

# ACCOUNTANT

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## How *Fair* is Fair Value Accounting?

**Wealth Statement for Zakat**





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# Editor's Letter

## HOW FAIR IS FAIR VALUE ACCOUNTING?

In the midst of all the uproar over fair value, or mark-to-market, accounting rules the specialists were divided in to two camps. Critics of fair value blamed the methodology that forced companies to take unnecessary writedowns on illiquid financial assets. Proponents of fair value claimed that 'historical cost was irrelevant'.

For the purposes of auditing fair value poses an unusual dilemma i.e., if management isn't certain about the fair value of their holdings, how can the auditor? This magnifies the scope of the valuation work. According to an October 2007 BusinessWeek article, 63 percent of the net assets of one of the world's largest bankrupt funds had been fair-valued.



Though the focus of fair value measurement has primarily been on financial instruments, it can as easily be extended to other assets and liabilities such as business combinations. One way of evaluating risks in disclosure is to look for an authorized, independent valuation of assets report.

We all know that investors want to know what an asset is worth today. That should imply that investors want fair value information along with historical cost information to determine a robust cash flow and operational results. But if some financial instruments are measured at historical cost, and others at fair value, and the manner in which they are measured differs from company to company, where's the comparability?

## APPLES TO ORANGES?

And how does one determine a market price where there is no market. If historical cost ignores price signals, mark-to-market is over-reliant on price which leads to another important question: in a world of frequently illiquid markets should fair value serve the interests of the company, or should it serve the cause of public policy?

From a public policy point of view fair value has implications beyond accounting procedures. With ever more assets and liabilities to be measured at fair value there should be guidelines and continuation of accounting, auditing, and valuation policies that safeguard the interests of the investing public. Fair value, after all, must be fair to all. The public's trust in audited financial statements must not waver.

A handwritten signature in black ink, appearing to read 'Adnan Zaman', written in a cursive style.

Adnan Zaman

# President's Page

## HOW FAIR IS FAIR VALUE ACCOUNTING?

*"Everything that can be counted does not necessarily count; Everything that counts cannot necessarily be counted".*

*Albert Einstein*

The Financial Crisis jolting the financial paradise opened a Pandora's Box of blame game with Fair Value Accounting bearing the brunt of it. The foundation of the profession of accountancy being transparency and accountability, objection by accountants to 'Fair Value Accounting' might seem like a cardinal sin to the public!



For the Financial statements to provide insight to public, the information should be understandable, relevant, reliable and comparable. With IASB advocating Fair Value Accounting on account of it being relevant, I feel that as much as relevant information is critical, other attributes should be given due credit for data is termed as information only when it is understandable, reliable and comparable.

It is argued that Fair value for assets or liabilities reflect current market conditions providing timely information, resulting in increased transparency to investors and others and encouraging prompt corrective actions. While none can deny the importance of transparency it is smeared by the allegation that fair value is not relevant and potentially misleading for assets that are held for a long period.

Assets and liabilities which are required to carry at fair value need a number of estimation methodologies. Generally market value is considered the most reliable. However for many assets and liabilities there is no market value available resulting in a lot being relied upon other methods of estimation. Here is the catch! How fair is that method? How understandable, reliable and comparable is the value worked out by management whose objectivity is not free from doubts. Reliance on valuers and actuaries is also an issue. In any case, as against historical cost the fair value is definitely a grey area for auditors to form an opinion thereon without subjectivity.

I feel that going back to Historical Costing would be a step back; however the implementation of Fair Value Accounting needs to be revisited in order to remove the misgivings and to remain fair to the existing and prospective investors of an entity.



**Abdul Rahim Suriya**

# JOIN THE DISCOURSE

This issue's topic is:

## The Greatest Risks to Global Business in 2010

2010 Global Risks Report by the World Economic Forum has highlighted the following as the greatest risks to global business in 2010:

- ▶ structurally deficient or obsolete infrastructure;
- ▶ spread of chronic disease; and
- ▶ illicit trade

Where do you think the greatest potential for risk may lie in 2010?

### COMMENTS

**Risk No.1** structurally deficient or obsolete infrastructure. Who is it at their most vulnerable? It can't be the Chinese, with their heavy increase in public spending, or the oil rich Arab world. They have paid the price for extravagance.

**Risk No.2** spread of chronic disease with its accompanying hype over swine flu and Y2K which promoted business worth trillions of dollars?

**Risk No.3** illicit trade. The risks and opportunities surrounding illicit arms trade will go on creating booming markets for arms manufacturers and suppliers to give control over natural resources in Africa and untapped resources in Afro-Asian regions of Bolivia, Sierra Leone, Somalia, Afghanistan and Balochistan.

The so called risks in my opinion are the opportunities envisaged by the opportunists. That's the name of the geo-political game!

**Rafi Hyder**  
Karachi

The major threat to global business in 2010 is the poor standard of governance that allows hundreds of thousands of corporate victims to surface suddenly. In Asia, the fall from grace of the software giant Satyam took markets by surprise threatening to cause a massive flight of investment from India which would have severely affected outsourcing business to Indian firms.

In Pakistan there have been some spectacular failures of corporate governance, where in some cases the regulator was involved in precipitating the failure, while in others the regulator was too late to arrive on the scene. In the case of a large investment bank, by the time the regulator had started the investigation the scale of defalcations had become so large and complex that a professional accounting firm was nominated to carry out an investigation. How was it that so many reviewers at so many levels missed the fraudulent transactions?

The recent credit crisis, which came about through poor governance on the part of bank managers dealing with securitization of mortgage loans, put the stability of the entire global financial system at risk.

The breakdown of corporate governance is the biggest risk to the global economy. The Pakistan Institute of Corporate Governance (PICG) has started training of directors but a lot more remains to be done. There is a dire need to change the culture of a board by ingraining in young managers that the route to long term success is determined by the choice of values a company espouses.

**Muntazar Bashir Ahmed**  
Lahore

The three risks identified by the World Economic Forum are the outcome of uncontrolled capitalism which believes in passing on the economic benefits to the poor and less privileged population by means of a trickle down effect. The concept of private or free enterprise allows concentration of wealth in a few hands and leaves their distribution at their discretion, like a pond full of water with barren lands around it surviving on the oozing water.

These risks are not 2010 specific. These would continue to increase with more risks added every year. The solution lies in setting up of economies that believe in the fair distribution of wealth.

**Tariq Jamil**  
Islamabad

'Structurally deficient or obsolete infrastructure' is the most significant problem faced by countries like Pakistan. The ongoing war on terror has far reaching impact on local businesses which is also deteriorating the quality of infrastructure. Everyone is aware that Pakistan is spending huge funds on this war but lesser re-funds from the main stakeholders are burdening the already huge budget deficit.

A recent reduction in developmental budget is another example of tight monetary conditions for our Government. It suggests that people are less important than winning wars. Keeping this in view I think that in the current economic conditions it would be a great achievement for any business to sustain itself rather than showing growth.

**Saad Ahmed Khan**  
Karachi

In my opinion the fear of business failure is the greatest impediment in 2010 which will reduce business prospects across the world. We witnessed substantial growth in businesses till 2007. The worst experiences of 2008 and 2009 due to upsurge in commodity prices cannot be avoided this year. As a risk

manager, I find that business people have started talking about risk instead of waiting for risk alerts from their risk management teams. This policy shift can be witnessed in any organization. This will lead to better management of the organization as people start realizing the importance of controls and risk management.

In the banking industry, investor dynamics have changed from high risk takers to risk-averse unit holders. At ABL AMC we have tapped this opportunity and generated sizeable business from risk-averse investors. The success has been exponential i.e. Rs.10 billion incremental from the date of launching of funds. Prudent investment will prevail in 2010.

**Faisal Nadeem Mangroria, ACA**  
Karachi

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Referring to the 2010 World Economic Forum's Global Risk Report, for me the greatest potential risk lies in deficiencies in the control and supervision infrastructure as these have prominently featured in the shape of the greatest recession of our generation. The dearth of consensus towards a solution and contradictory forecasts and results are further undermining the badly needed recovery of the world economy.

We all forgot that at the end of the day markets are operated by human beings who tend to be too confident of their own abilities, compromise their professional integrity, and are seduced in to accepting excess risk.

**Aiman Mumtaz**  
Abu Dhabi

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Global business has always faced emerging challenges and risks and therefore the risk identification, risk management and mitigation program has to be continuous and uninterrupted. Certainly the obsolescence of infrastructure, chronic disease, and illicit trading are the bigger issues to be faced in 2010. Yet, I believe that while judging and forecasting such risks, the business world typically ignores the environmental risks arising from climate change, misuse of resources, and over exploitation of scarce natural reserves.

In my view the most crucial challenge for risk identification and for managing modalities is to mitigate the environmental risks, specially the risks associated with diminishing vital resources like useable water. The world is now at the verge where comprehensive planning to manage these risks is vital for our outright existence.

**Muhammad Kamran Nasir**  
Karachi

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In my opinion the greatest risks to global business will be:

- Energy crisis
- Law and order, terrorism, and political strikes
- Cost inflation with stiff competition
- New technologies accompanied by day to day swift changes
- Financial volatility

Organizations are realizing that risk is no longer a liability and if managed adequately becomes a powerful asset that may offer a competitive advantage.

**Haroon Sulaman**  
Faisalabad

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The confrontation between economic giants US and China and between the US and European Union will increase the geopolitical risk in 2010. This growing political instability is the greatest risk to global business in 2010 as it will not only have repercussions on the progress of emerging economies but it can also

damage the process of world economic recovery.

**Adeel Ahmed**  
Karachi

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My take on this: global risks are not applicable in their entirety to Pakistan, at least not in the short run. One has to add new dimensions to the already identified global risks while relating them to Pakistan. Not only that, but we need to identify our very own unique risks knocking on our doors ... corruption, energy crisis, bad governance, climate change, illicit trade. We need to identify, assess, and prioritize these risks in order to be able to devise a road map on how to overcome them.

I'm reminded of something Lillian Carter, Peace Corps volunteer and mother of former US President Jimmy Carter, once said, "I don't think about risks much. I just do what I want to do. If you gotta go, you gotta go."

**Shuja-Ul-Mulk**  
Peshawar

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One of the biggest challenges to global business will be to restore customers' trust. Businesses, small and large, will have to make visible steps to enhance customer confidence and attract more investment. On our home front the war against terrorism is placing heavy burdens on our economy as our resources are constantly directed towards preventive measures instead of progress through investment.

**Muhammad Amin**  
Faisalabad

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Eurasia Group, a New York-based risk advisory firm, issues an annual list of the top 10 global geopolitical threats every year, and this year's top 5 risks spotlight US-China relations, the Iranian regime, European fiscal divergence, US regulations, and political changes in Japan. Surprisingly enough it also discusses Pakistan -India further down the list.

I personally consider deficient infrastructure and chronic disease as more significant risks than illicit trade. Only proper periodical investments are the solution for the appalling infrastructure failures and spread of chronic disease.

**Hassan Kamal Farooqui**  
London

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The global risks report rightly identified the key risk areas to global businesses in 2010. However, I believe that depreciating existing infrastructure and limited fresh investments vis-à-vis required level of infrastructural developments pose major threat to businesses worldwide. Of course, it's difficult to analyze risks in isolation as various other factors, interalia political, environmental, and financial risks may have an equal impact.

**Rana Muhammad Nadeem**  
Lahore

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In addition to weak infrastructure, illicit trade and chronic disease, the greatest potential for risk may lie under the following heads:

- gaps in governance; and
- unemployment which is now common to both the developed and developing worlds and will have an undesirable effect on consumption and a disproportionately large impact on youth.

**Muhammad Ibrahim**  
Karachi

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# Fair Value Accounting – Another Playground for Speculators?

Abdul Aziz, FCA

*Fair value accounting estimates provide more relevance and clarity in financial reporting and address the knowledge-based economy better than historical cost. Reporting fair value estimates and disclosing a range of possible outcomes may help the sophisticated investor but at the same time may plague the unsophisticated investor with ambiguity and information overload.*

Fair value may result in even greater vagueness as compared to historical cost accounting. We have seen in past, ambiguity in measurement and accounting had lead to some very serious indirect costs. When the information in the market lacks validity, investors devalue all companies, not just the ones with validity issues. In recent years, inaccurate accounting information has developed a lack of trust on auditors, financial analysts, and senior executives. To overcome this validity issue in fair value accounting regulators have greatly increased the regulations on auditors, managers, and boards of directors.

However, in the shadow of these ever growing regulations companies are concerned about the timing of switching between fair value and historical cost, inclusion of the types of assets and liabilities and at which level of the fair value hierarchy, identifying the market as the primary market of the asset or liability and in addition to these, identifying external factors that could potentially affect changes in fair market value.

### **ESTIMATION ERRORS MAKING FAIR VALUES VERY UNFAIR**

Some accountants and analysts believe that fair value accounting provides more reliability on particularly intangible assets. However, the entire valuation depends upon certain assumptions and estimates. Estimation errors can easily distort the financial statements. Unrealized changes in fair values from one period to the next that are reported under fair value accounting as gains and losses in financial statements swing the results of operations to a completely different direction. The proper matching of assets and liabilities is even more difficult to implement than the matching of revenues and expenses used to be under historical cost convention.

Reliability of fair value estimates varies with the extent to which fair value estimates include the fair and independent values and management's internal (generally biased) information. The most consistent area posing issue of reliability on fair value estimates is related to the investment securities traded in active markets. The fair value estimates are largely derived from the analysis of banks and other financial institutions for which financial instruments comprise core operating assets and liabilities. There are companies that are completely different from companies holding inventory, property, plant and equipment, and other assets whose value comes from an execution of a business plan rather than fluctuations in market prices. Therefore, a generalization of these research findings and applying on the all sectors is itself a big question mark.

### **Fair Value Accounting Issues in Financial Sector**

#### **ASSETS NOT HELD FOR TRADING**

Fair value is appropriate for assets that are held for trading purposes or if an entity's business is based and managed on fair value. In those situations, the expected cash flows and earnings are based on buying and selling in the markets, and fair value can approximate what those cash flows/earnings will be. However, for entities whose business models are not based on buying and selling in the markets, such as traditional commercial banks, fair value provides neither the most relevant nor the most reliable information. It does not necessarily reflect the expected cash flows and earnings, and it will result in misleading the readers of banks' financial statements.

#### **RECORDING LOSSES BASED ON MARKET PERCEPTION**

Investment securities that are traded or are available for sale are marked to market value. In some cases the changes in mar-

ket values are recorded in earnings and capital, and in other cases the changes in market values are recorded only in capital. In any event, fair value has an impact on publicly reported capital.

Recording other than temporary impairment that is based on credit impairment is non-controversial in the banking industry – banking institutions fully understand and support the need to record such impairment. However, there is much controversy with recording losses that are based on the market's perception of fair value, which often results in recognizing losses that exceed credit losses or recording losses for securities that have experienced no credit problems and are fully performing in accordance with their terms. The erosion of earnings and capital due to a market's perception of losses or due to a lack of liquidity that drives values lower is misleading to investors and other users of financial statements.

### **UNCERTAINTY IN THE MARKET**

The current liquidity situation in the market due to improper use of fair value may develop in to a difficult and unfair situation. Capital can be artificially eroded despite solid fundamental credit performance and the lending capability of a bank can be reduced. This reduction in lending power negatively slows down the economic activities that ultimately put borrowers at risk. This situation also puts pressure on asset-backed security prices. The resulting misleading information is contributing to the uncertainty in the markets and the further constriction of credit in investment markets.

Many areas of the market are always uncertain and the market prices are discounted significantly below the expected cash flows to be received. Therefore, any bank that holds an investment security in its "held to maturity" securities portfolio faces this problem when securities that may have a good economic value end up having a comparatively low market value. Under the current application even if the cash flows are performing well and the entity holding the security has both the intent and ability to hold the securities until the security matures, the entity must still write down the security to the current fair value. This devaluation will not have any subsequent reversal of the loss even if the asset recovers its market value. The situation gets worst in future as reported yields on these investments will be disproportionately high.

### **EXPECTED LOSSES VS. FAIR VALUE**

Consider a bank that made loans and securitized them as a mortgage backed security. The bank is required to record mark to market losses as opposed to the maximum expected lifetime losses that are also absorbed by collateral. This accounting practice is resulting in a significant overstatement of losses and having a negative impact on tangible common equity. The bank will not sell the securities at the estimated market value as the value of the securities and the estimate of cash flows is much greater than what the market is willing to pay.

The bank attempted to buy similar mortgage backed security at a comparable yield and credit quality, but cannot find them at the price the bank is being required to mark them down at. This is because the "market" quotes the bank is required to use do not represent the actual cash flow value of the underlying loans.

### **FAIR VALUES MEASUREMENT ERROR**

Fair value estimates of bank assets and liabilities are likely to

contain measurement error. Unrecognized gains/losses could cause earnings and regulatory capital to be more volatile than under historical cost model. This would occur if measurement errors in bank assets' fair values do not fully offset bank liabilities' fair values.

Regulators need to address how best to minimize the ratio of the bad-to-good volatility. It will be an appropriate question if regulation of bank capital will be more efficient under one fair value or current mixed attribute model.

### ECONOMIC CONSIDERATIONS

What will be the real economic consequences of requiring banks to use mark-to-market? One key implementation issue is whether real economic decisions by bank managers will improve. Extra volatility of fair value income and regulatory capital could cause bank managers to choose lower risk investments than would be the case if investment decisions were based solely on economic considerations.

