

Y V Reddy: Role of accountants in fostering economic growth

Inaugural address by Dr Y V Reddy, Governor of the Reserve Bank of India, at the International Conference on Role of Accountancy Profession in Anchoring Economic Growth, organised by the Institute of Chartered Accountants of India, Mumbai, 19 January 2006.

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Distinguished guests, ladies and gentlemen,

I am thankful to Shri Kamlesh Vikamsey for inviting me to this august gathering. This Conference is of relevance to all of us, not only because of the eminence of the speakers who are addressing this gathering, but also because it represents an important step by the Institute of Chartered Accountants of India (ICAI) to distill from the experiences of other countries in its quest for global benchmarking of our accounting standards. The agenda for the Conference is comprehensive while focusing on critical but contemporary issues. I congratulate the organisers for ensuring a professionally stimulating feast. In my address today, I will confine myself to a few general observations.

Broadly speaking, from the micro-economic point of view, accounting standards encompass mechanisms for providing information about the financial condition and performance and importantly, the risk profile of firms to all potential users. It therefore, constitutes one of the core elements of the financial infrastructure. From the macro-economic point of view, the information supplied serves a dual function. First, by facilitating the identification of most productive use of economic resources, it constitutes the basis for assessment of prospective rewards and risks. Second, it acts as an enabling mechanism for control over the effective utilisation of resources. Taken together, this forms the basis of income allocation among various constituents and the exercise of financial discipline.

It is not appropriate to believe that the 'invisible hand' of the market would generate the requisite information, irrespective of the accounting standards in place. This argument of the presumed omniscience of markets tends to disregard the fact that producing information can be costly. More importantly, the costs of generating information are private, while the benefits are dispersed across all potential users, resulting in a tendency to under-supply. This under provision of information, as you would all know, was a key factor behind the build-up of financial imbalances and contributed to the enormity of the Asian crisis. In fact it is the Asian crisis that brought into clear focus the close links between micro and macro aspects of economic growth as well as institutional aspects as distinct from policy aspects of economic management.

Effective market mechanisms must, therefore, be instituted to ensure efficient capital mobilisation and its prudent allocation in securing long-term economic growth with assured stability. Needless to say, the development of efficient markets needs to be supported by high-quality market participants. Intermediaries, issuers, investors, regulators and professionals play important roles in generating this growth dynamism in our financial markets. Within the context of both domestic and international challenges, the accounting profession therefore plays an important complementary role towards building a credible, reputable and internationally competitive economy, irrespective of the capacities in which they perform. This includes not only in your capacity as auditors, but also as advisors, consultants, directors or even as members of the corporate sector.

In auditing financial statements, accountants have the most intricate knowledge of the financials of companies. They are able to ascertain the drivers of performance and are equipped to provide an independent and objective evaluation on the opportunities and risk profiles of firms. Thus, for instance, in the absence of accurate financial reporting, it would become difficult for banks to make informed decisions about credit allocation unless they have confidence in the information provided by financial reporting. It is the quality, reliability and objectivity of this information which stakeholders rely upon to make informed judgment and allocate resources efficiently.

Transparency is imperative to imbue confidence amongst investors in our markets. The quality of information and the integrity of the market place act as strong modes for brand differentiation. While the quality of information has immediate and far-reaching implications for a particular enterprise, it eventually permeates to the market and the economy as a whole. It is, therefore, not surprising to find

that the accounting profession is being constantly challenged to meet the demands for quality information. As key providers and verifiers of information, the bottom-line is simple: the higher the quality and integrity maintained by the profession, the stronger and more resilient will our markets be.

The investing public in India is at present broader and much more discerning than earlier. A crisis behind closed doors in past decades often becomes a matter of the broadest public concern at present. The globally noticed accounting irregularities at leading corporate entities in recent years have provided graphic evidence as to how much the absence of accurate, timely and comparable financial information can impede the effective working of markets. More generally, the debilitating effects of deficiencies in financial reporting have been amply demonstrated by the spate of financial crises and scandals in recent years. Thus, the importance of integrity of auditing functions for maintaining financial stability is now well-recognised. Professions such as yours could possibly take the lead in self-policing. The mix between self-regulation and regulatory discipline need not be watertight, but instead be flexible to inspire high levels of professionalism and integrity so as to ensure increased transparency and greater accountability. By providing the foundation for compilation of credible financial statements, the accounting profession facilitates market discipline, engenders confidence among various stakeholders and reduces the possibility of misleading information that can disrupt stability of financial systems.

