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Make customers pay for the use of regulatory services

Jayanth R. Varma

In India, neither SEBI nor the Registrar of Companies has a system of carrying out a regulatory review of the accounting statements filed by companies.

IT is often said that regulation has a cost but does not have a price. In the financial sector for example, regulatory services are provided by RBI, SEBI, IRDA and other government bodies at the taxpayers' cost and the users of these services do not have to pay for them.

As a result some services of dubious value may be provided though there is no real demand for them. At the same time, some kinds of services that are very useful to the society may not be provided in adequate measure because the Government did not budget for them.

Another result of not pricing regulatory services is that regulators no longer see the consumers of their services as customers to whom they are accountable in the long run. A businessman who stops listening to his customers would soon be out of business, but a regulator need have no such worry as he has no paying customers.

This article argues that several regulatory services can and should be priced. This would increase efficiency, improve accountability and allocate regulatory resources to the areas where they are most valuable. In this article, I shall consider one example of pricing regulatory services: regulatory review of corporate accounting filings.

In India, neither SEBI nor the Registrar of Companies has a system of carrying out a regulatory review of the accounting statements filed by companies. This means that while there are a plethora of regulations about how the balance sheet and profit and loss account should be prepared, there is no system of ensuring that all these requirements are complied with.

In the US, the SEC does have a system of review of accounting filing but the Enron case showed the system in a rather poor light. According to the SEC, the primary goal of the review is to "ensure that required disclosures are set forth in the report and that the disclosures themselves are facially accurate and comprehensible". However, when such review "reveals a troubling item or some indicia of fraud ... staff may refer it ... for further investigation".

It is generally accepted that an SEC review of Enron's filings in 2000 and possibly even in 1999 would very likely have thrown up enough disturbing signals to warrant an investigation. But during the entire period from 1997 to 2001, Enron's filings were not reviewed despite the company's size and complexity.

Review of accounting filings is an important regulatory service that is not provided at all in India and probably under-provided in the US.

I would argue that the best solution to this problem is to price the service. Any body should be able to pay the prescribed fees to the regulator and seek a review of the filings of any

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company. The result of the review when completed should be publicly released and the person paying the fees should not have any priority in receiving this information. The fees can be quite modest.

According to data revealed by the SEC after the Enron episode, the 330 staff in the SEC's corporate finance division reviewed a total of 3,025 annual reports and IPO filings implying that a review requires 0.11 person years to complete. A reasonable estimate of the total costs including overheads of one person year for an Indian regulator would be less than Rs 10 lakh. This would mean that the fees for a regulatory review of an accounting filing in India should be approximately Rs 1,00,000.

Many people would readily pay this modest fee even though the results of the review would be publicly released and would not be the privileged information of those who pay for it. For example, a short seller who expects the results of a review to be adverse would gladly pay for this review after he has established a large short position. A private equity firm planning a large investment would readily pay for a review as part of its due diligence process. So might a potential corporate raider. Thus the success of this scheme would be greatly enhanced by the presence of free short selling and a vibrant market for corporate control.

People might object that such a facility would be misused by corporate rivals to settle scores with each other. I would not worry about this at all. Rather I would be delighted that the crooks themselves are paying the bill for the reviews that keep them honest.

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