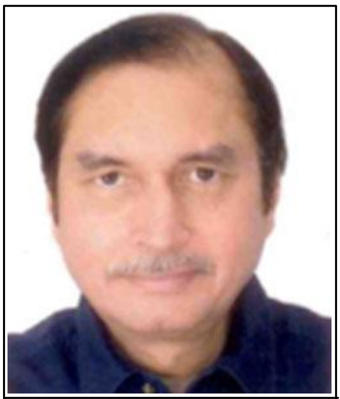
Role of Auditors in Promoting Investors Confidence in the Changing Milieu



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Past few years have been characterized by an unprecedented loss of confidence in the global financial system. The sub-prime mortgage crisis originating in the United States triggered a worldwide contagion of bank failures or near failures which resulted in a near global financial crisis. Major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis. This resulted in a domino effect in terms of reduction of supply of funds, slowdown of investments, negative industrial growth, business failures, loss of jobs etc. India too has been affected but, in common with other Asian economies, India has weathered the crisis relatively well, given the circumstances. In these situations, it is the small and medium level enterprises which suffer the most.

2. Though the worst of the crisis can be said to be behind us, lying ahead are several unresolved problems, policy challenges and, no doubt, further surprises. There is still a lot of uncertainty in the air. But, what has become clear is that the global financial system needs to find better means of understanding and dealing with systemic vulnerabilities arising from excess liquidity, leverage, risk–taking and systemic concentrations across the financial system. Past experience has clearly shown that whenever financial imbalances arise, financial distress can easily occur and become rampant due to the increasing linkages across the globe. The financial markets will remain global and interconnected. Despite past experience, financial innovation will continue to play an important role to foster economic efficiency. While efforts are being made to re-enforce the financial sector and its regulation, we need to give focus to the fact that the national governance and regulatory systems are strengthened not only to prevent such failures but to check this domino effect so as to protect the common man.

3. The importance of financial reporting in providing essential financial information about the company to its shareholders and other stakeholders is universally recognised as an integral and important part of good corporate governance. The auditor's role is to give an independent opinion on the company's financial statements, assessing whether they present a true and fair view of the state of the company's affairs and whether there is material misstatement in them or failure to conform to relevant technical standards.

4. Effective public oversight over the audit profession is a vital element in the maintenance and enhancement of confidence in audit functions. In the context of jurisdictions like India, the horizon for independent oversight of auditing profession is gaining momentum and setting-up of an independent Quality Review Board is one such step. With a view to improving the quality of audit services in India, the Ministry of Corporate Affairs, Government of India has established Quality Review Board, in exercise of the powers conferred u/s 28A of the Chartered Accountants Act, 1949 to:

(a) make recommendations to the (ICAI) Council with regard to the quality of services provided by the members of the Institute (ICAI);
(b) review the quality of services provided by the members of the Institute (ICAI) including audit services; and
(c) guide the members of the Institute (ICAI) to improve the quality of services and adherence to the various statutory and other regulatory requirements.

5. As per the mandate, the Quality Review Board has issued a detailed 'Procedure for Quality Review of Audit Services of Audit Firms in India' (the 'Procedure') providing for various matters, adopting best practices, in laying down the necessary system for conducting recurring inspections of audit firms in India. In accordance with this Procedure, the Board has already initiated a system of review of audit services of the audit firms in India pursuant to a process comprising selection of the audit firms for inspection and engagement of Technical Reviewers so that the Board is able to assess a) the quality of audit and reporting by the auditors; and b) the quality control framework adopted by the auditors/ audit firms in conducting audit.

6. At the international level, co-operation amongst the public oversight bodies is an important recent addition to the international agenda. A major lesson learnt from the crisis in international financial markets is that international co-operation needs to be more straight-forward. The action plan issued at the G20 summit had also called for enhanced co-operation amongst public oversight bodies for auditors. International Forum of Independent Audit Regulators (IFIAR) was established on 15 September 2006 by independent audit regulators from 18 jurisdictions. Since its creation, IFIAR's membership has grown in the light of the establishment of new independent audit regulators in different

jurisdictions around the globe and bringing together independent audit regulators from a total of 46 jurisdictions. IFIAR focuses on the following activities:

- Sharing knowledge of the audit market environment and practical experience of independent audit regulatory activity with a focus on inspections of auditors and audit firms,
- Promoting collaboration and consistency in regulatory activity, and
- Providing a platform for dialogue with other international organizations that have an interest in audit quality.

