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Sustaining Value Creation

Beating Competition

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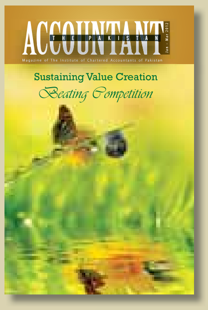


Every organization's main concern is to stay ahead of the competition, however it is now being recognized that the best way to beat competition is through sustainable value creation. The concept of value as a strategic advantage according to John Gamble and Arthur Thompson, authors of **Essentials of Strategic Management** is "The most appealing approaches to differentiation are those that are hard or expensive for rivals to duplicate." Therefore, an effective value creation strategy can beat almost any competitor, globally and domestically. In this issue titled "Sustainable Value creation: Beating Competition" we have tried to put together thoughts and ideas for building a sustainable competitive advantage.

Editor's Letter

Sustainable Value Creation is the new mode of business that addresses fundamental societal issues by identifying new, scalable sources of competitive advantage that generate measurable profit and community benefit.

According to the IFAC Sustainability Framework, Sustainable development is meeting the needs of current generations without compromising the ability of future generations to meet their own needs. Sustainable value creation has three important dimensions for all organizations namely; how viable it is economically, how responsible it is socially and towards the environment.

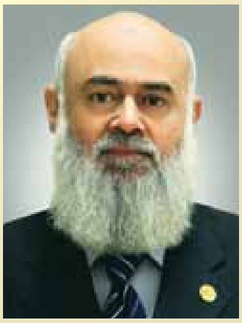
A sustainable future is only possible if organizations recognize the role that they can and need to play. With the transition of the role of the Accountants, accountancy profession and professional accountants are looked upon to integrate and account for sustainability which is essential in creating the understanding of organisational role. The finance function can no longer be isolated in developing a sustainable organization; rather is more involved and therefore needs to be very clear on its role in providing and supporting sustainability leadership.

At this juncture there is need to create awareness of how the finance function can get involved in establishing a business case, we as accountants can influence on behavior and outcomes through incorporating sustainability considerations into strategies and plans, business cases, capital expenditure decisions, and into performance management and costing systems and can be pivotal in creating sustainable values for the organization.

The most successful organizations are those that have a clear understanding of the purpose of any business; create value for stakeholders. In today's economy, value creation is based typically on innovation and on understanding unique customer needs and professional accountants in business and industry can play an effective role in doing so.

Your institute remains committed to providing the avenues for development, one such example being the ICAP PAIB committee which provides opportunities to the professionals to come together, share expertise and broaden their horizon in addition to other avenues for the members.

Adnan Zaman, FCA



President's Page

Corporate sustainability represents the way companies achieve enhanced ethical standards and a balance of economic, environmental and social imperatives addressing the concerns and expectations of their stakeholders.

A sustainable enterprise is one that contributes to sustainable development by delivering simultaneously economic, social, and environmental benefits- sometimes also called triple bottom line. Sustainability, like shareholder value creation, is also a multidimensional challenge, but the positive thing is that many companies have start adopting it as an imperative business practice.

The technical jargon of the last decade was "Corporate Reporting", and this decade is expected to be the decade of "Sustainability and Sustainability Reporting". Environmental consequences resulting from company's actions have a profound effect on the society and people. Reporting these effects will indeed educate general public about environmental issues, and this awareness will hopefully benefit our future generations, although both are still in their infancy.

It is one of the duties, of a regulator of accounting profession, to take all possible steps for creating value in the profession. Cognizant of this responsibility, ICAP has been at the forefront of new developments at the national as well as at regional and international level.

Environmental consequences resulting from company's actions have a profound effect on the society and people. Reporting these effects will indeed educate general public about environmental issues, and this awareness will hopefully benefit our future generations. Keeping in view the rising interest of stakeholders in environmental information, the Joint committee of ICAP and ICMAP has set up an award for sustainability reporting. With the advent of this award, we trust that more companies would be tempted to make sustainability disclosures in their financial statements, and increasing quality of information provided to their stakeholders. We also hope that similar activities and competitions would be established by the regional professional bodies, to create awareness about environmental reporting.

Rashid Rahman Mir, FCA

Transforming Traditional Business Sustainable Value Creation

Muhammad Imran

> There's not enough money that we can give away to be viewed as a responsible company in 200 countries. And we can't do it sustainably. So the only way it can work is to weave responsibility into the core business of the company."
>
> Indra Nooyi, Chairman and CEO, PepsiCo"

Transforming traditional businesses to get competitive advantage is need of the day. CEO's across industries and around the world face common challenges when it comes to the future of business: how to create new growth opportunities, how to improve market share and how to achieve competitive advantage? The pressure on businesses is increasing to respond to these questions along with increased calls for transparency, globalization and intense scrutiny of their impacts on society and more. How businesses have to address these issues; one answer is through corporate philanthropy and employees' volunteerism- obliviously these interventions will continue and the other is to transform traditional business. The traditional business strategies are converging with societal issues and these societal issues are becoming new opportunities to achieve differentiation and growth for business. But the benefits will occur to the businesses that see it proactively rather reactively to be addressed through donations.

The businesses need to recognize the opportunity of playing a positive role in addressing societal issues by seeing those issues not problems, to be addressed through charity, but instead as opportunities for innovation and growth. The decision makers need to learn how to target basic societal problems which traditionally fall outside their scope. The companies need to adopt iterative approaches to implementation when scaling their initial success.

Tapping of opportunities and seizing the full advantage of Sustainable Value Creation requires immediate actions. Today businesses are under severe pressure to meet stakeholder expectations, increase transparency and identify new growth opportunities. At the same time complexity of societal problems and issues which can hamper Company's ability to flourish are rapidly increasing. **Sustainable Value Creation leads toward an elegant decision: whenever and wherever possible, blend the corporate interest with society's interest.** The concept of value creation is simple but the execution of strategy is complex and need to be carefully drafted and implemented.

Moving forward towards Sustainable Value Creation, businesses have to follow sustainable approaches, which provide measurable results, help in scaling and reinforcing the decisions and achieving high performance. The Companies need to follow an approach of planning, managing and scaling a Sustainable Value Creation strategy. The five step approach for Sustainable Value Creation leads to measurable outcomes and achieving corporate objectives.

Identify an opportunity

Determining opportunities in societal issues and converting these opportunities to generate profitable innovation is the most important step on the Sustainable

Value Creation path. Every industry has a core strategy linked with root cause of issues and opportunities for Sustainable Value Creation, businesses need to grasp the opportunity, build approach and then reap benefit while solving societal issue.

Be careful, every societal challenge that affects business does not lend itself to a commercial solution nor every corporate obstacle or strategic issue is linked to a fundamental societal problem. But for many fundamental societal issues, the strategy of developing products and services that address those issues in a way that also generate better financial performance represents untapped opportunity.

Industry	Strategic Issue	Possible Root Causes	Opportunity for value Creation	Approaches Required	Societal and Business Benefits
Materials	Rising costs of extraction and limits to supply	• Low consumer recycling rates impel extraction rather than reuse. • Growing levels of consumption from an expanding middle class.	Invest in convenient and cost effective recycling infrastructure and consumer education initiatives.	• Significant upfront R&D and infrastructure investment. • Partner with communities on education and collection. • Research into consumer attitudes	• Reduced landfill use. • Lower energy and other costs associated with recycling rather than extraction. • Improved recycling technology. • Opportunities for sharing technologies and insights.

The Sustainable Value Creation in some important respects is "business as usual." The function of business remains intact: to identify consumer needs and to create innovative products or services that meet those needs at a price that optimizes demand versus cost. However, what is new is the manner in which Sustainable Value Creation moves businesses beyond some of the restrictions inherent in traditional philanthropy and actually views corporate participation in the solution of fundamental societal issues as a source of competitive advantage. Business leaders believe that most of the business problems of the day are linked to societal problems and can be managed proactively rather waiting for the future when the optional will become more difficult.

Convert opportunity to Action

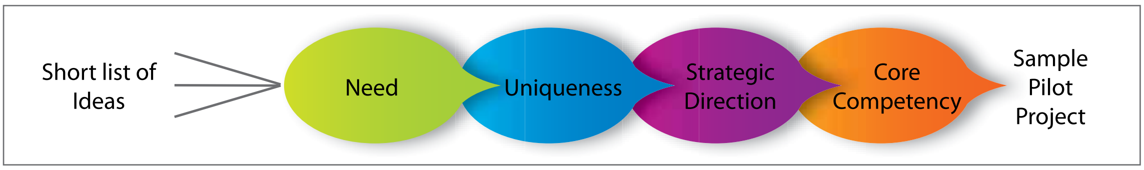
In order to convert the societal issues to profitable ventures, the businesses need to adjust their radar and identify the convergence between core business strategy and societal issues. This adjustment will make company a forward looking one and will help in prioritizing the issues to be worked on i.e. Take action, monitors for some time, disassociate.

Identifying societal issues that could be converted into profitable opportunity is not easy for businesses and most of the businesses face problem of identification of obstacles and opportunities, while converging societal issues and business strategy.

The business can find clues of societal issues having potential of business opportunity from its own financial forecasts, demographic or scientific studies, regulatory trends and media. The internal research teams can be an added advantage. Apart from it the important inputs can be found in customer feedbacks. The businesses have to become more intelligent and have to read between the lines to indentify the pain points and convert these pain points to profitable opportunities. By listening to the constituencies and connecting the dots between macro level societal issues and customer feedback, the businesses will be able to create profitable ventures. The businesses employees may also be a vital source for fresh ideas. The passionate employees having vision for converting a societal issue to profitable opportunity may become an impetus for the business.

Better adjusting the company's radar means seeing more opportunities in wide areas and prioritizing them more effectively. The ultimate objective is to prepare a list of issues into a shortlisted one of those which are clearly a broad need, unique, linked to company's strategic decision and manageable by the company's core competencies.

It's important to try to map some of the interconnected cause-and-affect issues related to needs. This is important step and should not be overlooked. Businesses usually skip this step and come to bottleneck at some later stage when funds have been spent. Each opportunity has advantages and disadvantages. Sometimes an opportunity becomes a part of brand of the organization while sometimes there may be more missteps and less known path. Either way, it is important for businesses to understand, at the outset, whether the projects they have chosen are distinctive or common. The best way is to engage in due diligence to filter the initial opportunities.



The company should take care and does not lead to determine the net present value of a Sustainable Value Creation project at this stage. It may be too early to expect detailed financial projection at the time. At the moment the high level objectives that feed rapid decision making and that involve stakeholders in tracking the success should be defined. The Sustainable Value Creation projects that match with company's capabilities, business know how, employee skills, supply

chain, infrastructure and technology should be worked. Be cautious, the success depends on finding a good fit between opportunity and competency.

Research, Develop and Repeat

These Sustainable Value Creation projects are business strategies subject to same firmness as any corporate initiative. But these need to be planned and managed in different way-like Research and Development project. These projects will require involvement in local communities, taking risks and learning from failures. The learning process will be iterative, taking place in real time. The Company's focus during implementation should be on setting directional goals and establishing a general target rather than specific milestone too far in advance.

While moving further, the company needs to understand the local context in order to reduce the difficulties and increase the chances of success. The project must involve understanding of the context of the population that will be affected. This helps company to align the initiative in line with community requirements and become transparent. The important goal is not to impose a solution but instead invest in communities that are asking for assistance on important societal issues. Determining consumer needs for Sustainable Value Creation projects is challenging and company may have to start work from scratch. The most of the work will be done in the local community rather than at headquarters. The employees may also be source for understanding the local context and building a trust with local communities. The organizations which are well connected with the local community i.e. NGO's may also be involved.

The "research, develop, repeat" refers most important spirit of "learning as you go". The businesses need to adopt this attitude while working on Sustainable Value Creation projects. The ability to go through a less specified process requires some special capabilities among company employees and also requires a culture prone to risk taking and apply lessons learned from setbacks.

Rewire the organization

Once a company has achieved some initial successes for Sustainable Value Creation with a pilot project; the organization needs to be rewired before bringing efforts to large scale strategic change. It involves implanting new structures, communications, incentives and new atmosphere to sustain new behaviors. Rewards, incentives and governance are real points where Sustainable Value Creation will actually be promoted and where it will succeed or fail. The structural changes are required in these three areas to embed Sustainable Value Creation in corporate behavior.

To reinforce and substantiate company's commitment to Sustainable Value Creation, the incentive structures need to be modified so that behavior actually becomes woven into the organization. Employees are incentivized to contribute more effectively to the goals of initiatives. Sound governance is one of the most important ways to embed Sustainable Value Creation even deeper in the way programs are managed and decisions made. Successful strategies are a shared effort that is reinforced through organizational structure of the company. As with any initiative needing to be supported by effective change management, communicating with employees regularly, reporting progress and sharing proofs is essential. Different forums and communication channels should be used as single channel may be overlooked. External communications are equally important in generating excitement and cementing commitment.

The measurement of outcome of Sustainable Value Creation program makes it different from other corporate initiatives that aim to have a societal impact. It is a strategy that is profitable in addition to being beneficial for the society. The companies will need to assess the impact and measure the value that is being produced, beginning with baseline, using right metrics and engaging measurement experts as appropriate. The company should be careful while applying metrics and try to opt for the right sized metrics. Being complex field, the only use of short term metric may lead toward confusion, as Sustainable Value Creation projects have generally longer Return on Investment (ROI) horizons. While determining business impacts, companies should focus on tangible and intangibles. For example, in addition to the harder numbers like costs and revenues, they should consider measures such as reputation, brand value, employee engagement and recruitment, and community reputation. While, in terms of societal impact both quantitative and qualitative data is required.

Reinforce the Value

Keeping the whole company focused and motivated as well as stakeholders committed is a big challenge and requires major commitments on the part of company i.e. inspire employees, guide consumers, educate investors and engage partners.

Inspiring employees is the foremost action as the employees actually transform the organization strategy into action. Many of the employees will quickly understand and support the Sustainable Value creation agenda. Skeptical employees all along the corporate hierarchy may resist the strategy, viewing it as a marketing or branding effort rather than as a substantive program. They may look as an unwanted addition to their day-today responsibilities. Resistance can be particularly acute within middle management, where profit and loss responsibilities emphasize hitting aggressive quarterly targets. The Company CEO must take personal responsibility for communicating the overall agenda of Sustainable Value Creation, taking special care to speak in his or her own, authentic voice. The buy in of the senior level management is also an important factor to inspire and support employees across the organization. CEOs need to motivate and convince the management team, but then must move them to act on behalf of the initiative—becoming both ambassadors and role models to the rest of the company.

Consumer behavior is another important factor as Company can be too far away of its market, creating products that are sustainable but fall too far outside the typical consumer comfort zone, tastes or willingness to pay. In order to handle these issue companies need to build awareness and steer demand among consumers by tacking the consumer concerns, although these may not be best for the company, but if company does not respond its competitor will. Educating consumers requires commitment, vision and direction from the top. The company needs to educate the consumers about the societal impact of the choices they make. The company should be persistent to initial setbacks. It happen sometimes that company designs, tests and develops a product that is believes meets all of the criteria of Sustainable Value Creation but which then fails and does not meet market expectations. The businesses should be inspired to overcome the deficiencies.

Educating investors to understand the Sustainable Value Creation models is important to get support, as strategies that blend societal and business outcomes will likely not be evaluated using the same criteria, as more traditional business opportunities, from the design stage all the way through to measuring success. The criteria that link positive societal impact and business benefits are more likely to be used to evaluate Sustainable Value Creation opportunities. Investors will not change merely because of good ideas; they want to see results. Companies and boards need to tell investors what they are doing and why it is of business value. One way to begin this process is to work with own Boards of Directors, clearly outlining a strategy that seeks to balance the longer range returns of Sustainable Value Creation with short-term business realities. This also requires the use of richer and comprehensive metrics that accesses performance on financial and societal fronts. These metrics includes Global Reporting Initiative (GRI) guidelines, United National Global Compact (UNGC) 10 principles, Organization for Economic Cooperation & Development (OECD) guidelines for multinational companies etc.

Successfully having an impact on fundamental societal problems is something that can rarely be accomplished by a single organization acting alone; partnerships and effective collaboration are always required. This kind of cooperation requires another kind of courage. Collaborations and partnerships can be difficult, but essential, as it is nearly impossible for any entity to address a fundamental societal problem alone. The collaboration may be within sector or cross sector. Many examples of Sustainable Value Creation projects are available throughout the world. Ranging from Novartis work in rural India, Pepsi work in Brazil and recent launch of easy paisa by Telenor- Pakistan through its microfinance bank are some of the examples of Sustainable Value Creation projects in place.

Conclusion

Sustainable Value Creation reestablishes the business norms, by defining new implication in Company's relationship to communities, consumers and markets. Whether a company is moving on account of competitive pressure, demand for growth or to meet stakeholder expectations and new markets, the formation of new era has begun.

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How IFRS can enable ESG Reporting

Naveed Abdul Hameed, ACA

This research paper was presented in the International Summit of South Asian Federation of Accountants (SAFA) held in Colombo, Sri Lanka on June 21st to 23rd 2012. The theme of the summit was 'Sustainability and Corporate Responsibility'. This article has been published in the SAFA Summit Magazine.

The growing needs of investors and other stakeholders on the reporting and interpretation of Environment, Social and Governance (ESG) information has laid the foundation of a new era in the corporate reporting. This is more true for industries having high environmental and social impacts of their business operations. There are numerous reporting frameworks developing globally to address ESG disclosures. However, the consensus of a globally recognized standard framework needs to worked out which might take time. The examples of such frameworks are G3.1 guidelines of Global reporting Initiative (GRI), Communication on progress of United Nations Global Compact and local regulations of many countries.

Environmental matters are becoming significant to an increasing number of organizations and may, in certain circumstances, have a material impact on their financial statements. This is particularly true for environmental liabilities. These issues are of growing interest to the users of financial statements and other stakeholders. Hence the recognition, measurement, and disclosure of these matters are the responsibility of management." — ACCA and KPMG, Environmental Liabilities: Paying for the Past, Providing for the Future, 2002.