### APPLICATION ISSUES IN METAL INDUSTRY

Finished goods inventory of precious metals is marked to market on the balance sheet. This represents a significant departure from the trend of current accounting standards which have been moving towards requiring mark-to-market accounting. Where the entity's disclosure of the "cash cost of gold" provides relevant information to investors, the investor cannot use this information at the same time to convert inventory it carried at cost under the sales method to a relevant estimate of its market value. The income statement is more relevant for firms that did not recognize revenue as production was complete, but rather used the traditional point of sale method as the critical event for revenue recognition.

In the present economic crisis the investible resources are flowing into metals especially in gold. The problem is that even though the USD has become stronger its value against gold has declined significantly. This situation provides huge scope for arbitrageurs and manipulators to profit from and mislead investors and accountants with the fair value of securities. The value of investments disclosed in the financial statements and their valuation is posing a challenge to accountants and auditors.

### INSURANCE INDUSTRY A BIG MESS

A current example of the possible impact of fair value reporting is the recent turmoil surrounding the insurance giant American International Group (AIG). Within the last year, the insurer has reported \$11 billion in asset writedowns. AIG executives have stated that they are trying, like many others, to value very complex financial instruments involving difficult estimates and judgments in a new world in accordance with new rules. Many trial lawyers believe that these types of situations will have significant impact on accounting related and securities class action litigation although the impact cannot be fully appreciated at this time as companies are just beginning to report under the new

rules for the first time.

### WHAT TO DO WITH PRIVATE SHARES/STOCKS

Consider a company did a transaction and as part of that transaction that company received 1,000 warrants to buy shares in a private company at \$5. Imagine that the private company in question subsequently raised a new round of financing at \$6. Under fair value accounting the company is required to record a gain of \$1 per warrant on its financial statements. The company has to take \$1,000 into income — even though there is no ready market to sell the warrants into, and as a private company there is no public market quote to refer to.

The fair value of the warrant will be determined fair enough as the new investor that paid \$6 per share already took the private nature of the company into account when they invested.

### DILEMMA FOR THE AUDITORS

Fair value was the main tool used to commit financial frauds, Enron being one of the prime examples of this kind of financial jugglery. The auditors are required to provide assurance to the investors and creditors that the fair value estimates are based properly on legitimate information. The auditors find themselves in an extremely tough situation with their limited resources to cover both internal control and financial statement audits. Auditors have no other choice but to make judgment calls about high-risk areas and use statistical procedures to determine where to invest engagement time.

In general the auditors are now in a crisis situation to ensure their clients report market values for their securities even though such market values are substantially declined compared to the values previously assigned to the securities. Some clients even pressurize their auditors to accept their fair values in the absence of other reliable market information that can be used as fair value for those particular assets. The failure to require clients to properly report the market values for their existing holdings would expose the auditors to significant liability.

Due to the enormous uncertainty and the magnitude that usually make the financial statements swing in opposite direction with slight error on estimated fair value assumptions will always have to be carefully investigated. The additional time and risk involved in auditing the fair value measures definitely escalate the cost and ultimately the additional audit fees.

*Abdul Aziz is Regional Director Finance and Operations for Sabre Travel Network, Middle East.*

**Some accountants and analysts believe that fair value accounting provides more reliability on particularly intangible assets. However, the entire valuation depends upon certain assumptions and estimates. Estimation errors can easily distort the financial statements.**

Altaf Noor Ali, FCA

# Fair Value Accounting: What would you like it to be?



## **PREAMBLE: THE INEXACT LANGUAGE OF CONVEYING BUSINESS FACTS...**

“Accounting is the language of business”, the Professor went on saying it till all of us got the idea... for a lifetime. That was our first lesson of financial accounting by Prof. Karar Hussain (late) at St. Patrick Government College – around 1983.

Sometime later he asked us: “How much is “a” and “b”?”... and before we could respond, he went on to amuse us by saying that if your employer asks you, your response should be: “What would you like it to be, Sir?”

That concluded our first phase of our accounting education: “Accounting is the language of the business, and it is not exact”. As such, there is no concept of a perfect valuation as much as there is no concept of perfect accounting.

## **FROM HISTORICAL COST TO FAIR VALUE VALUATIONS:**

The present day fair value measurement (Refer Window 1) model appears to have its roots in seventies when the accountants in their quest of discovering a perfect convention for valuation of elements of the financial statements (assets, liabilities and equity) took fancy with the concept of ‘constant purchasing power’ and experimented with current cost accounting and infla-

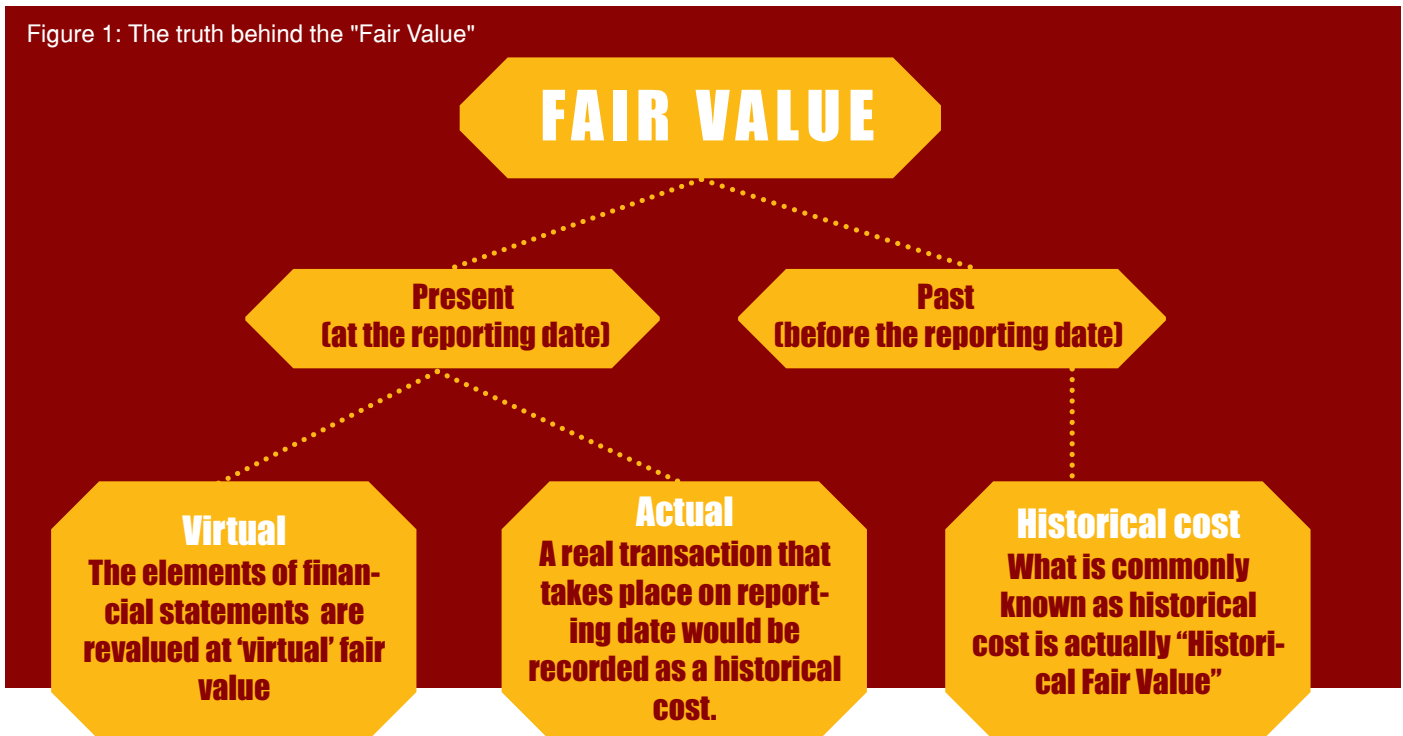
tion accounting. Thanks God, by late seventies the weaknesses of following these conventions was clear and its indiscriminate use in preparing the financial statements was internationally discarded.

Meanwhile, the accounting regulations also graduated from the pure historical cost convention in certain ways. It is no more an unpardonable sin to imagine some elements of the financial statements stated at fair value along with the ever-green historical cost (Refer Window 2 and 3). For any accountant, it was basic to learn that the inventories, if any, are to be stated in financial statements at the lower of actual cost or net realizable value at the reporting date (IAS-2 Inventories, Para 9).

## **FIRST LOVE: VALUATION OF EQUITY INVESTMENTS**

I noticed the first visible change during mid-nineties as an individual shareholder (technically, “certificate-holder”) in the reporting of the equity investments at market value at the reporting date held by the close-end mutual funds managed by

Figure 1: The truth behind the "Fair Value"



the Investment Corporation of Pakistan (ICP) and listed at the Karachi Stock Exchange. The disclosure of market value based net asset value relieved me from doing my own computation for "discovering" the true "net asset value of the funds". All equity investments held on the reporting date were thankfully stated at the market value. However, the notes to the financial statements were not more specific for an "Alice in Wonderland" like me to know if the fair value or market value for a particular scrip was the closing price (i.e, the one at which the last transaction was recorded at the closing time), or was it the bid or offer at the closing time on the reporting date (in case of no transactions recorded in that scrip), and if it was adjusted for any transaction costs.

Whereas I was clear that equity investments are much more soundly valued on market value basis than historical cost, I was

obviously equating the fair value of equity investments with its market value. Would that be correct for non-equity financial instruments or debt securities like term finance certificates, which not actively traded? Furthermore, assuming that fair value equals market value, it requires a buyer and a seller and a market. Now for a perfect valuation, the market needs to be perfect as well. Do we have one? Can we call Karachi Stock Exchange a perfect market to value the scrips listed therein? Is there any stock market that can claim to be perfectly reflecting the fair values of equities?

#### REVALUATION OF LONG-TERM ASSETS:

Thereafter, sometime around the mid-nineties or perhaps even earlier, it became almost fashionable for every second listed company to revalue its long-term fixed assets thereby creating a "reserve for revaluation of fixed assets" and increasing the amount of equity by such amount. For example, if the land and building was to be stated at Rs. 100,000 historical cost net of depreciation at the reporting date, its revaluation at Rs. 500,000 meant an increase in equity of Rs. 400,000 without actual inflows of any funds.

I noticed that most revaluation was on account of the real estate assets held by the company on the reporting date. Of course, these valuations were being done by the experts in the respective field but I wondered if auditors had means or expertise to point out any inaccuracies in valuations.

For example, in case of revaluation, can we add millions to the equity based on simple one page certification by an expert, as in case of something as unique as valuation of land and building?

I suspected personally that most revaluations were done to avoid the further need of injecting equity into the business and primarily to bring the debt-equity ratio in position where bank borrowing were permissible.

In most of the revaluation of long-term assets I saw, it was primarily the value of land that was revalued. The question is

#### Window 1: Fair Value Measurement

The International Accounting Standards Board issued the exposure draft ED/2009/5 on "Fair Value Measurement" in May 2009 for comments by 28 September 2009.

The fair value measurement project was added to the Board's agenda in September 2005.

The project plan envisages completing deliberations and balloting by 30 June 2010, with the IFRS to be published shortly thereafter. This has been postponed for another six months at least.

The draft IFRS defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price).

In the absence of an actual transaction at the measurement date, a fair value measurement assumes a hypothetical transaction in the most advantageous market for the asset or liability.

how many of us would consider real estate market to be a perfect market?

### FAIR VALUE OF ASSOCIATED COMPANIES HELD FOR LONG-TERM

Time now to apply the concept of fair value to the investment in the shares of a listed company held reported as an associated company by another listed company. Do you think it should be stating its investment in the associated company on cost or fair value?

As a shareholder, when I inquired of the reason why the investment in the associated company was stated at the historical cost which was way lower than the current market value, I was told that the IFRS prescribes that an associated company held as a long-term investment is to be stated at the historical cost rather than its fair value, and as usual that the auditors consented to the treatment.

When I reminded the management of this company of its responsibility of a faithful presentation and substance-over-form in presenting its financial statements, I was advised to take up this matter with the international standards setting organization. My regrets for not doing so! However, my consolation was that in the recent financial statements the historical cost valuation approach was abandoned by the company. I could not figure out if it was because of change in standards or the perception of the management.

### COMPULSIVE TRANSFER PRICING OR FAIR VALUE

I also remember the time when our local pharmaceutical multinational companies were accused of transferring financial resources to their parents by compulsive buying of raw materials for drugs at exorbitant costs and largely leaving the local shareholders high and dry by not declaring the real profits.

The motive for the practice was simple for a taxman to under-

#### Window 2: Interesting facts about fair measurement project...

The project was initiated to:

- clarify the fair value measurement objective;
- develop a single source of guidance for all fair value measurements currently required or permitted by IFRSs in order to simplify IFRSs and eliminate the dispersed and inconsistent fair value measurement guidance;
- improve and harmonise the disclosure requirements for items measured at fair value; and
- increase convergence with US GAAP.

A fair value measurement requires an entity to determine:

- the particular asset or liability that is the subject of the measurement (consistently with its unit of account).
- for an asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use).
- the most advantageous market for the asset or liability.
- the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use in pricing the asset or liability and the level of the fair value hierarchy within which the inputs are categorised.

stand. A corporate pays tax at about 30-40% on its profits. The profit after tax is an anemic reflection of profit before tax. On the other hand, financial resources transferred by way of paying for the material is independent of any such formalities and is much lower in terms of transaction-related taxes.

As always, this issue too was investigated by the Committees etc. brought to an end by an argument that the cost of acquiring drug-related proprietary raw material is relatively high because it includes a portion of the research of which the product is the output, but it was still the fair value.

### FAIR VALUE OF STOCKS UNDER TESTING TIMES

My last example is from our recent experience when the stock market was closed during the last quarter of 2009 for a consecutive period of more than three months. During this period, the entities holding equities traded at the market were provided with a special mechanism by the Securities and Exchange Commission of Pakistan to report on the valuation held by them at 31 December 2009. This was done as because the IFRS does not provide for any mechanism for the valuation of stocks if the market is closed. So SECP went ahead and came up with an innovation of their own!

### FAIR VALUE OR IS IT VALUATION AT A "VIRTUAL FAIR VALUE"?

The essence here is that when an entity enters into any financial transaction say, purchase of a long-term asset at time "t" we assume it to be so at a fair value whereas that very fair value would transform itself and will be termed as a historical cost at "t+1", till it is revalued again on a 'virtual fair value' by some external reference, at say "t+2".

In other words, the term "historical cost" is a misnomer as it is actually "historical fair value" whereas what we term as a fair value is virtual, not real as that would only be so in an actual transaction (see figure 1).

In the end, the examples above go on to show that fair value is as fair as the person who is applying it. As you say that the taste of the pudding is in the eating, the same is the case with the fair value. It depends a lot on its interpretation and application. Calling something 'fair' would not make it so and the same goes for the use of the term 'fair value' in the financial statement.

#### Window 3: Overall changes to the IFRS framework

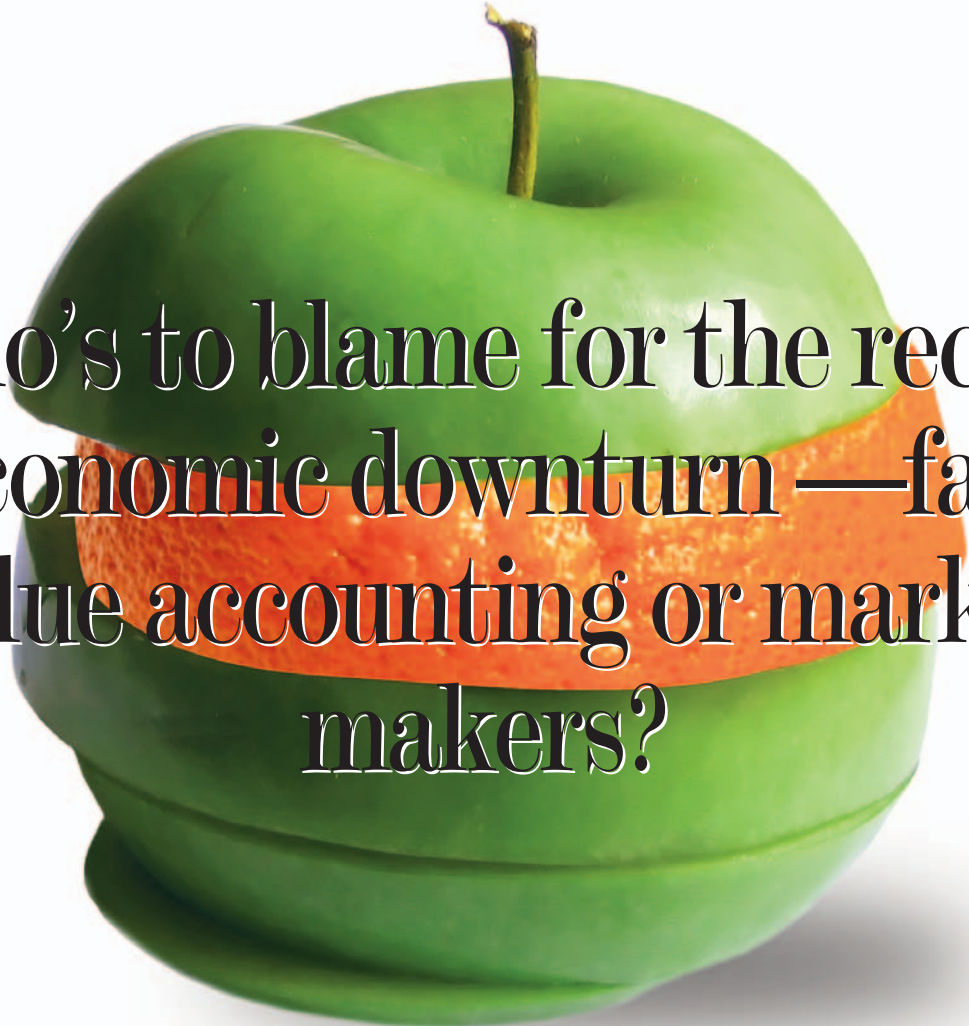
Appendix D to the ED on Fair Value Measurement lists the Amendments to other IFRSs.

