



CHALLENGES AND OPPORTUNITIES IN THE .NEW MILLENNIUM - FINANCIAL SECTOR PERSPECTIVE

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ABSTRACT

The Indian financial sector has been buffeted by a recent global development in accounting and financial markets. Technology is enabling the financial sector to transfer funds and settle trades across borders in real times and novel financial instruments such as securitisation of debt and derivatives while extending the reach of investment manifold are also resulting in recycling of existing funds. This article examines recent trends in the financial sector and sums up the key issues facing Indian financial professionals.

The financial sector has undergone significant changes over the years and today presents significant opportunities for financial professional. With a rapidly changing economic and regulatory landscape, accountants are today acquiring the coveted status of trusted business advisors, influencing business decisions of entrepreneurs. Having said that, on account of a certain degree of over-reliance placed on professionals in the financial field, the accounting and financial services industry is also becoming significantly prone to litigation as recent developments indicate. This article provides an insight into some of the

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more recent trends in the financial sector, both in India and overseas and examines their implications for financial professionals.

Breaking new ground

The New Economy has given rise to opportunities for financial professional in creating innovative financial instruments, developing software to transact in such instruments and in developing legislation for accounting for such instruments. The desire to generate wealth on a sustainable basis has also led to sophisticated and well-administered form of collective investment vehicles. Governments have also had to keep pace in drafting tax laws to tackle innovative financial structuring, thus presenting tax professionals with planning avenues.

Financial instruments

Businesses have been requiring different forms of financing, depending on their revenue and expense models and the stage at which they are in the business life cycle. While debt and equity have been traditional forms of finance, venture capital has been of relatively recent origin. Venture funding refers to wealthy individuals or companies investing in start-up businesses, which have innovative business models and expect to grow very quickly. It started with the likes of Microsoft, Apple and Sun Microsystems, which required initial funding in order to commence operations in high-technology areas. The intention of the venture capitalist is to fund the venture and once it happens as a business, to cash out at a considerable profit. The dotcom boom witnessed a plethora of venture funds investing in businesses which had untested business models and in the process burning up a great deal of money, since many of the businesses either did not have a revenue model at all or alternatively failed to generate sustainable cash flow.

While venture capitalists have become wiser and more cautious with experience, they require financial advise in determining which businesses are worth investing in, figuring out the price they should pay for the business and in structuring the deal for maximizing post-tax gains. In addition, many of the venture capital funds are based overseas, and investors need advise in routing their investments through from tax-friendly jurisdictions, which also offer them safety of monetary dealings.

With international financing growing in a big way, whereby companies are raising from overseas, it has become necessary to develop instruments that protect the risk arising from fluctuations in foreign exchange rate movements. Such instruments are in the nature of optional, forwards and futures. For instance, a security option provides a right, without an obligation, to buy or sell a certain

security at a pre-determined price at a future point of time. A forward on a currency enables an investor to purchase the currency sometime in future, at a pre-agreed price, irrespective of the then prevailing prices. The vagaries of the stock market, commodities market and currency market have led to the development of these instruments which 'hedge' the related risks. Conceiving these instruments, which are referred to as derivatives (since they derive their value based on an underlying rate, e.g. a security or currency) presents an opportunity to financial professionals who can create value for their clients by minimising risk. Further, pricing of these complex instruments and accounting for them are new areas, where financial professionals can contribute in a significant way.

Investment planning and international tax

With cross border transactions coming of age, investment planning has gained importance in the financial world. Such planning needs to take place at the corporate and individual levels. At the corporate level, companies are increasingly ascertaining low-cost bases of operations and setting up business presences in these locations. It is essential that they structure their investments in these locations securely, so that they retain management and capital control, while at the same time ensuring that the form of business presence makes sense from a tax and regulatory perspective. This typically entails routing investments through a tax-friendly jurisdiction and capitalising on the various investment incentives offered by the country in which the investment is made. In the Indian context for example, foreign companies route their investments into India through Mauritius, and avail of tax incentives offered in India for setting up software or electronic hardware export units.

With barriers of trade falling, Indian companies are also exploring options in setting up units abroad. For instance, many software companies are setting up development centres and marketing offices in developed countries, to acquire greater market share. These companies require advice not only on setting up entities abroad, but also on repatriating overseas profits while minimising the total tax cost, developing a reinvestment plan consistent with the company's growth strategy and distributing profits to shareholders.