The pace at which International Financial Reporting Standards (IFRSs) are being adopted by countries has found to be very fast in the last decade. 2005 was the year of implementation of IFRS in all European countries. In the Pittsburg Summit of 2009 the G20 leaders reinforced the adoption of IFRS and asked for its implementation as global accounting standards by 2011. Considering the increasing focus of institutional investors on ESG factors, a question arises – do the present IFRSs allow for recognition, measurement and disclosure of ESG related information? IFRSs do not cover any specific reporting requirements for governance and social matters. Therefore, the following lines only describe the reporting perspective of environmental issues.

On having a bird's eye view of IFRS, one can conclude that there is no exclusively dedicated standard providing for ESG information. However, on the closer look of these standards and after analyzing various financial statements prepared in accordance with IFRS, one can find numerous requirements in the IFRS which deal with environmental accounting and reporting with focus on environmental assets, liability and expenses. It is worth noting that for many companies environmental issues are no longer off-balance sheet items.

IFRS has a regulatory backing in more than 100 countries. In this way, IFRS is now being seen as having a unique advantage of bringing environmental reporting through regulatory frameworks of many countries. However, the level and quality of environmental reporting varies among the territories and depend upon legal, social, cultural and political factors. This article underpins

the intersection between IFRS and ESG reporting and provides insights on whether IFRS provides enough information to enable a user to assess the financial impact of environmental risks and related opportunities.

Before discussing the technical requirements in IFRS, it is noteworthy that there are certain qualitative features of IFRS which strengthen the case of **fair presentation and disclosure** of ESG matters in the financial statements. Such qualitative characteristics have been specified in the 'Framework for the preparation and presentation of financial statements'. These qualities are:

- Accountability
- Relevance
- Materiality
- Faithful representation
- Substance over form
- Neutrality
- Prudence
- Completeness; and
- Comparability

The following explanation reveals how different International Accounting Standards (IASs) and IFRSs address environmental reporting.

IAS 16: Property, Plant and Equipment

IAS 16 also deals with environmental assets acquired for safety or environmental reasons. Though these assets do not directly contribute to the future economic benefits, their use is the integral part of main operations and necessary to derive future economic benefits from other assets. The use of such assets might also be inevitable by virtue of legal or regulatory requirements in some countries for the processing or manufacturing of certain products. For these reasons an environmental asset may qualify for recognition as an asset and the recognition, measurement and disclosure of such environmental assets shall be made in accordance with IAS 16.

Further, in accordance with IAS 16 future dismantling, decommissioning and site restoration expenses (rehabilitation costs) are added to the cost of fixed asset to the extent that these are recognized as provisions under IAS 37, *Provision, Contingent Liabilities and Contingent Assets*. Rehabilitation costs include the cost of rehabilitating damage incurred on initial acquisition and set-up of an asset, as well as damage incurred over its life. To the extent that damage is incurred in the initial set-up of an asset, the anticipated cost of restoring the site and removing the asset shall be recognized as a provision, and as part of its cost. A provision for environmental rehabilitation costs resulting from damage caused during operation of the asset shall be made when the damage is incurred.

From an environmental perspective land, plant and machinery and vehicles are also significant environmentally sensitive fixed assets in that they contribute to the 'environmental impairment' of natural assets.

IAS 37 Provisions, Contingent Liabilities and Contingent Assets

This standard is very relevant from environmental perspective and some social issues. It deals with provisions and contingent liabilities arising from past events having environmental consequences. Possible scenarios that may give rise to a provision or a contingent liability include waste disposal, pollution, decommissioning and restoration expenses, clean up cost and rehabilitation cost etc. Apart of legal environmental liabilities, the standard also deals with constructive obligations arising out of past events. For example, a company conducts its extractive operations in a country with no environmental legislation. However, the company has publicized its environmental policy, which states that any remediation expenses arising from polluting activities will be supported by the company. In case such incidents occur, the company has a constructive obligation, and implicitly a provision, for the best estimate of these future expenses will be recognized in the financial statements. It should be noted that IAS 37 is currently under review by IASB.

IAS 2 – Inventories

IAS 2 comes into action when highly polluting industries, such as mining, might recognize their waste materials as assets and measure them at the residual value. However, IAS does not allow this treatment and a waste site should not be accounted for as an asset unless additional costs were incurred to convert the waste into a commercial item.

IAS 10 – Events after the Balance Sheet Date

IAS 10 deals with the adjustments / disclosure in the financial statements relating to subsequent events. Subsequent events may also be relevant to environmental issues. IAS 10 states that subsequent events cover both favorable and unfavorable events, including (a) those that provide evidence of conditions that existed at the balance sheet date, and (b) those that indicate conditions that arose after the balance sheet date. For example an entity might become aware shortly after the end of its financial reporting year of a pollution incident, for example seepage of chemicals, that has gone undetected for some time (before the balance sheet date). In so far as the financial implications are assessable then this relates to a condition that existed before the balance sheet date and the accounts must be adjusted to recognize the event. Alternatively the effects of an environmental incident, for example an offshore oil spillage, occurring after the balance sheet date should not be recognized no matter how significant. If such non-adjusting events are material and non-disclosure could influence users then the entity should disclose the nature of the event and an estimate of its financial affect, or a statement that such an estimate cannot be made.

IAS 36 - Impairment of Assets

IAS 36 can be applied whenever a company's environmental assets are suffering impairment, either as a consequence of contamination, physical accident, and loss of contractual rights or depletion of mineral resources or by virtue of change in environmental legislation.

Also, where initial set-up and dismantling costs are included as part of the cost of an asset, and there is an indication that the asset may be impaired, the recoverable amount of the asset shall be calculated under IAS 36.

IAS 38 - Intangible Assets

IAS 38 is linked to the recognition and measurement of intangible assets including environmental assets such as development expenses or greenhouse gases' emission rights, either received as a subsidy or acquired from the market. It also provides for impairment testing of these assets if their carrying value exceed the amount recoverable from use or realization.

IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors

IAS 8 requires disclosure of accounting policies applied by an entity in the presentation of its financial statements. In some cases, a transparent presentation will require specific treatment of environmental issues. As with other items, environmental factors are reported in a way that reflects the substance of the transaction, determined by whether a transaction gives rise to new assets or liabilities. Exposure to inherent environmental risks is an evidence that an entity has an asset. Where environmental issues have a material impact on the financial statements, for example, where an entity is involved in emissions trading, it is often necessary to disclose the accounting policy that was adopted. An entity should also disclose the accounting policy adopted in respect of provisions for site restoration and environmental rehabilitation.

IAS 41 – Agriculture

IAS 41 does not specifically address any environmental matters, but targets a sector with highly sensitive environmental profile. It deals with the recognition, measurement and disclosure of biological assets (living animals and plants) associated with the agricultural activities of an entity. This standard defines agricultural activity as the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce, or into additional biological assets.

IFRS 6 - Exploration for and Evaluation of Mineral Resources

IFRS 6 is linked to extractive activities, which are widely acknowledged as environmentally-sensitive. The standard is a guide to the recognition of exploration expenses, including the recognition of mineral resources as assets. It also imposes the recognition of any dismantling and relocation obligations as a result of the exploration of mineral resources.

Interpretations issued by International Financial Reporting Interpretation Committee (IFRIC) of IASB

Following interpretations also deal with environmental matters:

- IFRIC 1, Changes in Existing Decommissioning, Restoration and Similar Liabilities
- IFRIC 5, Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds
- IFRIC 6, Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment

Narrative reporting

Accounting doesn't do things too well sometimes and that is why the narrative statement is going to be so important in addition to the raw facts...

My view is that financial accounting should show things in the raw, warts and all, and narrative reporting should say: 'Now, let me explain this to you.'... Getting people to do that properly [deliver management commentary that is meaningful], without just boilerplate, will be tough. It is going to be one of the big challenges for the accounting profession.

- Sir David Tweedie, Chair of the International Accounting Standards Board

Narrative reporting supplements and complements financial information by providing insights into an organization's performance that financial statements may not provide. Explaining how operations and ESG objectives are related to each other and how non-financial performance affects organizational strategies and performance can best be achieved with supporting narrative disclosures.

The IASB's IFRS Practice Statement on management commentary, released in 2010, defines the purpose of management commentary:

"Management commentary should provide users of financial statements with integrated information that provides a context for the related financial statements. Such information explains management's view not only about what has happened, including both positive and negative circumstances, but also why it has happened and what the implications are for the entity's future'.

Although disclosure about the financial impact of ESG issues might be included in financial statements, additional disclosure in narrative reporting (in management commentary) provides management with an opportunity to explain the context in which ESG issues have impacted, or may impact, financial conditions and results. In addition to discussing environmental and strategic issues, and matters concerning opportunity and risk, narrative reporting might further explain:

- environmental liabilities and related critical accounting estimates;
- disclosures about contingent environmental liabilities, whether or not disclosed in financial statements;
- asset retirement obligations, including site remediation costs and liabilities;
- financial and operational effects of environmental protection requirements; and
- environmental policies fundamental to operations

Way forward

- The IASB should prescribe minimum accounting information to be provided in relation to corporate environmental impacts, and this disclosure should be governed by a separate standard.
- It would be even more beneficial for IASB to draw the blueprint for separate financial statements addressing a company's relationship with natural capital and environment.
- IASB should play its role in strengthening the environmental reporting to build a strong foundation for moving towards integrated reporting, which will the ultimate corporate reporting model with the convergence of financial and non-financial matters.
- There shall be internationally recognized framework for reporting on governance and social performance.

Conclusion

IFRS does not directly deal with the measurement and reporting of green house gases, energy consumption, water usage and withdrawal, waste and effluents etc (*'non financial'* environmental information). However, if we discuss about the application of IFRS in environmental accounting then we mean environmental *'financial'* accounting (i.e. environmental assets, liabilities and expenses). And in order to ensure effective environmental *'financial'* accounting using IFRS there shall be a strong internal reporting system in place capable of providing sufficient *'non financial'* environmental information using advice from specialists if necessary. In this ways the companies can effectively measure and disclose 'financial' environmental information using IFRS and simultaneously enjoy true benefits of monitoring its environmental impacts by internal *'non financial environmental'* information.

The integration of environmental issues with the financial reporting framework is not only logical from the point of view of stewardship, enabling users of financial statements to make economic decisions regarding environmental impacts on assets, liabilities, income and expenditure; it can also reveal business opportunities, as well as offering a more holistic approach to risk management. This could result in enhanced profitability, reputation and relationships with employees and customers.

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Role of FINANCE DIRECTOR in GROWING ORGANIZATION

Mubeshir Ali Kazmi ACA

The **Chief Financial Officer** (CFO) or **Chief Finance and Operating Officer** (CFOO) is a *corporate officer* primarily responsible for managing the *financial risks* of the corporation. This officer is also responsible for financial planning, record-keeping and *financial reporting* to higher management. In some sectors the CFO is also responsible for analysis of data. The title is equivalent to Finance Director, a common title started in the *United Kingdom and used until recently it is widely used in Pakistan*. The CFO typically reports to the Chief Executive Officer (CEO) and to the Board of Directors and may additionally sit on the board, at times in the capacity of Company Secretary as well.

In Pakistan most of the businesses are managed by the people who usually own them. New businesses are commenced by entrepreneurs who, through some combination of wisdom and luck, create and implement a successful business strategy. The business expands and profits grow and this comes to need to hire professional managers. So people are recruited and promoted to manage it.

> ***We never know we need a finance director until we don't have one.***

When I was twenty one, I decided to become an accountant. That's about the least entrepreneurial thing any human being could choose to do. Because accountants are famously not entrepreneurial, and most people argue that the last thing you want in an accountant is the sort of qualities you might praise in an entrepreneur. However, growing business will not grow far or fast without a decent finance director to cope with the growing bureaucracy and to prevent things getting out of control. In a young business the role of finance management is about much more than finance – it's about people more than profit. The role of finance director in growing business in particular is about the functioning of the top management team, and the distribution of power.

The Finance Director – Why and When?

In today's increasingly challenging and volatile macro world, the role of the CFO has evolved significantly. Traditionally being viewed as a financial gatekeeper, the role of the CFO has expanded and evolved to a strategic partner and advisor to the CEO. In fact, in a report released by McKinsey, 88 percent of 164 CFOs surveyed reported that CEOs expect them to be more active participants in shaping the strategy of their organizations. Half of them also indicated that CEOs counted on them to challenge the company's strategy.

The uneven pace of recovery worldwide has made it more challenging for many companies. CFOs are increasingly playing a more critical role in shaping their company's

An entrepreneur needs to recruit someone with fundamentally different skills and outlook from himself.

strategies today, especially in light of the highly uncertain macroeconomic environments, where managing financial volatilities is becoming a centerpiece for many company's strategies, based on a survey held by Clariden Global.

The duties of a modern CFO now straddle the traditional areas of financial stewardship and the more progressive areas of strategic and business leadership with direct responsibility and oversight of operations (which often includes procurement) expanding exponentially. This significant role-based transformation, which is well underway, is best-evidenced by the "CEO-in-Waiting" status that many CFOs now hold. Additionally, many CFOs have made the realization that an operating environment that values cash, profit margins, and risk mitigation is one that plays to the primary skills and capabilities of a procurement organization, and become increasingly involved (directly via oversight or indirectly through improved collaboration) with the procurement function according to a recent research report that looks at the CFO's relationship with procurement.

This is one of the most critical decisions for the young business because it has a crucial impact on the future direction of the business. Here the main focus is to have a business that is set up to run itself with appropriate checks and balances. Many entrepreneurs find that as the business matures growth is as much about giving up controls as about putting controls in. This can be achieved through delegation and management. However, what is delegated and to whom? This really has a significant impact on the direction of the business.

Some recruit sales and marketing expertise in a conviction that building the top line is the most significant challenge. Further, they are of the opinion that accountants will add to cost not to profit. However, on the other hand, some look to the finance director as the key first recruit to the top team as they want to leave the financial levers of the business in the hands of someone who is really capable of managing it. The right time for the first finance director is of course impossible to define, but is sooner rather than later. A business that wants to be taken seriously by the investors must have an effective finance director influencing business strategy and exerting management control.

The Finance Director – Who?

It is really difficult to recruit first finance director. Before we recruit our first finance director we have to find the current one. Too often the book-keeper is called finance director, but not given the pay rise – always a good sign that they are FD in title but not role. Good FDs cost money. What sort of individual should the growing business be looking for? We want someone who knows how sizeable businesses are run, because this is what we are trying to build. When entrepreneurs are interviewing potential finance managers they ask candidates what they think their most important task will be. The answer they are looking for is something about the need to recruit their own successors. Most Finance Directors of large companies have finance qualifications such as an *MBA* (from a prestigious University) or come from an *accounting* background for example Certified Chartered Accountant. A finance department would usually contain some accountants with *Chartered Accountant* or equivalent status. The *Sarbanes-Oxley Act* of 2002, enacted in the aftermath of several major U.S. *accounting scandals*, requires at least one member of a *public company's audit committee* to be a financial expert.

The growing business needs someone who will influence the strategy and management of the business. This implies someone who can stand up to the founders, tell the story told by the figures with conviction, and provide an intellectual and commercial rigor to corporate decision-taking. It is possible to imagine a finance director without a professional accounting qualification, but only just. The role requires technical know-how in accounting and taxes, systems and controls, financial and human resource management, law and regulation. At the very least a finance director should add significantly to the technical capability of the senior team. If this is delegation, therefore, it is 'added-valued delegation'. If the new director is not better than the team, he won't change it. A qualified chartered or certified accountant is more likely to have the know-how than most, and the certificate helps reinforce credibility.

A finance director has to understand what entrepreneurship is about?

The Finance Director – How much?

Finding the right candidate is a serious challenge – working out how to pay him can be even worse. A worthwhile finance director is expensive in the sense that he might be our highest-paid employee. One successful entrepreneur observes that 'a good finance director is a business angel who brings something worth much more than money.' However, many other still argue that they can't afford one.

A good finance director is expensive – but he will pay for himself within a reasonable timeframe.

Staff is encouraged to focus on those aspects of their roles which will increase their income at the expense of those that do not. For a role like finance director, it can be difficult coming up with performance targets those are personal. The tidiest way of connecting a finance director's remuneration to the performance of the business is to give him shares. Certainly this can be a good step towards aligning the interest of the director with the interest of the business. Using equity as an incentive should not be confused with using cash. Cash is inherently short term. Equity rewards the long term. On the other hand, if we don't think this is a good idea, and there is some exceptionally tax-efficient mechanism around, particularly for the smaller, private business. Remember, however, not to let tax complicate the picture. Tax is a cart, not the horse. Work out what we want to achieve, and then work out the most tax-effective way of delivering it.

The Finance Director – and the rest of the Management Team

The most important challenge when defining the role for any finance director in a young, entrepreneurial business is to define how the role relates to other members of the management team. Joining a team that has been running for a time and is thus already established is different from being there from the beginning. If a team starts with a proper finance director in place from the beginning three's a chance that things will be set up on professional footing. However, joining an established team is a different and difficult experience for any finance director because he is thus both parts of the team and apart from it, working with the others but also for them and supervising them.

Striking up the right relationship with the boss is critical - many finance directors in growing business get off to the wrong start because they fail to understand the nature of the beast they are dealing with. The finance director must also lead and manage the authority's finance function and ensure that it is adequately resourced and fulfils the needs of internal customers. In particular, the finance director is responsible for ensuring that there are high standards of performance throughout the finance function whether it is provided directly, in a devolved environment or on an outsourced or partnership basis. A key aspect of this responsibility is ensuring that finance staff – whether or not they are managed directly by the finance director – are trained for their tasks and that their roles, duties and accountabilities are clear.

Entrepreneurs are increasingly well researched but the knowledge gained has yet to filter into common business thinking. There might be conflict of interest between shareholders and directors. However, a finance director's first responsibility is to act in the interest of the company not in the interest of the entrepreneurs because he is the one who can establish credibility on the small things (expenses etc.) as well as big ones (corporate finance etc.).

It is important for the finance director to understand an entrepreneur's attitude to risk. Entrepreneurs are more likely see themselves as calculated risk takers than gamblers. This may come as a surprise to the public and also to the average finance director. Further, a disciplined approach to management meetings should be implemented sooner rather than later.