The definition of fair value as used in IFRSs 1 and 3-5 and IASs 2, 16-21, 32 and 39-41 will be replaced.



# The Blame Game

Goind Ram Khatri, FCCA



Who's to blame for the recent economic downturn — fair value accounting or market makers?

The term 'fair value' or 'fair value accounting' has been the subject of a lot of controversy during the current financial crisis. Some commentators blame fair value accounting for the recent economic downturn and others believe that market makers are responsible for the distortion of the world economy. Looking a bit deeper at this discussion may not explain the financial crisis and recession but highlights some interesting themes.

## FAIR VALUE AND THE MARKET

The accounting rules have always been a target of blame. However, one needs to understand the role of these rules, as they are prepared keeping in mind the concerns of all stakeholders. Take the example of fair value which is defined as: *an amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.* As long as parties are knowledgeable and willing and the transaction conducted is an arm's length transaction, the price determined using such a principle reflects the fair price which could be obtained in the circumstances. Therefore, if market makers raise the price of a commodity and a counter party is willing to pay the price in an arm's length transaction then that price is truly reflective of fair value. Market created exuberance cannot be ignored and is almost impossible to quantify.

Looking back to the history provides us with an insight of how the market movers manipulated the price of an ordinary commodity such as tulips - a spring-flowering plant that grows from a bulb and has lance-shaped leaves. Tulips arrived in Holland in the mid-16th century and soon became a luxury good sold to courtiers and country gentlemen. As with the trade in special, rare, high value tulip bulbs, speculation in low value bulbs also started in November 1636. By 1637 the tulip market had collapsed with significant reduction in the prices as well as higher level of defaults on outstanding contracts.

The price of a special, rare type of tulip bulb, *Semper Augustus*, was 1,000 guilders in 1623, 2,000 guilders in 1625,

and 6,700 guilders by 1637. At these price levels one single tulip bulb could cost as much as a decent house in Amsterdam. After the "crash" prices were said to have fallen to less than 10 per cent of their peak values and by 1639 prices had fallen to 0.5% of the peak price. Clearly, such price movements are in line with a traditional bubble hypothesis: start low,



**The accounting rules have always been a target of blame. However, one needs to understand the role of these rules, as they are prepared keeping in mind the concerns of all stakeholders.**

reach high, end low.

History remembers the above speculative trading as *'tulip mania'* and it is considered as the first economic bubble. Tulip mania is seen as an example of the unweariness of the public and the dangers of financial speculation.

Tulip mania resonates with the recent economic downturn where the worldwide prices of property and stock market have crashed, dragging down the prices, in many cases, to less than 50% of their peak. It appears that either we forgot the lesson learned from tulip mania or that the speculators, once again, lead the market to their advantage as main players of the game.

## FAIR VALUE AND ACCOUNTING

'Fair value' is a powerful generic expression as used in the English language. However, its meaning becomes very specific in the accounting literature. Generally speaking, 'fair' value encompasses the behavioral aspects which may vary from person to person. The price of a commodity may be a fair price to one person but not to another. However, it is not possible for accounting standards setters to include behavioral aspects in determining fair value as this may be different from one person to another and is inherently volatile and unpredictable.

The IASB and others, including financial institutions themselves, have looked at other valuation models in an effort to do just that. New terms such as *economic value* and concepts such as *dynamic provisioning* attempt to strip out market exuberance and account for expected changes in behavior. However, as the accounting standards setters struggle with the competing requirements of the stakeholders a move away from fair value is not an easy proposition.

## CONCLUSION

Fair value is the price at which knowledgeable parties are willing to pay in an arm's length transaction. If speculators manipulate the prices and market participants are willing to trade on such prices then the prices determined are fair prices. It is hard to argue with such simple accounting principles! Until we can regulate the market better, or account for irrational behavior, history will continue to repeat itself and fingers of blame will point to the market makers.

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# An Appraisal of Federal Budget 2010-2011

Syed Mohammad Shabbar Zaidi, FCA

## REVENUE TARGET

- ▶ In the budget document total revenue collections from Federal taxes have been estimated at Rs 1,667 billion as against the target of Rs 1,380 billion for the year 2009-2010. Actual collection for 2009-2010 is expected to be around Rs.1,350 billion.
- ▶ This revenue target will be around 10 per cent of GDP.
- ▶ The primary question to be answered is whether or not the measures announced in the budget will improve Tax to GDP ratio and that in a meaningful manner.
- ▶ The answer is emphatically negative and I do not expect the same in the short run. I would, however be really worried if the direction is wrong.
- ▶ In the proposed budget the increase in revenue collection over the year is Rs.287 billion [Rs.1667-1380]. Out of the same Rs.200 billion is expected from inflation of around 10 per cent and around 4 per cent from GDP growth.
- ▶ Remaining recovery of around 80 billion is expected primarily from increase in tax at import stage from 4 to 5 per cent, increase in minimum tax from 0.5 per cent of turnover to 1 per cent, and increase in the sales tax rate from 16 to 17 per cent for the period July 1, 2010 to September 30, 2010 when a new Value Added Tax or General Sales Tax is expected to be implemented.
- ▶ This is not rocket science. It's simple arithmetic. It has to be noted that these are obsolete and traditional methods of balancing revenue collection which are not expected to provide vibrancy, efficiency and elasticity earnestly required in our tax collection system.

### Arm Twisting of Genuine Taxpayers

- ▶ Another important aspect with regard to tax collection is the recovery made through twisting the arms of the genuine taxpayers.

- ▶ Around Rs.50 to 70 billion has been raised through orders and assessments which are not maintainable in the court of law and the recoveries if made against these orders will ultimately be refundable. This is effectively an advance payment of tax. Thus, these are not 'actual collections'. This trend, which existed in the early 90s and had died down with the introduction of the new Income Tax Ordinance, 2001 has again cropped up. In these circumstances the real recovery of taxes is to be taken at around Rs.1,280 to Rs.1,300 billion for the year 2009-2010.
- ▶ Do we have a conducive environment for the recovery of the sum of Rs.1,650 billion?
- ▶ The bigger misfortune is the role of foreign advisors and intellectual and economists in Pakistan. There is constant pressure to increase the tax to GDP rate without even properly understanding the ground realities. These advisors and national intellectuals will have to honestly be a part of the national pressure groups in the movement to restore Pakistan's economic survival. In this country politicians, traders (businessmen engaged in trading), tax advisors, and above all bureaucracy is benefiting from the present tax system at the cost of the common man.

### INDUSTRIALISATION AND CUSTOM DUTY POLICY

- ▶ Mismanagement of custom duty structure in Pakistan is one of the foremost reasons for the decline in industrial activity in Pakistan.
- ▶ There are two aspects of this. First is the policy issue, being a blind adoption of reduction in duty rates under the shadow of compliance to World Trade Organization [WTO] guidelines [a policy mistake]. The second aspect is administrative in nature; being the curse of Afghan Transit Trade, under-invoicing and misdeclarations.

### GUISE OF WTO COMPLIANCE

- ▶ We are constantly told that under the present global economic system, there can not be any protection for the local industry by way of duty structure as we have to be compliant to WTO standards. There is no dispute over the fact that there should not be any 'tariff barriers' for trade. However, what is a 'tariff barrier' in a particular case is a subject of intensive study by technical people. We are all aware that one of the most relevant but toothless organizations in Pakistan is the National Tariff Commission [NTC] which is supposed to be an organization to determine effective duty structure.
- ▶ In short what we need to do is to undertake a 'zero-based' study of tariff structures.

### Defeatist Attitude

- ▶ It is very unfortunate that a case for reduction in duty compliance to WTO is made with a defeatist attitude. There is public acceptance by government officials that corruption in the nature of misdeclarations, smuggling, and abuse of ATT can only be avoided by keeping duty at the lowest level. This attitude is not acceptable and if we continue with the same then this country will face a huge trade deficit and unemployment. If this contention is correct then why do we need the custom department and the army of officials for this duty.

### ABUSE OF AFGHAN TRANSIT TRADE

- ▶ Afghanistan is one of twenty two land locked countries in the world. However, our trade agreement for Afghanistan is unique in the sense that there is neither any 'Quantitative Restriction' nor is there any refund of duty paid upfront. This

'free for all' system has effectively crippled our economy.

- ▶ We have seen the case where around 50,000 tons of 'Black Tea' has been imported for Afghanistan whereas as per information not a single cup of black tea is used in Afghanistan. This is only an example. This issue is so serious that effectively all our past measures for management of custom duty have failed. One of the most glaring examples was the imposition of regulatory duty in 2008 for 450 luxury items.

The solution is:

- placing 'Quantitative Restrictions' on Afghan imports; and
- levy of duty and the refund for the same on transit out of Pakistan.
- ▶ This issue has to be taken as a first priority in our trade policy. The Finance Minister has referred to strong lobbies which counter proper implementation of economic policies. Let me warn the Finance Minister that the most important lobby in this whole field will be those involved in abuse of ATT. We would have to build up a national consensus for the same for our survival.

### UNDER INVOICING

- ▶ Pakistan is one of those unfortunate countries which suffered heavily due to non-cooperation from friendly states. We have a flourishing business of under-invoicing that is promoted due to non-cooperation of two of our friendly states. China is the primary source of under-invoiced products and Dubai is used as a conduit in settling the payments through 'hawala' and other organized means. Let us admit that it is a reality that these two countries need not be blamed for our own follies.
- ▶ In case the general public was knowledgeable that the 'spark plugs' that they buy at Montgomery Road in Lahore or Plaza Area in Karachi are sold at ten times the price at which such products are imported then there would be pressure against such misdeclarations. This simple action is not done primarily to promote corruption or for fear of mafia involved in these trades.

### Free Flow of Exchange and Tax Amnesty

- ▶ The other tragedy of the matter is abuse of the free flow under our so called 'foreign exchange reform'. We have a parallel foreign exchange system which provides a mechanism through which payments can be made in US\$ to the importer from whom the under-invoiced products have been imported.
- ▶ We are hesitant to abolish FE 25 [a circular that allows Pakistani residents to maintain foreign currency accounts in Pakistan] and exemption under 111(4) of the Income Tax Ordinance, 2001 which are the legal means to promote such businesses. If someone were to ask what the biggest errors of Pakistani economic policy were I would refer to implementation and continuation of these two provisions.

### Have we taken correct remedies?

- ▶ We would have to seriously examine the foreign exchange systems and tilt towards the promotion of trade. Notwithstanding the merits of free trade this population of 180 million needs 'jobs' not support from Benazir Income Support Program (BISP) or food from Sallani Welfare Organization. These direct interventions are short term

solutions but not the end. This is equal to prescribing aspirin to a cancer patient. What we need is major surgery.

### SMUGGLING

- ▶ In our society availability of smuggled goods has been accepted as a norm. There is continuous inflow of smuggled goods across the borders. Containers flow from Karachi port as well as from 'Sust' borders in the Northern areas. Reduction in the duty rate or giving extraordinary powers to the custom official is shown as a solution to this problem. I totally disagree with the same. There is a need for a national anti-smuggling drive with political consensus for people to discourage it, and disassociate from purchase, sale and trade in smuggled goods.

### CUSTOM ADMINISTRATION

- ▶ There are two stages of automation in customs viz:
  - ❑ automation of process for clearance; avoiding human intervention; and
  - ❑ automation, if possible, for applicable duty rate and valuation process.
- ▶ For various ulterior motives, including lack of proper understanding, both these aspects have unnecessarily been mixed up and inter-related.
- ▶ It is to be appreciated that 'Customs' and 'Inland Revenue' are two different subjects. 'Customs' is effectively a subject of trade regulation. In countries like ours it should effectively be used as an aid for promotion of local industry and facilitation. Thus, as out of box thinking, a separate Board for 'Custom' like in India and many other countries can be explored. Furthermore, since almost all the activities are effectively undertaken at ports located in the south, therefore the, new board may be headquartered in Karachi.

### FEDERAL EXCISE DUTY

#### Abuse and Provincial Autonomy

- ▶ Federal Excise Duty structure is to be fundamentally revamped with the introduction of the proposed Value Added Tax. There had been serious intrusion by the federation in the right of taxation of the provinces through this tax for 'Services' specially in the nature of telecommunications, travel, banking and insurance.
- ▶ In fact the present unsettled issue between the Province of Sindh and the Federation on the implementation of Value Added Tax primarily relates to this subject only.
- ▶ At the first stage it has to be settled that Federal Excise Duty must effectively not be levied on 'services' which is a provincial subject.

### VALUE ADDED TAX

#### Why are we so confused?

- ▶ There are in principle five issues with reference to VAT:
  - ❑ Is it a new 'Tax'?
  - ❑ What is the issue between the Federation and Provinces (specially Sindh) with reference to services?
  - ❑ Would the same result in increase tax incidence, and resultant inflation?

- ❑ Is the wholesale or retail trade sufficiently documented to implement this tax?
- ❑ Whether or not 'zero rating' for exports continues to remain applicable to export oriented sector through which local consumption of such industries also remains outside the tax ambit?

#### Rationale for Implementation of VAT

- ▶ It is essential to understand that the rationale for introduction of VAT is based on the premise that:
  - ❑ contribution of services sector in overall tax base is to be improved. At present consumption tax is effectively restricted to goods;
  - ❑ local consumption of export oriented sector be brought into tax net; zero-rating for products rather than whole sector; and
  - ❑ all segments of business being wholesalers, distributors and large retailers be brought into tax net. This extension of documentation will ultimately lead to improvement in direct tax collection. Indirect taxes are in any way being recovered.

#### Is VAT a New TAX?

- ▶ Sales Tax on 'Value Added Tax Mode' and the present VAT Bill are two names of the same product. When we study the proposed VAT it is revealed that it is almost similar to the purist General Sales Tax as was introduced in 1996. Sales Tax system (in the VAT mode) has been defaced specially with reference to zero-rating, exemptions and mode of collection of tax at retail prices at manufacturing stage for certain products (Third Schedule basis of taxation). It is reiterated that VAT in the proposed form is legislation better than that prevalent at present. This justifies the introduction of the new law. Accordingly, the impression that it is a new tax has to be dispelled with.

#### Provinces' Right of Taxation

- ▶ Constitutionally, there is no dispute that consumption tax on services is the right of the provinces. In the past there has been intrusion in the right of provinces through FED on services as referred earlier. Furthermore, provinces can opt not to surrender their right of taxation of services to federation. We should all honor this provincial right. In my view, this matter is being unnecessarily complicated. There is no ideal system of VAT and every country on account of its constitutional provisions may implement consumption tax according to its own basis of distribution of taxes between Federation and the provinces. Thus, if the province of Sindh requires separate 'accounting' for tax on certain services then that should be honored and accepted.

#### Increase in Tax Incidence – Inflation

- ▶ VAT implementation is being linked to increase in overall inflation levels. VAT per se will not result in any increase in prices as the present rate of 16 per cent and certain higher rates as applicable are being reduced to 15 per cent across the board. Nevertheless, the issue of inflation is directly related to following two factors:
  - ❑ whether or not withdrawal of exemptions will increase the price levels for the reason that many products are not subjected to tax at present; and
  - ❑ whether or not multiple stage taxation for wholesale and

retail would effectively be implementable specially on account of substitution of Third Schedule [tax at retail price is charged from the manufacturer].

### Is Wholesale and Retail Trade ready?

- ▶ This is an important subject since at present our trade sector is filled with products being:
  - ❑ imports through ATT;
  - ❑ under invoiced products; and
  - ❑ products originating from unorganized, undocumented manufacturing sector.
- ▶ There have to be serious simultaneous actions on all such matters if any incremental improvement is required for implementation of multiple stage VAT.

### Further Tax [Not required]

- ▶ There is another issue of 'equalization' of tax incidence. This refers to the disparity which arises on account of sale to persons being retailers below the threshold limit.

This is particularly important in our economy as bulk of retailers fall outside the ambit of tax.

- ▶ In order to resolve the issue of equalization a proposal for a 'further tax' of 3 per cent is being considered. In my opinion, this action is not recommended. This would result in a perception, which in that case would become a reality, that tax rate is effectively being increased to 18 per cent.

### Zero-Rated Sector - Accept Past Failures

- ▶ The biggest distortion in the VAT system as introduced in 1996 is zero-rating for export oriented sector. As explained earlier we have zero-rated the export oriented sector as against exports. This reflects a defeatist attitude and is equal to action which was taken on account of complete failure in managing the refund mechanism. I fully acknowledge the fact

that I was a member of this team that worked out the excess refund paid on export sector in 2005 [around Rs.40 billion of refunds were issued whereas collection was around Rs.20 billion only].

### Zero-Rated Sector - Refund Management

- ▶ Total exports of Pakistan are estimated to be around US\$ 20 billion. This would mean that around Rs. 252 billion [US\$ 20 x 15% x Rs. 84] will be collected and would have to be refunded. The question is whether or not we have established an adequate system for managing such refunds. In case of any mismanagement genuine exporters will suffer giving boost to fictitious exports etc. There is a financial impact of this as well. It has to be ascertained whether or not export industry, at this stage, would be able to bear the finance cost for the timing differences.
- ▶ In these circumstances a prudent approach that would cover both the risks would be to introduce VAT on export oriented sector at a lower rate ranging from 2.5 to 5 per cent.

### Zero-Rated Sector - VAT or no VAT?

- ▶ To conclude this matter it is my view that implementation of a broad based integrated consumption tax is a step in the right direction. For national benefit this needs to be handled carefully and diligently in the forthcoming quarter with national consensus.