Another issue that comes to mind in structuring investments is transfer pricing. A significant proportion - estimated at 60 percent - of world trade consists of trade between related entities (or associated enterprises) of multinational enterprises. Different tax rates and rules between countries provide a potential incentive for multinational companies to structure their transfer prices to recognise lower profits in countries with higher tax rates and vice versa. This can reduce

the aggregate tax payable by the multinational, thus minimising the global tax rate. Transfer pricing deals with the price at which related parties deal with each other, in view of the special relationship that exists between them. Two unrelated parties, independent in their commercial and financial relations, would normally trade with each other, at an arm's length price. Between two related parties, it is assumed that because of the special relationship that exists between them, the transfer price that results from the negotiation will be influenced by that relationship. The arm's length principle provides that pricing of inter-company transactions between related parties should be based on prices that would be paid between unrelated parties in the same or substantially similar circumstances. Therefore, the need to determine an appropriate 'Transfer Price', which adheres to the arms length principle, assumes significance.

Investors have traditionally invested in share or bonds of specific companies and profit from the dividends declared by these companies or from the gains arising from the sale of these instruments. However, investors have, of late, been looking to spread their risks over a portfolio of companies. Further, small investors have also recognized that individually, they are unable to influence decisions of the management of the company, in view of their small shareholding. With the objective of spreading risk and institutionalising individual shareholders, mutual funds have entered the market, serving as undertakings of collective investment in transferable securities. Though the Indian mutual fund market is still in its infancy, investment funds abroad are a major source of capital for companies, while at the same time protecting the interests of the small investor. Mutual funds are customised to suit the risk profile of investors and could accordingly be in the nature of growth funds, which place emphasis on capital appreciation, by investing in companies which are likely to grow rapidly or income funds, which invest in securities which yield constant returns over the long run. Investment funds are easy to enter or exit, as they are mostly open-ended, enabling investors to buy or sell units at any point, at the prevailing Net Asset Value (NAV).

International tax is a concept of relatively recent origin, having developed to protect the interests of revenue and taxpayers alike as companies increasingly transfer funds via jurisdictions which offer them concessional treatment. Companies which set up operations in more than one country are subject to laws of each of those countries. This could lead to potential double taxation, whereby the same profits are subject to tax in the country where operations of the entity are carried out as well as the country in which the entity is situated. To eliminate the impact of double taxation, countries enter into bilateral tax treaties, which specifically provide where and at what rate profits arising from various types of activities would be taxed. Tax professionals are having to deal with this

new area of specialization, which involves acquaintance with the tax treaty network among countries.

Accounting and information technology

Advances in information technology have had a tremendous impact on the financial sector. Practically all financial transactions are backed by information technology in some way or another. On a day to day level, cash withdrawals, cheque deposits and bank statement updates are all processed through the Automatic Teller Machines (ATMs), virtually eliminating the necessity of a physical bank branch presence. The Internet banking facility has also enabled banking to become a 'click and portal' activity rather than a 'brick and mortar' exercise.

Software packages that perform accounting functions have greatly contributed to eliminating calculation errors and manual intervention in the book keeping process. Accounting software, which is normally built using relational databases, is available at varying price levels and functionalities. The lower-end softwares enable the accountant to enter accounting entries and generate books of accounts, while the more sophisticated softwares perform automatic accrual accounting, process transactions infused in the system through interfaces and generate a range of decision support reports for management.

Just as harmonisation of tax law is taking place globally, accounting standards are also being aligned worldwide. The International Federation of Accountants is in the process of getting all countries to adopt the International Accounting Standards, which would enable all financial statements to be cast uniformly. This also presents opportunities to accountants who can venture in the field of outsourced accounting, not only for Indian clients, but also internationally. Indian accounting professionals are of high quality in comparison to their global peers and are in a position to render accounting services to their overseas clients. As it is, companies like GE have established dedicated centres in India to provide financial analysis and accounting services to their overseas affiliates. The automation of accounting and enhancements in communication and connectivity have resulted in financial information being available in real time, across time zones. For instance, listed companies declare their financial results within a fortnight of the end of the accounting year and investment funds revalue their portfolio and declare Net Asset Values every day. Inevitably timing differences still remain, since globalisation has enabled institutions to invest across borders and time zones. So we have a case of an investment fund in Japan having invested US Treasury bonds declaring its Net Asset Value on a given day, with reference to the previous day's opening quote in the U.S. capital markets!