7. Apart from 46 members, a few international bodies such as the World Bank, European Commission, International Organisation of Securities Commission (IOSCO), Financial Stability Board etc. are acting as Observers. While currently independent audit oversight authorities from most of the prominent countries are members of the IFIAR no Indian body is a member of IFIAR. It is felt that significant benefits may be derived from practical co-operation and exchange of specific information between audit regulators and from the common and consistent views or positions on matters of importance. It would also be useful to engage in dialogue with the prominent members of IFIAR from various jurisdictions with a view to sharing knowledge and experience on a range of issues such as their frameworks for audit regulation and regulatory practices. The Quality Review Board also appreciates the need to establish international linkages and co-operation with the counterpart international bodies and organisations. Being an independent body charged with responsibility under Sec. 28B of the Chartered Accountants Act, 1949 to review the quality of services provided by the members of the Institute of Chartered Accountants of India including audit services, it is felt that these efforts would aim to serve the public interest and enhance investor protection by improving audit quality, through independent inspections of auditors and/or audit firms.

8. U.S. Public Company Accounting Oversight Board (PCAOB), in addition to inspecting registered public accounting firms located in the United States, also inspects registered public accounting firms located in foreign jurisdictions in order to assess those firms' compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the Securities and Exchange Commission, and professional standards in connection with their performance of audits, issuance of audit reports, and related matters involving U.S. public companies, other issuers, brokers and dealers. Under the Act and the Board's rules, non-U.S. registered firms are subject to PCAOB inspections in the same manner as U.S. registered firms. PCAOB has been inspecting non-U.S. registered firms since 2005 including audit firms located in India. It has been felt there is a need to enter into formal co-operative arrangement with the PCAOB for such inspections of audit firms located in India whereby the PCAOB may rely, to a degree deemed appropriate by them, on inspection work performed by the home country regulator.

9. The EU Directive on Statutory Audits also provides that firms auditing companies incorporated in a third country but listed on a regulated market in the European Union should come under the independent public oversight of the EU Member State concerned. This concerns companies and auditors from more than 60 jurisdictions outside the European Union. As part of its international agenda, the European Commission has been evaluating the situation of auditor oversight systems in third countries with the aim of allowing international cooperation on the supervision of audit firms in cases where auditor oversight systems in third countries are considered equivalent to that in the EU. The goal of this international cooperation is to avoid duplication of supervisory work, unnecessary burdens on audit firms, and to promote a high degree of investor protection by ensuring high quality audits and development of international capital markets. Based on their evaluation and discussion with the Indian authorities, India was included in a transitional period following the adoption of Decision by the EU on the continuation of audit activities of certain third country auditors and audit entities by the European Commission. In January 2011, the European Commission decided in respect of a few countries (including India) that since they have established or are in the process of establishing public oversight, quality assurance, investigation and penalty systems for auditors and audit entities, in order to carry out a further assessment for the purpose of taking a final equivalence decision in respect of such systems, there was a need to obtain additional information from those third countries and territories. Therefore, it decided to extend the transitional period. During this transitional period, the Indian auditors were allowed to perform their audit activities in the EU without being subject to EU auditor oversight or being required to register with EU competent authorities subject to the provision for giving certain information to the EU oversight authorities.

10. Promoting confidence in corporate reporting is vital to the healthy functioning of business entities and makes a significant contribution to the overall economic growth, and, while strong connections exist between corporate governance, corporate financial reporting and auditing, this synergy needs to be further developed so that it can build faith in the actions of the business entities and also protect our common future. The way in which auditors are regulated is an important component of national and international confidence regarding the financial information which flows to markets.