### Interim Arrangement in Sales Tax

- ▶ General rate of sales tax, till the introduction of VAT as proposed, has been increased from 16 to 17 per cent. This appears to be only a tax collection measure. There is a case for reduction of rate as being envisioned in the proposed VAT, therefore, the present action becomes totally unjustifiable.

### CONCLUSIONS ON INDIRECT TAXES

- ▶ To sum up the budget recommendations with respect to indirect taxation, it can be concluded that:
  - ❑ The present major issue of protection to local industry by tariff regime has not been taken into account;
  - ❑ Issues of Afghan Transit Trade, under invoicing and smuggling have not been taken up seriously;
  - ❑ Increase in Sales Tax Rate is not justified being 'inflationary' in character;
  - ❑ Proper road map for implementation of VAT is missing; and
  - ❑ there is no policy change being a reflection that bureaucracy is looking for easier choices for tax collection even at the cost of disturbing economic fundamentals.

### DIRECT TAXATION (INCOME TAX)

#### Primary Policy Error

- ▶ Window for whitening of untaxed money by way of remittance from abroad which is the biggest ill for taxation system [as briefly explained earlier] has not been plugged. There seems to be strong vested interest in the same; and
- ▶ The tilt towards presumptive taxation has not been removed. The budget does not seem to provide any road map or will towards the elimination of indirect taxation in the guise of direct taxation. At present, presumptive tax covers almost all the major activities of Pakistani businesses being exports

**Total exports of Pakistan are estimated to be around US\$ 20 billion. This would mean that around Rs. 252 billion [US\$ 20 x 15% x Rs. 84] will be collected and would have to be refunded.**

and all kinds of trade. If these major segments are taken out from taxation on net income basis then no meaningful improvement can happen for direct tax regime.

### LEVEL PLAYING FIELD FOR VARIOUS FORMS OF BUSINESS

- ▶ Pakistan's fiscal policy has been designed in a very strange way whereby, by design or implication, it encourages business in non-corporate sectors for the reason that:
  - ❑ Lower tax rates for individuals and partnership (association of persons) in business;
  - ❑ Exemption from withholding for Individuals and AOP in business; and
  - ❑ No minimum tax on Individuals or AOP in business.

### TAX ON BANK WITHDRAWAL

- ▶ I have the honor or dishonor of recommending the introduction of the provisions relating to withholding tax on cash withdrawals. I have no regret for the same. However, I reiterate that the purpose of recommending this provision was not tax collection but to unearth the persons dealing in cash who do not come within the tax ambit. The tragedy is that the tax department has not used this effective measure to identify and then penalize and prosecute the persons dealing in cash not within the tax net. This shows clear lack of conviction and enforcement by the tax department. It has to be admitted that this provision does not meet the test of good legislation.

### REINTRODUCTION OF TAX CREDIT FOR BMR

- ▶ After a very long time an effective measure has been introduced for the promotion of industrial sector. This provision effectively means that government will finance 10 percent of the cost of plant and machinery by way of tax credit for BMR. This is the need of the time. This issue is, however, required to be read with reference to the matter of presumptive taxation on exports. On account of being subject to presumptive tax regime the biggest and most vital sector of our economy, those engaged in exports would effectively not be able to avail the benefit of this productive measure. This would be a tragedy. It is therefore suggested as above that exports income should be taken out of presumptive tax regime and be zero-rated. This would promote documentation and allow the exporter to avail the benefit of an industrial promotion scheme of the government.

### TAX ON CAPITAL GAINS ON TRADE IN STOCK EXCHANGES

#### Permanent Exemption for Long Term Capital Gains

- ▶ Through an amendment introduced on this subject a very reasonable step has been undertaken whereby long term capital gains on sale of shares of listed companies have been exempted from tax for ever. Such time bound exemption which was provided by way a clause in the Second Schedule has now been incorporated in the law. Now we can emphatically state and plan that long term capital gains on sale of shares are exempt from tax in Pakistan for ever. In my view this would encourage people to distinguish between short and long term gains and discourage the tendencies to trade in shares.

#### Indexation for Foreign Investors

- ▶ There is a need to further refine the system for non-residents who invest in foreign currencies to the effect that there is indexation of the cost of shares in foreign currencies so that effective taxation is for the gain on sale of shares and not the effective notional amount of exchange difference arising due to the change in exchange rate parity for Pakistani rupee.

### TAXATION OF BANKING COMPANIES

#### Positive Correction

Seventh Schedule of the Income Tax Ordinance, 2001 is one of the products not properly understood by many stakeholders. This is a model whereby the role of regulator being State Bank of Pakistan has been accepted and protracted litigation and subjectivity with reference to charge for irrecoverable advances has been removed. Under the Seventh Schedule provisions for irrecoverable advances are allowable as per the amount so certified under the Prudential Regulations of the State Bank of Pakistan.

- ▶ This year the ceiling of 1 per cent has been enhanced to 5 per cent of advances for consumer loans and loans to small and medium sized entities. This is a correct step.

#### Remedy to Avoid Litigation

- ▶ Another good step which was suggested earlier was the introduction of similar mode to allow for irrecoverable advances for years prior to the introduction of the Seventh Schedule. Numerous cases are pending at various levels on this matter and the only workable solution for future is to allow for the charge for earlier years on similar basis. Enabling provisions to this effect have to be introduced.

### TAX ON OIL EXPLORATION COMPANIES

#### Implementation of MOU with PPEPCA

- ▶ There are three major issues in dispute between the oil exploration companies and the Federal Board of Revenue. In order to settle the matter a very reasonable document was exchanged between Pakistan Petroleum Exploration &



**After a very long time an effective measure has been introduced for the promotion of industrial sector. This provision effectively means that government will finance 10 percent of the cost of plant and machinery by way of tax credit for BMR. This is the need of the time.**

Production Companies Association [PPEPCA] and FBR in the form of a Memorandum of Understanding. In that MOU a manner of settlement of all the disputes was laid down.

- ▶ The implementation of MOU was delayed apparently on account of the fact that legality of the matter could have been challenged in the court of law. This is not a correct notion. I totally disagree with this contention. However, even if that contention is taken to be true the right approach is to incorporate the understanding exchanged in the MOU by way of 'explanation' or 'amendment' in the Ordinance.

### MOU with PPEPCA

- ▶ To sum up the issues relating to direct taxation it can be concluded that there is no policy direction for improvement, except taxability of trading capital gains. There are certain specific positive actions, however, on overall basis these measures proposed would fail to:
  - ❑ broaden the tax base;
  - ❑ disincentives for trading business against manufacturing and to curtail the process of whitening of untaxed income; and
  - ❑ abolition of the curse of presumptive taxation.

### CONCLUSION ON DIRECT TAXES

- ▶ On an overall basis it appears that the proposal in the budget 2010-2011 from the receipt side is a 'non-event'. This is a status quo position. We would have to sit down again to decide whether or not we have the 'space' for this status quo. In my view, time is short and we would have to take some strong, non-traditional actions. We would require a national political consensus for such a revolutionary incremental approach.

## PART II

### FEDERAL EXPENDITURE

#### PREAMBLE

In this Second Part of my article I would like to explain the expenditure side. This would be followed by the concluding Part III laying down certain suggestions for correction.

Let us admit that an analysis of the expenditure side of Pakistan's yearly current federal expenditure is generally not made in a manner 'understandable' by the common man. After each year's budget speech, expenditure side's discussions are effectively restricted to a notional sum which as explained in the following paragraphs is effectively only a book entry. It is termed as 'Public Sector Development Programme' [PSDP]. Government's side boosts the quantum of expenditure and its outcome for the common man's benefit whereas opposition considers heads of allocation of PSDP as not being reasonable. On the other hand, all the major heads which are almost fixed expenses and which eat up almost whole of the budget are not seriously discussed. I would like to be realistic. Thus my discussion in the following paragraphs is restricted to major costs being debt servicing, defence, administrative expenses and subsidies which account for almost 95 per cent of Federal Government's tax revenue. Thus, there is nothing much left for discussion. Accordingly, I would not like to discuss PSDP at all. What I want to stress is that expenditure side needs to be understood in simple terms. Revealing the

facts and composition of expenses in simple, true and fair manner is essential. This will remove many illusions which are created by amateurish political statements. Such an analysis may lead towards a positive correction in national economic priorities.

This side of the budget is the estimated allocation on 'Cash Basis' for various expenditures, as well as, outlay for loan repayments. In my view the only difference in the current account expenditure of the federal government over the conventional financial statements is that there is no 'accrual' for expenses [recording of liabilities] and expenditures generally exceed receipts. That excess is made up by another book entry is termed as 'Budget Deficit'.

In the following paragraphs, I would try to briefly explain the major expenditure components, the elasticity available for variation and possible future trends. However, at the outset, it has to be noted that very little space is left due to consistent over spending in the past on effectively 'unproductive' heads. In simple accounting terms it means that in the past, [same we are doing now] all expenditures were made on current operational heads without any increment in capital assets of the country, being human capital, infrastructure or sustainable industrial base. As a result, after 63 years of effective mismanagement we have created a balance sheet for the country where income generation is neither able to meet the current expenditure nor able to effectively serve the liabilities created in the past.

We are continuously living in the illusion that the government would be able to correct this position. This is not the case. There is no immediate solution. We would have to restructure this financial statement for future after realizing the facts, valuing realistically the potentials and correcting our national priorities. In that process if there are certain write offs or reductions then the same should be accepted and if certain waivers are required then these should be properly presented to the lenders. In case if certain restrictions are placed on our luxurious way of thinking then that should also be accepted. In the following paragraphs such aspects have also been identified to at least open a door for productive discussion.

### IS IT THE ISSUE OF TRANSPARENCY OR COMMUNICATION?

In my thirty years in the field of accounting and analysis of financial statements in the profession and as Council Member of the Institute of Chartered Accountants of Pakistan, the most difficult statement I have found to decipher is the 'Current Expenditure Statement' attached with the budget papers. It is only a ten twelve item schedule that describes the fate and the future of 180 million people. The manner of communication can be observed from the following quotation taken from the budget paper for the biggest expenditure. The largest expenditure has been described as:

*'Under General Public Service, the major portion gives to executive & legislative organs, financial and fiscal affairs. At Rs 1090236 millions it forms 78.5 % of the allocation of Rs 1387664 million. The main heads of expenses are superannuations and pensions, domestic and foreign debt servicing. Other major item is the transfer payments.'*

This is total disclosure for an expense of Rs 1.387 trillion. Is it

fair to this nation if we describe the major expenditure of budget with these statements?

I firmly believe that there is nothing wrong in the accuracy of the figures. However, it is totally inconceivable why we present these statements in this manner. Is it the question of transparency that we want to hide the real facts or are there certain fundamental issues inherent in the manner of communication? I am ready to give benefit of doubt to the preparers. However one thing I am totally unable to understand is the 'nomenclatures' used. For example, there is a head 'General Public Service' being the largest component with an outlay of around Rs 1.3 trillion. Within this head there is a sub-head 'Executive & Legislative Organs, Financial' which consist of a sum of Rs 1.090 trillion. This outlay includes interest cost on loan [actually paid], repayment of principal amount of debt and administrative expenses of Federal Government. I firmly believe everything is explainable and justifiable however what I am not able to understand is that why do we present these important facts in this manner? Is there any relation of interest repayment, that too being repayment of principal, with 'General Public Service'? Another example of this confusing nomenclature is 'Transfer Payments' etc. The primary issue is that why we are not able to present these ten or twelve items in simple and clear terms? Or do we not want the same. This strange and traditional manner of presentation creates a 'disconnect' between government and the common man that leads to trust deficit between the people and the government.

Our governments want to copy the style of 'Whitehall' and 'Washington' but they forget to appreciate that Whitehall's mindset and manner of presentation is close to the lives of real Britons. Over the last 50 years there has been a phenomenal change in the manner of presentation of public finance. Like many other things we are diligently following what '*Gora Sahibs*' have left for us. We do not understand that in their country bureaucracy has changed its style of working and is close to the common man in every sense whether it be communication, accountability or responsibility.

This is an issue of accounting. There is nothing wrong in the present system. Governments generally prepare and present their financial statements on 'Cash Accounting' basis. Even in USA this system is prevalent. There are very few countries which apply accrual or hybrid system for government accounting. In our case the problem is not cash accounting. Our problem is communication. In my view 'accounting' for businesses or governments is done not only to 'record' income, expenditure, assets and liabilities, but also to present and disclose financial information in fair, simple and an understandable manner. The former is book keeping. On the expenditure side the problem is archaic disclosure without any sense of materiality. We have notes for expenditure for say Rs 25 billion worth of expenses whereas break up for 'Others with Rs 126 billion and 'Transfer payments' of over Rs 200 billion is missing.

This is extremely important from the viewpoint of perception. A common man in this country has developed a feeling that something is being hidden. This perception is effectively is not correct. However, the way we present the case doubts become assumptions and assertions that leads to loss of faith and trust. In the following paragraphs I would like to explain the simple facts to portray a realistic non-politicized picture of our current expenditure. Accounting is not a science. It is an art. In our government accounting, the word 'art' has been taken in the common Pakistani parlance where we use this word in a different sense. In my view, with an independent and strong media this is a counter productive and incorrect approach.

## RESTRUCTURED EXPENDITURE STATEMENT FOR 2010-2011

I firmly believe that expenditure statement attached with the budget is correct however I would like to present the expenses projected for 2010-2011 in simple accounting terms under the following heads as under:

	Rs in billion
Debt servicing	750
Regular Defence	450
War on terror	120
Subsidies	150
Administrative Expense	200
	1,670

Thus as a total, these five heads eat up almost all of our federal government's revenue. It is exactly equal to our federal budget target of Rs 1,667 billion by coincidence. This coincidence reveals some bitter facts about our financial statements. As stated earlier now do we need to stress on what PSDP is or should have been. In the following paragraphs I would like to explain that almost all the heads are fixed costs and we do not have any plan or possibility to reduce the quantum under any of these heads. It, therefore, raises the question from where we would allocate the resources to the provinces and incur the PSDP. The objective of these comments is not to create a sense of hopelessness but to voice out a desire for correction. Restructuring or correction of any financial statement can only be properly made if its composition and nature is realistically analyzed on the basis of ground realities. This is the attempt here.

## PAKISTAN'S FOREIGN DEBT TRAP —REALITIES AND MISPERCEPTIONS

As an accountant I have not been able to prepare a positive balance sheet for any of the last 63 years. In all years there was a negative adverse position. What we face now is the accumulation of past actions. There is one hard fact in accounting that there is always a double effect and somehow figures have to be balanced. We all should know that Pakistan is constantly and continuously facing a current account deficit since inception. This year's deficit [2010-2011] would be around US\$ 8 to 10 billion [import bill less export, remittance and inflows]. This is a good year in that sense. We had over US\$ 10 billion in earlier years. The Economist publishes this primary economic data for various countries every week. What we see there is that there are very few countries which have constant negative trade balances. Either they are giants like USA with huge technological and knowledge capital or growing economies like India.

I wonder where we stand and how do we want to fill the gap even in future. In my view there is no road map. The biggest dispute I always had with the past government was covering such deficits by fluid inflows in US\$ in stock exchanges or the 1990s mode of foreign bank deposit inflows. These were quack remedies for a genuine disease of spending more than earnings. In my view the bubble has blown. It may be a blessing in disguise and we have to realize that these short term measures to balance the books are improper and unsustainable.

Total trade deficit of Pakistan would exceed US\$ 200 billion in total since inception. This US\$ 200 has either been funded by aid or through a loan. In this scenario the present loan liability of US\$ 54 billion does not seem to be high. This liability has increased from US\$ 35.4 billion in 2005 to US\$ 53.9 billion in 2010; an increase of 52 per cent over 2005 base. This is the cost of our past decisions which will be repaid by our future generations. The vital question is not what we have done in the past. That is history and can not be undone.

The primary issue is whether or not we have taken or are able to take any actions that can take us out of this trap. In my view the short term answer is in negative. At this juncture the discussion is restricted to budget expenditure therefore I would not dilate on the subject in detail however if you relate this aspect with Part I of my Article relating to imports, it can be easily picked up that there is no focus on 'Import Substitution' or a concerted effort to examine the import bill. This is the cause of major ills including erosion of industrial base, unemployment and resultant poverty. What we have to do immediately is to reexamine our import bill to exclude the items which we can not 'afford' in the present circumstances. If we can not reduce the loan liability we should at least try not to increase it any further.

We have to pay interest in US\$ for this liability and also repay the past principal that is due. In the current year, in the Federal Budget we have used a substantial sum of around Rs 180 billion for the repayment of past debts. In other words we are repaying past debts by obtaining new debts.

In order to present this position in the budget statement there should have been a simple reconciliation attached with the budget explaining opening balance of our foreign debt liability, new loans obtained, interest and principal repaid and the closing balance. This would have at least presented some information of the real position to the people. Discussion in the Economic Survey on this matter is reasonable however that information is an academic economic analysis that lacks certain requisite disclosures.

If we calculate in Pakistani rupee we have a fixed liability of interest (foreign debt servicing) of around Rs 225 billion [US\$ 54 x 84 x 5%]. This is in addition to outlay for principal which is becoming due. However, as per the economic survey total interest payment on foreign debts during the nine months upto March 2010 is only Rs 45 billion. In my view the minimum cost would not be less than Rs 200 billion in any case. This fixed liability has been calculated at a low interest rate of 5 per cent whereas exact rate is not publicly known. As stated earlier servicing this present debt can be managed or arranged however the real problem is that we are yearly adding around US\$ 6 to 7 billion on a conservative estimate in this figure. This constant trap is what is not being appreciated by the people and the governments, or if we know we want to avoid discussion on such bitter subjects.