Roles and Responsibilities of a Finance Director

- To be able to fulfill their statutory and public interest duties and to ensure that financial arrangements remain robust and effective finance directors must make a positive and effective contribution to an authority in five key areas. In effect these represent five discrete though related roles as shown in the diagram below.

Fulfilling Statutory and Public Interest Responsibilities

- Each of these five roles is critical to the achievement of the finance director's statutory responsibilities and these needs to be recognized in an authority's organizational structure and arrangements. The finance director should alert the authority to any areas in which arrangements adopted by the organization may militate against the discharge of his or her statutory responsibilities.

- Regardless of an authority's structure, it should be remembered that, whilst there can be considerable delegation of authority for financial matters, there can be no delegation of the ultimate responsibility – that rests at all times with the finance director.

The Finance Director – and the Financial Management

To do the job required of financial management, the finance director has to understand the business, its model and commercial drivers – as well as technicalities of financial reporting. Understanding the business is much about capacity and attitude of mind as capability. The finance director has to show that he understands the business. He has to talk cash and then he has to begin

to establish numbers that show the key business drivers. He can add immediate value by passing his own personal analysis of the business to the founders whose success is a secret even to them. A good finance director can influence management policy in all three of these areas;

- Ensuring that people management is disciplined and objective.
- Ensuring that overheads are kept in control and
- Ensuring the business gets the best from its suppliers and particularly that its leverage increases as the business grows

In addition to looking internally at the business's cash generating cash capabilities and changing the dynamics of the cash cycle itself, the finance director will of course find himself in the front line when seeking external financing in the form of debt or equity investment.

> ***The finance director's role starts and finished with business problems. In the middle there is a bit cash and tax, but the business is where it starts and finishes.***

Last but not the least, a good finance director has an important role in setting the right tone for a good control environment, ensuring that good apples don't turn into bad ones.

Effective corporate management enables authorities to pursue policy and service objectives within the law and in a properly controlled manner. Although councilors have ultimate responsibility for agreeing priorities and policy objectives, it is the corporate management team at officer level that is responsible for policy implementation, for leading and managing staff and for ensuring that there is an effective approach to performance management.

Regardless of the organizational and political structure it is important to distinguish between councilors' responsibility for leading the authority, representing citizens and establishing policies and officers' responsibility for day to day managerial and operational decisions relating to the implementation of those policies.

This handy and up to date information cuts through any confusion around the finance director's role in a young business. It explains clearly and concisely the opportunities and pitfalls – and how the finance director's role can be about much more than finance, focusing on people even more than profit.

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Guide to Risk Management

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An investigation into financial risk in a firm cannot be made in isolation and increasingly treasury must come out of its silo and manage financial risks in the context of the firm. Enterprise Risk Management (ERM) facilitates this by taking an integrated approach to risk management. However, although ERM is a fashionable concept, it can be difficult to conceive and even more difficult to implement. Consider the following examples:

- Two divisions of a large multinational firm have traditionally been managed independently. Both have credit policies which are not considered centrally. It turns out that both share a large customer and management decides that the combined credit risk is too large for the firm.
- A firm operating in the transport sector is exposed to the commodity risk in fuel prices. While a response to this risk could be to consider this to be purely financial, an ERM view is to consider how selling prices might be adjusted to cope with the volatility in fuel prices, dealing with it as a financial risk over any shortterm period. ERM takes into account the commercial and financial dimensions.

Enterprise risk management

ERM establishes coordinated risk management objectives with clear links to both the firm's business strategy and to investor expectations. Using an ERM approach, all managers in the firm become risk managers and indeed risk management could be viewed as simply 'management'. The treasurer's speciality is managing financial risk, but crucially as part of the management team. A firm's attitude to risk will be influenced, amongst other things, by:

- *the philosophy of the firm* – many firms are naturally more cautious, conservative and prudent than others, and will try to manage risks down to a lower level of exposure;
- *the financial structure of the firm* – a firm with high financial gearing (high borrowings) is more at risk to market rates such as interest rates and is more likely to take steps to reduce this and other risks than a more conservatively financed firm;
- *the volatility of its cashflows* – a firm with high operational gearing or operating in risky markets is more likely to take steps to reduce other risks, or put another way, a firm with stable cashflows can accommodate increased Financial Risk

  This is largely based on the sector in which the firm operates;
- the actions of its peers and competitors and the business sector it occupies;
- the expectations of the financial community, notably:

  - shareholders; and

  - lenders, including bankers, bondholders and pension trustees;
- the advice given by specialists in various areas;
- the stage of its corporate strategy – for instance, firms emerging from radical change such as an acquisition or a major capital expenditure programme will be reluctant to accept any additional risks for some time;
- the stage of product development, if one product dominates the firm. Thus, for example, an infrastructure or construction project has high risk during the construction phase as compared to the operating phase, similar to the introduction of any new product;

- the size of its risks in relation to some benchmark – e.g. the current year's earnings or the three year strategic plan; and
- natural hedges within its business.

Risk classification

The classic way to proceed with ERM is to list all the risks that affect a firm and map them onto a grid where the two dimensions are a probability of the risk and the severity of the consequences if the risk event materialises. To enable the listing of risks a convenient classification is as follows:

- *business risks* – the risks that arise from being in a particular industry and geography and from the chosen business strategy. Risks include wrong strategy, bad or failed acquisitions, new product failures, poor capital investment decisions, poor product mix, price and market share pressures, loss of key contracts, poor brand management, geographical and political risks;
- *financial risks* – the risks include liquidity (including the inability to obtain further capital), credit and pensions and the market based risks of foreign exchange, commodity and interest rates, as well as some risks that may be also be considered operational such as fraud, errors in administration, IT risk;
- *operational risks* – the risks that arise in the operational procedures that the firm uses to implement its strategy. Risks include; skills shortage, lack of raw materials, physical disasters, quality problems; and
- *compliance risks* – the risks that derive from the necessity to ensure compliance with laws and regulations which, if infringed, can damage a firm. Risks include; breach of listing rules, breach of regulatory requirements (in a non financial firm these include pension regulations and those surrounding utilities), breach of domestic Companies Act requirements, tax issues, health and safety breaches and environmental problems.

Risk response

For each risk there are broadly four possible alternative responses by the firm:

- avoid the risk.
- accept the risk and:

  - retain the risk; or

  - reduce (perhaps to zero) the risk by internal means; or

  - transfer the risk externally;

In deciding how to manage each risk it is useful here to remember that investors' motivation for the ownership of a firm is to seek extra reward from the extra risk compared to putting their money into alternative investments. The firm's response to risk is influenced by this and specifically investors generally expect the firm to take (accept) business risks but equally expect the firm to take action to mitigate (by transfer, management or avoidance) most other risks. This principle generally holds true – but there are several instances where an investor might seek other (financial) risks alongside the underlying business risks. This would be the case where the underlying business model does not provide sufficient returns for equity investors but the added financial risk in the form of leverage achieves the desired returns. This would happen in a Private Equity investment, for example, where investors gear average business returns to high and risky returns. As another example, utilities and property companies typically have high leverage to achieve adequate equity returns. An ERM philosophy is important, as it enables the firm's entire risk management – including business, financial and operational risks – to be aligned according to investor expectations. For example, investors will wish to take the risk of the launch of a new product but will not wish to see the firm sink money into pension schemes because of failed investments or pay fines because of polluting accidents.

This leads us to understand why risk should be managed. If the value of a firm is the future cashflows discounted at the return required by investors, and their required returns are linked to risk, then of two firms with the same expected cashflow, the firm with the lower risk will be worth more. Avoidance of financial distress is another key aim of risk management, and is arguably the most important aim.

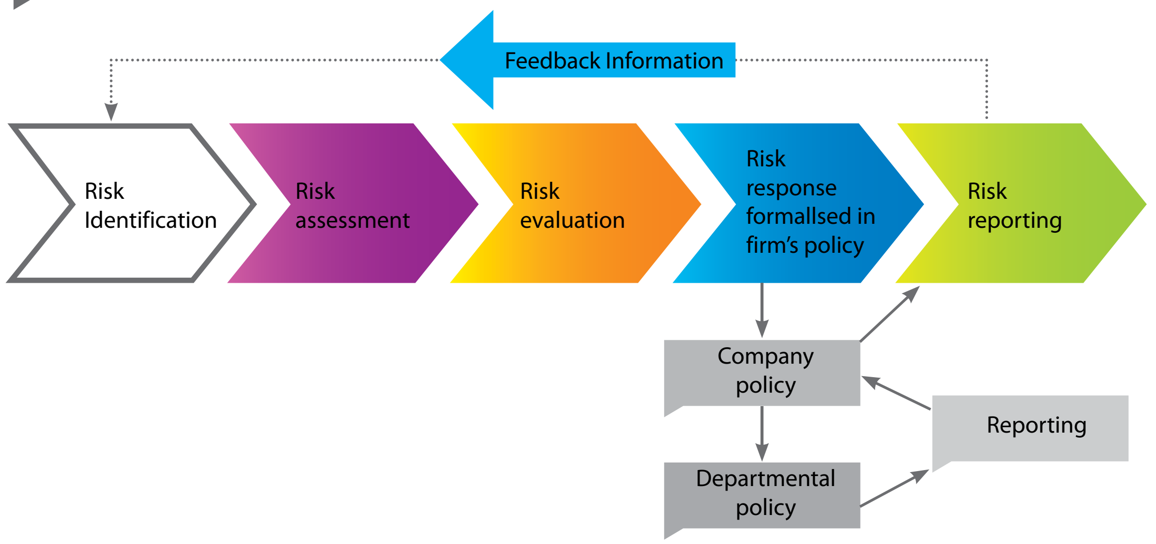
We now need a framework to see how to manage this.

Risk management framework

This framework, shown in Figure 1, has the following stages:

1. identify risks to the organisation's strategy;
2. make an initial qualitative assessment of the risks, estimating the probability and impact of each;
3. make a detailed quantitative evaluation of the risks, to better define their probability and impact and to establish a measure of the risk;
4. set out responses to each risk, taking account of linkages between different risks, formalised in company and departmental (including treasury) policies;
5. report on the outcome of policy execution, i.e. the progress of risk management, specifically to see if the response chosen

Figure I: Risk Mangement framework



has reduced the risk; and

6. periodically feed back and reevaluate the whole risk management process.

With this framework we can now see how we might construct an ERM approach and map risks onto a grid which looks similar to Figure 2.

On this risk map, a firm has identified five categories of both likelihood and severity of risk. It has further mapped seven particular risks on this grid, thus forcing action. Risk 1, for example, has a high priority for action. If a particular risk is not a business risk, i.e. the activity giving rise to the risk is not core to the business strategy, it might be appropriate to avoid the risk. Risks that are not avoided have to be accepted and either retained, or reduced internally or transferred. Typically firms will reduce risks by internal means before transferring any residual risk externally, to save on the costs of transferring the risk.

Each risk requires objectives and a policy so that each layer of management knows what it is trying to achieve, what power it has to do this and how success in management of the risk will be measured. Key Performance Indicators (KPIs) are useful tools here, driving regular reporting. A policy for each risk must cascade down the firm to reach individual departments so that each knows their own role in the management of the response to each risk.

Figure 2: ERM risk map

Severity of Consequence	Likelihood of Frequency				
	Remote	Low	Medium	High	Probable
Extreme		Risk 2		TRANSFER	
High					Risk 1
Medium			Risk 3	Risk 4	Risk 5
Low	Risk 6			MANAGE	
Negligible	ACCEPT AND MONITOR		Risk 7		

By identifying risks individually in this process, there is a danger that each risk is then treated on its own, in fact the very opposite of what ERM is trying to achieve. Each risk should therefore be seen in the context of the firm as it is taken through the framework. An important point here is to recognise how some risks might interact to increase their combined risk and how some might interact to reduce the combined risk. If an automotive manufacturer with two major brands were to launch a replacement model from each brand in one market segment simultaneously, that could well increase risk. Conversely a capital equipment manufacturer making bids for many different projects has increased his chance of gaining contracts, thus reducing risk. Correlation between risks is a key part of modern risk theory.

Financial risk

We now turn to the financial risks in which a treasurer is most usually considered the "custodian" but, as we have seen in an ERM context, not exclusively. In seeking to define financial risks, this is sometimes done by trying to identify where losses or financial distress might be caused by adverse events or market movements. However it can be more complicated than that. Financial market risks in particular can move in favour of the firm and a response to risk may be to seek to take advantage of such favourable movements, rather than simply to reduce or transfer the risk. Sometimes the reduction or transfer of risk might be a mistake. If a firm fixes interest rates prior to a recession in which its profitability falls, it will not be in a position to take advantage of falling interest rates, thus increasing risk of insolvency. In that case an apparent policy of risk avoidance has increased risk, and quite possibly weakened the businesses competitive position compared to competitors who have floating rates. This example reinforces the need to consider risks and their mitigation very carefully.

Liquidity risk

Liquidity risk, perhaps the fundamental risk of treasury, is the risk that a firm ceases to have access to the cash it needs in order to meet its financial obligations as they become due. It has several dimensions. First it applies at the overall level of the firm in its most consolidated form, let us call it "funding" liquidity risk, and it will arise where, as is common with corporate groups, financing is managed at parental level. Second is the risk of breakdown in markets which usually operate smoothly, let us call it "market" liquidity risk. Finally is recognition that, in international groups, liquidity must be available in all jurisdictions where the firm operates. The firm must fund its operations wherever they are in the world (although strictly it could decline to fund an un-guaranteed legal entity). Because survival of the firm is at stake, this is arguably the biggest risk facing the firm. If a firm fails, equity investors (usually) lose everything. If a firm survives (even marginally), there is a chance for equity investors to make good returns.

- *Funding liquidity risk:* This is the risk that the firm fails to obtain funds to meet cashflow obligations and may arise from breaches of covenants within its loan agreements, financial or otherwise. These are mostly caused by failing financial performance, but not always. Other causes include an inappropriate financing strategy, caused perhaps by failure to diversify its funding sources or having too high a proportion of its debt maturing at one point in time. Even if none of these actually happen, a poor business model may lead to an inability to finance or refinance.
- *Market liquidity risk:* This is the risk that financing is disrupted by closed or illiquid markets. It can range from the drying up of commercial paper or bond markets to the inability to do simple foreign exchange swap transactions.

  Liquidity risk is probably the most significant risk that the majority of treasurers have to manage. It is a risk which, if it materialises, may result in the company being unable to pursue its chosen strategy, especially if this requires expansion through acquisition or organic growth, or if it assumes the successful refinancing of existing debt.

Lender relationship risk

Considered by many to be a part of liquidity risk, the fostering of lender relationships is a key to being able to raise borrowing at any time. Banks are often the first port of call but lending by institutions forms an essential part of the lending for many firms in both public and private markets. Since the financial crisis the place of banks in the list of lenders has undergone substantial change. In some sectors, particularly very high grade borrowers, banks do not feature highly as a source of funds, but in the smaller firm sector, there is no real alternative, although banks are in fact reluctant to lend heavily in that sector. Banks themselves are under enormous pressures from revised regulations (notably Basle III) following the crisis. Lenders retain an impression of a firm from previous dealings and so issues of routine communication, avoiding surprises, ancillary business, loan amendments and fair pricing are all factors which can be managed so that the goodwill of lenders is kept. Relationship banking is a technique used by many treasurers to approach this issue.

Credit rating risk

Only few debt markets can be accessed without either a short or longterm public debt rating and even bank lenders (who do not require a firm to have a credit rating) take account of ratings. The cost of this debt finance and, equally importantly, the conditions of the finance, is closely related to the firm's credit rating. Many firms target particular financial ratios to manage credit rating risk and communicate this to the rating agencies through good and easy relationships.

Foreign exchange/commodity risk

These risks can increase profitability as well as cause losses compared to expectations and the treasurer may well respond to risk by adjusting a risk profile to take this into account. The types of risk considered here are transaction risk, pretransaction risk, translation risk and economic risk.

- *Transaction risk:* Transaction risk arises on the items that have been committed to by the firm which will require an exchange of currency or commodity at some stage in the future. They are usually short-term and on balance sheet although large capital projects such as infrastructure projects may extend over several years. The point is that the exposure is certain. Typical examples include purchase of stock in a foreign currency but can also include dividends and royalties and so on. Inter company dividends might give rise to transaction risk but these might need to be considered as part of translation risk (see below).

  Transaction risk requires a treasurer to get out and see what's going on in his firm, a classic case of ERM in action. He or she will not know by sitting at their desk, and even getting reports from operational management may not be as reliable as he/she thinks.
- *Pretransaction risk:* These are contingent risks and arise where the firm has made an offer to enter into a commitment which would become a transaction risk if the offer is accepted. Examples include publishing a price list in the firm's own currency which has foreign currency or commodity costs inherent in it, publishing price lists in a foreign currency under similar circumstances and any case of bidding for a contract with costs which are not certain.
- *Translation risk – accounting:* Firms with subsidiaries with a functional currency different from the reporting currency of the parent (usually but not always in a foreign country) will find that the translation of "foreign" balance sheets and income statements will vary between reporting periods. Translation of the balance

sheets amounts to calculating the accounting net worth of these subsidiaries and seeing how it has changed due to foreign exchange movements. Any foreign currency debt also falls into this basket. Translation of the earnings will similarly vary from period to period.

Treasurers have different views as to whether these constitute real risk. They arise merely because of the need to draw up financial statements and they are a manifestation of the overall business risk. Owners of the firm carry the risk and reward of trading overseas and so must expect such translation differences.

Nevertheless some treasurers respond to this risk with very precise programmes to hedge earnings into "home" functional currency from year to year. Foreign investments are also often financed by debt in the currency of the investment to reduce the size of the net investment and care taken with how to manage the interest and dividend flows.

Where translation risk certainly may cause problems in some firms is where financial ratios (such as interest cover, gearing and other ratios measuring credit risk) may change because of currency fluctuations, causing problems with financial covenants. Additionally it can give rise to a real risk of ability to repay debt or generate dividends. For example, a firm with cash generation in one currency and, debt or pension or dividend obligations in another faces real risk in its ability to service them.