11. India is today rated as one of the most attractive investment destinations across the globe. The UNCTAD World Investment Report (WIR) 2013, in its analysis of the global trends and sustained growth of Foreign Direct

Investment (FDI) inflows, has reported India to be the third most attractive location for FDI for 2013-2015. The UNCTAD Report further said in 2012, 44% of global FDI inflows were hosted by only five countries. China attracted the lion's share by USD 253 billion (or 18% of total) followed by the United States (USD 175 billion), Brazil (USD 65 billion), the United Kingdom (USD 63 billion) and France (USD 62 billion). India received FDI inflows of USD 26 billion in 2012 - down 29 percent from USD 36.19 billion in 2011. The Indian economy experienced its slowest growth in a decade in 2012, and also struggled with risks related to high inflation. As a result, investor confidence was affected and FDI inflows to India declined significantly. However, the report said the country's FDI prospects were improving as a result of opening up of the economy and creation of manufacturing zones for Japanese and Korean companies. Inflows into the services sector are likely to grow, thanks to ongoing efforts to open up key economic areas such as retailing. Flows to manufacturing are expected as a number of countries, including Japan and the Republic of Korea, establish country or industry-specific industrial zones in the Delhi-Mumbai industrial corridor, the report said.

12. The result of the government initiatives and liberalisation measures undertaken have resulted in tremendous response and growth in the FDI equity inflows to India since 2003-04, which have increased many-fold. While India was ranked 32nd in the world on FDI inflows in 2001 (as per UNCTAD data), its ranking improved to the 15th position in 2012. The cumulative amount of FDI equity inflows from April 2000 to March 2013 stood at US$ 290 billion, according to the data released by the Department of Industrial Policy and Promotion (DIPP). The huge increase in investment mirrors the foreign investors' faith in the Indian markets.

13. The continuing thrust has been on making the FDI policy more liberal and investment friendly. The FDI guidelines have been significantly rationalized, simplified and consolidated, with the aim of providing a single policy platform for reference of foreign investors. A large number of new sectors, such as petroleum and natural gas, civil aviation, retail were either opened up to foreign investment or significantly liberalized during this period. Some of the important changes include dispensing with the condition of prior approval in case of existing joint ventures/technical collaborations in the same field and permitting FDI in Limited Liability Partnerships.

14. India needs infrastructure investments of over USD 1 trillion over the next five years. In order to address this mammoth need the Government has fashioned a number of policy initiatives. To attract more funds in the medium to long term the Government has announced that it would create special vehicles in the form of notified infrastructure debt funds. India is encouraging increased reliance on Public Private Partnerships (PPPs) and also have put in place a policy and regulatory framework for PPPs for all infrastructure sectors that can be commercialized. The FII limit on investments in corporate bonds has been raised to USD 40 billion. Moreover, 100 per cent FDI is allowed in most of the infrastructure sectors such as roads and highways, ports, airports and power.

15. We are reaping the benefits of financial sector reforms initiated during the early 1990s. In a continuation of this process, a range of legislation awaits Parliamentary approval. Together they cover a wide canvas of reforms in various sectors including insurance, banking, pension, higher education, mining, postal and courier services. The law relating to land acquisition is being modified to expedite the process of land acquisition. The Companies Act is being amended to make India a more business-friendly destination. It also proposes to have a transformative effect on the way auditors are regulated in India. Banking and other financial services are also high on the reform agenda to strengthen the banking sector, increase its competitiveness and promote financial inclusion. Given what has happened in the financial world over the last few years, extreme care has to be exercised in building a robust banking system. While foreign investment in this sector is welcome, under no circumstances would India like to be saddled with sub-prime banks.

16. However, there are lots of challenges facing the Indian capital market. Benchmarking the risk/return characteristics of India's equity markets against the world average shows that India's stock market has historically been more volatile. This should not come as a surprise as the past decade witnessed several political and economic uncertainties, undermining business and investor confidence. Foreign institutional investors' (FIIs) participation grew steadily over the past few years. Greater inflows are still to be expected, arising from international investors' quest for higher returns and improved portfolio diversification, buttressed by ongoing structural changes in India's economy and its financial markets. Sustained inflow of capital will not only bring greater liquidity in the market, but foreign presence will encourage further market transparency.

17. Developments of global financial crisis have also served to highlight the vulnerability of the Indian capital market to global economic turbulence and exposed our increased dependence on corporate customers and the retail distribution system. It is, therefore, an opportune time for the industry to dwell on the experiences and develop a roadmap to strengthen investor faith and confidence in the health of the industry. There is a need to develop a regulatory regime in which high standards of corporate reporting and governance are intelligently and diligently applied, which would underpin the healthy functioning of markets to the benefit of business, investors and other stakeholders and enhance the economic strength in competitive markets. The role of a credible public oversight over the audit profession would be crucial in achieving this.