

*Challenges to the Accounting Profession: Some Reflections**

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Thank you for inviting me to speak at this conference of the Western India Regional Council of the Institute of Chartered Accountants of India (ICAI).

2. When I got invited to speak at this conference, at first I was a bit surprised. I wondered why you might be wasting valuable conference time listening to the Reserve Bank when there is not much in common between the Reserve Bank and the accounting profession, except possibly the fact that we both lose sleep when numbers go wrong. I then spoke to my staff and realised how wrong I was. We share considerable professional space and have several mutual concerns. I will address some of those shared concerns.

3. Before doing so though, I must acknowledge another link between the Reserve Bank and the accounting profession through Shri Y. H. Malegam, who has been a Director on the Central Board of the Reserve Bank almost continuously since 1994 except for a brief interlude of a few days. Shri Malegam is, by wide acknowledgement, one of the foremost Chartered Accountants in India who has set very exacting standards of professional competence, and more importantly, of professional conduct. The Reserve Bank has benefited enormously from his vast knowledge of accounting, his understanding of the financial sector and his judgement of the larger public interest. As a profession, you can all be proud of colleagues like Shri Malegam who enhance public respect for the accounting profession.

The Accounting Profession

4. The development of the accounting profession owes its origin to the emergence of the joint stock company and the consequent separation of ownership from management. This arrangement triggered the

need for an independent and informed opinion on the accounting of the owners' funds entrusted to the management for their stewardship. The '*raison d'être*' of the profession is consequently based on the confidence which the profession enjoys with the investing public, and its continued relevance is essentially tied up with retaining this confidence. While initially the profession provided this confidence only to the shareholders of joint stock companies, today it provides this assurance to a wider base of stakeholders including the government, the banking system, regulators and society itself.

5. At the Reserve Bank, we depend on the accounting profession for at least two reasons. You audit the Reserve Bank's balance sheet of course, and you also audit the balance sheets of commercial banks which we regulate and supervise.

Reserve Bank's Balance Sheets

6. Let me make a brief comment here on the Reserve Bank's balance sheet. The balance sheet of the Reserve Bank is different from that of commercial organisations in some important respects. Uniquely, the Reserve Bank is statutorily mandated to have two balance sheets – one for the Issue Department and the other for the Banking Department. The Issue Department handles the task of issue, exchange and withdrawal of currency notes. The Banking Department maintains the deposit accounts of banks and of governments. The rationale for building a firewall around the balance sheet of the Issue Department is to maintain the integrity of the asset backing for the currency that we issue. The firewall ensures that the explicit promise that every currency note carries, which is to pay the bearer the sum mentioned therein, is honoured in the full accounting sense. Our other balance sheet, that of the Banking Department, reflects the transactions we perform in our role as banker to banks and to the Central and state governments.

* Inaugural address by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India at the 26th Regional Conference of the Western India Regional Council of the Institute of Chartered Accounts of India in Mumbai, December 16, 2011.

7. In the Reserve Bank, we are deeply conscious of our responsibility for maintaining the integrity of our balance sheets. The Reserve Bank's balance sheets are analysed by a wide array of stakeholders to study the underlying monetary and macroeconomic trends so as to make informed decisions. We have an obligation, therefore, to maintain the highest standards of clarity, transparency and disclosure, and we try our best to meet this obligation.

RBI and the Accounting Profession

8. While the financial statements of the Reserve Bank are subject to audit by your profession, as the regulator and supervisor of the banking system, the Reserve Bank is a major stakeholder in commercial banks whose financial statements are audited by you. In our view, auditors are the 'eyes and ears' of the Reserve Bank, and we trust them to alert us to early warning signals to assist us in our supervisory process. We also encourage auditors to discuss any regulatory issues with the Reserve Bank before finalising the accounts. Further, during the process of 'Annual Financial Inspection' of banks, the inspection team interacts with the auditors to discuss issues of regulatory concern.

Challenges for the Accounting Profession

9. As several stakeholders depend upon the accounting profession, the profession too has to recognise that it has to continue to inspire the trust and confidence of the stakeholders if it has to remain relevant and value adding. In recent years, several challenges have emerged, both at domestic and global levels which, if not effectively addressed, could erode that confidence. Let me address what, in my view, are some of the key challenges.