- *Translation risk – economic:* An alternative way of looking at translation risk is to consider the economic value of overseas businesses. The economic balance sheet of a company captures the idea that its businesses are assets, and its market capitalisation reflects the fair value of these businesses (translated at prevailing exchange rates) adjusted for other non business assets and liabilities (debt, pension deficits other liabilities etc). This is effectively the way an equity analyst looks at a company. A company with a sterling listing with a significant US business is exposed here. A significant rapid strengthening of sterling against the dollar, absent any other effects (see economic risk below) would cause a rapid loss of value to sterling shareholders. This would be readily visible if the overseas business were to be sold after such a movement in rates, and would become visible over time as the reported earnings deteriorate on weaker accounting translation of results. This is a major risk area for the treasurer of an international group, and is usually dealt with by holding significant amounts of debt in the related overseas currencies.

- *Economic risk:* This is perhaps best described as the risk arising on future transaction streams. It is essentially about the competitive position of the firm. Market rates may move so that the pricing model of the firm becomes less competitive. The risk reflects the fact that no hedge can be for ever and the firm's marginal exposure to market rates cannot be avoided.

As an example consider a German engineering firm exporting to the US, with its major competitor in the US being a Japanese manufacturer. Such a company has exposure not only to the EUR/USD exchange rate on its transactional and pretransactional exposures, but also has exposure to EUR/JPY. If, in the future, the yen weakens against the US dollar more than the Euro weakens (reflected in the EUR/JPY rate), then the Japanese competitor will be in a stronger position, able to either reduce its price to reflect this, or maintain pricing and make higher margins.

This is an example of ERM in practice as the response to changing exchange rates in both firms is likely to be as much about managing the commercial relationship with the customer over a long period, as about immediate action in the financial markets.

Example

Consider a UK company which has an investment in the US. On the consolidation of this investment, the sterling value of these dollar assets will vary depending on GBP/USK exchange rates ruling at the date of consolidation, and the domestic valie of the related foreign currency earnings of the investment will vary depending on the average exchange rate during the year.

	USD million	GBP million	GBP million
	1.50	1.60	
Gross assets	1,000	667	556
Liabilities	250	167	156
Net assets	750	500	469
		1.55	1.65
Net profit after tax	150	97	91

Interest rate risk

Interest rate risk is the exposure of the firm to changing interest rates. It has three main dimensions:

- changing cost of interest expense or income;
- changing business environment as a result of changing interest rates leading to changing business performance; and
- changing market values of any debt outstanding.
- *Changing cost of interest expense or income:* This risk arises whenever a company refinances its borrowings, e.g. by issuance of commercial paper, drawdowns within a committed bank facility or making a bond issue. Therefore timing can be critical. Companies with debt charged at variable rates (e.g. based on Libor) will be exposed to increases in interest rates, while those companies whose borrowings costs are totally or partly fixed will be exposed to a fall in interest rates. The reverse is obviously true for companies with cash

to invest.

Another aspect of interest rate risk is the risk of changes in margin or spread, usually following a refinancing. Lending margins (spreads) over benchmark bonds rose significantly during the credit crisis and while they have largely returned to pre crisis levels (for investment grade and larger firms at least), firms refinancing bank facilities or capital market debt face this risk, and commercial paper issuers and other users of uncommitted facilities will face this every day.

As a response to both these elements of interest rate risk, the choice of borrowing instrument used can be made to allow a firm to fix or float either element of its overall interest rate. A fixed rate bond issue fixes both the underlying interest rate and the spread for the life of the bond. A committed revolving bank facility fixes the margin for the life of the facility (subject to pricing grids) while allowing the underlying interest rate to fluctuate. Commercial paper issuance means that both the underlying interest rate and the spread will fluctuate. Interest rate swaps are also used as a classic response to alter the fixed/floating mix.

- *Changing business environment:* Changes in interest rates also affect businesses indirectly through their effect on the overall business environment. Generally, as interest rates and thus the cost of borrowing rise, usually as a response by the authorities to high economic activity, economic activity falls and profitability is depressed as firms face lower sales volumes in contracting markets. Some companies may find that they have a form of natural hedge against interest rate exposure. Common examples can be found in the regulated sectors such as the electricity industry or housing associations which are allowed to increase their charges by the Retail Prices Index (RPI). Interest rates tend to be higher when inflation is higher creating a natural offset. Nevertheless, this link can be a complex one, with some leading or lagging or even an inverted link, and it is notoriously difficult to model.
- *Changing market values of any debt outstanding:* Changes in interest rates will change the value of fixed rate debt and investments. Investors in these instruments are heavily affected but it can be a risk to issuers in some circumstances, and is a particular risk for firms with future healthcare or pensions commitments. As interest rates fall, the value of liabilities rises and vice versa. In this area of pension commitments quite complicated forces have been acting in the past few years. Underlying interest rates fell through the credit crisis (as measured by government bond rates), pushing up liabilities by that measure, although the accounting valuation of liabilities did not rise so strongly because of the rise in spreads on (mainly financial) AA bonds. This highlights how difficult it is to measure these liabilities.

Although a corporate borrower will commonly report its bonds in issue substantially at their face values in its financial statements, should it wish to redeem the bonds early (e.g. from the proceeds of a rights issue), it will have to do so at their current market value (or according to other market norms), which may be significantly different.

Illustration:

- Turnover
  To whome does the company sell?
  Are customers price or quality sensitive?
  Do customers have access to alternative products?
  What are the standard terms of business?
  Where does the company sell?
  What is the proportion of domestic and international sales?
  Which currencies are sales made in?
  Are exchange controls operating in certain countries?
  Is there a concentration by country, industry or customer?
  Where are the company's competitors based?
  What currencies do competitors sell in?
  What currencies do competitors buy in?
  What is the competitor's hedging policy?
- Cost of goods sold
  Where does the firm manufacture the goods it sells?
  What goes into what the firm makes or does?
  Where are the company's suppliers based?
  What currency do suppliers invoice in?
  Do suppliers carry currency risk?
- Other costs
  How significant is interest income and expense?
  Are premises, equipment or vehicles leased?
  Are the rental payments effectively fixed rate finance?

Balance sheet

- In which currencies are its major assets and liabilities denominated?
- What is the economin value attributable to these assets/businesses and liabilities denominated in these currencies?
- Are receivables or payables concentrated in a few large counterparties?
- What is the currency denomination of receivables and payables?
- Does the company finance its customers?
- What is the company's financial structure?
- What is the maturity profile of its debts?
- In which markets does it raise its finance?
- What is the fixed/floating structure of its debts?
- Dose the company have debt that includes financial covenants?
- What impact does the pension fund have on finances?
- Does the company have cash on deposit?

Counterparty risk
Counterparty risk, also known as credit risk, is the risk that a counterparty fails to perform its contractual obligations. It is important in treasury transactions, primarily in the placing of deposits with banks and foreign exchange and derivative transactions. It is also important in customer and supplier relationships. If the counterparty fails, financial loss to the company may result. Counterparty risk is clearly best managed on a companywide ERM basis to cover all instances of exposure, in much the same way as banks treat their corporate customers. In particular, it is easy to conclude there is no major single debtor risk when looking at a company by component operating divisions, but aggregating across divisions may present a different picture.

Other financial risks

Pension risk
This risk is covered elsewhere in this Handbook but is almost entirely based in defined benefit schemes and their equivalents around the world. The risk arises mainly in the changing underlying market and economic variables affecting assets and liabilities in a scheme, which is separate from its sponsoring firm. A further risk arises, however, because a deficit can give rights to the scheme and can impact the ability of the sponsoring firm to pursue its strategy. This is usually found in the case where a sponsoring firm wishes to increase its financial risk, through a leveraged buyout, for example, or by gearing up to make an acquisition.

Weather risk
This risk reflects how a business is affected by weather. Although the risk can be transferred into the financial (and insurance) markets, the main problem both for economic and accounting purposes is establishing an appropriate correlation between business performance and the weather at the defined reference points.

Operational risk in treasury
This risk arises as a byproduct of financial risk management activity, which necessitates the existence of a treasury department or treasury type activities undertaken by any person. It can be categorised as arising broadly from external events/business discontinuity, error or fraud.

External events/business discontinuity
Strictly, external events refer to events entirely outside the business, such as flood or seismic events, while business discontinuity is nearer the business, such as communications breakdown or market interruption. The effect of each on treasury is much the same.

Error
Many different types of error can arise in the day to day operations of treasury, from making transactions the wrong way round (e.g. buying instead of selling), making them in the wrong amount, paying the wrong counterparty in a transaction, failing to fund expensive overdrafts and so on, to preparing reports on the basis of wrong information, leading to incorrect decisions.

Fraud
Fraud is clearly the risk of misappropriation of funds or, also quite common, the inappropriate taking of risk decisions, such as taking large positions.

Management of financial risks

Remembering the order of approach in dealing with risks:

1. identify
2. assess
3. evaluate
4. respond to each risk with a policy
5. report; and
6. feedback

We now consider how the treasurer may deal practically with the financial risks we have seen.

Identification of financial risks
This is best approached on a "bottom up" ERM basis, and the treasurer should get out and about to operating divisions/units to find out what they perceive to be the risks to their objectives, although the treasurer should have a good understanding of what to expect. There will also be some risks, e.g. translation risk which are "centralised" and can be viewed as 'ownership' risks. Liquidity should be viewed from all directions.

One common approach is to analyse the income statement and balance sheet on a line by line basis and identify those financial risks which apply to each line. This analysis might be conducted with the set of questions illustrated for each main subject.

This approach might usefully be extended to the cashflow statement to check for any obvious liquidity or other issues such as changes in working capital, and investment or disposal programmes. Other approaches (more suitable for discussions with nonfinancial personnel) may be to identify key business drivers or business processes and analyse the financial risks inherent in those drivers or activities.

Assessment of financial risks

To map risks onto the ERM risk map requires them to be initially assessed for severity and probability and is essentially the first stage in ranking them for priority treatment. Risk assessment is a qualitative attempt at ranking risks by assigning them an initial probability and impact, and plotting them on a risk map such as that illustrated above. The process sets a priority order (from high probability/high impact to low probability/low impact) for the more detailed risk evaluation phase.

Evaluation of financial risks

Evaluation of financial risks takes the assessment to a further stage of analysis and, crucially, requires the creation of a measure of the risk. This measure is important because it allows the creation of an objective for that particular risk. Thus in liquidity risk we may not simply say that a firm has sufficient cash for its needs but we should measure the headroom (cash and undrawn facilities available) over the next say, 18 months. With a measure, even if qualitative, we can design a Key Performance Indicator (KPI) for that risk and then target a particular level and see what effect certain actions have on that KPI and use it as a basis for reporting. Examples of measures that might be used in risk management could include:

- Probability of interest cover falling below threshold as a measure of interest rate risk.
- Value at risk from transaction exposures.
- Number of nonbank lender meetings held every year and participation at meetings.
- Size of panel of banks to be derivative counterparties.

Some of the quantitative tools used at this stage include sensitivity analysis, scenario analysis and mathematical techniques. Qualitative measurement may often also be used. Whatever the process or technique selected for measuring or assessing financial risk, it should be appropriate in the context of a company's overall governance, control and risk management process.

- *Sensitivity analysis:* This technique assesses the impact of a notional change in the market rate or price of the underlying risk. It is often made by comparing the magnitude of such notional changes against a benchmark such as the underlying budget or forecast for the revenue, cost or balance sheet item.

  For example, Company A has USD 500 million of borrowings all at floating rate. It measures the risk of borrowing at a floating rate by assessing the impact of a 1% increase in US dollar interest rates – USD 5 million. This would be evaluated in the context of budgeted interest expense for the year of e.g. USD 27 million and budgeted profit before tax of USD 100 million.

  The same approach can be applied to foreign exchange, commodity, equity risks and other financial risks which are dominated by financial prices.

- *Scenario analysis:* This assesses the impact of a notional change in a number of market rates or prices which may affect multiple risks. This assessment can again be made by comparing the magnitude of such changes against a benchmark such as the underlying budget or forecast for the revenue, cost or balance sheet item. Scenarios can be run using computer models to change a variety of input variables in a simulation approach; or it can be run on a qualitative basis. "What effect might an extended recession/ speedy recovery have on the price of oil?" "What are the implications of the oil price for the strength of USD?"

- *Mathematical techniques:* These include techniques such as Value at Risk (VAR) and Monte Carlo simulations, touching also on scenario analysis. VAR is a relatively simple technique to source a single number for the risk in a portfolio at a certain confidence level. It does rely on being able to use certain statistics for each asset class such as volatility and correlation between asset classes, which can be difficult to source and use with confidence. It does, however, use probability, which sensitivity analysis and scenario analysis do not easily accommodate. Monte Carlo techniques use multiple scenarios to find a distribution of possible outcomes in a particular case. Such techniques have been used in the analysis of

Example: Policy construction

Item	Remarks
Policy name	Give the policy a name
Policy objective	Identify the risk the policy is to address
Policy direction	Give the overall direction of approach to these risks
Risk measurement	How is this ris measured
Bench marking	Establish externally available
Responsibility / Oversight	At what level / who should have ultimate responsibility for the management of this risk?
Procedures	What controls or procedures can be put in place to control this risk?
Decision making	Provide an overall framework for decision making by managers and staff
Policy key performance indicators (KPI)	Select policy KPI(s) to be used to measure the risk and monitor performance. What target is selected for the KPI?
Reporting / feedback	How should performance against the policy KPI(s) selected above be reported / fed back?
Continuous improvement	What procedures are required to ensure that the policy is kept up to date, is adhered to, and has the desired effect?

defined benefit pension schemes for many years but have not been widely used in the corporate arena or in ERM. They are a helpful tool – but they have some serious limitations and need to be used appropriately.

- *Qualitative measurement:* Not all financial risks are influenced by changes in market rates and prices. Examples of such risks are bank relationship risks and liquidity risk. A firm may assess the significance of these risks according to their potential impact on its strategic objectives if they were to arise. For example, the likelihood of being unable to raise longterm finance is likely to have significant implications for a company with an expansionary strategy involving substantial amounts of new finance.

Policy response

The response of the firm to a particular risk should be set down in a policy. One example of the policy construction could be as in the following example.

This policy relates directly to a risk, and tells us all we need to know about how to manage it, from measurement to who has authority to make decisions to what the target is for the measurement, i.e. the KPI. It concludes with how the KPI is to be reported and what can be done to improve the process or modify it as circumstances change. Examples of targets for KPIs leading on from the measures shown above could be:

- Interest cover to be greater than 3.0 on a 95% confidence basis over an 18 month period.
- Value at risk from transaction exposures to be less than £100,000 on 95% confidence basis over the life of the exposures.
- Nonbank lender meetings to be held every six months with target of 30% participation of lenders in the register.
- Six banks always to be available as derivative counterparties.

Reporting and feedback

The process of reporting and feedback are simple in concept and should be based on the measure and KPI selected for the particular financial risk. Feedback is crucial to manage any weaknesses in either the whole risk management process or the particular risk being reported on and is vital to keep risk management aligned with overall enterprise developments. Without reporting and feedback the process will become sterile.

Conclusion

Financial risk, often seen as the preserve of the treasurer, needs to be seen in the context of the firm. Plenty of techniques are available for the management of financial risk but the treasurer needs to ensure that the processes used are always approved at the highest level of the firm, with easy to understand targets and applied rigorously, including reporting so that all layers of management are kept fully informed. The treasurer can then be seen to be fully contributing to the success of the firm in reducing risk.

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Towards a
Level Playing Field

(a discourse by Fuad Azim Hashimi – President & CEO, Pakistan Institute of Corporate Governance, April 2012)

A level playing field is simply a situation which offers no advantage to any particular side or group or person. In terms of a national economy, it is foreseen as a situation in which all competitors are in a position of equal strength or weakness.

Why talk about a level playing field in the context of a national economy. Basically, private enterprise is central to economic growth in a free market economy. However, for domestic firms, Public Sector Enterprises (PSEs) – also called State Owned Enterprises (SOEs) – are realities as is the foreign investor.

Hence, a level playing field avoids market distortions, increases competitiveness and improves the investment climate.

Most Asian economies are similar as regards the shareowner characteristics of domestic firms, SOEs and multinationals operating in their countries. One does not truly see the broad-basing of shareholding as is prevalent in the developed economies where control can still be exercised with a share ownership of less than ten percent. So what then are the priorities that have been identified by such Asian economies as essential for a level playing field between private enterprise and SOEs.

- Complete the corporatization process and harmonize SOEs legal status
- Develop a structured and transparent board nomination process for SOEs
- Clarify SOEs business objectives and make non-commercial ones explicit
- Ensure SOEs are subject to a robust audit system
- Actively monitor and benchmark SOE performance
- Avoid interference by Government in SOE management
- Increase competencies in SOE boards
- Provide proper training for SOE board members including at induction
- Develop performance evaluation for SOE boards

One can argue that equally important and essential for a level playing field are the following:

- Ensure an arms length relationship between SOEs and state-owned banks and financial institutions
- Increase the independence of SOE boards
- Require large SOEs having substantial public interest to be as transparent as listed companies
- Publish aggregate reports on state ownership
- Ensure that SOE boards are actively engaged in shaping the strategy of the business

Some of the initiatives taken by Pakistan to address the foregoing are noteworthy like the implementation of rules for regulating public procurement of goods, services and works for the public sector, the institution of the Competition Commission in October 2007 and the issuance of the draft Public Sector Companies (Corporate Governance) Regulations 2012. Without detracting from any of these or other initiatives like the formation of the Task Force by the Economic Recovery Unit of the Ministry of Finance, there are some final thoughts that need to be importantly considered to bring about the desired level playing field between private enterprise and SOEs.

- Separate ownership from ministerial control that may influence market regulation in favour of SOEs
- Allow the independent boards to select and appoint the "right" professional person for the "right" job especially the CEO
- Withdraw any exemption of SOEs from applicability of general laws
- Lay material information in annual reports especially relating to company objectives, associated risks in fulfillment of such objectives, financial guarantees given by the state and disclosure of related party transactions
- Recognize all stakeholders of SOEs
- Make the ownership entity additionally accountable to parliament and subject to state audit

In closing, while it may not be possible to remove all the bumps and holes – and just as every related party transaction need not be bad for business as long as conflict of interest is adequately addressed - every attempt must be made to mitigate risks related to state ownership of business.

