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Global Depository Receipts(GDRs):  
Pakistan's Experience in International  
Capital Markets



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## **GDRs: Pakistan's Experience in International Capital Markets**

In the backdrop of domestic privatization, high quality companies in less developed countries are tempted to list their shares in overseas secondary market products such as ADRs or GDRs. As cross listing becomes a global trend, Global Depository Receipts have become part of internal financial liberalization in the developing world.

Certain countries like South Korea, Taiwan and India limit foreign ownership while others like Egypt and Pakistan may have risky settlement procedures. In these markets, investors welcome the convenience of trading through depository receipts and familiar settlement procedures. As a matter of fact, under a new regulation, Indian companies following local accounting standards instead of IFRS can now list directly with the UK Listing Authority (UKLA). However, these companies can not sell their securities to retail investors.

The successful listing of MCB Bank Limited and OGDCL GDRs on the London Stock Exchange (LSE) was followed by the listing of UBL shares on LSE. The OGDCL listing employed the book building method for price determination which is the accepted standard in most developed markets. LSE officials termed the OGDCL listing 'a significant step in the Government of Pakistan's privatization agenda'. Similar GDRs of National Bank of Pakistan, Habib Bank Limited and Kot Addu Power Company are expected to be off-loaded at LSE in coming months.

The World Bank and International Monetary Fund (IMF) also encourage strong local stock markets. However, the urge for massive internal and external privatization as means for achieving greater international trade exposure should be strictly regulated. The best example is that of China where the government has a controlled financial system in place.

While the need to cross-list to exploit what foreign markets have to offer is great, it is prudent to remember that cross-listing is feasible only when there is enough liquidity in the home market to provide a guarantee to foreign investors. Developing countries like Pakistan need to ensure that their own financial systems are adequately regulated to provide that guarantee.



**Imran Afzal**  
President

**Abdul Rahim Suriya**



## GDRs: Pakistan's Experience in International Capital Markets



Recent studies in to the motivation of firms to list abroad find that "firms that participate in international markets tend to see their valuation increase, obtain better financing opportunities and extend their debt maturity".

Until now, the focus of cross listing had been on firms in developed markets. With the coming out of emerging economies, there is an academic interest in firm and country factors influencing the decision to cross list. The quality of the institutional framework, World Bank and IMF data on per capita GDP and inflation, the degree of macroeconomic stability/instability and law and order, all come in to question. Companies choose to go for foreign listing mainly in search of strong overall liquidity, improved pricing leverage, extended research coverage, enhanced visibility, status and profile and for better valuation.

International Capital Market is characterized by presence of most sophisticated global institutional investors and greater access to non-QFII international and retail investors. As companies become more global, competitiveness among exchanges continues to grow.

Depository Receipts (DRs) are negotiable certificates that represent a company's publicly traded equity. They are typically quoted in US dollars and are governed by the trading and settlement procedures of that market. There are primarily two forms of DRs: American Depository Receipts (ADRs) – listed in the US and Global Depository Receipts (GDRs) – listed in London or Luxembourg.

Pakistan is an emerging economy with GDP growth rate of approximately 6% over the last couple of years. The Karachi Stock Exchange (KSE) is one of the fastest growing bourses in the world, hence attracting many foreign investors. The listed companies on KSE have benefited from this and some of them explored international markets to raise capital through the issuance of GDRs.

The first Pakistani company to enter the GDR market was Pakistani Telecommunications Company Limited in September 1994 with an offering of US\$ 898 million at the price of US\$ 179.6 per GDR. The Hub Power Company Limited and Pakistan Cement

Company Limited (formerly Chakwal Cement Company Limited) were next to follow with an offering value of US\$ 175 million and US\$ 100 million in October and November 1994 respectively.

MCB Bank Limited was the first Pakistani entity in the last 10 years to issue GDRs on the London Stock Exchange. The issue accounted for an inflow of approximately Rs. 9 billion. The GDR issue attracted demand in excess of US\$ 700 million from over 50 investors globally.

The success of MCB GDRs offering encouraged the Government of Pakistan to offer GDRs of Oil and Gas Development Company Limited (OGDCL) and United Bank Limited (UBL) and raised US\$ 738 million and US\$ 650 million respectively. Both these issues were on the London Stock Exchange. This has manifested the confidence of foreign investors in the economy of Pakistan. The most recent Pakistani company to issue GDR's was Lucky Cement Limited which raised US\$ 109.3 million. The offer was oversubscribed by about 2.5 times. The GDRs of more Pakistani entities including United Bank Limited, National Bank of Pakistan and Kot Addu Power Company and Habib Bank Limited are proposed to be offered.