Another issue related to disclosure and transparency is the placement of such debt outside the Federal Account and with State Bank of Pakistan. In my view, on overall national basis, this placement does not make a difference and as a nation we should be aware of our overall liability and related expenditure with a clear schedule for future repayments.

To sum up the issue of foreign debt liability and outlay it should be clearly understood that there is no short term or medium term solution to get rid of this foreign debt trap. We have missed the boat by not spending the loans in building 'assets'. For example, we built the whole new city of Islamabad by borrowing from such

loans without realizing that productivity and governance are not related to physical structure. It is a paradigm that has not changed. In other words, it was a long term project loan that has been used for working capital requirements. Can we expect a good fate for an entity where long term loans acquired for assets have been used for working capital requirements? Let us sit down seriously and restructure the financial statement. In my view this balance sheet requires a waiver. Would we be able to arrange for the same? It is a difficult proposition however we would have to build up a case for that.

### LOCAL PUBLIC DEBT- PAKISTAN, A BANKER'S PARADISE

The next major expenditure is cost of servicing the local public debt. There are three basic component of this debt viz:

- ▶ Permanent Debts;
- ▶ Floating Debt being Market Treasury Bills; and
- ▶ Unfunded Debt being National Saving Schemes.

The size of such debt and its economic relevance are the subject of a separate debate. However, if we look at the present scenario for local debt the position is not different from foreign debt. We are borrowing further to repay the past liability and also adding on the liabilities. The amount of local debt has increased from Rs 2.17 trillion in 2005 to around Rs 4.5 trillion in 2010. If we take an average interest cost of 10 to 12 per cent then this would mean that total interest cost on conservative basis would be around Rs 400 billion (Rs 428 billion as per Economic Survey).

In this field we should give credit to the past government [1999 to 2005] where effective liability and expenditure of the government debt became low on account of reduction in the interest rate. Unfortunately that positive trend has also disappeared in the recent years.

We are a strange country where we issue 'Defence Saving Certificates'. This effectively means that we are asking the common man to lend money to the government for our war efforts. These kinds of borrowings are done during the war time. Are we saying that we are constantly at war? This paradigm has to change and the common man of Pakistan should understand there is an issue on the public debt side.

Servicing the debt of Rs 8.16 trillion (local plus foreign) would eat up around 250 billion out of total revenue base of Rs 1700 billion. This means that 47 per cent of federal government revenue would be spent on debt servicing only. This is a defective balance sheet. Is there any way to get out of this trap? Apparently not; however, as a first step we have to bring these factors in front of people in simple terms so that a clear picture may emerge.

### THE STORY OF FLOATING DEBT

Government's continuous borrowing from the market, which effectively represents a guaranteed secured return for the banks plays a very important role in the public finance function. At this stage I do not want to give the effects of these actions. What we should understand is the reality. There is continuous borrowing by the government from the market by way of Treasury Bills and the government's floating debt has increased from Rs 700 billion in 2005 to 2.299 trillion in 2010. If this trend continues then by the end of this term of government we would add around Rs 2

trillion further in this figure. This trend is continuing and I do not find any policy mechanism or option to change the system. In the economic survey a very interesting remark has been made. It states that:

*“subdued credit demand from the private sector has been underlying theme of the year and a primary cause of huge increments in case of market debt instruments.”*

The other remark is even more interesting as it states that:

*“the market preference of government debt instrument, owing to risk aversion and absence of private sector demand, greatly assisted in augmenting the participation in MTB’s auction over and above the targeted amounts.”*

We should at the outset understand what we are doing. It is quite simple. Pakistani banks are collecting deposits from the public at the average rate of 6 to 8 per cent and lending it risk free to government [for unproductive purposes] at the rate of 10 per cent plus. This is a very good system for the banks, however, is it good for the nation is an open question. In my view this does not provide a medium term or long term solution to our problems. At this stage, I do not want to enter into the debate of State Bank of Pakistan’s discount rate of plus 12 per cent, which I do not justify, however what I understand is that if any one can arrange deposits at around 8 to 9 per cent in Pakistan then the best business for that bank is to lend to the government. Is this country not a bankers’ paradise in every sense?

What I perceive in future is inflows in the foreign banks from outside Pakistan, in the form of deposits to be lent to government with a clear spread of over 5 to 6 percent. This happened in 1990s and we are heading towards that position again. The question we have to answer is whether or not we are heading towards a right direction and whether or not our free for all banking system is acting in a manner conducive to economic needs.

We continuously talk about reduction in the saving rates. The issue is different in Pakistan. Whatever we save is borrowed by the government at a very high rate and used for incurring regular expenditure. Thus any economic analysis of saving versus consumption has a totally different perspective in Pakistan. The role of banking system in the process of economic development in my view requires serious reconsideration. This raises a very fundamental question whether our banking system, unlike China and India, being totally in private hands, has really served the needs of public. What we need is a concerted debate on our monetary policy. What we immediately need are banks and financial institutions dedicated to ‘industrial finance’ with restriction on lending to government, trading and money markets. Such institutions are to be given tax breaks.

Furthermore we have to know that our liabilities and related Pakistani rupee cost has increased by around Rs 1500 billion just on account of devaluation of Pakistani rupee by 30 percent. This is the issue of foreign exchange rate which is another open book.

To conclude the subject of expenditure in the nature of interest costs and repayment of present debt, the situation is bleak. There is a definite fixed cost of around Rs 750 billion which is expected to further increase by 20 per cent each year. However the bigger tragedy is that there appears to be no easy and approachable solution for this problem.

## DEFENCE EXPENDITURE AND EXPENDITURE ON WAR ON TERROR

There are very few countries in the world where territorial disputes linger on for such a long time. We have to admit that effectively both our eastern and western borders are inhibited by hostile governments. Whether or not their people are hostile is another open question. This years’ budget includes Rs 440 billion for regular defence expenditure and around Rs 120 billion for War on Terror. The need for such defence expenditure or its political and security issues is not the subject of this discussion.

In the budget papers there is a schedule relating to break of defence expenditure of Rs 442 billion. Out of the same Rs 287 billion consists of employees’ related expenses and operating expenses. Investments in assets is Rs 120 billion.

What is to be realized is that under this head also there is expenditure of current nature. Thus it does not transpire whether real potential deterrent in the form of efficient equipment is being added. This appears to be an expenditure on traditional army on the model left to us after the Second World War.

When we go across the military areas everything reminds us of the position where colonial powers left us. Furthermore the component of foreign and local expenditure out of the total expenses is not known. That analysis is relevant in order to identify the part of import bill that is made for defence purposes. In US\$ terms the expenditure for the year is around US\$ 5.2 billion which is not substantially higher than what we used to spend in 2000s or earlier. However

there is another very strange correlation. Defence expenditure of this country has always remained almost equal to 25 per cent of the total federal revenue collection. Is it a coincidence or we have effectively agreed upon that quantum of fixed cost?

The analysis of defence expenditure further reveals a glaring fact that within this expenditure the possibility of reduction, notwithstanding the security issues seems to be difficult for other causes also. Once, the ex-military officials in a budget discussion made a very interesting observation. It was stated that this sector is providing employment to over half a million



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people. He was not wrong and as a student of economics I see logic in the argument. It is a strange phenomenon of Pakistan's demography.

As a state we have not been able to provide productive employment to our people therefore this kind of employment is effectively a way of sustenance. This trend is not good and we have to look for ways to get out of this paradigm. If a substantial number of youth from Potohar's rural area by default join the forces for employment, then before reducing the expenditure on that

side we would have to look for ways to promote employment for these youngsters. Otherwise in today's time it could be a breeding ground for recruitment for other kinds of war. This is what has actually happened in our FATA areas and Swat. This is effectively a chicken and egg situation for Pakistan.

What is an optimal size of expenditure in a particular economy on defence is an irrelevant question. The answer lies on the security environment. However the fundamental question is whether or not such security issues are settling or is there a move towards settlement? If both the states continue to use useful resources on defence then that will be a tragedy of the common man of Indian subcontinent on either side of the border. This confrontation which effectively started with Kashmir issue was practically a matter of economic survival of the

country on account of the sources of rivers flowing in Pakistan. A reasonable 'Indus Water Treaty' being an economic solution was made in the sixties. Now that issue has cropped up again and there is a need for another 'Addendum to that Treaty' in the present situation. An economic settlement would ultimately reduce military tensions.

Over time, especially after 9/11, conventional views of war and military confrontation require reconsideration. On the eastern side we have nuclear power being seven times our size. Full scale war is deterred by the nuclear capabilities of both the countries however, continuous confrontation can breed another kind of war that could destroy the very fabric of society on both sides of the border.

We all should know that in the immediate future we would be spending around 25 per cent of total federal government's revenue on this head. Is it justifiable? Or is there is any chance of reduction? This issue requires a change in the mindset of the common man on both sides of the eastern border. This does not seem to be a case in immediate future however we all should re-

alize that economies, specially our financial statements do not allow us to keep the matter 'pending'.

### EXPENSES OF WAR ON TERROR

War on terror being military operations on the western border is a new war. I consider that expenses on this war are not part of expenses on defence of Rs 442 billion as discussed above, however since exact disclosure for this head is not available in the federal government's financial statement therefore no definitive view can be made.

It is my view that expenditure under this head is around Rs 120 billion and a reasonable sum on that account is being met by Coalition Support Fund [CSF]. I strongly wish this to represent a temporary expenditure and for the cost to disappear from our books in the near future. Nevertheless, it has to be appreciated that the consequential loss claim of this war is going to be phenomenal, even if we win this war. There would have to be a complete reconstruction of whole infrastructure that is being destroyed. This would require 'Marshall Plan' like efforts and the world at large, especially our US allies, should realize that this is not wholly our war, it is an international confrontation.

There is an issue of transparency on this account also. It would have been better if separate disclosure had been made for expenses and recoveries. This nation deserves to know the cost their future generations would suffer on account of ideological adventures by our military rulers and their legacies in the past. I am sure that this nation would not endorse or support any such effort in future if economic consequences are completely, independently and fairly disclosed and explained.

### FEDERAL GOVERNMENT'S ADMINISTRATIVE EXPENSES

In almost all the discussions on budget the end or punch line is that rulers and government should leave their luxurious lifestyle if we want to correct our economic ills. This statement is correct, however, what I would like to add is 'intellectual luxury' that is ingrained by sitting in palatial mansions in green fields of Islamabad should also be curtailed. This intellectual luxury is the belief that there is nothing seriously wrong with our economic policies and these problems are the result of any short term economic management or some specific predecessor in the past.

Both the luxuries should be stopped. In my view the most difficult job in present Pakistan is the Finance Ministry. This is a job where the owners [common Pakistani] do not know the real status of their business, the managers [Parliamentarians, Prime Minister and the President] are not interested in the business at all, full revenues are not recorded in the books [tax evasions to the tune of Rs 400 billion at least] and expenses are misappropriated. In addition to the same the opening balance sheet is in negative. What an 'accountant' being the Finance Minister can do in this situation.

It appears that total administrative expenses of the federal government are around Rs 200 billion. Further break-up of these expenses is not available however it appears that around 50 per cent of the expenses are incurred on salaries and employee related costs. Within such costs, around 40 per cent are spent on retired employees' expenses. This is the issue of the size of governments. At the moment we have over 60 ministries in the federal government whereas as



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per our constitution there should not be more than 5 ministries at the federal level. This size is to be reduced as soon as possible. This is not only the issue of expense and luxurious style of governance. It is also the issue of duplication of efforts and inefficiency. We should all accept that military governments are very fond of large governments in Islamabad. In the political government of 1970s the issue of 'Concurrent List' was made to last for a period of ten years only. However, the regimes in the intervening periods never raised this issue. Now again in the 18th Amendment this issue has been resolved and concurrent list has been removed. This is a big achievement that is not being recognized on the economic front.

A political government is necessarily closer to the people and realizes that this country is an economic federation where delivery of services like education, health, irrigation, agriculture, law and order is a provincial subject and the same can not be done from Islamabad. It is however very unfortunate that very few of our independent economists and intellectuals really believe that it can be done. We have all grown up in societies where powers and responsibilities were centralized. It would take us time to realize that governance can only be made directly and not through remote control.

On the practical side I consider that there is no elasticity available with the government for the reduction of the amount spent on federal government. In spite of the claim that there would be a reduction of 10 per cent in all expenditures I wonder how that can be achieved where around 60 per cent is spent on salaries that have been increased reasonably.

In my view the expense on federal government has to be reduced by half and these expenses should not exceed Rs 100 in current price terms. However, I am sure that the same would not be done before 2013. Even at that time a question of any reduction can only arise if there is a political government in power [after the elections] that believes on strong provinces rather than strong federation. However, in accounting terms duplication of efforts and remoteness of governance is a simple issue that has to be understood by the people. We talk about developments in India, China and Malaysia without realizing that in all these countries provinces are very strong economically. In China we can even see different rate of taxation on income. This centralized governance structure is not workable.

Reduction in the federal government size is practically a very difficult task as that would require closure or transfer of infrastructure located in Islamabad [though unnecessarily] to the provinces. Out of these resources the most immobile constituency is 'staff'. Are we ready to accept that such federal government employees would be seconded or transferred to provinces? In my view that exercise is not only difficult but also not thought through properly. In case we are serious about it then we should make a medium and long term policy and plan for this change.

I believe that it would be the return of the government from Islamabad that was wrongly made in 1960. The most interesting episode I faced in this regard is the talk on CNBC Pakistan where Dr. Salman Shah and Dr. Aisha Ghaus Pasha were present. When I stressed on transfer of government I was shocked to hear that these knowledgeable and independent persons did not seem to have confidence that this objective can be achieved in the short run.

This is not the issue of efficiency, capability or availability of resources in the provinces. We all know the deplorable quality of

our education system and if we today argue that the same would be spoilt further if we abolish the Ministry of Education at the Federation then we are not fair with ourselves. The issue of Higher Education Commission is mixed up with primary and secondary education that is to be provided to common man locally and which can not be managed remotely from the hills. Ministry of Education at Islamabad would always consider that everything is hunky-dory around the country as they are not responsible directly for the quality of education and even for the existence of any such facility. This the simple issue of 'disconnect'.

The other issue is style of governance and the luxurious way of living of our Ministers. Though the direct cost involved may not be material however we should realize that the same has very serious perceptual issues. Why do our Ministers and Chief Minister always use Mercedes Benz? Why can't it be a 1600cc car. This is the issue of feudal culture that has pervaded our society. There is an immediate need to correct this phenomenon.

Even in our country people like Mohammad Khan Junejo and Malik Mairaj Khalid symbolically tried to do away with this culture. However, their positive actions were undone by the following governments. The character of simplicity should be ingrained in our society and as first step all luxury vehicles should be banned or placed under very high duty to reflect that financial resources of the country as a whole do not deserve this kind of 'symbolic extravagance'.

### SUBSIDIES

Total expense on subsidies is around Rs 126 billion in the budget document however in real terms the cost would be around Rs 200 billion. At the outset, I would state that if we live under the illusion that in the short run we would be able to get rid of these subsidies then we are wrong. I may even support the continuation of the support as a vital portion of these subsidies relates to segments of our society whose rights have been usurped in the past. Now it is the question of survival.

The major part of subsidy of around Rs 90 billion relates to power. This is a very mismanaged and misunderstood segment of our national financial statements. We all should know that as a nation we have been providing electricity free of cost to FATA for over 63 years. We still do not receive any recovery from these areas. In other words remaining people of Pakistan are bearing the cost of electricity provided to FATA. The other factor is losses in distribution. However, as we go deep down the issue it is revealed that there is much more than that. Of all the three potential sources of generation of electricity being hydel,



**Reduction in the federal government size is practically a very difficult task as that would require closure or transfer of infrastructure located in Islamabad (though unnecessarily) to the provinces.**

gas and furnace oil there is misdistribution within these segments. This is not the subject matter of discussion here however the fundamental question is whether in the year 2010-2011 or in the following years we would be able to make these distribution companies self sufficient.

The answer seems to be in the negative. The reason is quite simple. Hydel's contribution is almost full for the time being and there is quantitative limitation for gas supply. The only resource we would be able to use is furnace oil. The prices of furnace oil, other things remaining same, would not allow us to correct the situation. The only way would be to increase the 'tariffs'. That may be a correct step from accounting viewpoint however notwithstanding its merits in the present fragile political situation government would not be able to take the tough decision of charging for the electricity without subsidy. Accordingly, we would need around Rs 100 billion for power subsidy for the time being, therefore, we should consider it as a fixed cost in our national current expenditure account.

The other major subsidy is support in the commodity prices which is made through PASSCO, TCP and USC. Let us all admit that free market mechanism in the commodity sector is not working properly in this country. There are constant problems of shortages of commodity and the government has to intervene to stabilize the prices. In almost all the cases such intervention is required as there has been mismanagement of affairs. However, let us admit that such actions would continue to be required in future. Thus on the conservative basis let us admit that expense on account of subsidies in the market sector would require around Rs 30 to 40 billion.

Let us summarize the expense side of budget. There are almost fixed costs of around Rs 1500 to 1600 billion. This would eat up around 95 per cent of our federal revenue base. Now relate this position with the issue in increasing the revenue bases as presented in Part I of this Article. There is a need to balance out books and to re-examine our trade and financial priorities.

There is another interesting fact that from 1999 to 2008 we had a government headed by an Army General supported by a seasoned banker and there was effectively no opposition. The international financial scenario and US\$ / Rupee parity was favourable, however, no sustainable corrective measures were taken for reduction in these two constant burdens on Pakistan' fiscal account being defence and debt servicing. Why it was so? I wonder whether or not this budget or the present economic policy can provide a solution. The answer is in negative. As stated earlier, as a first stage for any correction, including restructuring, we should properly and honestly present the financial status to the people. Once the public is reasonably aware there would be a national pressure for correction which has been missing in the past. All these aspects would be discussed in the following Part III of this Article.