Greater Expectations

Saquib Shirazi

As the investment landscape in Pakistan continues to remain uncertain, the economic prospects appear challenging. The civil society seems frustrated while the political leadership is pre-occupied with non-issues. Much of the needed reforms and improvement in governance remain a distant dream. However, the markets are still strong - and growing!

Reasons for this paradox are understandable. Pakistan is a consumption led economy. Given the large population, the domestic market potential is the opportunity. Rural areas have benefitted from the agriculture commodity boom. Despite the floods, the higher farm income has helped cushion inflationary pressures. In contrast, urban areas' purchasing power has reduced due to the rising food and petrol prices. Electricity and gas shortages have added to the daily woes. However, the flow of foreign remittances keeps the retail and service sectors ticking. Informal credit has also become available. A rising trend in the sale of consumer durables is thus not surprising. Sale of motorcycles, for example, has risen from 100,000 to 1.5 million units in less than 10 years. Apart from textiles, some other industries are also gaining economies of scale and within the next 2-3 years, should become regionally competitive. The progress is despite the inefficiency of the public sector enterprises - power, energy, rail, and aviation - which has put the private sector at a significant disadvantage. That, in turn, has limited the average economic growth to a disappointing 2.5 percent over the last four years.

Resilience, innovation, entrepreneurship and a high work ethic remain the hallmark of Pakistanis and its private sector. The economic potential will remain untapped unless investment is accelerated. Foreign direct investment can help bridge the gap to some extent. Access to foreign markets and aid will remain essential, especially to help improve infrastructure, health and education. However, the sustainable Pakistan growth story should focus on self reliance – on the back of private sector's entrepreneurship, people potential, local market access and conversion of investment from "a basic level to a value added level" in both agriculture and manufacturing. A thoughtful approach to enhancing regional trade can also unleash a win-win scenario.

The judiciary and the media can prove to be an important catalyst if the combined weight encourages the political leadership and the establishment to focus on improving Governance and Institutions. The youth is demanding change. It expects an economic vision that helps create jobs, patronizes the formal economy and generates revenues for the much needed investment in social safety nets. Examples of countries like Indonesia give people hope for change. An atmosphere of Greater Expectation is building up as people look forward to a better future.

Strategies For Raising Funds Through Financial Instruments

Sirajuddin Aziz

Since the Asian crisis, considerable attention has been paid to the role of corporate bond markets in overall financial sector stability and economic development. Several studies have found that financial market development is correlated with economic development. Financial markets are the surest route to growth and stability; innovations in financial instruments provide an important and essential contribution to the sustained and rapid growth of market economies. With this concept forming the premise, the article will outline the importance of Corporate Bond Markets and the development of the Fixed Income Instrument Market in Pakistan.

Companies have four basic financing options:

1. Retained earnings,
2. Bank borrowings,
3. Corporate bonds, and
4. Equity.

In emerging markets, including Pakistan, over 80 percent of corporate financing is in the form of bank loans and corporate bonds fulfill only a portion of external financing for firms. The corporate bond market in Pakistan, similarly, is still in its early stages of development, with total public corporate debt issues accounting for just over one percent of GDP.

Several reasons highlight the importance of the Corporate Bond Market, the prime ones being:

i. Corporate bonds serving as a source of long-term/ alternate funding
ii. The competition it serves to the banking sector
iii. Its role in contributing to the overall stability of the financial sector

** Please note that the article does not contain citations/ references.*

The primary reason that underscores the significance of developing corporate bond markets is that they provide an alternate source of external funds for the private sector other than equity and bank borrowing, which also enhances financial stability and efficiency of credit allocation. This alternate source of financing, in the words of the former Federal Reserve Chairman Allan Greenspan, acts as a "spare tire" for the economy. For example, after the Asian crisis, the weak banking sector provided an impetus to development of the corporate bond markets in emerging Asia. By diversifying their source of funds, companies can adjust their borrowing between the banks and debt markets.

The complementary roles of corporate bond markets and banks can ensure financial stability even if one channel of financial intermediation is under stress.

A corporate bond market can also enhance financial sector stability by mitigating rollover risk and interest rate risk for the borrowers. In case the interest rates are raised due to monetary policy or exchange rate considerations, the firms which rely on short term bank lending will face higher debt servicing costs at rollover and may be unable to borrow in case of a credit crunch.

In contrast, firms which issue longer-term securities have access to capital at more predictable rates.

The deepening of domestic bond markets – including the development of domestic currency and corporate bond markets with longer maturities – remains a key challenge for many emerging markets. These indigenous efforts have received international support, e.g. the G8 'Action Plan for the Development of Local Bond Markets in Market Economies' and initiatives of development banks, such as the ADB, to issue regional bonds. This brings us into the arena of financial innovation and the promise it holds for the development of financial instruments and the overall market. Financial innovation is truly welfare enhancing if it brings about a reduction in the cost of capital WITHOUT a commensurate increase in systemic risk. The benefits of relatively broad and deep capital markets, complemented by an active derivatives market, can be measured in terms of factors such as:

- lower pricing,
- reduced cost of capital,
- mitigated risk exposures,
- broader access to capital and
- increased liquidity, among others.

Innovation ought to make the:

- movement of capital more efficient,
- risk management more targeted,
- hedging better matched and
- trading less costly.

Financial innovation also ought to contribute to:

- better management and transfer of credit risk,
- the unbundling and tranching of risk,
- improved liquidity,
- more optimal portfolio diversification, and
- broadened credit risk dispersion.

However, financial innovation is not without risk and, as has recently been illustrated by the US sub-prime fallout, can even create or exacerbate risk. Financial incentives at the individual level, coupled with advancements in technology and financial engineering skills, can result in situations where new instruments, vehicles and strategies outpace the existing market and regulatory infrastructures. Such developments have the potential to present challenges for both market participants and supervisors. The transfer of risk to unknown counterparties could create concentration of risk exposures, within or outside the regulated financial sector, especially in a relatively small emerging-market economy. The ability of transferring risk relatively easily may make debt originators less diligent, while investors may not fully understand the products in which they invest and the risks that they are taking on.

An advantage for emerging market countries in pursuing financial innovation and adopting synthetic or structures financial products is that they can learn from the mistakes of others and hence, shorten the learning curve and development trajectory for themselves.

Emergence of fixed income markets is a recent feature, predominantly gaining traction after the 1970 period. The perpetual cycles of crisis that emerged on the financial horizon in the 1990s stressed the importance of diversifying the risk profile within the financial system. Catering of this idea was identified with addition of a fixed income market as an alternate source of funding through the banking and equity sector. Hence, with this perspective, development of the Fixed Income Market has attained high importance in the new financial market architecture.

Financial markets that mobilize domestic savings and efficiently allocate these and foreign inflows to the most productive investments have long been recognized as key drivers of economic development. Emerging markets have greatly increased the efficiency of and access to their financial markets, which shall remain crucial in undertaking the substantial investments needed to stimulate and sustain growth and employment generation over the coming years.

Country Context

The eras of financial market developments in Pakistan can broadly be segregated into:

1947-1960,
1961-1970,
1971-1990, and
1991 to date periods.

The 1947-1960 period was marked with private sector development, however this trend was overshadowed in 1961-1970 when Public Sector Development Institutions overtook. This trend sharpened in 1971-1990 when private sector developments altogether shrunk and banking industry came under Government control. Post-1991 period witnessed liberalization stance of the Government and market-based reforms.

Growth of fixed income market in Pakistan also followed the pattern that was marked with private sector development, nationalization, and liberalization in the post-independence to 1990 period. The initial phase lasted up to 1990, when Federal and Provincial Governments used to borrow on tap instruments with predetermined rates. The main thrust of Federal Government borrowing was through captive funding. Large statutory preemptions and borrowing from the SBP at highly concessionary rates enabled the Governments to finance their large fiscal deficits. In such an environment the only tool available to counteract was to make successive increases in Statutory Liquidity Requirement (SLR) and Cash Reserve Requirement (CRR), so as a whole there was very little scope for development of Government Securities Market in Pakistan that could provide benchmarks for private sector to play their role in development of Capital Market in the country.

To cover non-banking segment, Prize Bonds were introduced in 1960 followed by various NSS schemes, however they were no alternate to market based instruments as they were all on tap.

Onward 1990, market-based Government Securities came in to existence. With the introduction of long term paper in 1992 (FIBs), long term yield curve came into being giving opportunity to the Corporates to come up with their instruments that became reality in 1995 with the Issuance of First TFC by Packages Limited, however actual pace gained momentum onward 2000, with the introduction of long term instrument i.e. Pakistan Investment Bonds (PIBs), but the pace is still very slow with many challenges still to overcome.

And so, this brings us to the question: What are the Essentials for Developing Fixed Income Instrument Market in Pakistan?

1st area required for the development of fixed income bond market is to have well-functioning Money Market knitted with well-directed Monetary Operations.

In case of Pakistan, the monetary tools being used currently are Auctions of Government securities, Open Market Operations, Reserve Requirement, Swap and Discount window. However, the most active tool being used for managing very short-term interest rates is Open Market Operations (OMOs) that are called by the SBP as and when market conditions desire. Under OMOs, SBP targets Monetary Aggregates by adjusting banks' reserves. But for interest rate signaling, auction cut-offs of Market Treasury Bills (MTBs) are used and in this respect 6 months MTB instrument is considered prime.

Monetary policy transmission mechanism adopted in Pakistan is that of targeting the monetary aggregates, therefore perfect control over interest rates cannot be obtained at any point in time (as only one variable can be controlled directly, either price or quantity). In this framework it is assumed that through restricting the money supply, interest rates can be controlled effectively. This creates volatility as perfect control over interest rates cannot be achieved by adopting this mechanism, which is not conducive for development of Fixed Income Market in Pakistan.

Some suggestions …

1. To improve Management of Government cash flows to maintain better liquidity management by the Central Bank.
2. Issuance of Securities for both Monetary and Fiscal policy purposes.

2nd area required for the development of fixed income Bond Market is to have Issuance Strategy, Market access and Debt Management Framework right in place.

Several jurisdictions have systematic patterns for the issuance of Government Bonds in terms of regular calendars for issuance, auctions, and frequency of issuance. China, Chinese Taipei, Korea, Malaysia, New Zealand and Singapore provide the annual issuance plans mostly by the end or beginning of each year, or at the budget time each year. The annual issuance plans cover at least issuance size and potential new issues for the New Year while the other details are announced later. Hong Kong, Philippines and Thailand provide issuance calendar quarterly. An issuance calendar for the next three months is always available in Japan.

Contrary to these practices, though 3, 6 and 12 months T-bills auction is held each fortnight with known track to the market, targets are announced only two days prior to auction date. Since T-Bills are used as a monetary policy instrument, targets remain at the discretion of the Central Bank. As regards Long-term instrument (PIBs), their auctions are scheduled each quarter. This situation reflects need for lots of reforms to be made at DPCO's end for their capacity building and raising their analytical skills in managing GOP debt portfolio which is highly skewed towards shorter end of the yield curve creating roll over risk for the GOP and distortion in yield curve essential, for the development of Fixed Income Bond Market in Pakistan.

Some suggestions …

1. To define and adhere to the principles of broad market access and transparency in Government funding operations.
2. To define clear objectives and debt management strategy that involves market finance and introduction of risk management objectives.
3. To build sound institutional framework for debt management with appropriate governance structure.
4. To identify how technology can be used to create new channels for securities distribution.

3rd area required for the development of fixed income bond market is to have Benchmark issues in the market.

Number of benchmark issues in G-10 countries varies from 1 to 12 whereas, Japan has only one of 10 years maturity bond while on other extreme, Holland has 12 benchmark issues with short term maturity to long term maturity. Asian emerging-market countries experience tells that prior to 1997 crisis, except China and Philippines, most of the East Asian Emerging-market countries were not active issuers of the Government Securities as they were running fiscal surplus, however now all countries including Hong Kong are issuing securities spanning from 28 days to 10 years. Reopening operations are carried out in almost all countries like France and New Zealand whereby same maturity bond is offered in the consecutive auctions for a year or for more than one year.

There is a need to strike a reasonable balance between short and long term borrowing by the GOP to create effective benchmark issues in the market. This is not strange that by following this strategy, weighted average duration of the GOP domestic debt portfolio is just about 1.1 years, whereas in Sri Lanka it is 1.71 years and in India it is above 5.0 years. In developed countries this duration is mostly above 8.0 years.

Buy Back and reopening programs can also be established.

4th area required for the development of fixed income bond market is to have diversified Investor base.

Experience of developed and developing countries in diminishing reliance on captive source of Government Funding reflects that until 1980s most of Western Europe and Anglo American countries were relying on this source. Recent example is of Singapore, where Central Provident Fund is required to be invested in non-marketable Government Securities.

Diverse investor base lowers the debt cost and volatility in market yields.

In developing Retail investor base which is most reliable investor base one needs to take account of security, high yields and ease to access. Foreign investor base can enlarge the investor base and contribute to financial innovation in domestic markets thereby yielding efficiency gains and the introduction of good practices in the provision of financial services, however they are more prone towards risk as they are more susceptible to market volatility, hence to check this risk, prudential supervision and regulations are adequately required before moving towards any financial liberalization.

Mutual Fund Industry considered to be the backbone of fixed Income Market is at its infancy in Pakistan. Pakistan was the pioneer in the field of Mutual Funds in the South Asia Region, when it launched National Investment Trust (NIT), an open-ended mutual fund in 1962, followed by the establishment in 1966 of Investment Corporation of Pakistan (ICP), which launched a series of close-ended mutual funds. Both NIT and ICP were established in the public sector. However, it (Pakistan) subsequently failed to maintain the tempo of the initiative taken in the field until early nineties.

However, during the last couple of years, the industry has made a remarkable and phenomenal growth not only in its size and category (open end funds and closed end funds) but also in product diversification and market penetration.

Some suggestions …

1. To reform Contractual Savings Systems and Insurance Sector gradually moving from quantitative, restricted investment framework to a prudent market based investment framework.
2. To Develop Mutual Fund industry.
3. To improve information and actuarial disclosure requirements for institutional investors.
4. To review laws and regulations applicable to collective investment vehicles in offer to maintain proper separation between asset Management and Investment Banking.
5. To improve supervision and regulation of financial institutions.
6. To introduce Certification Standards for Investment Advisors.
7. To evaluate the benefits of encouraging foreign investors, such as eliminating with holding taxes on their investments.
8. To promote Retail Investors interests through new distribution channels including Mutual Funds and automated trading formats.

5th area required for the development of fixed income bond market is to have developed Primary Market in the country.

Developing Primary Market is a dynamic process that depends on a country's initial condition and on the sequencing of reforms. In some countries like USA same financial institutions as Primary Dealers are used for monetary policy Operations; however two sets of Primary Dealers are possible. One can be used for issuer and other for Central Bank Operations.

Pakistan started developing Government Bond market in 2000 by introducing Pakistan Investment Bonds and making their sale through selected Primary Dealers.

The other issue is non-existence of auction calendar for the issuance of long-term instruments. Further the auctions announced in this respect most of the time represent small size issues that are not sufficient to create Bond Market liquidity.

6th area required for the development of fixed income bond market is to have well functioning Secondary Market in the Country.

Countries in the world have varied experience in developing secondary Market of the Securities. India and Malaysia developed discount Houses to increase trading volume and to establish bond market. Jamaica, Iceland, Thailand, Malaysia, Nepal have instituted Secondary Market window as transitional arrangement. Bank of England operated secondary market window for gilt-edged indexed linked instruments to encourage the market. In Germany the Bundersbank of Germany participates in the market on 8 regional exchanges for buying and selling securities to reduce price volatility in secondary market trading. In Poland the National Bank of Poland provides an inter-dealer brokerage system for Central Bank Bills and T-bills.

In Pakistan the PDs are the main players of the secondary

market as by regulations they have to be the price makers. PDs share in PIB secondary market trading was more than 90% and in MTBs it was in excess of 75%.

Secondly to improve secondary market trading of the bonds Central Bank needs to establish a bond-trading desk at its Treasury for its market interventions.

7th area required for the development of fixed income bond market is to have Legal and regulatory framework.

Roosevelt in First inaugural address in 1933 said …

> *"… our progress toward a resumption of work require two safeguards against a return of the evils of the old order; there must be a strict supervision of all banking and credits and investments; there must be an end to speculation with other people's money, and there must be provision for an adequate but sound currency".*

Fundamental Rules concerning market conduct should be included in Securities Regulations. In framing these Rules consultation with Self Regulating Organizations is the right approach. The Rules and Operating procedures governing the payment and settlement system should be made public ensuring all accountability levels. Its framework should allow oversight monitoring and reporting to all concerned.

Last area required for the development of fixed income bond market is to have well designed Taxation Policy.

Tax policy has significant impact on financial decisions of investors and firms, for instance, mutual funds and asset backed securities will have difficulty in competing against traditional substitutes without proper tax treatment. So a well-developed financial system requires a well designed tax policy. Most of the OECD countries are following integrated approach where tax is deducted at all sources of income at one rate, however some countries are still observing Tax deduction at compartmentalized level. The last approach is becoming obsolete day by day. Withholding Tax is one way of generating revenue through deduction of Tax on interest earnings.

The Corporate Bond Market in Pakistan is smaller in comparison to many equivalent economies; however, there are indications towards positive development in this area.

An encouraging indicator of Pakistan's corporate debt market is the relatively broad spectrum of issuers and diversity in background of investors. Since the inception of TFCs, issuers have hailed from a wide range of industrial classifications including leasing companies, sugar manufacturers, textile mills, chemical manufacturers, synthetic fibre manufacturers, pharma companies, commercial banks, investment banks etc.

One of the more encouraging developments in the Pakistani corporate debt market has been the innovation in the structure of the instruments. Over the years there a number of features have been introduced in the structure of debt instruments in Pakistan and the features have been successful in making corporate bonds more marketable to investors while retaining benefits for issuers.

Some noteworthy features have been the introduction of call and put options, floating coupons, caps and floors, conversion options, perpetuity etc. The introduction of these features has made investments in TFCs an easier decision than before. Investors are now more easily able to pick and choose the instruments more suited to their cash flow requirements and interest rate outlook.

