem to be particular emphasis on corporate governance systems to be adopted by companies. The Minister for Company Affairs stated that 'the government is opposed to policing India Inc. but corporate governance in the country needs to be regulated (Yahoo!India News, 18 October 2004, p.1) The secretary of the Ministry noted that the establishment of the National Institute of Corporate Governance 'was an important collaborative initiative in this regard' (p.2). The focus of this Institute is explained lower on this page and can be summarised as improving Indian companies use of corporate governance. Also in October 2004, the Securities and Exchange Board in India (SEBI) issued a revised

[1] Organization for Economic Cooperation and Development

clause 49 of the Listing Agreement that contains provisions of corporate governance practices to be adopted by larger listed Indian companies. The revisions incorporated in the document included

> amendments/additions to provisions relating to the definition of independent directors, strengthening the responsibilities of audit committees, improving the quality of financial disclosures, including those related to related party transactions … requiring Boards to adopt a formal code of conduct, requiring CEO/CFO certification of financial statements. … Certain non-mandatory clauses like whistle blower policy … have also been included (SEBI, 2004a, p.1)

Other points that indicate an emphasis by regulators relating to corporate governance are

- In association with various Indian professional and industry bodies, The Ministry of Company Affairs has established National Foundation for Corporate Governance. The focus of this body is to include creating awareness on the importance of Indian companies adopting good corporate governance practices, encourage research into corporate governance and by working with authorities to improve the implementation and enforcement of corporate governance (National Foundation for Corporate Governance, 2004, p.1).

- The Chairman of SEBI suggested introducing ‘a comprehensive model for rating the corporate governance practices’ of companies in India. The rating model would encompass ‘the implementation of the codes of corporate governance in letter and spirit’. This latter reference to spirit probably means that ethical considerations would be included in the rating model (Kurup & Verma, 2002, p.1).

- The Indian government is a sponsor of the Global Corporate Governance Forum whose mission is to help countries improve the standards of governance for their corporations (Global Corporate Governance Forum, 2005, p.1).

Similar to Australia, India’s corporate governance guidelines are base upon an if not why not approach as companies include in their annual reports a Compliance Report on Corporate Governance which must include a section noting corporate governance practices noted in Clause 49 and not adopted by the company and the reasons for not adopting these practices (SEBI, 2004b, p.11) The compliance report must be audited (p.11).

Reform process in India

Similarly to Australia, in India an investigatory report on the problems and suggested reforms to auditing and corporate governance was produced. The Report was entitled Report of the Committee on Corporate Audit and Governance (Naresh Chandra Committee)(2002). Naresh Chanda was the chairman of the committee. The reforms suggested in this report were debated and subsequently two bills were produced. They were the Companies (Amendment) Bill 2003 and the Chartered Accountants (Amendment) Bill 2003. The Companies (Amendment) Bill 2003 contained 174 clauses and subsequent amendments were upwards of 40 (*The Hindu Business Line*, 21 October 2003. p.1). It was felt

> that the proposed law, in its present form would create hurdles for smooth functioning of the corporate sector
> ...
> (and was) not in conformity with the basic thrust of economic policy initiatives. These clauses transmit damaging signals to both domestic and foreign investors (p.2).

Consequently, in October 2003, the government decided to withdraw The Companies (Amendment) Bill 2003 (p.1). In August 2004, the government released a Concept Paper containing a Model Codified Law (Giridharan, 2004, p.260). This paper aims to reduce the sections of the Companies Act from the present level of 781 sections to 289 (p.268). The Government plans to introduce the bill for the Companies Act in May 2005 with the government wishing to 'free the corporate world of bureaucratic hurdles and provide it with a level playing field for competition with multinational companies' (HindustanTimes.com, 25 November 2004). Cabinet approved the Chartered Accountants Bill in October 2004 ensuring that 'there are no technical glitches to (its) passage to Parliament' (Srivats, 2004, p.1).

Conclusion

In this month's edition of Current Affairs in Auditing we have began our series of discussions on confidence in various Asian countries financial reporting systems by discussing the reasons for reform and a brief overview of the reform process in India. The Asian countries we will discuss are those Asian counties that provide a significant number of students to study business in Australia.

In India we have found that due to Enron and other collapses and scandals in US and to facilitate foreign investment and trade, India must implement some reform. However the mix of external and internal regulation must not overtax India's scarce resources and should not impose harsh regulatory burdens on industry that may lead to Indian companies not being globally competitive. Along with a global trend for the adoption of corporate governance by companies, these factors favour regulation to be based around companies adopting corporate governance practices.

In next month's edition of Current Affairs in Auditing we will discuss the significant reforms that have been debated in India that apply to corporate governance, the auditing profession and audit independence. We will find the issues debated bear a striking resemblance to those discussed in Australia.

Questions

1. Discuss the factors that are relevant for determining the optimum mix of internal and external regulations relating to auditing and corporate governance in India

2. Discuss why self regulatory corporate governance practices adopted by companies forms the basis of India's regulatory effort to improve financial reporting and auditing.

3. Discuss the advantages and disadvantages of adopting an if not why not approach when considering the type of corporate governance practices to be adopted by Indian companies

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