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### DISCLAIMER

The above comments, views and suggestions are the views of Muhammad Shabbar Zaidi and do not necessarily represent the views of A.F. Ferguson & Co., Chartered Accountants, where Mr. Zaidi is a Partner, or The Institute of Chartered Accountants of Pakistan where he is a member of the Taxation and Economic Advisory Committee, or the Revenue Advisory Council, or the Federal Board of Revenue where Mr. Zaidi is a Member.



# Cash Flow Measures for Insights in to All Business Activity

In investments cash flow or cash earnings represents earnings before depreciation, amortization, and non-cash charges. Cash flow from operations is important because it indicates the ability to pay dividends.

Tariq Jamil, FCA

Cash flow analysis provides insights in to a company's financing, forecasting and as part of liquidity analysis. A typical cash flow statement would provide information of cash inflows and outflows under three broad activities namely operating, investing and financing and the net movement in cash and cash equivalents during the period, but it is important to analyze cash flows in more detail.

For example, the statement would provide information of the amount invested in acquiring capital goods or for capital expenditure, but it would not confirm what

portion of this is for capital maintenance and what portion is investment in future growth opportunities. This type of question would be answered only through a detailed analysis of the statement of cash flows along with knowledge of the company's business environment and strategies.

While analyzing cash flow the focus should be on the following questions:

☞ Are acquisitions or replacements of capital assets financed from internal cash generations or from external

funds?

- ☞ How is business expansion financed?
- ☞ Is there dependence on external financing?
- ☞ Is there ability to repay debts?

Is there financial flexibility to meet the challenges of unanticipated needs and opportunities?

☞ Are the earnings of good quality?

While interpreting changes in working capital items, we cannot be oblivious of the economic circumstances, inflationary

conditions and market conditions. For example-

- ☞ an increase in receivables can be viewed as increase in customer demand but it could also be interpreted as inability of the company to collect its receivables within allowable credit time limits; and
- ☞ an increase in raw materials could be interpreted as increase in customer demands, but it could also be interpreted as inability of the company to accurately assess the demand or sell products when finished goods inventory is particularly on the rise;

Analysis of cash flow from operations could identify problems in case of both successful and unsuccessful businesses, but those may not necessarily be interpreted in the same manner. The reasons could be strikingly different. For a successful business to experience increasing employment of funds in receivables and inventories could be represented by expanding customer demand and accordingly the resultant increase in profitability is useful in obtaining additional financing from both debt and equity suppliers. The profitability, which could be attributable more to income accrual, ultimately yields positive cash flows.

An unsuccessful business experiences cash shortages from slowdowns in receivables and inventory turnovers, losses in operations, or combinations of these and other factors. The unsuccessful business can increase cash flows by reducing receivables and inventories, but usually this is done at the expense of services to customers, further depressing profits.

These factors are signs of current and future crises and cash shortages including declining trade credit. Decreasing cash flows for an unsuccessful business have entirely different implications than they do for a successful one. Even if an unsuccessful business borrows money to offset the decline in operating cash flows, the costs and results of borrowing only magnify the ultimate loss. Profitability is a key variable, without it a company is doomed to failure.

The statement of cash flow is useful in identifying misleading or erroneous operating results or expectations. It is more a reliable and credible source of a company's actions and intentions than the predictions and press releases of management.

While analyzing cash flow statement we need to examine relations among items presented therein. Certain transactions

are related. For example, assets are purchased by issuing debt. However, such relationship should not be inferred where it is non-existent. A change in cash, whether positive or negative, cannot be judged solely by the statement of cash flows. It must be analyzed in relation to other variables in a company's financial structure and operating results. For example, an increase in cash can arise from sacrificing a company's future earning power by selling valuable assets, or by taking on debt at high costs or unfavorable terms. Relations among financial statement items and their implications are important for the reliability of cash flow analysis.

The following two cash flow ratios are very useful in analyzing flow of funds to a business:

### CASH FLOW ADEQUACY RATIO

This ratio measures the ability of a business to generate sufficient funds from operations to cover capital expenditures, investment in inventories, and cash dividends. Such ratio is usually calculated by dividing 'three year total of cash from operations' by 'three year total of capital expenditures, inventory additions, and cash dividends'.

Mere calculation of cash flow adequacy ratio is not enough; it has to be interpreted correctly. A comfortable and acceptable situation would be that the total of cash from operations is equal to the total of capital expenditure, inventory additions and cash dividend. It indicates that cash needs are met without any external financing. Low cash from operations would be interpreted as internal cash generation which is not sufficient to maintain dividends and current operating growth level.

### CASH REINVESTMENT RATIO

This ratio measures the percentage of investment in assets representing operating cash retained and reinvested in the business for both replacing assets and growth in operations. This ratio is computed by dividing the amount of 'operating cash flow as reduced by dividends' by the amount of 'totals of gross plant, investment, other assets and working capital'.

Other useful cash flow ratios for analyzing flow of funds of a business are cash flow to fixed charges ratio, cash to current assets ratio, and cash to current liabilities

ratio.

A balanced cash flow is an essential prerequisite for managing massive borrowings. It is therefore necessary to analyze the ability to repay loans before taking an onerous burden of debt. What is needed is a long term view of the market demands as there is always a risk of change in market demands of products and services due to many factors including overpricing, recession, competition, new players in market, introduction of new products and services etc. We need to remember that without positive and healthy cash flow generated from continuity of profitable sales, excessive debt burdens can break even the finest managed companies.

Examples are the Gulf war or the recent worldwide recession which hit the airlines and hotel businesses very badly. This resulted in belt tightening. Air travel worldwide was hit hard during the Gulf war when seat occupancy fell to dangerously low levels. Similarly, hotels lost business as most companies reduced their costs by insisting their executives spend less time away from home incurring lodging and subsistence costs. The fall in business certainly impacts the profitability and impairs the ability to repay loans and continued heavy overheads. In such a situation some drastic measures are taken to put the business back on track by lowering of the price, retrenchment of surplus staff, and overall cutting on the overheads.

Nevertheless, lowering of prices is not necessarily the answer. If the extra business generated is only marginal then cash flow can be reduced even further, thus compounding the problem. What is required is a thrust into new market development to attract additional business from alternative sources that will lead to an increase in positive cash flow.

British Airways introduced improved service and facilities to attract more business travelers particularly from rival carriers as lowering of prices alone would have added a further dent to an already stretched cash flow. Forte and other leading hotels and leisure groups introduced two, three and five day all inclusive breaks that attracted additional business from new sources such as family holidays so that people who in better times would have taken an overseas holiday took their break far

more cheaply in the UK and took advantage of the inclusive deals. These changes without a doubt made a useful contribution to overheads and proved to be an invaluable benefit to cash flow and debt repayment.

Too many companies fall into the trap of over-expansion based on a notion that increased demand for their

product or service will continue unabated long into the future. Businesses that may be subjected to massive fluctuations in demand for their products or service are advised to take on the burden of additional debt with great caution. Debt is never easy, but becomes a more viable proposition when the bearer has a

cash flow which is unlikely to be seriously subjected to major downturns in demand.

The credit rating agencies give due consideration to the availability or otherwise of the free cash flow while rating a company. The computation of 'free cash flow' is considered a useful analytical derivative of the statement of cash flows. There is no agreement on the exact definition of the expression 'free cash flow'. There are two widely accepted definitions:

- ☞ 'free cash flow' represents cash flows from operations as reduced by net capital expenditures required to maintain productive capacity and dividends on preferred stock and common stock;
- ☞ 'free cash flow' represents net operating profits after tax as increased or decreased by change in net operating assets (it represents change in working capital for net cash flows from operations and the increase in long-term operating assets). In this case the focus is on the company as a whole without regard to financing. Accordingly, dividend is not considered in this definition.

A positive free cash flow reflects the amount available for business activities after allowances for financing and investing requirements to maintain productive capacity at current levels. The growth and financial flexibility depend on adequate free cash flow. We, however, need to recognize that the current format of statement of cash flows does not provide for separate disclosure of the amount of capital expenditure needed to maintain productive capacity. It is shown as part of

the total capital expenditures. Unless separate disclosure of the capital expenditure needed to maintain productive capacity is done, it would not be possible to accurately and reliably measure the free cash flow. Public accountants should consider modifying the disclosure requirements in the statement of cash flows to provide this information to their readers.

A credit rating agency is bound to lower the credit rating of an entity with a strong history of positive free cash flow and cash flows from operations, but whose free cash flow recently turned negative and it is expected to remain so in foreseeable future. A negative free cash flow is a bad sign. It implies that a company must either sell assets or acquire debt or equity financing to maintain current operations. A significant change in free cash flow must be seriously scrutinized in assigning a new credit rating.

The significance of cash flow lies in interpreting financials and carrying out an effective in-depth analysis as it provides a reliability check on accrual accounting. Again, there are several positive and negative assertions that exist regarding accruals and cash flows. It is therefore essential for an analyst not only to beware of the myths and misconceptions surrounding accrual accounting, income and cash flow, but also of the universal truths about accrual accounting, income and cash flow.

Some commonly known myths and truths are:

- ☞ It is a myth that cash flows cannot be manipulated. It is probably easier to manipulate cash flow than to manipulate income. For example, cash flow can be increased by delaying either capital expenditures or the payment of expenses, or accelerating the collections from customers.
- ☞ It is a myth that it is impossible to consistently manage income upwards in the long run because accounting rules dictate that accruals eventually reverse and at some stage accrual and cash accounting coincide in the long run. It may not be true as most companies can aggressively manage income upward for several years at a time. Some companies may opt for massive write offs in bad years or in recession when other companies are also showing poor results, as an income-increasing strategy for other years.

- ☞ It is true that accrual accounting numbers are subject to accounting distortions due to existence of alternative accounting methods along with earnings management, arbitrary accounting rules and estimations. A financial analysis or valuation that ignores these facts and accounting adjustments is likely to produce erroneous results. For example, a valuation method that simply uses price-to-earnings ratios computed using reported income is less effective.

These myths and truths raise a serious question as to whether we should abandon accruals for cash flows. Analysts who advocate abandoning valuation models based on accrual income in favor of a cash flow model take the position that accrual accounting is unscientific and irrelevant and that cash is king. On the contrary, analysts who advocate for accrual accounting believe that with all the most talked about limitations such as arbitrary rules, alternative method of accounting, estimation errors and earnings management, accrual accounting is better than cash because it is conceptually superior and works practically and there is an enormous amount of valuation information in accrual accounting numbers.

Finally, cash inflows and outflows are interrelated. A failure of any aspect of the company's business activities to successfully carry out its assigned task affects the entire cash flow system. A lapse in sales affects the conversion of finished goods into receivables and cash, leading to a decline in cash availability. A company's inability to replace this cash from sources like equity, debts or accounts payable can hamper production activities and produce losses in future sales. Conversely, restricting expenditures on items like advertising and marketing can slow the conversion of finished goods into receivables and cash. Long-term restrictions on either cash outflows or inflows can lead to company insolvency. The solution lies in maintaining an effective cash cycle and net working capital management.

# VALUE MANAGEMENT IN A GROWING ORGANI- ZATION



Ruhail Mohammed, CFO Engro Corporation Ltd.

## VALUE BASED MANAGEMENT: THE CFO'S ROLE

Value based management aligns a company's overall goals, analytical techniques and management processes with the key drivers of value. The ultimate objective of a value creation mindset is to maximize shareholder wealth.

The CFO is an integral part of the management team which shapes strategy. His role is to ensure that key performance parameters are met, and Strategic Business Unit leaders are energized towards efficiency and improvement.

The CFO ensures that return on capital is maximized by optimizing business activities to meet stakeholder expectations. By leveraging his experience, the CFO aims to improve the performance of the company.

## ENGRO'S INVESTMENT STRATEGY

Due to the Global Credit Crisis, World GDP growth rate was down to negative 1 percent in 2009. Pakistan also suffered due to a slowdown in exports. Higher fiscal and current account deficits led to higher interest rates and devaluation in the country.



*Prof. Dr. Khawaja Amjad Saeed, FCA, Principal Hailey College of Banking & Finance, University of Punjab*

## PRELUDE

Pakistan is facing many challenges. Poverty alleviation is an active challenge. Gap between the haves and have-nots is another. Acceleration of the pace in economic development is a priority. Promotion of employment in general and that of self-employment is the need of the hour. Quantum jump in production and productivity in all sectors of the economy is on top of the agenda. Tackling the issue of high growth concurrent to social justice has become an outcry. In short, we are desperately in need of tackling problems on several fronts.

One wonders where to start. The answer is to give top priority to the energy problem to strengthen the base and pave the way for sharing the economic dividends across the board in order to ensure all round prosperity and social stability in the country.

## ENERGY: THE GROWTH DRIVER

Economy has three constituents namely, agriculture, manufacturing and services sectors. Economic success achieved in all sectors is attributable to several factors including in particular energy. Therefore, energy can rightly be called the engine of growth.

One theory in economics is that economic development can flourish if the government provides infrastructure. Infrastructure is of four types namely, intellectual, physical, social and finan-

cial. Energy constitutes physical infrastructure. It is generally believed that the tremendous success achieved in agricultural sector in Indian Punjab is attributable to road development and a consistent energy supply.

All over the world energy has served as a catalyst for achieving accelerated socio-economic development. This belief needs to be inculcated in Pakistan. These steps must be undertaken to strengthen the supply side and contain the demand side so that ample energy is available for the following:

- Agricultural sector to ensure a breakthrough in production and productivity.
- Manufacturing sector to optimize the use of resources to boost production to meet domestic demand and expansion in exports.
- Services sector to enable 52% contribution to GDP to strengthen logistics for backward and forward linkages.

## IN RETROSPECT

Except for IPPs during Benazir Bhutto's tenure in the mid 1990s no government took active interest in boosting supply side of energy. Due to social turbulence in Balochistan gas reserves were not activated. Hydel dams were not built. Thus,

supply side was ignored. Some announcements were made in 2006 but these lacked genuine implementation.

On the other hand, demand side continued to show an upsurge. Use of electrical appliances continued to increase and the government was forced to announce load shedding, also called load management. This will continue till such time that the supply side shows significant increase.

## SUPPLY SIDE OF ELECTRICITY

Installed generation capacity is shown in the following table:

### Installed Generation Capacity

S. No.	Particulars	%
1.	Wapda Hydel (Hydel 58 % Thermal 42 % = 100)	58
2.	IPPs	30
3.	KESC	09
4.	Nuclear	03
		100

Unfortunately hydel generation of electricity was ignored in the past, although it is the cheapest source of energy, now around Rs. 1.92 per unit.

Untapped capacity of 58,000 mw exists which, if properly addressed, can give a real boost to the supply side. The increase in oil prices (from a normal of US \$ 50 to \$ 147 per barrel) gave a big jolt as the cost of generating electricity from oil increased considerably. Innovative thinking of buying from available sources on deferred payment basis in particular from Saudi Arabia and Iran was lacking. Commercial diplomacy was not used as an effective instrument. Unutilized capacity of IPPs was not addressed due to circular debt issue. KESC, after privatization, never invested money in its expansion. Nuclear energy generation is a difficult issue. Thus, supply side constraints and/or neglect were responsible for the gap between demand and supply of energy.

## GAS: CONSUMPTION PATTERN

The following table shows the broad pattern of gas consumption in Pakistan:

### Gas Consumption in Pakistan

S. No.	Particulars	%
1.	Power	42
2.	Industry	19
3.	Fertilizer	16
4.	Households	16
5.	Others	07
		100

Generating power from gas is comparatively cheaper than using oil. Therefore, the trend to generate energy from gas has been growing over time as it is cost effective.

Industry in general and fertilizer factories in particular use 35% gas. Currently textile has been exempted from gas quota allocation whereas fertilizer factories will be affected by restricted supply of gas.

## ELECTRICITY CONSUMPTION PATTERN

The following table presents electricity consumption pattern.

### Electricity Consumption Pattern

S. No.	Particulars	%
1.	Households	43
2.	Industry	28
3.	Agriculture	12
4.	Commerce	07
5.	Others	10
		100

Unfortunately load shedding has affected household life, slowed down industrial growth (negative growth of 7.0% registered in 2008-09), partially affected agriculture and forced shops to be closed at 8:00 pm. We must learn to live with the inevitable till supply side improves.

## ENERGY FUTURE DEMAND FORECAST

The current and future needs of energy for each province in Pakistan are given in the following table:

### Demand: Existing & Projected

S. No.	Province	Existing mw	2024-25
1.	Punjab	7,027	29,103
2.	Sindh	2,642	10,993
3.	Khyber Paktoonkhwa	1,697	7,018
4.	Balochistan	494	1,964
		11,840	49,078

The above projections should motivate policy planners to rise to the occasion and develop a policy framework for implementation to accept future challenges. The earlier this is done the better.

## WAY FORWARD

The vital question is: What is the way forward? Some steps have been announced by the government of Pakistan in the short run and some in the long run. We need to fight on all fronts. Some suggestions are offered below:

### A: Supply Side

- Gas exploration be accelerated. All social hitches be negotiated and legal hurdles be properly and promptly tackled.
- Hydel unutilized capacity of 58,000 mw be tapped with a practical program.
- Circular debt problem be solved on urgent basis to enable fuller utilization of existing generation of electricity from IPPs.
- All provinces should allocate substantial amounts for consumption of smaller hydel dams for generating electricity to meet local needs.
- Friendly countries be approached to provide access to instant availability of electricity near Karachi Airport. Turkey has taken the lead.
- Electricity generation from coal, wind, solar and other non-traditional sources be addressed immediately.

