Leveraging regulatory change for competitive advantage

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Corporate implosions over the last decade and the subsequent increase in demand for continuous improvement in the boardroom have heightened the pace of change in corporate governance worldwide. A plethora of changes in regulation over the last few years have brought back the spotlight on corporate governance practices of Indian companies. These regulatory changes are focused towards building an environment conducive for attracting investments and have cast significant additional responsibilities on managements, boards, independent directors and auditors.

Some of the key changes in the regulatory environment include mandatory audit firm rotation, documentation of internal financial controls, financial reporting under Ind AS, and Goods and Services Tax. Indian companies should embrace these changes not just for compliance but use them as a tool to develop competitive advantage.

As per the recent survey by Grant Thornton US, organisations spend 12% of their total revenue on governance, risk and compliance (GRC) activity. A reasonable question to ask then is: **What does a company stand to gain through enhanced level of corporate governance?**

In the Indian corporate corridors, there is an increased acceptance that good corporate governance is a means to create a business environment of trust, transparency and accountability for financial stability, leading to a reduced cost of doing business- of raising capital, of hiring talent, of suppliers and of attracting customers.

Mandatory Audit Firm Rotation (MFR)

To reduce the risks of excessive long-term familiarity with a tenured Audit firm, the Companies Act 2013 (2013 Act) provides for MFR for all listed and all but certain small unlisted companies, such that audit firms completing a term of 10 consecutive years or more need to be rotated beginning 01 April 2017. Post completion of the term of 10 years, the cooling off period of five years is mandatory to re-appoint the same audit firm again. The Argentina, Brazil, China, Korea and more recently the EU have already introduced MFR in one form or another.

MFR can be seen as a measure to strengthen auditor independence and increase professional scepticism resulting in improved governance norms. The underlying objective is to overcome the perception of a close relationship between the auditor and the management by changing the external audit firm on a regular basis. The expectation is that new auditor will spend more time seeking audit evidence with a fresh perspective, rather than just relying on prior experience with the client.

The supporters of MFR suggest that a long-term relationship may also mean that the audit approach becomes 'stale' and susceptible to repetition. A new audit firm would bring a 'fresh set of eyes' on the company's financial statements and would likely identify more issues than an incumbent audit firm. This would in turn result in improved financial reporting. However, there could have been possible alternatives to MFR, including the need to supplement MFR with other complimentary changes that would enhance the oversight over the audit process as have been suggested in the EU (banning restrictive clauses, introducing stronger requirements on independence, establishing list of non-audit services, imposing limitations on fees charged for non-audit services). Also, the approach could have been to apply the MFR norms in a phased manner by initially applying it to only the largest listed companies (say the Nifty 50) and then to other companies to avoid a 'cliff-edge' effect on the audit market.

How does the company stand to gain by being prepared for MFR in advance? In a survey by Grant Thornton & PRIME Database, 52% companies were of the view that they would be in favour of complying with MFR requirements earlier as it would ease the adoption of Ind AS. However, out of respondents required to adopt MFR from 2017-18, only 9% had already rotated audit firms by 2015-16. This would suggest a significant number planning to early adopt MFR from 2016-17 and not wait until the mandatory deadline of 2017-18. The survey also reveals that whilst there is significant awareness about the changing regulatory landscape and acknowledgement of the effort involved in changing an audit firm, the awareness however, is yet to be translated into action. 82% of respondents were yet to start planning or have only a preliminary informal plan. **73% of the respondents at the same time supported MFR and believed it was would enhance objectivity leading to improved financial reporting**.

No statistical evidence is available of whether MFR truly meets the intended objective of 'independence' or whether it just results in an added administrative cost for the companies. Indeed critics say that the maximum number of frauds and financial reporting errors happen in the first couple of years of a new audit firm. There is no

point in further debating the merits or demerits at this stage. The opportunity from MFR is to at one hand reduce the number of audit firms who audit public interest entities to a more manageable number for the regulators than the current 1,000 plus, and at the same time open-up the upper end of the audit market to more firms. This is a great opportunity for corporate India to help create at least 10 new large but not massive audit firms who could help improve the choice and the quality of financial reporting, and in the long run the value from Audit for all.

Internal Financial Controls

As per the Companies Act 2013, companies in India must document their Internal Financial Controls (IFC) and have their external audit firm attest to their design effectiveness and operating effectiveness. It has been fourteen years since the Sarbanes Oxley Act (SOX), laid down a similar requirement for US, however the same was restricted to large public companies, unlike India where it is applicable to all Companies! IFC is much wider than SOX requirements.