Competence

10. First, the challenge of competence. With the growing complexity of the financial sector and the emergence of new and sophisticated financial instruments, the knowledge base of the profession needs to keep pace with these emerging practices and innovations. This requires, not just a continual review of its curriculum, but more importantly, an active, well-diversified and constantly updated programme of continuing professional education for its members.

Continuing professional education cannot be a mere 'tick in the box' or determined by participation in number of hours of education or training, but should be evaluated by way of outcomes – upgradation of relevant knowledge and skill sets.

11. Towards improving the skill set of the accounting profession, with particular reference to auditing banks, the Reserve Bank has taken some initiatives. We have established a practice of an annual Statutory Auditors' Conference to apprise the statutory auditors of banks on the critical issues in the area of banking regulation and supervision. The conference also provides a forum for auditors to give us their feedback on current concerns and to suggest any changes to our supervisory and regulatory policies. We have found this to be an effective forum for mutual exchange of views, and I hope you likewise have found it to be value adding. I am open to suggestions on improving this engagement.

12. I am also happy to note in this context that as a result of your Institute's initiative, India is embarking on convergence with international financial reporting standards (IFRS), which would then result in our financial accounting and reporting getting to be world class. As you are no doubt aware, IFRSs are largely broad principles rather than detailed rules. Their application requires judgment and possibly even lateral thinking, especially in the area of determining the fair value of financial assets and liabilities. The auditing profession needs to improve its skill endowment to facilitate a smooth and efficient convergence with IFRS.

Globalisation

13. The second challenge the profession needs to reckon with is globalisation. Globalisation implies that countries can no longer afford to remain isolated in so far as their operating and legal systems are concerned. For the profession, this gets reflected not merely in international accounting and auditing standards but also in a number of other areas like education, ethics, etc. I gather the ICAI, with its 180,000 members, is the second largest accounting institution in the world. It is not sufficient that the Institute merely responds to and adopts global standards. It should, in fact, go further and actively participate in the formulation of these standards.

14. I am happy to learn that the President of ICAI has recently been elected as a member of the board of the International Federation of Accountants (IFAC) and that there is an Indian member on the IASB. I also want to commend the Institute for its active participation and involvement in several international committees and projects aimed at improving accounting systems and processes. I would only urge that going forward, ICAI should proactively take the lead in the formulation of accounting standards in areas where we have specific concerns as an emerging market economy (EME).

15. Another task the profession needs to address in regard to managing globalisation is how it will select, from within its membership, persons of the requisite competence to participate in the global forums, and how it will provide them both financial and professional support to make this participation rewarding to them individually and to the profession more broadly. Needless to say, the process of selection of persons for representing the Institute in international forums should be strictly meritocratic and transparent.

Information Technology (IT)

16. Next on my list is the challenge of Information Technology. In the past, one of the main objectives of audit was ensuring the arithmetical accuracy of financial statements. With the advent of IT, this task has now been taken over by machines. This has both nudged and facilitated the profession to move up the value chain. The main task of the profession has now shifted to judgments of value, and to discharge this task, auditors have to demonstrate much higher levels of maturity, integrity, independence and balanced judgment. The development of these qualities will be a major challenge in the future.

17. Let me make a comment with regard to IT in banking. Over the past decade, most commercial banks have successfully implemented core banking solutions. This has created both opportunities and challenges for auditors. Challenges come by way of lack of visible evidence, risk of undetected system errors and bugs and frauds hidden in a labyrinth of data. Retrieving information in the computerised environment and assessing the implementation of computer-related processes will also be critical to the audit process.

Opportunities come by way of increasing use of computer assisted audit tools (CAATs) to access databases beneath the accounting software to create queries, write reports and develop audit trails. While the profession has risen to the challenge of auditing banks in an IT environment, we need to explore further on how audit can overcome the challenges and exploit the opportunities of the IT environment to make audit of banks more effective and meaningful.

Opportunities

18. I am told one of the issues agitating all of you is expansion of opportunities for the accounting profession especially in view of the growing membership of the Institute. So far, you have enjoyed a monopoly position in respect of certain areas of work, for example, the audit of financial statements. The easy way out to seek and expand opportunities would be to agitate for continuation of this monopoly position. I believe this will be a mistake. Rather, the profession needs to identify emerging opportunities in the market place and develop the skill needed to exploit them.