Plumbing the depths

The accounting industry has recently been shaken out of its relatively staid existence, with the public at large alleging that audit firms are incapable of anticipating business failures and hereby losing confidence in the veracity of audit opinions. This has led to wide ranging reform in the accounting profession, which is still underway and the results of which are still far from establishing a fact pattern.

Understanding the business

A vexing issue currently confronting the accounting fraternity is the reflection of business reality in financial statements. Accordingly bodies have placed increased emphasis on understanding the business of the enterprise, so that financial statements in fact truly support the business performance of the enterprise. However, accounting standards have still been unable to cope with advances in financial engineering and ingenuity. For instance, "Special Purpose Entities" are employed by overseas corporations, which need not be included in the financial statements of the enterprise and thus can be used to hide debt and losses from the company's books. Even in India, special purpose vehicles have been widely used, especially to structure foreign investment in certain restricted sectors. While accountants have been seeking refuge in the fact that accounting standards do not provide guidance on several topics and hence the financial impact of certain business issues cannot be ascertained, shareholders and creditors of affected corporations have been holding the accountants equally responsible for business failures.

Auditing and consulting conflicts

Over the years, many audit firms having derived considerable experience and knowledge in dealing with financial issues confronting business, began to provide consulting services to their clients. Consulting services took a variety of forms, including information technology solutions, design of financial systems, human capital services, e-business, legal and tax planning. Audit firms increasingly positioned themselves as end-to-end business solution providers, who partner their clients in succeeding in their businesses. Over time, the revenues from the consulting business grew, to a point where consulting fees overtook revenues from the bread and butter audit practice. This led to conflicts first internally between audit and consulting partners over profit sharing, leadership and strategy issues. More recently, the conflicts became more evident, as audit firms apparently sacrificed the principles of independence, by compromising the quality of audit in order to bag more lucrative consulting business from their audit clients.

The accounting profession has woken up to this apparent conflict of interest, and is in the process of implementing sweeping reforms that will cause the accounting firms to return to their core audit business. In view of the proposed regulation, many of the larger accounting firms are in various stages of spinning-off their consulting practices as stand-alone entities and are returning to their roots as accounting and tax firms.

Audit risk and consolidation of audit firms

The investor community has begun to rely increasingly on audit opinions of large firms for making investment decisions of buying, selling or holding on to scrips. In addition, employees are increasingly investing in the stocks of their employers in respect of pension plans, putting pressure on auditors to provide opinions as to the truth and fairness of the company's financial reporting. Although the composition of a company's financial statements are the responsibility of the management of the company and the auditor can only perform control and substantiate checks to determine if the financials appropriately reflect business reality, the investors have typically trusted the company's auditors in addition to the company, in the event of a corporate impropriety in the financial statements. It has time and again been held by courts that the auditor is a watchdog and not a bloodhound and that the auditor cannot be expected to detect complex schemes of fraud or unethical business practices. However, the inadequacy of accounting standards or guidance on certain issues puts the auditor on the back foot while dealing with complex financial instruments or structuring of special purpose entities where few precedents exist. In these cases, the auditor has to take a judgment call and either align with the management's viewpoint or accounting treatment or choose to dissent, on grounds that are ethical but may not have legal or statutory backing.

Auditors have, in the last few years, been hounded by widespread litigation arising from business failures. To put matters in perspective, if a business model is flawed, there is nothing that the accuracy of financials can do to put the business on the right track. During the dotcom upswing, there were several ideas put forth by entrepreneurs and plenty of funds doled out by venture capitalists, but little attention was paid to whether the businesses had viable revenue models. As a result, the bubble burst, causing a rippling technology meltdown in its wake.