In respect of banks, the Reserve Bank of India (RBI) shares a synergistic relationship with accounting profession. The RBI conducts both on-site inspections of banks as well as technology-driven off-site surveillance of banks to ensure compliance with the prescribed guidelines. In addition, the RBI relies on accountants to ensure compliance with financial reporting requirements. In the course of monitoring compliance with the prudential regulations, the RBI identifies and requires corrections for departures from established accounting standards. It also pursues the auditors' qualified opinion with the banks and their auditors. This serves to provide the RBI with valuable insights on the inhibitors of performance, which can be utilised to advise banks on corrective measures.

Some time ago, a Working Group was constituted by the RBI, chaired by Shri N.D.Gupta, a former President of the ICAI, to identify banks' compliance with Indian Accounting Standards and recommended steps to eliminate or reduce any deviations from them. Based on the recommendations of the Group, guidelines were issued in March 2003 on certain accounting standards. Subsequently, detailed guidelines were issued to ensure banks' compliance with these standards in April 2004. These improvements will further align our accounting practices with those prevailing internationally. I would like to highlight in this context the emerging importance of the accounting profession in view of the impending implementation of Basel-II framework for capital adequacy.

With the opening up of the Indian economy, firms are sourcing finance from abroad through both the debt and equity routes, as also acquiring stakes abroad. The issue of adopting best practices in accounting, tailored to country-specific requirements, has acquired added importance and priority in this context. This demand for greater transparency and more effective financial reporting has placed renewed pressures on those preparing and attesting financial reports to comply with the accepted accounting standards, and also ensure that these standards are properly applied. Since some of the software companies and a few manufacturing corporates from India are now rated globally best, RBI intends to be similarly the best. Needless to say we expect Indian accounting profession to be among the world's best, if it is not already so in any specific aspect.

Many of you would be aware that RBI has been making pro-active efforts to facilitate positioning of international financial standards and codes in relevant areas of the financial system in India. As part of this process and to guide the overall process of implementation of appropriate changes in respect to various segments of the financial system, the RBI had, in consultation with Government of India, constituted a Standing Committee on International Financial Standards and Codes in December 1999. The Standing Committee, in turn, constituted Advisory Groups in ten core subject areas pertaining to the financial system, broadly encompassing the key areas prescribed by Financial Stability Forum. Out of these, the Advisory Group on Accounting and Auditing (Chairman: Shri Y.H.Malegam) compared the Indian standards and relevant statutes with international standards and made recommendations for reducing the gap.

In this regard, it is heartening to observe that the accounting and auditing standards in India are being increasingly benchmarked against international standards. I am also happy to note that the ICAI is making sustained efforts to align the Indian accounting standards with the international ones. A Review of the recommendations of the Advisory Group by the Reserve Bank in December 2004

shows that the gap between International Accounting Standards and Indian Accounting Standards has been gradually narrowing, reflecting the foresight of the profession in recognising the importance of international comparability.

As my remarks would testify, the relationship between the RBI and the ICAI has been mutually reinforcing, where both can draw on each other's strengths and contribute to an efficient and stable financial system. I am happy to state that we have decided to constitute a small group comprising the representatives of the RBI and the ICAI who can meet at regular intervals and sort out pending issues relating to standardisation of audit formats, concurrent audit of banks and empanelment of auditors as well as implementation issue on certain accounting standards.

Before concluding, let me say a few words on the role of auditors in economic reforms. While the reform process had largely emphasised the need for improving the balance sheets, it is very critical that these measures really get reflected in the financial statements and present a true and fair view of the financial position of all entities. The reform process would be evidently incomplete if the balance sheet integrity is not ensured.

Though it is generally thought that the primary responsibility of the auditor fraternity is towards the shareholders of the entity, I believe that in the financial sector in a liberalised environment, their role is much wider. For example, they owe perhaps greater responsibility to all the varied stakeholders of banks, viz., depositors, regulators, banking community within the country as also the banking community outside the domestic market who have to undertake banking/ correspondent relationships with the domestic banking system,; that is, in effect the entire system - domestic and global. As you are well aware, the audit of a banking entity is special relative to the audit of a corporate since banks are universally considered to be special. In the case of a corporate audit, the stakeholders are primarily the shareholders and in case of a crisis, the fall-out would be by and large localised to the corporate entity concerned. In the case of a banking entity, the systemic impact of any crisis may not remain localised to the banking entity but could under certain circumstances translate into a systemic issue with far greater consequences. It would be appropriate to conclude that perhaps a critical link in the successful implementation of the financial reform process lies with the auditors of banks when they ensure that the financial statements of banks reflect the highest level of integrity.

I am sure that the deliberations over the next few days will provide useful insights which could be fruitfully explored to the benefit of all concerned.

We too look forward to benefiting from your deliberations.

I wish the Conference all success.

Thank you.