19. Let me cite an example. With concepts like core banking and centralised record keeping, the relevance of the audit of branches of public sector banks (PSBs) has significantly declined. These banks have represented to the Reserve Bank that the audit of bank's branches should be reduced. There is merit in this suggestion, since currently the cost of audit of PSBs is significantly higher than the cost of audit of comparable private sector banks. However, the Institute has been resisting this because it would mean a reduction in work for its members.

20. I believe the Institute's efforts in this regard are ill-advised. In fact, it makes much more sense for the profession to sharpen its skills in the area of concurrent audit for which a need exists than to agitate for retention of work which does not add value. Similarly, the profession has shied away from the responsibility for prevention and early detection of fraud. The need for such a service exists and if the profession does not fulfill that need, other agencies which can provide this service will displace auditors and deprive them of a potentially expanding opportunity.

Independence

21. Let me now turn to the challenge of 'independence'. The growth of large international firms of accountants has created an opportunity for the provision of a multiplicity of services. Clients benefit from such umbrella services and attach value to it. However, this also raises the vexed question of the extent to which provision of these multiple services erodes the concept of independence.

22. The case of Enron, which took down along with it the audit firm Arthur Andersen, comes to mind in this context. The sudden collapse of Enron, an energy trading and distributing company, ranked seventh in the Fortune 500, raised a number of questions about the accounting and auditing practices followed by the company. The company used creative accounting to shift losses and debts off the company's balance sheet into special purpose entities (SPEs) thereby concealing the extent of its indebtedness. The company was also reported to have withheld information about SPEs which could have led auditors to insist on their consolidation in the balance sheet. Enron's accounting transgressions misled investors to believe that the company was more profitable and less leveraged than it really was.

23. Andersen audited Enron for all sixteen years since the company's formation. On top of pure audit, it also sold internal-audit and consulting services. Despite this privileged insight, Andersen did not discover that Enron was publishing incorrect financial statements leading to the term 'Enronisation of financial statements'. This raises an important question of conflict of interest. Is it the case that the extensive consultancy work done by Arthur Andersen for Enron compromised its independence leading to its failure to detect erosion of accounting standards? It also subsequently came to light that some members of the Audit Committee faced financial conflicts of interest, generated in part by the company's donations to charities to which they were connected. Could this conflict have been prevented?

24. Accounting and auditing practices were also called into question in the collapse of Parmalat, the largest dairy company in Europe, in one of the biggest

accounting frauds in corporate history. Like Enron, Parmalat too undertook elaborate derivative deals, often using complex offshore structures that involved some of its many subsidiaries. Investors and bankers struggled to understand the balance sheet or gauge the true extent of its liabilities. By the time it collapsed, Parmalat had established dozens of arrangements involving offshore companies, which did not form part of the company's consolidated financial statements.

25. Instances such as these reaffirm the need for systemic reforms in two areas. The first is the regulation of auditors. The profession has argued for years that self-regulation and peer review are the right way to maintain standards. But the conduct of Enron, Parmalat *etc.* under the very nose of auditors has raised question about the effectiveness of soft regulation. The profession has to find a way of remedying this if it wants to prevent the imposition of an external regulator.

26. The second reform is the need to eliminate conflict of interest in accounting firms. Should there be a ban on auditors selling consulting services to those they audit? One view is that there is no real conflict of interest and that better audits would be the best way to assure regulators that such a ban is unnecessary. Yet if confidence in auditing is to be regained, perception is equally important. Regulators are likely to demand some meaningful change on the issue of such conflict of interest. Overall, this is a complex issue which needs to be addressed dispassionately.

Inter-disciplinary Approach

27. Inter-disciplinary approach is the next challenge on my list. In a complex world, no single profession can meet all the requirements of market participants. Neither is it possible for individual professions to operate in silos catering to specialised needs. Inter-disciplinary interaction is therefore not only unavoidable, but in fact desirable. But this creates its own problems, particularly in the area of disciplinary jurisdiction as professional standards in different governing bodies – if such a body exists – may be different and members of such bodies may be differently regulated.

28. The recent global financial crisis illustrates the problems that can arise from divergence of views across disciplines – in this case between the accounting profession and prudential banking regulators. There is widespread criticism that the accounting standards, more so fair value accounting insisted on by accountants, failed to reckon with illiquid markets and distressed sales, and thereby contributed to the crisis, or at the very least exacerbated the severity of the crisis.