The Islamic Instruments market is an addition in the architecture of Fixed Income Market in Pakistan. The growth is immense but still it requires sovereign instruments for benchmarking that needs to be innovated under local environment. Very few instruments and that too are available in quasi-national market.

The local derivatives market is yet to find a sure footing. Once interest rate and credit derivatives become regularly traded products we can be sure of seeing a lot more innovation in the structure of corporate debt.

Further there is also a need of developing Mortgage instrument/Infrastructure Bond Market in Pakistan. Constraints at the moment are lack of expertise on part of financial institutions to deal in this segment and the absence of critical mass in the market (size of mortgages with the banks at the moment are less than Rs 30 billion). However this is a growing area for the future.

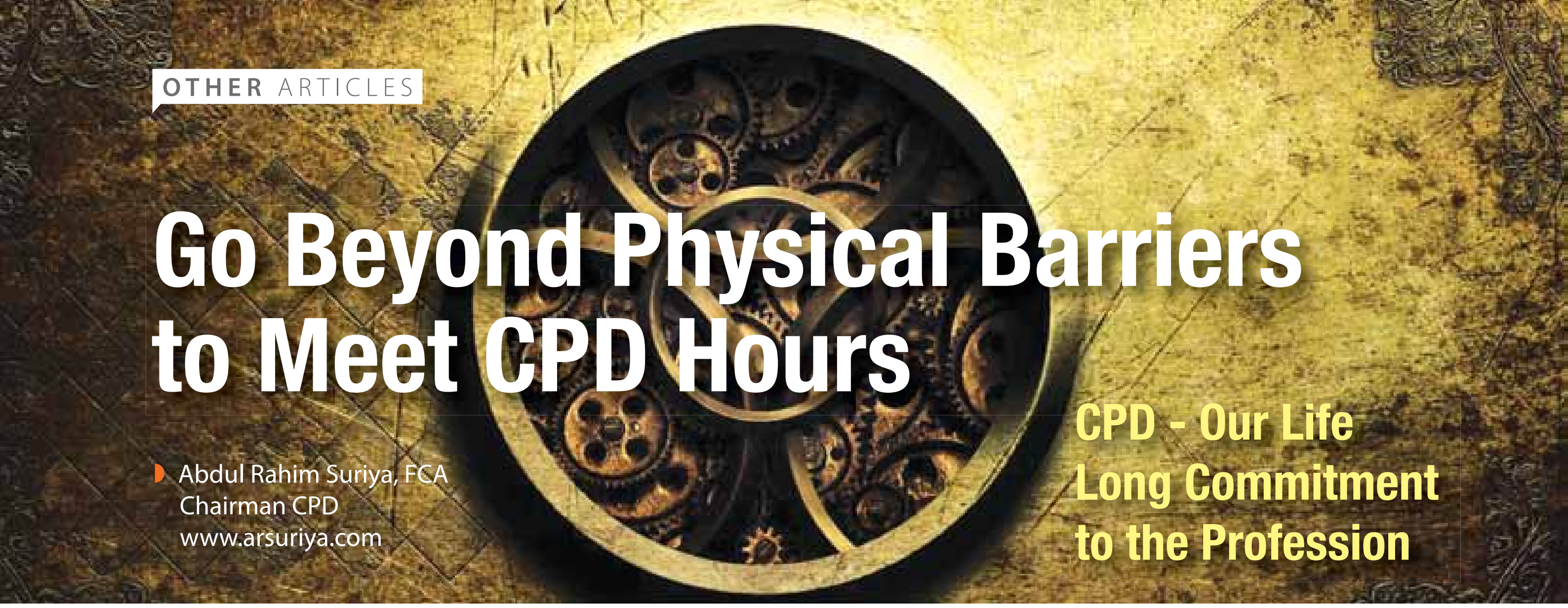
Recommendations

1. Define proper incentive framework for govt. securities issuing activities at sub national level and for public sector entities
2. Promote common infrastructure
3. Streamline procedure for public issuance

While we have explored in somewhat detail the contours of the local bond market and the advantages of Financial Innovation, in closing, and particularly in the wake of the US financial meltdown, I would like to share Franklin Delano Roosevelt's timeless wisdom, uttered in 1937, in the midst of the Great Depression …

"We have always known that heedless self-interest was bad morals. We now know that it is bad economics".

Go Beyond Physical Barriers to Meet CPD Hours



Abdul Rahim Suriya, FCA
Chairman CPD
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CPD - Our Life Long Commitment to the Profession

CPD and Accountancy Profession

The level of professionalism, knowledge and skills expected from a chartered accountant - is very high. The Institute is aware of such expectations recognizes it justifiable in view of the level of public interest attached to the profession. Accordingly, one of the five fundamental principles underlined in the Code of Ethics for Chartered Accountants, prescribed by the Institute, requires from a chartered accountant to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques.

It is believed that learning process of a true professional accountant does not end with the achievement of qualification. Essentially, the responsibility of an individual in respect of professional development becomes more critical in terms of serving the public interest after obtaining chartered accountancy qualification. The minimum benchmark to ensure compliance of the requirement of the Code of Ethics by members of the Institute is prescribed through implementation of International Standard that provides guidelines towards Continuing Professional Development (CPD).

CPD refers to learning activities that develop and maintain capabilities which enable professional accountants to perform competently within their professional environments. Despite the fact that CPD, on its own, does not provide assurance that all members will provide high quality professional service all the time, a CPD requirement is important in preserving the standard of the profession and in maintaining public confidence.

IFAC's International Education Standard - 7 of IFAC

IFAC places great value to CPD and its pronouncements IES-7, deals exclusively with the requirements and guidance on CPD. IES-7 recognizes three different approaches to be adopted by a professional body to ensure its members continuing development:

a. In-put based approaches – A professional body establishes a set amount of learning activity, generally measured in CPD hours or credits that are considered appropriate to develop and maintain competence. Usually, these credit hours are gained by attending seminars, workshops where the learning outcomes are not assessed by any independent body.

b. Out-put based approaches – A professional body requires professional accountants to demonstrate, by way of outcomes, that they develop and maintain professional competence. The outcome could be a reliable assessment by a member that he or she reflects on the needs, plans activities and takes measures, and finally assesses the results on performance. The members comply with the requirement by ensuring that required learning outcomes are achieved and are assessed by the reliable independent evaluators. Attending a learning activity and obtaining successful assessment criteria is one of the examples of output approach.

c. Combination approaches – A professional body effectively and efficiently combines elements of the input and output based approaches, setting the amount of learning activity required and measuring the outcomes achieved.

Generally members go for input approach. ICAP has adopted a combination approach before moving towards a comprehensive output-based system.

Recent initiatives

The Institute is keen to bring forward new endeavors and initiatives to provide more avenues for professional development of its members.

Collaboration with management training institutes:

In its endeavor to facilitate members and students get benefit from renowned management training institutes and accelerate the development of the skills of members ICAP has made arrangements with reputable management training institutes, like IBA, which now offer special discounts to ICAP members on their open enrolment programs.

Collaboration with PICG for Certified Director Course:

CPD Committee also primed a deal with PICG to offer a Certified Director Course to ICAP members stretched over 3.5 days, instead of original course program of 4.5 days. As against the normal registration fee charged by PICG of Rs.225,000 the registration fee of the program organized in collaboration with PICG would be only Rs.125,000/- per participant. The first program was held from May 28 to 31, 2012 where 17 participants attended. Arrangements are being made to organize same program in Lahore and Islamabad. List of members who have so far attended such courses is placed on ICAP website.

CFO Conferences:

The Professional Accountants in Business Committee (PAIB) of ICAP has introduced the concept of CFO Conference. The First CFO Conference was organized in March 11, 2010. So far the PAIB committee is credited with organizing six such CFO Conferences. The learning resources developed and videos of the CFO Conferences are now placed on the website of the ICAP at http://www.youtube.com/icappakistan

PERN II :

The Institute for its members and students acquired the connectivity of the Pakistan Educational Research Network II of HEC. This facility provides access to a wide range of research papers and other learning resources. Over 1000 members and students have already registered for the facility. Members and students are encouraged to take more benefit from this arrangement. For guidance, Mr. Fahim Siddiqui, IT Head can be contacted.

Organization of CPD activities at ICAP

Although the avenues to gain CPD credit are not limited to ICAP, the Institute takes upon itself to provide a forum for learning to its members. Organizing CPD activities has been one of the prime assignments of the Regional Committees of the Institute since 1995, when the council entrusted Regional Committees with the task to conduct CPD activities, however the overall directions and policy formulation remained with the CPD Committee formed by the Council. Additionally, the overseas chapters of ICAP members are now also gearing up to provide CPD opportunities to overseas members.

The activities undertaken by each Regional Committee are as follows:

Southern Regional Committee	(SRC)	14 programs
Northern Regional Committee	(NRC)	36 programs
ICAP Chapter Kingdom of Saudi Arabia		7 programs

NRC which covers quite a number of cities establishes city CPD committees to undertake these activities more efficiently.

Going beyond physical barriers to meet CPD hours

A common misconception exists that to earn CPD credit one must attend seminars, workshops or training of ICAP or any management training organizations, which is far from the truth! The Institute recognizes a broad range of activities that contribute towards the desired professional development of a member. The CPD Directive provides a comprehensive list of such activities which is as follows:

Activity	CPD Credit Hours
Watching videos of the ICAP CPD programs	Half of the actual duration Maximum of 20 hours
Reading journal articles, newspaper reports, subscriptions etc	Actual reading time, subject to maximum of 2 hours per article subject to the maximum of 10 hours per annum
Visit to ICAP libraries	Actual time spent in the library
Teaching	One and half the actual time of the session subject to maximum of 20 hours per annum.
Presenter, participant or session chairman in short courses, seminars, conferences, trainings and media including interviews in print media.	Twice the actual time of the presentation.
Research paper published in a peer reviewed journal	8 hours
Contributing article in ICAP's, or other, local or international publications	4 hours
Registered and evidence-based E-learning courses from recognized content providers.	Actual time
Completing degree courses and studying relevant professional certifications.	5 times of the examination hours or 40 hours, whichever is lower, in a CPD year.
Participation in council, committees, working groups of ICAP and other regulatory bodies	Actual time of the meeting
Writing of books on professional interest, technical and reference manuals including study pack	1 hour per page of technical content. Maximum 40 hours per release.

The Revised CPD Directive

The International Federation of Accountants (IFAC) has made it mandatory for its member bodies to design and implement a CPD mechanism in such a way that it becomes a component of continued membership for the professional accountants.

The Institute has recently revised its CPD Directive 8.01 which will improve the effectiveness of the professional development process of the members.

According to the adopted combination approach of CPD, under the revised Directive, ICAP requires from its member to complete at least 120 hours or equivalent learning units of relevant professional development activity in each rolling three-year period subject to a minimum 20 hours in each year. **Out of the 120 hours 60 hours or equivalent learning units should be verifiable.** The first rolling period of all existing members would start on July 1, 2012 and would end on June 30, 2015.

A 'Verifiable CPD Activity" undertaken by the member must be supported by documentary evidences required to be maintained by the member provided under paragraph 13(a) and 13(j) and 13(l) for one year after the close of rolling period.

A 'Non verifiable CPD Activity" is an activity where a member is unable to prove that the CPD learning activity has taken place. Ordinarily, non-verifiable CPD does not have a defined learning outcome and is not designed to address a specific learning need. General reading, as defined in paragraph 13(k), is an example of non-verifiable CPD.

Non-compliance of the CPD requirements is contrary to the professional behavior expected from a chartered accountant and same may be referred to the Council for necessary action.

General trend of CPD program attendance

At present the Institute experiences serious lack of reporting of CPD activities by its members resulting in a disturbing state of affairs in terms of compliance by members. However there are instances where members achieving more than the minimum requirements per year. The high achievers names are published in our monthly newsletter.

CPD Reprieve

The Council of the Institute has decided to allow a onetime amnesty to all members at the commencement of first rolling period under revised Directive 8.01 whereby the CPD record of all members would start with a past compliant status. The first rolling period of three years would commence on July 1, 2012 with zero balance in deficient member's CPD account maintained at ICAP. **Members who have excess credits hours would be awarded carry forward onto the rolling period.** However, members are required to complete minimum 20 hours in each year irrespective of their credit balances.

Periodic reporting and record keeping

Under the revised Directive the responsibility of keeping evidences would rest with the members. The Institute would maintain the account on the basis of periodic declaration of the members made on prescribed form. However, the Institute may require the evidences of verifiable activities on test basis.

FAQ *

Q.1 What is rolling period?
Rolling Period: The process of professional development of a member requires appropriate career planning. It is globally accepted practice that such planning should cover three year period being reasonable term to assess the outcome and make corrective actions. This concept forms the basis of three year rolling period, which has been introduced by IES 7 and Directive 8.01 for undertaknig the CPD activities by a member. The member is required to plan and undertake minimum 120 CPD hours within each three year period.

Q.2 What about excess credits available in member's account?
Credits more than 120 hours: A member may plan more than 120 hours in a rolling period based on the competence required for the professional role that is to be performed by the member. These excess hours, therefore, should not affect the minimum expectation from a member by the Institute, that is, 120 credits within each rolling period. Effectively, at the start of each rolling period the member will not be able to claim any excess in his/her account pertaining to last rolling period.

Q3. When will the first rolling period of existing member start?
First rolling period: The Council has decided to specify July 1, 2012 as the first day of the first rolling period of every existing member. Accordingly, all the existing members would be required to complete 120 CPD hours during July 1, 2012 to June 30, 2015. Any excess as at June 30, 2012 in the account of members will be carried forward to the first rolling period and will be offered against the requirement of 120 hours in the first three year rolling period.

Q4. How will deficiencies at the start of the rolling period be dealt?
Deficiencies at the commencement of the first rolling period: In the light of the decision of specifying July 1, 2012to June 30, 2015 as first rolling period, the Council condoned the sanctions applicable on members who will not be able to report or complete their required CPD credits before July 1, 2012.

Q5. What change has been brought towards reporting?
The member will periodically, at least once in a year, submit details of CPD activities. While evidences of the CPD activities will not be submitted to the Institute unless specifically required by the Institute. Keeping in view the global practices, it is expected that the members may prefer to file the details of CPD activities at the time of annual renewal of their membership.

* FAQ are developed by Mr. Omair Jamal, Director CPD - ICAP

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Want to ask a question, share your opinion we are listening!

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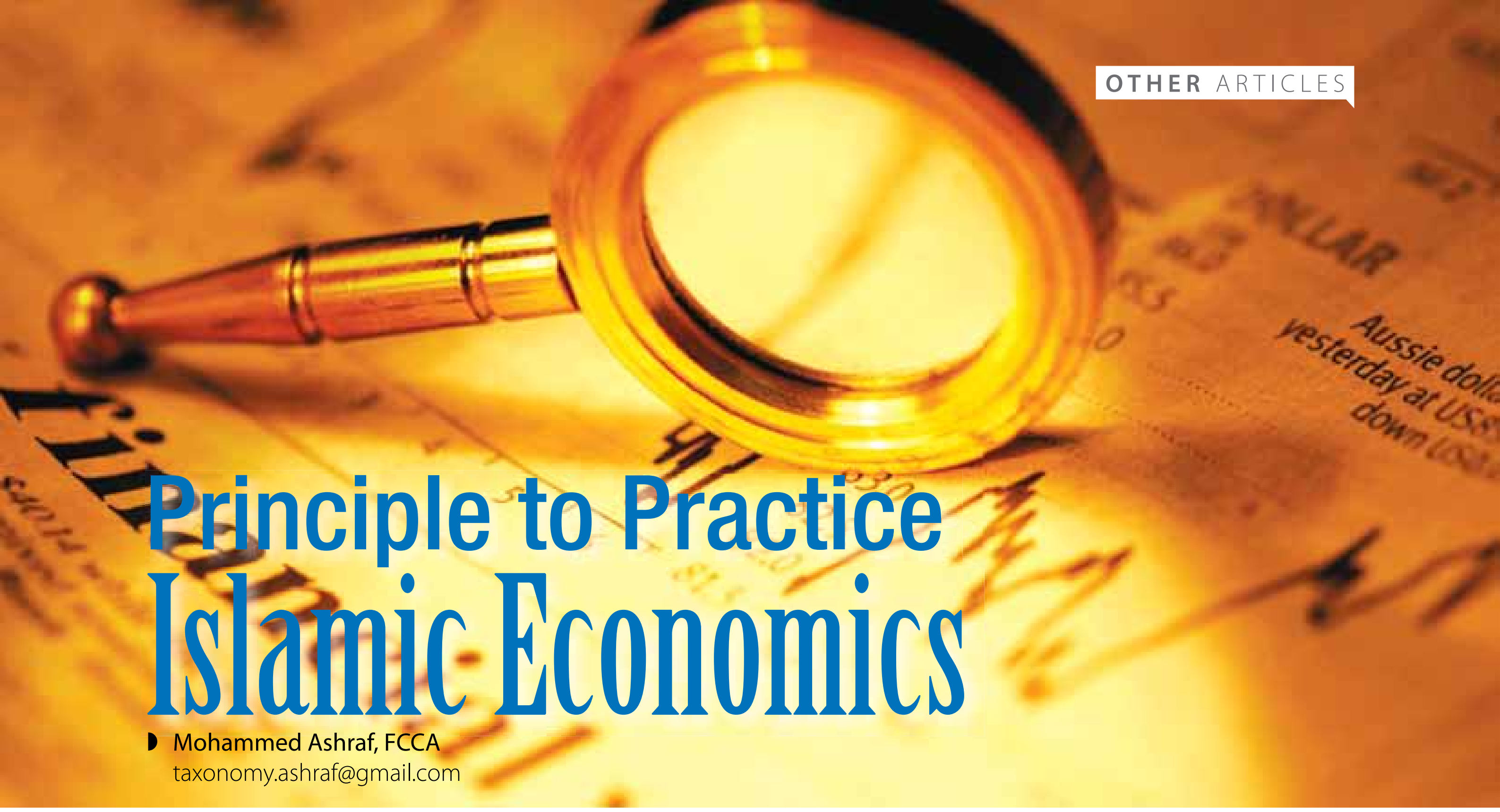

Principle to Practice Islamic Economics

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Many people always try to fit in the Islamic Economic Principles into the modern economic terminologies instead of adopting a vice versa approach. Without even realizing the fact that these modern terminologies were either originated from the Greeks or research of Muslim economists. In order to remove this misconception, this article is an endeavor to highlight the origin of modern economic concepts and key aspects of Islamic Economics including monetary and fiscal policy from principles to practice.