### B: Demand Side

- Our public is urged to follow measures for appropriate use of available electricity.
- Wastages be avoided to conserve electricity.
- Line losses must be minimized to enable bigger supply of electricity to meet the growing demand.
- Cooperation be extended to implement the demand management plan of the government.

## RAMAZAN KAREEM



Mohammed Ashraf, FCCA

# Wealth Statement for Zakat

**Z**akat (Obligatory Charity) is a certain fixed portion of the wealth and is applicable on almost each and every kind of the property. Zakat of a Sahib e Nisab is to be paid yearly for the benefit of the poor in the Muslim Community. The payment of Zakat is obligatory as it is one of the five pillars of Islam. Zakat is the major economic means for establishing social justice and leading the Muslim society to prosperity and security.

“And that which you give in gift (to others) in order that it may increase (your wealth by expecting to get a better one in return) from other people’s property, has no increase with Allah; but that which you give in Zakat (Sadaqah, Charity etc.) seeking Allah’s countenance, than those they shall have manifold increase [Surah e Ar Room : 39].

### IMPORTANCE

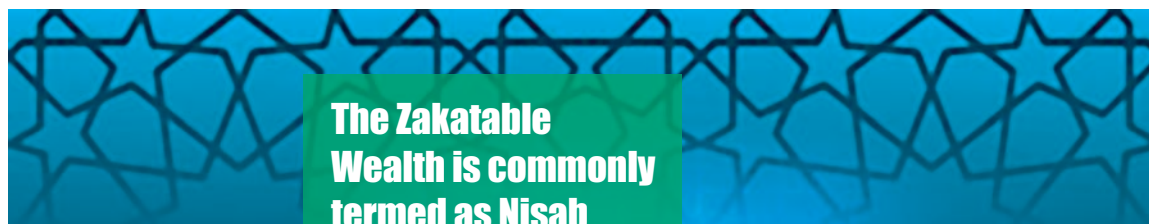
There are five pillars of Islam and Salat (Prayer) was declared as differentiating factor among believers and non-believers. Surprisingly, Salat (Prayer) and Zakat appeared jointly at more than 30 places in Holy Quran – Surah e Al Baqarah, Nisa, Maidah, Anaam, Araaf, Toobha, Maryam, Anbiya, Hajj, Momineen, Noor, Naml, Room, Luqman, Ahzab, Mujadilah, Muddassir, Zilzal, etc.

“And they were commanded not, but that they should worship Allah, and worship none but Him Alone (abstaining from ascribing partners to Him), and perform Salat and give Zakat, and that is the right religion [Surah Al Zilzal:5].

Narrated Ibn Abbas Raziallahu Anhu: The Prophet

Sallallahu Alaihi Wasallam sent Mu'adh Raziallahu Anhu to Yemen and said, "Invite the people to testify that none has the right to be worshipped but Allah and I (Sallallahu Alaihi Wasallam) am Allah's Messenger, and if they obey you to do so, then inform them that Allah has enjoined on them five Salat (Prayers) in every day and night, and if they obey you to do so, then inform them that Allah has made it obligatory for them to pay the Zakat from their properties and it is to be taken from the wealthy among them and given to the poor among them [2:478 – Bukhari (O.B)]

Narrated Abu Huraira Raziallahu Anhu: When Allah's Messenger Sallallahu Alaihi Wasallam died and Abu Bakr Raziallahu Anhu became the caliph, some Arabs convert to disbelief. Abu Bakr Raziallahu Anhu decided to declare war against them. Umar Raziallahu Anhu said to Abu Bakr, "How can you fight with these people although Allah's Messenger Sallallahu Alaihi Wasallam



**The Zakatable Wealth is commonly termed as Nisab which is prescribed for various types of wealth. For instance, Gold equal to 20 Mithqal (7.5 Tola) i.e. approx. 94 grams, Silver is 200 dirham (52.5 Tola) i.e. approx. 640 gram, food-grains and fruit is 5 Awsuq i.e. 673.5 Kilogram, 5 camel and cows; and 40 sheep etc.**

said, "I have been ordered by Allah SWT to fight the people till they say: "none has the right to be worshipped but Allah, and whoever said it then he will save his life and property from me except on trespassing the law (rights and conditions for which he will be punished justly), and his account will be with Allah SWT". Abu Bakr Raziallahu Anhu said, "By Allah! I will fight those who differentiate between the Salat (prayer) and the Zakat, as Zakat is the compulsory right to be taken from the property (according to Allah's order). By Allah! If they refuse to pay me even a she-kid which they used to pay at the time of Allah's Messenger Sallallahu Alaihi Wasallam, I would fight with them for withholding it". Then Umer Raziallahu Anhu said, "By Allah! It was nothing, but Allah SWT opened Abu Bakr's Raziallahu Anhu chest towards the decision (to fight) and I came to know that his decision was right [2:483 – O.B.].

**SUPERIOR ZAKAT**

Narrated Abu Huraira Raziallahu Anhu: A man came to the Prophet Sallallahu Alaihi Wasallam and asked, "O Allah's Messenger which charity is the most superior in reward?" He replied, "The charity which you practice while you are healthy, niggardly and afraid of poverty and wish to become wealthy. Do not delay it to the time of approaching death and then say, 'Give so much

to such and such, and so much to such and such.' And it has already belonged to such and such (his heirs)." [2:500 – O.B]

**ZAKATABLE WEALTH (NISAB)**

Zakatable wealth (wealth liable to Zakat) only comprise of honestly earned money (Halal) and does not include accumulated interests, not honestly earned money (Haram) etc. Narrated Abu Huraira Raziallahu Anhu: Allah's Messenger Sallallahu Alaihi Wasallam said, "If one gives in charity what equals one date-fruit from the honestly earned money and Allah accepts only the honestly earned money – Allah takes it in His Right Hand and then enlarges its reward for that person, as anyone of you brings up his baby horse, so much so that it becomes as big as a mountain."

The Zakatable Wealth is commonly termed as Nisab which is prescribed for various types of wealth. For instance, Gold equal to 20 Mithqal (7.5 Tola) i.e. approx. 94 grams, Silver is 200 dirham (52.5 Tola) i.e. approx. 640 gram, food-grains and fruit is 5 Awsuq i.e. 673.5 Kilogram, 5 camel and cows; and 40 sheep etc.

Narrated Hazrat Anas Raziallahu Anhu: When Abu Bakr Raziallahu Anhu sent me to (collect the Zakat from) Bahrain, he wrote to me the following:

In the name of Allah SWT, the Most Beneficent, the Most Merciful

These are the orders for Zakat which Allah's Messenger Sallallahu Alaihi Wasallam had made it obligatory for every Muslim, and which Allah had ordered His Messenger Sallallahu Alaihi Wasallam to observe:

Whoever amongst the Muslims is asked to pay Zakat accordingly, he should pay it (to the Zakat Collector) and whoever is asked more than that (what is prescribed in this script) he should not pay it. For twenty four camels or less, sheep are to be paid as Zakat; for every five camels, one sheep is to be paid, and if there are between twenty five and to thirty five, one Bint Makhad (one year old she camel) is to be paid, and if there are between thirty six to forty five, one Bint Labun (two year old she camel) is to be paid, and if there are between forth six to sixty, one Hiqqa (matured 3 year old she camel) is to be paid, and if the number is between sixty one to seventy five, one Jadha (4 year old she camel) is to be paid, and if the number is between seventy six to ninety, two Bint Labun (two year old she camel), and if the number is between ninety one to one hundred and twenty, two Hiqqa are to be paid, and if they are over one hundred and twenty, for every forty over one hundred and twenty, One Bint Labun is to be paid and for every fifty over one hundred and twenty, One Hiqqa is to be paid and whoever has got only four camels, has to pay nothing as Zakat, but if the owner of these four camels

wants to give something, he can. If the number of camels increases to five, the owner has to pay one sheep as Zakat. As regards the Zakat for the (flock) of sheep): and if they are between forty and one hundred and twenty, one sheep is to be paid, and if they are between one hundred and twenty to two hundred, two sheep is to be paid, and if they are between two hundred and three hundred, three sheep is to be paid and for over three hundred, for every extra hundred sheep, one sheep is to be given as Zakat, and if somebody has got less than forty sheep, no Zakat is required, but if he wants to give, he can. For Silver: the Zakat is one-fortieth of the lot (i.e. 2.5%), and if its value is less than two hundred dirhams (i.e. approx. 640 grams, there is no Zakat, but if the owner wants to pay he can [2:534 – O.B.].

Quran has also specified about the irrigating land. "And it is He Who produces gardens trellised and untrellised, and date palms, and crops of different shape and taste (their fruits and their seeds) and olives, and pomegranates, similar (in kind) and different (in taste). Eat of that fruit when they ripen, but pay the due thereof (its Zakat, according to Allah's Orders, 1/10th or 1/20th) on the day of its harvest, and waste not by extravagance. Verily, He likes not Musrifoon (those who waste by extravagance) [Surah Al Anaam: 141].

Narrated Abdullah bin Umar Raziallahu Anhu: The Prophet Salallahu Alaihi Wasallam said, "On a land irrigated by rain water or by natural water channels or if the land is wet due to a nearby water channel, Ushr (i.e. one tenth) is compulsory (as Zakat); and on the land irrigated by the well, half of an Ushr (i.e. one-twentieth) is compulsory (as Zakat on the yield of the land)" [2:560 – O.B.]

Narrated Abu Huraira Raziallahu Anhu: Allah's Messenger Salallahu Alaihi Wasallam said, "There is no compensation for one killed or wounded by an animal or by falling in the well, or because of working in mines; but Khumus is compulsory on Rikaz (buried treasure or wealth)." [2:575 – O.B.]

Narrated Abu Huraira Raziallahu Anhu: Allah's Messenger Salallahu Alaihi Wasallam said, "There is no Zakat either on a horse or a slave belonging to a Muslim" [2:542 – O.B.]

## ZAKAT, USHR AND KHUMAS TABLE

### RIKAZ

Buried treasure or wealth 20%

### AGRICULTURE LAND PRODUCE

Land irrigated by rain or natural water or wet land 1/10th Ushr

Land irrigated through well 1/20th Ushr

### ASSETS AND STOCK – 2.5%

Gold equal to 20 Mithqal i.e. approx. 94 grams  
Silver equal to 200 dirham i.e. approx. 640 gram,  
Food-grains and fruit equal to 5 Awsuq i.e. 673.5 Kilogram,

### CAMELS AND COWS

5 Camels One Sheep  
25 to 35 Camels One Bint Makhad  
(1 Year old She Camel)  
36 to 45 Camels One Bint Labun  
(2 Year old She Camel)

46 to 60 Camels one Hiqqa (matured 3 year old she camel)  
61 to 75 Camels one Jadha (4 year old she camel)  
76 to 90 Camels Two Bint Labun  
91 to 120 Camels Two Hiqqa  
Every 40 over 120 One Bint Labun  
Every 50 over 120 One Hiqqa

### SHEEP

40 to 120 Sheep One Sheep  
121 to 200 Sheep Two Sheep  
201 to 300 Sheep Three Sheep  
Extra 100 over 300 Sheep One Sheep

### EXEMPTIONS

Less than 40 Sheep Exempt  
4 Camels or Cows Exempt  
Gold less than 20 Mithqal i.e. approx. 94 grams  
Silver less than 200 dirham i.e. approx. 640 gram,  
Food-grains and fruit less than 5 Awsuq i.e. 673.5 Kilogram,  
No exemption from or basic threshold for Rikaz and Ushr  
Assets in personal use  
Revenue Generating Assets like Factories, Plant and Machinery,  
Personal Conveyance and one House for self use

### VARIOUS ASSETS

Defense Saving Certificate	Principal Amount
(Interest is forbidden in Islam)	
Shares listed on Stock Exchange	Average Share
Value for the Year	
Instrument of Islamic Bank	Principal +
Instrument of Conventional Bank carrying Islamic Banking	Profit declared to date whether credited or not.
Finished Goods, Works in Progress	Principal
Value for the Material	Average year
Accumulated Balance in PF, Gratuity or on Taqwa (fear Superannuation Fund of Allah) and Circumstances	Depends
Employee Balance	Yes
Employer Contribution	Yes
Accumulated Interest	No
Gold – Check Karat Value	Yes
Advances against Plots/Flats etc for Investment	Yes if not for the purpose of Residence

### VARIOUS LIABILITIES

Liability as on the date of Payment of from Assets	APPLICABILITY Deduct Zakat
Contingent, Deferred or Provisional Liability	Not Deductible

## ISSUES IN ZAKAT PAYMENT

### In Kind or Cash

Narrated Anas Raziallahu Anhu: Abu Bakr Raziallahu Anhu

wrote to me what Allah SWT has instructed His Messenger Sallallahu Alaihi Wasallam to do regarding the who had to pay one Bint Makhad (i.e. one year old she camel) as Zakat, and he did not have it but had got Bint Labun (i.e. two year old she camel). (He wrote that) it could be accepted from as Zakat, and the collector of Zakat would return twenty dirhams or two sheep; and if the Zakat payer had not a Bint Makhad, but he had Ibn Labun (i.e. two year old camel) then it could be accepted as his Zakat, but would not be paid anything [2:528 – O.B].

### Individual and Joint Ownership Property

Narrated Anas Raziallahu Anhu: Abu Bakr Raziallahu Anhu wrote to me what was made compulsory by Allah Messenger Sallallahu Alaihi Wasallam. Neither the property of different people should be gathered together nor the joint property should be split for fear of (paying more or receiving less) Zakat [2:530 – O.B].

### Definite Share Joint Property

Narrated Anas Raziallahu Anhu: Abu Bakr Raziallahu Anhu wrote to me what was made compulsory by Allah Messenger Sallallahu Alaihi Wasallam (regarding Zakat) and there was mentioned in it: If a property is equally owned by two partners, they should pay the combined Zakat and it will be considered that both of them have paid their Zakat equally [2:531 – O.B].

### Defective or Old Animals in Zakat

Narrated Anas Raziallahu Anhu: Abu Bakr Raziallahu Anhu wrote to me what Allah has ordered His Messenger Sallallahu Alaihi Wasallam (about Zakat) which goes: - Neither an old nor a defective animal, nor a male goat may be taken as Zakat except if the Zakat payer wishes [2:535 – O.B].

### Avoid Best Property as Zakat

Narrated Ibn Abbas Raziallahu Anhu: The Prophet Sallallahu Alaihi Wasallam sent Mu'adh Raziallahu Anhu to Yemen and said, "You are going to a nation (from) the people of the Scripture (Divine Book – Jews and Christians etc). Avoid the best of the property of the people as Zakat" [2:537 – O.B]

### Buying Back Goods Donated as Zakat

Narrated Umar Raziallahu Anhu: Once I gave a horse in Allah's Cause (in charity) but that person did not take care of it. I intended to buy it, as I thought he would sell it at a low price. So, I asked the Prophet Sallallahu Alaihi Wasallam about it. He said, "Neither buy, nor take back your alms which you have given, even if the seller were willing to sell it for one dirham, for he who takes back his alms is like the one who swallows his own vomit." [2:567 – O.B]

### Detrmination of Purchase Date

This is a practical problem as everyone wants to pay during the month of Ramazan! One does not know the time of death, hence, cannot defer the same till the month of Ramazan. You also don't know when would be the Day of Resurrection. Avoid deferring the same if you don't have the cash flow problems. Professional accountants' forum (profacforum@yahoo.com) has prepared a detailed guide on this issue and one may refer to the same.

### ZAKAT DUE - PAY ZAKAT BEFORE ITS TOO LATE!

Narrated Haritha Bin Wahb Raziallahu Anhu: I heard the Prophet Sallallahu Alaihi Wasallam saying, "O people! Give in charity as a time will come upon you when a person will wander about with his object of Zakat and will not find anybody to accept it, and one

(who will be requested to take it) will say, 'If you had brought it yesterday, I would have taken it, but today I am not in need of it.' [2:492 – O.B].

Narrated Abu Huraira Raziallahu Anhu: The Prophet Sallallahu Alaihi Wasallam said, "The Hour (Day of Judgment) will not be established till your wealth increases so much so that one will be worried, for no one will accept his Zakat and the person to whom he will give it, will reply, 'I am not in need of it.' " [2:493 – O.B]

### PENULATIVE PROVISION

Narrated Asma bint Abu Bakr Raziallahu Anhu: The Prophet Sallallahu Alaihi Wasallam said to me, "Do not withhold your money, (for if you did so) Allah would withhold His Blessings from you." In another quotation: "Do not withhold your money by counting and hoarding it [being afraid that it (money) may be exhausted (by spending in Allah's Cause) lest Allah should withhold His Blessings from you] [2:513, 514 – O.B].