29. Post-crisis, there is convergence in the views of prudential regulators and accounting standard setters on the desirability of forward looking expected loss approach to loan loss provisioning. The international accounting standards board (IASB), financial accounting standards board (FASB) as well as the basel committee on banking supervision (BCBS) are actively engaged in finding a commonly agreed solution to this complex problem.

30. While discussing the issue of loan loss provisioning, I would like to highlight the Reserve Bank's concern on the issue of divergence in identification of Non Performing Assets (NPAs) and provisioning as certified by statutory auditors *vis-a-vis* the findings of the supervisory inspection conducted by the Reserve Bank. In the Reserve Bank's view, in certain cases, the statutory auditors have underestimated the extent of NPAs and the required provisioning. Since the Reserve Bank, as the supervisor of the banking system, relies and leverages on the work done by auditors, the profession should effectively address this issue. Ultimately, it is the statutory auditors' certification that is taken as the 'true and fair' statement of the accounts of a bank and is disclosed to all stakeholders. It is, therefore, of prime importance that there is no underestimation of provisioning requirements while finalising financial statements of banks.

Value Systems

31. Finally, let me turn to the sensitive and important issue of a value system. Recent months have witnessed an agitation across the country about erosion of values in the public domain. The norms of a society are determined by the dominant sections of that society, and the accounting profession is certainly a dominant section of society. The value system you practise in

your professional conduct influences the value system of the society. Sadly, we see several transgressions.

32. Take the case of Worldcom. Worldcom indulged in major accounting misstatements which hid the precarious financial position of the company. Investigations revealed that more than three billion dollars worth of costs were wrongly classified as capital expenses over a five quarter period. This boosted the reported profits, which were in fact fictitious.

33. The case of Satyam Computer Services here in India was similar. The company's chairman confessed to more than a billion dollar fraud on its balance sheet which was hidden from the company's board, its senior managers and of course the auditors for several years. The truth followed a now familiar pattern – overstating profits, understating liabilities, and overstating cash causing a big hole in the balance sheet.

34. With so much accounting misconduct in big corporations, stakeholders wonder why books are not being reviewed on the default assumption that there could be fraud afoot. Accounting experts explain that the kind of forensic auditing that reconstructs fraud is so time-consuming and expensive that it could bring an honest business to its knees. However, I strongly believe that a robust system of audits, a corporate culture in which ethical conduct is encouraged and exemplified and an active and independent Board of Directors can make such frauds harder to perpetrate, easier to detect and help restore public confidence in published results.

35. What has been the Reserve Bank's contribution in this regard? Recognising the importance of the internal audit and inspection function as an effective management tool, in April 1994, the Reserve Bank advised all banks to set up an audit committee of the board (ACB) of Directors. Needless to say, we need to have skilled and qualified persons on the ACBs to make them truly effective. Accordingly, in September 1995, we advised banks to ensure that there is at least one non-executive director who should be a Chartered Accountant on the ACB. ACBs have since been contributing immensely by providing direction and also by overseeing the internal control function in the bank. We have kept the CEO of the bank outside the ACB to keep it independent. However, the second in

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command, the Executive Director concerned is a member of the ACB to bring the insider perspective to bear on the Committee's deliberations. However, the presence of an executive director may be seen as compromising the independence of the ACB. I will be interested in your views on this.

36. Returning to the larger issue of a value system, the challenge before the profession is, therefore, to demonstrate by its own conduct, its concern for upholding a value system within itself and consequently within its clientele as also to initiate programmes which create sensitivity to the need for greater ethical conduct. In this context I would only like to reiterate that you have a significant role as the conscience-keeper of the business world.

Conclusion

37. Let me now sum up. I have started with briefly identifying the shared professional domain of the auditing profession and the Reserve Bank. I have alluded to the uniqueness of the Reserve Bank's balance sheet, or, indeed, balance sheets. I then went on to indicate, what in my view, are some of the key challenges that the profession has to address in order to remain effective and to add value to the real sector. Where relevant, I have given contextual references and illustrations from the Reserve Bank, particularly stemming from its role as the regulator and supervisor of the banking system.

38. I wish your deliberations over the next two days all success.