Given recent frauds and financial scandals, decline in market capitalisation and resulting loss of investor confidence in our capital markets, it is believed that of all of the recent reforms, the internal control requirements have the greatest potential to improve the reliability of financial reporting. After setting-up the initial framework, a lot can be achieved by re-organising the existing internal audit function. Since IFC is an ongoing requirement, the internal audit plan can be re-aligned to support the management in reviewing strategic as well as operational areas.

To truly unlock the value that can be achieved by adopting the internal financial controls, management should take a step back and evaluate how it is addressing the risks to its organisation in light of the company's size, complexity, global reach and risk profile. There is a choice between doing the minimum to comply and making the most of the benefit from the compliance. Companies that choose to do the right thing will unlock value, avoid financial reporting surprises and support sustained business performance over the long run. **Reliance on a poor control framework is often worse than having no control at all.**

Ind AS

With the MCA's announcement on the roadmap for Ind AS implementation, eventually all unlisted companies with a net-worth of more than Rs. 250 crores (around $40 million) and all listed companies will move to the new accounting standard called 'Indian Accounting Standards' or 'Ind AS' in short. Whilst Indian standards were already largely aligned to International Financial Reporting Standards (IFRS), the new Ind AS is nearly entirely converged with IFRS. Impact of this momentous change needs to be considered on performance, on people and on processes.

Business performance: a fresh outlook

The new financial reporting framework introduces new dimensions – 'equity' may become 'liability', 'operating revenue' may become 'finance income', profit and loss may become more volatile due to several hidden elements in contracts, and the list goes on. A timely look at the contracts and evaluation of consequences will not only prevent undesirable results, but also allow businesses to think 'out of the box' and take advantage of one-time choices available.

Transition to this new accounting language is not only an accounting change but also an enormous change in the way corporates structure their business contracts and their organisation. It is imperative for the management to convey such changes to stakeholders, given that the business has not changed but numbers have moved significantly or ratios have altered.

Business leaders also need to consider that their financial statements are a critical communication to stakeholders. But how effective are they in meeting stakeholders' needs? When communicating with stakeholders they can make them effective using the following tips:

- **Holistic approach** – consider your annual report as a whole and deliver a consistent and coherent message throughout
- **Keep it simple** – provide commentary on more complex areas in plain English
- **Non-GAAP financial measure** – do so transparently, so that they do not mislead users but instead provide useful additional information which supports your story

People matters: the softer angle of transition

Change in financial reporting landscape will not be restricted to finance departments. It will possibly touch all aspects of a modern organisation – taxation, IT, human resources, sales, legal and more. While certain employees will be more affected than others as their KPIs and KRAs will need re-alignment in line with the new standards, their skillsets will need a major upgrade. This will be required so that the workforce can deal with the change professionally and maintain the highest standards of corporate governance.

In the ensuing years, we might also see enhanced regulatory oversight. Judgment and estimates play an important role in financial reporting under Ind AS and judgment can differs from person to person, organisation to organisation.

Processes: internal controls

Irrespective of accounting language, processes and controls are strategic part of any business and one may win trust of stakeholders by having such systems in place that can deal with any complex situation. Corporates need to re-visit their existing controls and ensure that they are sufficient enough to provide guidance to company

about their estimates, judgments and policies. The adoption of IFC provides an opportunity to do so.

Goods and Services Tax

Goods and Services Tax (GST) is anticipated to be the largest reform since independence in India. Introduction of GST is expected to result in 1-2% increase in GDP of the economy owing to expansion of tax base as well as coverage. Post GST, India can expect to have one common Indirect tax law (even though a dual Central & State GST would remain) which will subsume most of the existing multiple and complex Indirect taxes. It is expected to bring in ease in doing businesses by increased digitisation, eliminating tax cascading, simplifying compliance and creating much needed clarity on taxation of business transactions.

Introduction of GST will require businesses to revisit their complete supply chain to identify impact of GST on their own businesses as well as their vendors and customers. They will also need to assess the overall financial impact cash flows and infrastructure requirements to align to this significant reform. In order to ensure a smooth transition, businesses would do well to perform a detailed analysis well in advance and clean-up any existing issues. GST presents an opportunity for businesses to further unlock their growth potential by pro-actively identifying opportunities for cost-optimisation, price- competiveness and streamlining overall compliance framework ahead of time.

In a recent Grant Thornton global governance survey, India Inc. identified four areas on which boards should increase focus over the next 10 years to support growth prospects of businesses-

1. Strategy
2. Sustainability
3. Digital economy expertise
4. Identification and prevention of fraud

Compliance with laws is an opportunity and a threat. However, eventually culture is the main bedrock of good corporate governance. A combination of best in class compliance and a purpose driven culture will help separate the best from the rest in India by 2020. Are you ready for the journey?

Optimists sees green light everywhere; anticipating potential hazards coming down the road. Their vision is beyond the present. They also recognise when the road is opening up and they can safely put their foot down on the pedal.