Narrated Abu Huraira Raziallahu Anhu: The Prophet Sallallahu Alaihi Wasallam said, "on the Day of Judgment camels will come to their owner in the best state of health they have ever had in the world, and if he had not paid their Zakat then they would tread him with their feet; and similarly, sheep will come to their owner in the best state of health they have ever had in the world, and if he had not paid their Zakat then they would tread him with their hooves and would butt him with their horns." The Prophet Sallallahu Alaihi Wasallam added, "I do not want anyone of you to come to me on the Day of Resurrection, carrying over his neck a sheep that be bleating. Such a person will say, 'O Muhammed! (Please intercede for me,)' I will say to him, 'I can't help you, for I conveyed Allah's Message to you.' Similarly, I do not want anyone of you to come to me carrying over his neck a camel that be grunting. Such a person will say, 'O Muhammed! (Please intercede for me,)' I will say to him, 'I can't help you, for I conveyed Allah's Message to you.' [2:485 – O.B]

Narrated Abu Huraira Raziallahu Anhu: Allah's Messenger Sallallahu Alaihi Wasallam said, "Whoever is made wealthy by Allah and does not pay the Zakat of his wealth, then on the Day of Resurrection his wealth will be made like a bald-headed poisonous male snake with two black spots over the eyes. The snake will encircle his neck and bite his cheeks and say 'I am your wealth, I am your treasure.' "Then the Prophet Sallallahu Alaihi Wasallam recited the holy Verse: "Let not those who covetously withhold..... (to the end of Verse 3:180) [2:486 – O.B]

### PROTECTION FROM PENULATIVE PROVISION

Narrated Adi bin Hatim Raziallahu Anhu: While I was sitting with Allah's Messenger Sallallahu Alaihi Wasallam two persons came to him; one of them complained about his poverty and the other complained about the prevalence of robberies. Allah's Messenger Sallallahu Alaihi Wasallam said, "As regards stealing and robberies, there will shortly come a time when a caravan will go to Makka without any guard. And regarding poverty, The Hour (Day of Resurrection) will not be established till one of you wanders about with his object of charity and will not find anybody to accept it. And (no doubt) each one of you will stand in front of Allah SWT and there will be neither a screen nor an interpreter between him and Allah SWT, and Allah will ask him, 'Did not I give you wealth?' He will reply in the affirmative. Allah SWT will further ask, 'Didn't I send a Messenger to you?' And again that person will reply in the affirmative. Then he will look to his right and he will see nothing but Hell-fire, and then he will look to his left and will nothing but

Hell-fire. So let each one of you save himself from the Hell-fire, even by giving half of a date-fruit. And if you do not find a half date-fruit, then (you can do it through saying) a good pleasant word (to your Muslim brother). [2:494 – O.B].

### BENEFICIARIES OF ZAKAT FUND

Zakat is one specific kind of Sadaqa which is to be collected according to certain rules and regulations from the rich Muslims and distributed among the poor ones. Zakat is meant for eight types of people as mentioned in the Noble Quran : Zakat are only for the (1) Fuqara (the poor who do not beg), (2) Al-Masakin (the poor who beg), (3) those employed to collect the funds, (4) to attract the hearts of those who have been inclined towards Islam, (5) to free the captives, (6) indebted people, (7) for Allah's cause (i.e. for Mujahadeen – those fighting in the holy wars) and (8) for the way farer (a traveler who is cut off from

everything); a duty imposed by Allah. And Allah is All-Knower, All-Wise (V.9:60).

Narrated Abu Said Al Khudri Raziallahu Anhu: Once on the day of (Eid ul Fitr or Eid ul Azha) Allah's Messenger Sallallahu Alaihi Wasallam went out to the Musalla (Place of offering Salat). "Then he left. And when he reached his house, Zainab, the wife of the Masood, came and asked permission to enter. It was said, "O Allah's Messenger Sallallahu Alaihi Wasallam! It is Zainab, "He Sallallahu Alaihi Wasallam asked, "Which Zainab?" The reply was that she is the wife of Ibne Masood Raziallahu Anhu. He said, "Yes, allow her to enter." And she was admitted. The she said, "O Prophet of Allah Sallallahu Alaihi Wasallam! Today you ordered people to give alms and I had an ornament and intended to give as alms, but Ibn e Masood Raziallahu Anhu said that he and his children deserved it more than anybody else." The Prophet Sallallahu Alaihi Wasallam replied, "Ibn e Masood Raziallahu Anhu had spoken the truth. Your husband and children had more right to it than anybody else." [2:541 – O.B].

Narrated Amr bin Al Harith Raziallahu Anhu: Zainab, the wife of Abdullah bin Masood Raziallahu Anhu, further to her above Hadith, said almost the same, but added in this quotation, I went to the Prophet Sallallahu Alaihi Wasallam and I saw there an Ansari woman who was standing at the door (of the Prophet Sallallahu Alaihi Wasallam) with a similar problem as mine. Bilal

**Zakat is one specific kind of Sadaqa which is to be collected according to certain rules and regulations from the rich Muslims and distributed among the poor ones. Zakat is meant for eight types of people as mentioned in the Noble Quran:**

Raziallahu Anhu passed by us and we asked him, "Ask the Prophet Sallallahu Alaihi Wasallam whether it is permissible for me to spend on my husband and the Orphans under my Protection." (So Bilal Raziallahu Anhu went inside) and asked the Prophet (regarding our problem). (The Prophet Sallallahu Alaihi Wasallam said,) "Yes, (it is sufficient for her) and she will receive a double reward (for that): One for helping relatives, and the other for giving Sadaqa." [2:545 – O.B]

### UNINTENTIONAL MISTAKE IN SELECTION OF BENEFICIARY

Narrated Abu Huraira Raziallahu Anhu: Allah's Messenger Sallallahu Alaihi Wasallam said, "A man said that he would give something in charity. He went out with object of charity and unknowingly gave it to a thief. Next morning the people said that he had given his object of charity to a thief. (On hearing that), he said, 'O Allah! All the praises and thanks are for you. I will give

alms again.' And so he again went out with his alms and (unknowingly) gave it to an adulteress. Next morning the people said that he had given his alms to an adulteress last night. The man said,

'O Allah! All the praises and thanks are for you.' (I gave my alms) to an adulteress. I will give alms again and (unknowingly) gave it to a rich person. (The people) next morning said that he had given his alms to a wealthy person. He said, 'O Allah! All the praises and thanks are for you.' (I had given alms) to a thief, to an adulteress and to a wealthy man.' Then someone came and said to him, 'The alms which you gave to the thief, might make him abstain from stealing, and that given to the adulteress might make her abstain from illegal sexual intercourse (adultery), and that given to the wealthy man might make him take a lesson from it and spend his wealth which Allah has given him, in Allah's cause" [2:502 – O.B].

### ZAKAT BENEFICIARIES – CATCH 22!

Narrated Abu Said Al-Khudri Raziallahu Anhu: Some Ansari persons asked for (something) from Allah's Messenger and he gave them. They again asked him and he gave them again till all that was with him finished. And then he said, "If I had anything, I would not keep it away from you. (Remember), whoever abstains from asking others, Allah will make him contented, and whoever tries to make himself self-sufficient, Allah will make him self-sufficient. And whoever remains patient, Allah will make him patient. Nobody can be given a blessing better and greater than patience." [2:548-O.B.]

Narrated Abu Huraira Raziallahu Anhu Allah's Messenger said, "By Him in Whose Hand my life is, it is better for anyone of you to take a rope and cut the wood (from the forest) and carry it over his back and sell it (as a means of earning his living) rather than to ask a person for something and that person may give him or not." [2:549-O.B.]

Narrated Abdullah bin Umar Raziallahu Anhu: The Prophet Sallallahu Alaihi Wasallam said, "A man keeps on asking others for something till he comes on the Day Resurrection having no flesh on his face." The Prophet Sallallahu Alaihi Wasallam added, "On the Day of Resurrection, the sun will come near (to the people) to such an extent that the sweat will reach up to the

middle of the ears, so, when all the people are in that state, they will ask Adam AS for help, and then Moosa AS and then Mohammed Sallallahu Alaihi Wasallam.” [2:553 – O.B]

Narrate Abu Huraira Raziallahu Anhu: Allah’s Messenger said, “Al Miskin (the poor) is not the one who goes round the people and ask them for a mouthful or two (of meals) or a date or two but Al Miskin is that who has not enough (money) to satisfy his needs and whose condition is not known to others, that other may give him something in charity and does not beg of people.” [2:557 – O.B]

### ZAKATABLE PERSON [SAHIB E NISAB] – CATCH 22!

Narrated Asma bint Abu Bakr Raziallahu Anhu The Prophet Sallallahu Alaihi Wasallam said to me, “Do not shut your money bag; Otherwise Allah too will withhold His Blessing from You. Spend (in Allah’s Cause) as much as you can afford” [2:515 – O.B].

Narrated Hakim bin Hizam Raziallahu Anhu: The Prophet Sallallahu Alaihi Wasallam said, “The upper hand is better than the lower hand (i.e. he who gives in charity is than him who takes it), one should start first to his dependents. And the best object of charity is that which by a wealthy person (from the money which is left after his expenses). And whoever abstains from asking other for some financial help, Allah will him and save him from asking others, and whosoever is satisfied with what Allah has given him, Allah will make him self-sufficient” [2:508 – O.B].

### ZAKAT INTERMEDIARIES

Narrated Abu Musa Raziallahu Anhu: The Prophet Sallallahu Alaihi Wasallam said, “An honest Muslim trustee (Store Keeper) who carries out the orders of his master and pays fully what he has been ordered to give with a good heard and pays to that person to whom he was ordered to pay, is regarded as one of the two charitable persons” [2:519 – O.B]

Narrated Abu Musa Raziallahu Anhu: Whenever a beggar came to Allah’s Messenger Sallallahu Alaihi Wasallam or he was asked for something, he would intercede (and say to his companions), “Help and recommend him and you will receive the reward for it; and Allah SWT will bring about what He will through His Prophet’s Sallallahu Alaihi Wasallam tongue” [2:512 – O.B].

Narrated Hazrat Aaisha Raziallahu Anhu: Allah’s Messenger Sallallahu Alaihi Wasallam said, “when a women gives in charity some of the foodstuff (which she has in her house) without spoiling it, she will receive the reward for what she has spent, and her husband will receive the reward because of his earning, and the storekeeper will also have a reward similar to it. The reward of one will not decrease the reward of the others.” [2:506 – O.B]

### ZAKAT COLLECTORS’ CATCH 22!

Narrated Umar bin AL-Khattab Raziallahu Anhu: Allah’s Messenger Sallallahu Alaihi Wasallam used to give me something but I would say to him, “Would you give it to a poorer and more needy one than I?”: The Prophet Sallallahu Alaihi Wasallam said to me, “Take it, if you are given something from this property, without asking for it or having greed for it, take it; and if not given do not run for it.” [2:552 – O.B]

Zakat collector should not be a harsh person to deal with! Narrated Ibn Abbas Raziallahu Anhu: The Prophet Sallallahu Alaihi Wasallam sent Mu’adh Raziallahu Anhu to Yemen and said, “Be afraid of the curse of an oppressed person because there is no screen or hurdle between his invocation and Allah.” [2:573 –

O.B]

### ZAKAT COLLECTORS’ – SPOT CHECKING!

Narrated Abu Humaid As Saidi Raziallahu Anhu: Allah’s Messenger Sallallahu Alaihi Wasallam appointed a man called Ibn al Lutabiyya, from the tribe of AL Asd to collect Zakat from Bani Sulaim. When he returned, (after collecting the Zakat) the Prophet Sallallahu Alaihi Wasallam checked the account with him.” [2:576 – O.B]

### DOES GOOD BRING EVIL!

Narrated Abu Said al Khudri Raziallahu Anhu: Once the Prophet Sallallahu Alaihi Wasallam sat on a pulpit and we sat around him. Then he said, “The things I am afraid of most for your sake (concerning what will befall you after me) is the pleasures and splendors of the world and its beauties which will be disclosed to you.” Somebody said, “O Allah’s Messenger, can the good bring forth evil?” The Prophet Sallallahu Alaihi Wasallam remained siled for a while. It was said to that person, “What is wrong with you? You are talking to the Prophet Sallallahu Alaihi Wasallam while he is not talking to you.” Then we noticed that he was being inspired divinely. Then the Prophet Sallallahu Alaihi Wasallam wiped off his seat and said, “Where is the questioner?” It seemed as if the Prophet Sallallahu Alaihi Wasallam liked his question. The he said, “Good never brings forth evil. Indeed it is like what grows on the banks of a water stream which either kills or makes the animals sick, except if an animal eats its fill the Khadira (a kind of vegetable) and then faces the sun, and then passes out dung and urine and grazes again. No doubt his wealth is seet and green. Blessed is the wealth of a Muslim from which he gives to the poor, the orphans and needy travelers. No doubt, whoever takes it illegally will be like the one who eats but is never satisfied, and his wealth will be witness against him on the day of Resurrection.” [2:544 – O.B.]

### CONCLUSION

Narrated Abu Huraira Raziallahu Anhu: The Prophet Sallallahu Alaihi Wasallam said, “Every day two angel’s come down (from the Heaven) and one of them say, ‘O Allah! Compensate every person who spends in your cause,’ and the Other (angel) says, ‘O Allah! Destroy every miser.’ [2:522 – O.B.]

One must be very cautious in selecting the intermediary for Zakat because Organizations sometimes work for worldly benefits may destroy the reward hereinafter as stated in Holy Quran. “And that which you give in gift (to others) in order that it may increase (your wealth by expecting to get a better one in return) from other people’s property, has no increase with Allah; but that which you give in Zakat (Sadaqah, Charity etc.) seeking Allah’s countenance, than those they shall have manifold increase [Surah e Room : 39].

### Editor’s Note:

*The views expressed in the article are solely of the author and do not represent the views of the Publications Committee and the Institute. Zakat is a religious duty, and its computation is a sensitive issue. There might be a few treatments on which interpretations of different scholars and schools of thought are different. This article is not meant to provide elaborations on such differences of opinion. Accordingly, it is advisable to refer to a Shariah scholar while computing Zakat liability.*

## In Conversation with Gold Medalist

I have always found ICAP to be very supportive towards the students, fair and approachable.



*A bright student since school, heading to fulfill her parents wish seeing her as a doctor however, love of mathematics intervened between her and her parent's dream when registering for College. "I took up Pre engineering in Inter because I couldn't leave maths and also because of the common perception that weak students pursued commerce in Inter. However by the mid of 1st year I started to explore the career options; Engineering didn't seem lucrative enough and IT never interested me, as fate would have it TSA came to my college for their orientation program. It was in that session that I got to know of a new option—Chartered Accountancy. I researched very carefully about the profession, I would like to appreciate ICAP too as during my research about CA I always got a prompt response regarding all my queries."*

Hardwork, dedication and self belief are the cornerstones of success as truly depicted by Ms. Shumaila Momin. Qualifying with six (6) gold

medals and currently employed in a multinational; she is not only a source of pride for her family but for the entire Chartered Accountant fraternity.

To get to know more about her and her journey we met at ICAP Head office on 25th June for a rendezvous with Ms. Shumaila Momin.

Sharing her initial aim Shumaila said "When I entered Chartered Accountancy I was aiming at qualifying as early as possible, however it was after my 1st Gold Medal in Intermediate (Overall C and D Module) that I got the confidence and then aimed for Gold medals in E and F.

When asked about the source of her motivation, Shumaila smiled and said "My driving force and the reason behind my success is my family, I couldn't have achieved all of this had it not been for my family support. There were times when I used become demotivated but they never once

doubted my ability, truly it is because of their faith that was able to achieve all of the success.

Reminiscing about her two most memorable moments Shumaila quietly smiled and said "You won't believe it but throughout my school and college my teachers used to push me for a position but I never got one, I always used to feel maybe there is something lacking in my efforts and give more the next time, when I actually got a Overall Gold Medal I felt ecstatic as I actually got a position for the 1st time, hence its very close to my heart.

At the time of my BFD attempt I was so fully convinced that won't clear BFD ,and not only that but had also convinced my family that don't keep any hope from me, when I got to know the result I was speechless and could only gesture with my hands to my family !

Giving her recipe to success Shumaila said:

- ▶ Cover the syllabus properly.
- ▶ From the first day be fully focused; keep in mind the end result.
- ▶ Study regularly.
- ▶ The 2 months examination preparation leave is the most crucial, plan ahead your studies .Focus on your strengths and weakness, for example Managerial Accountant was always my favorite and I never needed to give a lot of time to it, on the other hand I gave a lot of time to BFD as I found it to be difficult. You should be able to identify your strengths and weakness and plan accordingly.

Shumaila didn't agree with the idea that CA comes with a price of losing out on the social life, "There are ups and downs in every profession, there are moments when you have to let everything go because of the bigger picture but that doesn't mean that you are losing your social life, it can be managed, I continued my volunteering services throughout my study and even now with my professional commitments am managing it. It is just that there are certain phases where you need to focus on the end result. Once you qualify you get everything back. To get something worthwhile you need to go an extra mile"

About ICAP's education and training scheme Shumaila was of view "I have always found ICAP to be very supportive towards the students, fair and approachable. I don't think there is anything lacking in the scheme, however I feel that CAs in general ,lack presentation skills, although ICAP conducts competitions and firms also conduct sessions but I feel this is something that all need

to work on by themselves. We need to develop good presentation skills in order to continue to move forward in the industry.

Shumaila firmly rebutted the idea of a glass ceiling for females in the CA Profession," I truly believe that as long as you are giving your 100 %, you are dedicated ,there will never be any hindrance in your growth" "Let your work do the talking" is her manifesto. "I have never been in a situation where I was singled out because I was a female, yes there might be some limitations but that is not specific to this profession only, I would like to see more girls pursue Chartered Accountancy, it is a great challenging profession with exceptional social repute. The limitations are just set by the society, if you are dedicated and have a supporting family you can get through it.

On how to further strengthen the CA fraternity, Shumaila while appreciating the seminars and other events said 'They really do provide ample opportunity to network with CAs and also formation of Professional Accountants Women Forum is a great initiative to involve women CAs."

As an advice to the young aspiring CA's Shumaila said "Always do your background research, know what you are getting into, be determined and focused from the day one.CA is recognized worldwide,has exceptional social repute and even with the current economic situation CAs have a 100 % employment rate. One more thing I would like to suggest is that when you are determined to do CA then join in after Inter as you will be able to understand the system and the examiners better".

We wish Shumaila the best of luck for all her plans and future, may she continue to make the entire CA fraternity proud.

**An advice to the young aspiring CA's would be to do your background research, know what you are getting into, be determined and focused from the day one.CA is recognized worldwide, has exceptional social repute and even with the current economic situation CAs have a 100 % employment rate.**