Basics of Monetary Policy

Conventional monetary policy can be traced back to late 19th century when it is used to maintain gold standard and it's most modern form is known as gold bullion standard [GBS]. GBS is a system in which gold coins do not circulate, but in which the authorities have agreed to sell gold bullion on demand at a fixed price in exchange for circulating money. Until 1971 most monies of the world were backed by gold. Surprisingly, the current value of paper or electronic money are not backed by gold but can be adjusted by the creators of money.

Monetary policy attempts to stabilize the economy by controlling the interest rates and spending by restricting the governmental borrowings. The monetary policy is a big impediment to free market economy because government controls the economy through monetary policy which is not possible in a gold environment. This is exactly what happened in so called free market capitalist economy in 1931 when gold replacement of currencies were stopped by banks.

With the passage of time, just to control the so called free economy through monetary policy, a layer upon layer over currencies were introduced, that is, initially currency was introduced then undermining currency positions were covered up through book adjustments and now through the concept of plastic money.

Monetary Policy in Islam

The prime concept of free economy is already present in Islamic Economic Principles [IEP]. IEP are strictly against the concentration of wealth and prohibits through the one and only evil – The Riba [Interest].

In contrast to conventional monetary policy, IEP does not suffer from the evils of interest rates, Seignorage (the benefit from printing money) and borrowing money from the population through bills etc. As the concept of interest is absent in IEP, hence, the concept of monetary policy in IEP is restricted to maintaining gold standard, that is, for what it was initially developed.

Gold Standard is based on Islamic principles. Islam considers commodities with intrinsic value as currency. Following are some examples of commodities used as currency: Gold, Silver, Rice, Dates, Wheat, Barley and Salt. Price of a commodity is set by the market itself without any government intervention.

The concept of money was prevalent even prior to Last Prophet PBUH, whereby 1 Dinar [Gold] is equal to 10 Dirhams [Silver]. Even today, silver has a defined parity with gold. The Goldsmith used to put there stamps on Dinar and Dirham to prove there authenticity.

In most of the historical accounts, it states that among the Rashideen caliphs, Syeddana Uthman ibn Affan RA was first to struck the coins, some accounts however states that Syeddana Umar RA was first to do so. When Persia was conquered three types of coins were current in the conquered territories, namely Baghli of 8 dang; Tabari of 4 dang; and Maghribi of 3 dang. Umar (according to

some accounts Uthman) made an innovation and struck an Islamic dirham of 6 dang.

Under IEP, the role of central banks under Islamic Economic Principles would be of International Trade Accounting of a country, review the Shariah Compliant Financial Products and regulate the financial institutions. Consequently, the concept of banking under IEP would be offer Shariah Compliant Financial Products as intermediary, gold vaults for customer and converting currency into gold on account holders' demand apart from currency handling in transitory phase.

Basics of Fiscal Policy

Fiscal policy is contrasted with monetary policy which attempts to stabilize the economy by controlling interest rates, exchange rates and the supply of money. It uses two main instruments - government spending and taxation. Changes in the level and composition of taxation and government spending can impact on the following variables in the economy:

- Aggregate demand and the level of economic activity;
- The pattern of resource allocation;
- The distribution of income.

Basics of Keynesian Economics

Keynesian economics, called Keynesianism and Keynesian theory, is a school of macroeconomic thought based on the ideas of 20th-century English economist John Maynard Keynes.

Keynesian economics argues that private sector decisions sometimes lead to inefficient macroeconomic outcomes and, therefore, advocates active policy responses by the public sector, including monetary policy actions by the central bank and fiscal policy actions by the government to stabilize output over the business cycle. The theories forming the basis of Keynesian economics were first presented in The General Theory of Employment, Interest and Money, published in 1936. The interpretations of Keynes are contentious and several schools of thought claim his legacy.

Keynesian economics advocates a mixed economy - predominantly private sector, but with a significant role of government and public sector - and served as the economic model during the later part of the Great Depression, World War II, and the postwar economic expansion (1945–1973), though it lost some influence following the stagflation of the 1970s. The advent of the global financial crisis in 2008 has caused resurgence in Keynesian thought.

Fiscal Policy in Islam

During the period of Islamic Governance in Madina, a social transformation took place as a result of changing land ownership giving individuals of any gender, ethnic or religious background the right to buy, sell, mortgage and inherit land. Based on the Quran, signatures were required on contracts for major financial transactions concerning agriculture, industry, commerce and employment. Copies of the contract were usually kept by both parties involved, hence, all we are practicing now is not an alien to Islamic Economic Principles [IEP].

As we all know that IEP is deduced from Quran and Sunnah. Early Islamic Economic Thinkers have developed various economic models that forms the concrete basis of modern economic principles.

Early Islamic Economic Thinkers

Among the earliest Muslim economic thinkers was Abu Yousuf (731-798), a student of Imam Abu Hanifah. Abu Yusuf was chief jurist for Abbasi Caliph Haroon Ar Rasheed, for whom he wrote the Book of Taxation (Kitab al-Kharaj). This book outlined Abu Yusuf's ideas on taxation, public finance, and agricultural production. He discussed proportional tax on produce instead of fixed taxes on property as being superior as an incentive to bring more land into cultivation. He also advocated forgiving tax policies which favor the producer and a centralized tax administration to reduce corruption. Abu Yusuf favored the use of tax revenues for socio economic infrastructure, and included discussion of various types of taxes, including sales tax, death taxes, and import tariffs.

Early discussion of the benefits of division of labor are included in the writings of Qabus, Ghazali, Farabi (873–950), Ibn e Sina (Avicenna) (980–1037), Ibn Miskawayh, Nasir uddin Tusi (1201–74), Ibn e Khaldun (1332–1406), and Asaad Davani (b. 1444). Among them, the discussions included division of labor within households, societies, factories, and among nations.

Many scholars trace the history of economic thought through the Muslim world, which was in a golden age from the 8th to 13th century. A common theme among these scholars was the praise of economic activity and even self-interested accumulation of wealth. Persian philosopher Ibn Miskawayh (b. 1030) notes - "The creditor desires the well-being of the debtor in order to get his money back rather than because of his love for

him. The debtor, on the other hand, does not take great interest in the creditor."

Ibn Taymiyyah

The power of supply and demand was understood to some extent by Ibn Taymiyyah and he illustrates:

> "If desire for goods increases while its availability decreases, its price rises. On the other hand, if availability of the good increases and the desire for it decreases, the price comes down."

Ibn Taymiyyah also elaborated a circumstantial analysis of the market mechanism, with a theoretical insight unusual in his time. His discourses on the welfare advantages and disadvantages of market regulation and deregulation have an almost contemporary ring to them.

Ghazali

Ghazali (1058–1111) classified economics as one of the sciences connected with religion, along with metaphysics, ethics, and psychology. Authors have noted, however, that this connection has not caused early Muslim economic thought to remain static. Ghazali suggests an early version of price inelasticity of demand for certain goods, and he also discuss equilibrium price.

Ghazali was also noted for his subtle understanding of monetary theory and formulation of another version of Gresham's law.

Nasir ud din al Tusi

Persian philosopher Nasir ud din al Tusi (1201–1274) presents an early definition of economics (what he calls hekmat-e-madani, the science of city life) in discourse three of his Ethics: -"the study of universal laws governing the public interest (welfare) in so far as they are directed, through cooperation, toward the optimal (perfection)."

Farabi

Farabi notes that each society lacks at least some necessary resources, and thus an optimal society can only be achieved where domestic, regional, and international trade occur, and that such trade can be beneficial to all parties involved.

Ibn Khaldun

In 1964, Joseph Spengler's "Economic Thought of Islam: Ibn Khaldun" appeared in the journal Comparative Studies in Society and History and took a large step in bringing early Muslim scholars to the attention of the contemporary West. Ibn Khaldūn or Ibn Khaldoun (March 19, 1406 AD/808 AH) was an Arab Tunisian historiographer and historian who is often viewed as one of the forerunners of modern historiography, sociology and economics.

Perhaps the most well–known Islamic scholar who wrote about economics was Ibn Khaldun, who is considered a father of modern economics. Ibn Khaldun wrote on economic and political theory in the introduction, or Muqaddimah (Prolegomena), of his History of the World (Kitab al-Ibar). He discussed what he called asabiyya (social cohesion), which he cited as the cause of some civilizations becoming great and others not. Ibn Khaldun felt that many social forces are cyclic, although there could be sudden sharp turns that break the pattern.

He is best known for his Muqaddimah (known as Prolegomenon in English), which was discovered, evaluated and fully appreciated first by 19th century European scholarship, although it has also had considerable influence on 17th-century Ottoman historians like Hajji Khalifa and Mustafa Naima who relied on his theories to analyze the growth and decline of the Ottoman empire. Later in the 19th century, Western scholars recognized him as one of the greatest philosophers to come out of the Muslim world. The key concepts of Ibn e Khaldun are briefly discussed below:

Asabiyya – Social Cohesion

Ibn Khaldun wrote on economic and political theory in the Muqaddimah, relating his thoughts on asabiyya to the division of labor: the greater the social cohesion, the more complex the division may be, the greater the economic growth.

His theory of asabiyyah has often been compared to modern Keynesian economics, with Ibn Khaldun's theory

clearly containing the concept of the multiplier. A crucial difference, however, is that whereas for John Maynard Keynes it is the middle class's greater propensity to save that is to blame for economic depression, for Ibn Khaldun it is the governmental propensity to save at times when investment opportunities do not take up the slack which leads to aggregate demand.

Labor Theory of Value

Ibn Khaldun also introduced the labor theory of value. He described labor as the source of value, necessary for all earnings and capital accumulation, obvious in the case of craft. He argued that even if earning "results from something other than a craft, the value of the resulting profit and acquired (capital) must (also) include the value of the labor by which it was obtained. Without labor, it would not have been acquired."

Population and Economic Growth

Ibn Khaldun noted that growth and development positively stimulate both supply and demand, and that the forces of supply and demand are what determine the prices of goods. He also noted macroeconomic forces of population growth, human capital development, and technological developments effects on development. Ibn Khaldun held that population growth was a function of wealth. He illustrates as follows:

> *When civilization [population] increases, the available labor again increases. In turn, luxury again increases in correspondence with the increasing profit, and the customs and needs of luxury increase. Crafts are created to obtain luxury products. The value realized from them increases, and, as a result, profits are again multiplied in the town. Production there is thriving even more than before. And so it goes with the second and third increase. All the additional labor serves luxury and wealth, in contrast to the original labor that served the necessity of life.*

Concept of Supply Side Economics

Another modern economic theory anticipated by Ibn Khaldun is supply-side economics. He argued that "high taxes were often a factor in causing empires to collapse, with the result that lower revenue was collected from high rates."

Ibn Khaldun introduced the concept now popularly known as the Laffer Curve, that increases in tax rates initially increase tax revenues, but eventually the increases in tax rates cause a decrease in tax revenues. This occurs as too high a tax rate discourages producers in the economy.

Ibn Khaldun used a dialectic approach to describe the sociological implications of tax choice (which now forms a part of economics theory):

> *"It should be known that at the beginning of the dynasty, taxation yields large revenue from small assessments. At the end of the dynasty, taxation yields small revenue from large assessments."*

He said that in the early stages of the state, taxes are light in their incidence, but fetch in large revenue...As time passes and kings succeed each other, they lose their tribal habits in favor of more civilized ones. Their needs and exigencies grow...owing to the luxury in which they have been brought up. Hence they impose fresh taxes on their subjects...and sharply raise the rate of old taxes to increase their yield...But the effects on business of this rise in taxation make themselves felt. For business men are soon discouraged by the comparison of their profits with the burden of their taxes...Consequently production falls off, and with it the yield of taxation.

Concept of Money

Ibn Khaldun understood that money served as a standard of value, a medium of exchange, and a preserver of value.

Concept of Giant Corporate and Multinationals

He mentioned that Businesses owned by responsible and organized merchants shall eventually surpass those owned by wealthy rulers.

Conclusion

It is evident from the above that the majority of modern economic terminologies are deduced from the principles enunciated in Quran and Ahadees. Further, the foundation of modern economics is based on the work of Imam Abu Yousuf, Ibn e Taymiyyah, Ghazali, Farabi etc.

The core difference lies in the concept of interest which is not only absent in Islamic Economic Principles but is absent. The second article of the series will be on Islamic Economic Governance.

Avoiding Lawsuits

Tajammul Shah

I recently gave a presentation at the CFO conference, in Islamabad entitled "Hot Legal Tips", with the underlying theme being how to avoid lawsuits. This article is a synopsis of that presentation.

Before, an attempt can be made to take steps to avoid 'lawsuits' it is pertinent to fully comprehend what a lawsuit is? This may, on the face of it, appear obvious, but is it so obvious and do the employees of an organisation understand this? It is important to comprehend what a lawsuit is, in order to trigger the alarm bells in the minds of the employees at an early stage to enable them to take the necessary steps to prevent a potential lawsuit.

For the purpose of this article, I will confine myself to the definition of 'lawsuit' found in the Oxford dictionary, which is as follows:-

"an argument or a disagreement referred to a court of law for settlement"

In light of the above-stated definition it is essential to look at the components that form the said definition.

The first component that needs to be reviewed and understood is what is "an argument or disagreement"? An argument is where two parties, usually in a state of hostility, have reasons for or against a decision, idea or outcome, while the word disagreement, means being in a state where there is no joint decision on an issue or point. Hence, it can be assumed that where there is a lack or absence of meeting of minds of two parties (whether this is in a conducive or hostile environment), there is an argument or disagreement between such parties. For the sake of convenience, I will refer to these terms jointly and severally as a 'dispute' from here onwards in this article.

The second component is 'court of law', and this is usually a body set up under the constitution of the land and/or state to interpret and implement laws of the land.

The final component is 'settlement' and this means to reach an agreement, however in this context it would be one that is imposed by court of law.

If the definition of a lawsuit was to be summarized, it could be interpreted as being a dispute which is being agreed upon and is of a legal nature as a court of law only has jurisdiction to entertain such disputes.

The next step is to understand when an organisation can get embroiled in a legal dispute. However, at this stage, it is important to note that the remaining discussion in this article, will be mainly focused on listed companies, even though some of what may follow, may be relevant to other companies as well.

In order to understand, how and when a legal dispute may arise, it needs to be understood what is a company and the legal environment in which it operates.

All companies are creatures of the legal system in which they operate. This essentially means that they owe their existence to the law under which they have been created and it is this law that has vested in them certain rights as well as subjecting them to various legislative obligations. Two of the most important rights given to a company are, firstly the right to enter into legal obligations with third parties, and secondly the right to sue and be sued in its own name.

The legislator in return for giving such wide legal rights, has imposed various legal obligations on companies to safeguard the interest of investors and third parties dealing with companies. Failure to fulfil these obligations entails various legal repercussions such as penalties, imprisonment or even winding up. All employees of a company are its agents and thus they could themselves, in their own capacity, be subjected to certain penalties as well.

Consequently, what has been stated above means, that a company has a legal right to enter into a legal relationship with third parties (i.e. contractual relationship), while there are other relationships, which have been created directly under law (i.e. legislative relationship).

Under a contractual relationship the company is free to define the parameters of the relationship, while the legislative relationship is dictated by law.

In the context of the above-stated relationships, a lawsuit will usually arise, when one party to the relationship has failed to respect the defined parameters of such relationships, thus leading to a dispute, which needs to be referred to a court of law to be settled or resolved.

Now that the mechanism, that creates and defines the relationships that a company may have, is identified and understood, an appreciation and awareness of these relationships needs to be created. .

There are five main types of relationships which will be discussed below and these are as follows:-

1. Shareholders
2. Regulators
3. Employees
4. Suppliers
5. Customers

A brief discussion and review of each of the relationships, as stated above, is as follows:- .

Shareholders - This is a contractual relationship, the parameters of which are primarily negotiated, but certain rights are dictated by legislation and the reason for this is to prevent companies from denying certain rights of the shareholders for the greater good and protection of minority shareholders. When an investor buys shares in a listed company, he does so under a contract and his rights and obligations are usually found in the constitution of the company i.e. the Memorandum and Articles of Association. The shareholder will have contractual relationship with the company, as well as with individual shareholders.

The legislative rights of shareholders are mainly enshrined in the Companies Ordinance 1984 and the SECP Act 1997. The main rights usually found accruing to the shareholder under contract and/or legislation are as follows:-

- **Right to buy and sell shares** - Shareholders should be free to invest and divest in the company
- **Right to information** - companies must give shareholders regular, detailed disclosures on financial results, operations, and major events that can assist shareholders in their selling or purchasing of shares decisions.
- **The right to attend and vote at General Meetings** - The most important vote is to approve new members of the board. Some of the other issues shareholders vote on include executive compensation, mergers, and changes in critical business.
- **Right to call EGM** - Shareholders holding not less than 10% of the issued share capital of the company, or such lesser number as is provided in the Articles, may call for an EGM (S.91 Companies Ordinance 1984).
- **General right to be treated fairly** - protection against prejudicial and oppressive behavior of management of the company.
- **Right to approach the Court** - Members holding not less than 20% of the issued share capital can apply to court. Court can make order as it thinks fit.
- **Right to wind up the Company** - members may pass a special resolution to wind up the company if, for example, the company cannot pay its debts, etc.

Regulators - They are created under law and have various supervisory powers including powers to penalise and punish. The most important and central regulator for companies is the Securities Exchange Commission of Pakistan (SECP). The SECP enacts various laws and regulations and pursuant to such laws and regulations govern the ways in which companies operate.

Employees - Employees relationship is governed by a contract of employment, which has a special place under law in comparison to normal contracts. The contract of employment for management is usually a negotiated agreement, which, usually encompasses the companies normal policies and procedures as part of such agreement. However, it is important to note that a company's contract with workmen, in addition to being a negotiated agreement, is subject to certain legislative protections.