The audit profession lives and dies on reputation, and is paranoid of facing court trials from acrimonious investors who have lost moneys on a business,

which has gone bust. Audit firms have, therefore, been resorting to out of court settlements, rather than going in for a prolonged court battle which could go either way. This has put a strain on their cash flows, on the one hand, and on the other made them realize that they are better off combining practices and aligning together than pursuing individual agendas. Several audit firms have identified correspondents or established members firms in many countries, with a view to spread risk and position themselves as being global service providers. This phenomenon also provides comfort to clients who come to expect uniform levels of service across member firms worldwide.

Due to the increased risk levels in auditing, non-audit practices of accounting firms, such as tax and corporate finance have also had to reconsider if they want to be part of the same establishment or choose to breakaway as independent businesses. In any case, audit fees are likely to see an increase, due to consolidation of audit firms and the higher risks associated with undertaking an audit.

Corporate governance and business ethics

Corporate governance has been discussed time and again and is especially in vogue whenever there are glaring instances of business failures or when investors' funds are inappropriately deployed. Several countries, including India, have legislated corporate governance principles, that are aimed at greater transparency in financial disclosure, providing protection to small investors, keeping investors informed of significant business decisions and performance outlook, greater interaction and responsibility amongst members of the boards and ensuring that corporate actions (such as declaration of dividends or bonus shares) reach the shareholders timely. At the end of the day however, corporate governance is to be practiced, not only preached. It is upto the company in question to have the will to 'think straight and talk straight' to its stakeholders - consumers, suppliers, employees, creditors and investors. In this regard, the formation of investor forums, collective investment vehicles and industry forums can serve to put pressure on errant companies, but it is ultimately up to each company to decide which course of action it wishes to adopt. There are a handful of shining examples of Indian companies which are listed on stock exchanges abroad and have foreign shareholders, which necessarily and voluntarily subject themselves to rigorous disclosure norms, going far beyond the letter of the law. There are on the other hand, myriad other companies where board meetings are a farce, debt repayment is always in default, investors have no idea beyond a window-dressed set of financial statements as to what is happening to the company and promoters enrich themselves while haemorrhaging the company.

Where do we go from here?

Business at the speed of thought

While opportunities and challenges, strengths and weaknesses have always confronted businesses at various points of time, today's business world is moving very rapidly. It takes no time for a business to hit rock bottom from a position of absolute strength. On the other hand, it takes significantly longer for a new player to move to the top of the table, due to intense competition. Having said that, the 4-Es of GE leadership come to mind - the personal "Energy" to welcome and deal with the speed of change; the ability to create an atmosphere that "Energises" others, the "Edge" to make difficult decisions' and the ability to consistently "Execute". These qualities, that have made GE No.1 or No.2 in every business it is engaged in, apply to every organisation and individual in today's context. In addition, with business increasingly running on intangibles - intellectual and human capital, brand, technology and quality - it is important to recognize that the cumulative value of physical assets need not add up to the combined value of an enterprise. Recent corporate deals have witnessed businesses having properties running into millions being disposed of for much less than book value and on the other hand, much smaller companies being valued at high premiums for the intellectual capital and reputation that they bring to the table.

Back to the basics

Professionalism begins at school, where we learn the basics of networking, dealing with competition and inculcating value systems. The British rule in pre-independence India provided a launch pad to the accounting profession in India, leading to the constitution of the Institute of Chartered Accountants of India in 1949. This was followed by the legislation pertaining to the establishment of the Institute of Cost and Works Accountants of India in 1958 and the Institute of Company Secretaries of India in 1980. These bodies today constitute apex professional institutions in the corporate and financial sectors.

The Indian accounting and company secretarial professions having come of age, the institutes have been working continuously at amending the syllabii to adapt it to changing business and public expectations. Examinations are stiff, practical training is mandatory and importance is attached to codes of ethics and professional conduct. The Institutes have also been tying up with Indian universities and colleges, so as to enable these institutions to equip students with adequate knowledge so that they are able to take up and qualify creditably in the Institutes' examinations.

Yet, the Institutes can do only so much. While it can train students to become respectable and competent professionals, it is then left to the individuals passing out of the portals of these hallowed institutions to prove themselves worthy of their alma mater. Continuing professional education and peer review with a maverick approach and harmonising skillsets and knowledge across professions are but a few best practices that Indian finance and corporate professionals have to come to terms with to succeed and win on the global landscape. The blurring dividing lines between information, communication, and entertainment herald a boundaryless world among professionals.