Pakistan is in the process of being accepted as one of the players in international capital markets. Developing countries like ours must remove, as much as possible, regulatory barriers to allow local firms access to more liquid international exchanges. That does not mean that the role or importance of local stock exchanges is at all diminished. On the contrary, a strong local stock market ensures the entry of new and fledgling companies into the system for the first time. The bottom line is that stock market development depends largely on the development of a good legal system, particularly the protection and enforcement of minority shareholder rights. Stock market development also appears to complement the development of other forms of finance to promote growth, both at the aggregate level as well as at the individual firm level.

Imran Afzal

# Discourse

*We have added a new segment to The Pakistan Accountant.*

*The idea behind 'Discourse' is to capitalize on members' insights on current national and international issues, and generate ideas and solutions through healthy debate. More importantly, Discourse is intended to give members a sense of ownership through participation.*

## THIS MONTH'S TOPIC IS:

### **Coupling and Decoupling from US economy: what it means for emerging markets in Asia, Middle East and China**

"The East versus West decoupling argument has proved to be nothing more than a fallacy, with the last few months demonstrating that markets are in fact more inextricably linked than ever before, thanks to globalization."

**Craig Farley**  
Ashburton's India specialist

The 'coupling vs. decoupling' argument reminds me of the television serial 'How the West was Won' that ran many years ago. We know how the West was won, but do we ever stop to think how the East was lost?

It took the East India Company more than a century to annex India to the British crown but they did so by and by. We have never actually utilized indigenous potentials to the maximum and, thus, running after globalization is proving to be disastrous.

**Rafi Hyder**  
Karachi





Foreign companies may depend less on the American consumer than in the recent past. Morgan Stanley says "U.S. exports account for only about 2.9% of Japan's gross domestic product, compared with 4% of GDP in previous decades. Emerging markets, meanwhile, are increasingly selling commodities and other goods to China and India, lessening their historical dependence on the U.S. export market."

Since we do not have plans for diversification of our exports and the newly elected government has not given any indications for improving ties with emerging markets, feared recession in the US may adversely impact our economy as well as the economy of China, which has substantial exports to the US.

In view of the above Pakistan should seek further markets for its exports instead of dependence on the US and look forward to Asian, Gulf and other regional markets for stability of its economy and decouple itself gradually but carefully.

**Asif Mubeen**  
Karachi

An ominous recession in the US questions the recent changes on the global economic scene. Heavy dependence, in the past by South East Asian and Middle Eastern countries, on the US economy is being affected due to the recession. One of the major indicators is the dollar, which has fallen to record lows against other currencies, and is also set to hit Asian economies as part of the "coupling" effect.

Most Asian countries are dealing with this threat by "decoupling from US economy" by lessening their dependence on the US through increased intra-Asian trade and a more vigorous outreach to the European economy.

However, I am of the view that there can never be a decoupling from the US economy --- though the magnitude of the impact will not be what it was in the past --- as the US is still one of the big export markets for Asian countries.

**Muhammad Rizwan Rauf**  
Karachi

The four biggest emerging economies, which accounted for two-fifths of global GDP growth last year, are the least dependent on the United States: exports to America account for just 8% of China's GDP, 4% of India's, 3% of Brazil's and 1% of Russia's. Over 95% of China's growth of 11.2% in the year to the fourth quarter came from domestic demand.

So the decoupling 'fallacy' from US economy seems to be turning into reality, but the globalization factor is still holding the economies together.

**Muhammad Waseem Mir**  
Lahore

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Letters to Discourse must include writer's full name, town/city and membership number and addressed to:  
**The Pakistan Accountant**  
Chartered Accountants Avenue, Clifton, Karachi with the word DISCOURSE in the subject heading or e-mail your letter to: [asad.shahzad@cpa.org.pk](mailto:asad.shahzad@cpa.org.pk)

Letters may be edited for purpose of clarity or space.



# SBP Issues Guidelines on Global Depository Receipts (GDRs)

Global Depository Receipts (GDRs) provide investors an opportunity to reach beyond the geographical confines of their parent country. Recent years have seen a growing number of emerging market countries opting to raise capital from international investors through issues of depository receipts (**Box 1**).

Depository receipts have become increasingly popular because they give companies, particularly those from developing markets, a convenient way to attract a broad range of investors than is possible locally (**Box 2**).

Pakistan entered the GDR market in 1994 through the issuance of Reg S / 144A offering of Pakistan Telecommunication (Sep 1994), Hub Power Company Limited (Oct 1994), and Pakistan Cement Limited (Nov 1994). There is no trading volume data available for these securities, although an ADR converted price is being quoted on Bloomberg.