Suppliers - A purely contractual relationship, where the company and the suppliers are free to determine the parameters of such relationship.

Customers - A contractual relationship supplemented by various rights given under legislation to consumers. For example if a consumer buys any goods pursuant to an agreement, then such agreement shall be subject to the certain legislative protections such as the Sale of Goods Act, 1930, which, for example, amongst other things requires that the goods shall be fit for the purpose for which they were intended.

In conclusion it is imperative to mention that the aim and purpose of this article is not to go into detail of various legislation but rather to outline the legal environment in which a company operates. An appreciation of this by employees, will in my view assist in moulding the mind to recognise the signals which could lead to a potential lawsuit.

Every organisation should create the requisite awareness of the pertinent legal issues, as well as embedding a culture of compliance. Everyone in an organisation needs to understand their duties under law. This means recognising the various relationships, how they are created and the role played by the employees in such relationships.

How to Build Your Business Advisory Practice

Practice Management Tips for SMPs

◗ Stuart Black, Member, IFAC SMP Committee (see bio) and
◗ Paul Thompson, Deputy Director, SME and SMP Affairs, IFAC

This article examines the business case for small- and medium-sized practices (SMPs) to develop a business advisory practice and offers tips for getting started.

Introduction

In the future, SMPs may no longer be able to rely solely on traditional accountancy-based services as their main source of revenue and growth, as demand for these services declines. In many countries, fewer small- and medium-sized entities (SMEs)—the typical clients of SMPs—are being audited, as thresholds are introduced or increased and governments move toward self-assessment of tax to reduce compliance costs for SMEs. In addition, technology is commoditizing many of the day-to-day compliance services traditionally supplied by SMPs, reducing the need for a professional accountant and driving down price.

The good news is SMEs are increasingly demanding a broader range of professional services, in particular, value-added business advisory services, which SMPs are well positioned to provide. As small businesses themselves, SMPs share similar aspirations, concerns, and attributes with their clients and are in an ideal position to become trusted advisors.

Why SMEs Look to SMPs for Business Advice

SMPs should leverage the following unique qualities when building their practices.

Competency: SMEs often lack a full range of managerial expertise in-house and outsource some managerial functions, such as CFO, to SMPs that have the required technical competencies and expertise.

Integrity and Trust: As members of a regulated profession with codes of ethics, accountants enjoy "institutional" trust. Their provision of compliance services wins them "competence" trust. This is a time-proven formula. Unfortunately, there can also be a reluctance to utilize advisory services until the expert has already provided a specific demonstration of their competency.

Responsiveness/proximity: SMEs rate highly SMPs' responsiveness to their demands. The proximity of SMPs to their SME clients is also important as many owner-managers appreciate personal attention from their advisers and value ease of access.

A Full Menu of Business Advisory Services

SMEs are demanding the following services, which SMPs can provide. These services can help ensure the efficiency, transparency, and sustainability of SMEs, improving their financial performance and boosting client satisfaction (and possibly demand!):

- **Business development:** strategic business planning, budgets and projections, sustainable business practice, virtual CFO, etc.
- **Corporate advisory:** business structuring, valuations, litigation support, forensic accounting, treasury, debt/equity funding, equipment finance, due diligence and business buy/sell, etc.
- **Wealth creation and preservation:** financial position evaluation, investment strategy development, asset allocation, estate/succession planning, pension planning, etc.
- **Tax consulting:** tax advice and/or representation on tax matters to revenue authorities, etc.
- **Management accounting:** budgeting, management reporting, cost accounting, benchmarking, product/customer profitability analysis, etc.

7 Things to Consider When Building a Business Advisory Practice

The following considerations can help SMPs succeed when building or laying the groundwork for a business advisory practice.

1. **Modify your mission statement, vision, and plan:** When expanding or changing the direction of your practice, set out a clear vision for the future and a roadmap for how to get there. You should also revisit your mission statement and adjust it as needed to reflect your practice's modified or expanded service offerings, such as

"We are dedicated to adding and sustaining value for families and their businesses."

2. **Educate and train your people:** Providing high-quality business advisory services demands a different skills base than that to provide traditional accountancy-based services. You can develop the capacity for business advisory by expanding both the technical and soft skills of existing staff. Some accountants can make the transition to business adviser through experience and self development, while others may need training or coaching.

3. **Focus on a specific industry sector or specialization:** Few SMPs will be able to gain and maintain the knowledge and skills necessary to be competent in all areas of business advisory. Therefore, SMPs should consider carving out a niche and participating in a referral network of SMPs that can provide the other services. A common model is to focus on a specific industry sector, such as hospitality, or to develop a specialization, such as sustainable business practices, in order to differentiate your practice from the competition.

4. **Develop relationships with other firms:** Referral networks offer many potential advantages, such as helping your practice increase its client base. Participating in a network is an effective way to satisfy the increasing breadth of demands from SME clients and can help demonstrate to new clients that you have the capability of a larger practice. Referral networks can extend beyond accountancy to areas such as legal, HR, and IT.

5. **Promote the practice to existing and new clients:** Promoting and marketing your practice, and the value of your services, will be crucial to success. There are a number of reasons why SMEs choose SMPs to provide business advisory services (see above). SMPs should leverage these qualities by promoting them to potential clients, who are often unaware that their professional accountant can provide these services. As accountants often have little or no expertise or experience in promotion or marketing, you may want to hire a marketing consultant or train an existing employee to do this. Your marketing expert can help you determine if you need to change the way your services are marketed and help you explore new channels, such as social media.

6. **Change your business model:** Business advisory services may require a different business model from that of traditional accountancy-based services. For example, business advisory services may be better suited to a business model based on selling intellectual capital rather than time. This lends itself to value pricing. To supplement this, you might wish to emulate the airline industry model, which divides their client base into premium and economy and offers a different value proposition to each—for the premium clients, a high-end service, at a correspondingly high price, and for the economy clients, a basic "no frills" service that frees up time to devote to the premium clients.

7. **Embrace technology:** Advances in technology present a significant opportunity for SMPs to operate more efficiently, reduce costs, and offer additional value-added services. Cloud computing, for example, allows SMPs to more actively engage with their SME clients on a day-to-day basis and offer services such as virtual CFO cost effectively.

Putting Ideas into Action

To help you build a business advisory practice, we encourage you to download the IFAC Guide to Practice Management for Use by Small- and Medium-Sized Practices (PM Guide). This free guide comprises eight stand-alone modules on topics ranging from planning and building your firm to managing people and client relationships. It features case studies, checklists and forms, and an office procedures manual.

[ADAPT SECTION TO INCLUDE YOUR MEMBER BODY RESOURCES]

Additional Resources for SMPs

The following resources (all free of charge) are accessible via IFAC's International Center for SMPs: www.ifac.org/SMP:

- Publications
  - PM Guide User Guide
  - The Role of SMPs in Providing Business Support to SMEs.
- Presentations and videos from 2011 IFAC SMP Forum in Istanbul, Turkey, especially Session 3, SMPs Evolving to Better Serve SMEs
- Quarterly SMP eNews
- Relevant Links (especially the categories 'business advisory' and 'practice management')
- For translations of these and other resources, visit IFAC's Translations Database.

Fraud RISK Assessment

Afshan Aleem
Senior Research Officer, ICAP Secretariat

"Creating and maintaining high standards of ethical behavior is the responsibility of every employee. Concern is rising about every type of fraud as businesses face more varied threat. Companies are growing increasingly aware of their exposure to corruption but often still do not have structures in place to address it."

Auditing and Fraud Detection is a Serious Business: You need to be trained on the right tools! "Fraud will always exist at some level and in some form throughout any organization that employs people to fulfill its mission. With proper controls and hiring procedures you can mitigate the risk (not eliminate it). With functioning systems the risk is lower."

Overture

Today almost all organizations are exposed to Fraud Risk, therefore fraud risk assessment of an organization's financial statements is essential for all organizations regardless of size and nature. An effective fraud risk management should identify where fraud may occur and who the offenders might be. Auditing standards like ISA 240 encourage auditors to make an accurate assessment of fraud risk at the initial level in an audit engagement and then design audit procedures to identified risks. Accountability for preventing and detecting fraud rests with management entities. Despite the fact that the auditors are not and cannot be held responsible for preventing fraud and errors, they can have a positive role in preventing fraud and errors by deterring their occurrence. The auditor should plan and perform the audit with an attitude of professional skepticism, recognizing that condition or events may be found that indicate presence of fraud or error may exist. Based on the audit risk assessment, auditor should develop programs to audit procedures by which to obtain reasonable assurance that the financial statements in their entirety, all significant errors and fraud have been identified. The auditor should ask the management information related to any significant fraud or error detected in order to identify key problems that could lead to implementation of audit procedures more than usual. Nevertheless the auditor faces the inevitable risk that some significant errors can be detected, even if the audit is well crafted and done properly.

Audit objective

In concocting and implementing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud. According ISA-240 the only duty of auditor regarding fraud is that the external auditor should make sure that fraud which is committed

is properly reflected in financial statements and if there is an error, then it should be corrected. Originally it is the duty of management (internal auditor in particular) to prevent or detect and correct fraud and inform external auditor about any known past fraud.

If the fraud is carried out by only one director, then whether material or immaterial it should be communicated to those charged with governance but if it involves all those charged with governance then it should be communicated to legal authority by the auditor after consulting the situation with the lawyer. An auditor is not bound to be a detective, to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watchdog, not a bloodhound. 'An auditor conducting an audit in accordance with ISAs is responsible for acquiring reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error'(ISA 240 (Redrafted), paragraph 5). Hence, both the entity itself and the auditors have responsibilities for fraud and error. It could be said that management, and those charged with governance, have the primary responsibility for fraud and error, whereas the auditor has a secondary responsibility. It is important, however, to ensure that the extent of these secondary responsibilities are clearly understood, The auditor's responsibility to consider fraud in an audit of financial statements, which became effective for periods commencing on or after 15th December 2004.

According to ISA 240 (Redrafted) the difference between fraud and error depends upon whether deception has been used, and the distinction between the responsibilities of those charged with governance and auditors for fraud prevention can be described respectively as primary and secondary responsibilities. Auditors are required, however, to maintain an attitude of professional skepticism throughout the audit, and members of the audit engagement team are required to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud. ISA 240 (Redrafted) requires auditors to perform risk assessment procedures to obtain information for use in identifying the risks of material misstatement due to fraud.

Fraud risk assessment is a fundamental part of auditor's risk evaluation in the planning and execution process of a normal audit. In order to effectively dealing with fraud and corruption during audit, auditors should be able to set the tone on fraud awareness and sensitiveness from early beginning of their audit by conducting effective communication among team members by discussing and brainstorming on how and where fraud and corruption can be perpetrated in an entity. This procedure becomes a good basis for gathering information needed to identify and assess fraud and corruption risks. An appropriate process of fraud and corruption risk assessment at an entity wide level will help auditors to identify high risk areas which then become a basis for auditors to carry out adequately by identifying red flags particular or specific to each high risk areas. IAS 240 and 330 represents the fraud and corruption detection process and its identification in the high risk areas indicated in the Guidelines.

Characteristics of fraud

The term "fraud" refers to a pre conceived act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Two types of intentional misstatements are relevant to the auditor, that is, misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

Responsibilities of the auditor for fraud assessment

Due to Fraud, an auditor carrying out an audit in accordance with ISAs 240 obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. An auditor cannot acquire absolute assurance that material misstatements in the financial statements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the audit core evidence available to the auditor is persuasive rather than conclusive in nature. When attaining reasonable assurance, an auditor maintains an attitude of professional skepticism throughout the audit, considers the potential lack for management override of controls and recognizes the fact that audit procedures that are effective for detecting error may not be appropriate in relation of an identified risk of material misstatement due to fraud. The remainder of this ISA caters additional guidance on considering the risks of fraud in an audit and designing procedures to descry material misstatements due to fraud.

Conclusion

The aftermath of identifying fraud risks on auditors' obligation appear to depend on professional judgment and attributes of the risk with which the auditors can investigate the identified risks. The external auditor's examination is not a guarantee that fraud does not exist. Auditor's primary role is not the detection of fraud. It is management's responsibility to have controls to provide that fraud will either be prevented or detected. Internal audit should not be responsible for fraud detection, but should instead focus on assessing whether management's processes and controls to prevent or detect fraud are adequate to the task. Internal auditor has a responsibility for reporting any deficiency in the external audit team to the audit.

Fraud assessment is something that is oftentimes 'brushed under the carpet' because auditors do not like confabulate such issues with their client. Most of the times it can be very awkward discussing fraudulent activity with clients and they might take it as an offence! However, ISA 240 does stipulate that professional skepticism must be adopted in all audits. In the event that auditors discover a fraud, then they should (in all circumstances) consult the provisions of ISA 240 and ISA 260. Where the integrity of those charged with governance is brought into doubt the auditor should seek legal advice.

Overall deficiency of governance of internal controls by owners, upper management and board of directors remains the main contributors to fraud. This is apparent from the *Report to the Nation on Occupational Fraud and Abuse 2010*. Sarbanes-Oxley was implemented in 2002 with the particular purpose of addressing instances of fraud. However, the level of fraud has continued to increase. Tracking down fraud through education is an important factor to help decline the occurrences of fraud. As technology becomes more embedded into businesses, it will become indispensible for the internal technology experts to have knowledge of detecting and preventing fraud using technology. Accountants having experience in technology will become more and more valuable to fraud prevention as fraudsters become more technology savvy. Strong ethics and fraud policy development is one essential step to prevent fraudsters from perpetrating acts of fraud within an organization. Internal auditors should also conduct a risk assessment to determine the risks and vulnerabilities of the internal and external controls that are in place. Fraud will likely never

be eradicated in its entirety. But the fraud assessment can only help to promote an understanding as to who fraudsters are and why they inflict into fraudulent acts, which will hopefully help to detect, deter, and prevent these acts.

According to ISA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements* clearly focused that the responsibility for the prevention and detection of fraud and error rest with management, through the implementation and continued operation of adequate accounting and internal control systems. Such systems may decline but do not eliminate the possibility of fraud and error. In contrast, the auditor is not and cannot be held responsible for the prevention of fraud and error. The fact than an annual audit is carried out may, however, act as deterrent. The auditor must therefore seek sufficient appropriate audit evidence that any fraud or error which may be material to the financial statements have not occurred. If it has occurred, the auditor must ensure that the effect of fraud is properly reflected in the financial statements or the error is corrected. Because of the inherent limitations of an audit, there is an unavoidable risk that material misstatements in the financial statements, resulting from fraud or (to a lesser extent) error, may not be detected. Where such a misstatement is detected after the audit, the auditor will only have failed to adhere to basic principle and procedures if it is found that the audit procedures undertaken were not adequate in the given circumstances.

References from the Standards

ISA 240 *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements.*
ISA 260 *Communication of Audit Matters to those Charged with Governance.*
ISA 315 *Obtaining an Understanding of the Entity and the Environment in which it Operates.*
ISA 330 *The Auditor's Procedures in Response to Assessed Risk.*
ISA 520 *Analytical Procedures.*
ISA 540 *Auditing Accounting Estimates.*

Report on SAFA Board Meetings

March 14 & May 3, 2012

Abdul Rahim Suriya, FCA
SAFA Board Member - ICAP

New SAFA Member

CPA Maldives is admitted as an Associate member of SAFA, with its addition the total number of associate members of SAFA is now nine. ICAP and other SAFA members are assisting the Maldives in developing a Training Programs.

Webinar

The board was apprised that the first ever SAFA-EEFA Webinar was held successfully on March 23, 2012 which was also attended by the Director and Manger Technical services ICAP.

Risk & Strategy to Mitigate Risk

It was discussed that member bodies should seriously consider risk and threat from foreign accounting bodies in the South Asian Region and formulate strategy to mitigate such risks.

Regional Trade

Vice President SAFA, Mr. Abdul Manna from Bangladesh, reiterated that SAFA could be instrumental in promoting the regional trade.

Common Syllabus of SAFA

It was further decided that the matter of common syllabus of SAFA will be taken up in next meeting.

SAFA's Action Plan for the year 2012

The Secretary informed the members that the SAFA's Action Plan for the year 2012 has been submitted to IFAC.

SAFA Best Presented Accounts Awards Competition 2011

Following points were discussed:

The Banking Sector category to be divided into two categories, namely,
"Public Sector Banks" and
"Private Sector Banks (including co-operative banks)

Following would be new categories:

- Public Sector Banks
- Private Sector Banks (including co-operative banks)
- Financial Services Sector
- Manufacturing Sector
- Communication and Information Technology
- Service Sector (Excluding Financial Services and Communication and IT sector)
- Non-governmental Organizational including NPOs
- Public Sector Entities
- Insurance Sector
- Agricultural Sector

It is decided that additional marks for sustainability report and for independent assurance would be awarded.

BPA award ceremony is expected to be held in the second week of December 2012.

Award for Corporate Governance would be titled as "SAARC Anniversary Awards for Corporate Governance". It was also decided to invite SAARC Secretary General for this awards ceremony.

Sustainability Reporting

I. For promoting Sustainability Reporting in the SAARC region , the board agreed to:

   a. Organize technical Sessions and Seminars on Sustainability Reporting in the SAFA/ Member Body Seminar/Conferences.

   b. Disseminate the need and importance of Sustainability Reporting by the SAFA member bodies among the corporate sector in their respective jurisdiction. The practice being followed among MNCs in Bangladesh was cited as a model.

   c. Hold a South Asian Conference on Sustainability Reporting or Joint Programmes within a country as was done in the case of Pakistan.

II. Vice President ICA India informed the board about the recent study on Sustainability Reporting published by ICA INDIA

Future Events

- The EFFA Conference would be held in Italy Rome, during 9-10th May 2012. The topic of the conference is "Exploring Business and Professional Ethics for SMPs and SMEs".
- SAFA Board meetings and SAFA - CMA Conference would be held on June 21-23, 2012 at Colombo, Sri Lanka

Student Conference

CA Student Conference is being held in July 2012 at Nagpur India. Members were requested to send their students.

SAFA Summit

2nd SAFA Summit would be hosted by ICMAP on November 9-10, 2012 in Lahore Pakistan.