In line with global trends, Pakistan saw a revival of GDR issues during 2006, after a gap of more than 10 years. So far MCB, Oil and Gas Development Company Limited (OGDCL) and United Bank Limited (UBL) have successfully launched GDRs amounting to a total sum of US\$1.5 billion at the London Stock Exchange (**Table 1**).

The GDRs of OGDCL, MCB and UBL have a two way convertibility option, however this convertibility is limited to the number of GDRs issued at the time of initial offering. This facility is beneficial in providing the investors arbitrage opportunity and also in hedging risk. This option gives foreign investors the ability to convert their GDRs into local ordinary shares and reconvert their ordinary shares into GDRs, which would be subject to the availability of headroom.<sup>1</sup> This convertibility facility has been widely used

by the investors and so far around 49.4 million GDRs have been converted. Specifically 33 million GDRs of OGDCL, 4.6 million GDRs of MCB and 11.8 million GDRs of UBL have been converted.

Encouraged by the positive response of international investors towards Pakistani GDRs, the government is planning to issue other GDRs of leading banks in the public sector i.e. National Bank, Habib Bank, in addition to a power generation company i.e. Kot Addu Power

## Box 1: Depository Receipts

A depository receipt (DR) is a negotiable instrument representing ownership of a given number of a company's shares and can be listed and traded independently of the underlying stock, in a different jurisdiction. Since the 1920s, American Depository Receipt (ADR) is one of the most common types of DRs which provides opportunities to companies to raise funds from international markets, while also diversifying their portfolios. Global Depository Receipts (GDRs), European DRs and International DRs are other types of DRs traded at international bourses. GDRs are commonly listed on European stock exchanges, but offerings do occur elsewhere. In April 2007, the first ever listing on the Singapore stock exchange took place. Both ADRs and GDRs are usually denominated in U.S. dollars, but can also be denominated in other currencies.



**Table 1: Recent GDRs Issued**

Amount in Million US \$, Numbers in Millions

	Issuance Date	Amount Raised	No. of Issuance		Conversion upto Oct 2007	
			GDRs	Ordinary shares*	GDRs	Ordinary shares*
MCB	Oct-06	150	8.6	34.5	4.6	18.5
OGDCL**	Dec-06	738	39.1	390.6	33.0	329.7
UBL	Jun-07	650	50.6	202.3	11.8	47.2

\*against GDRs

\*\* GDR re-issuance totaled to 14.8 million of ordinary shares till Oct 2007

Source: Local custodian banks

**Box 2: Strong Growth of GDRs Anticipated**

According to JP Morgan Depository Receipts Group, Depository Receipts (DR) have gained widespread popularity across the globe as more and more companies are using this tool to access cross border capital and as an investment option to facilitate global exposure. Looking at this rising interest, it is anticipated that during 2007 there will be a strong and record-setting growth in liquidity and capital raised from American Depository Receipts (ADRs) and Global Depository Receipts (GDR).

During the last five years a tremendous growth in trading values of GDRs has been observed. GDRs showed a record liquidity during 2006 (Figure 1) with a rise in trading volumes by 22 percent to reach 67 billion shares, and rise in trading values by 88 percent to reach US\$1,657 billion as compared with the previous year. In 2006, Oil and Gas, Telecommunications and Mining were the top three sectors with almost 40 percent of the overall trading value.

From a regional perspective, Korea, Taiwan and India remained dominant in Asia in term of issuing GDRs during 2006, whereas there has been a significant demand for GDRs from new markets in Asia including Pakistan and Vietnam. The main driving force behind this phenomenon was privatization, and increasing appetite for emerging markets exposure.

In Europe, Russian issuers were dominant in raising capital through DRs where Russian oil and gas giant Rosneft Oil Company JSC raised approximately US\$6.4 billion in DR form which is the largest ever offering of DRs. Moreover, another 12

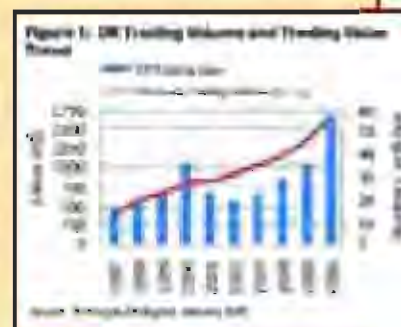
Russian issuers raised capital in DR form, where metals & mining, and oil and gas sector remained dominant.

In Latin America, the dominant market was Brazil which almost covers two thirds of new DR entrants for the region. Argentina also revisited the international capital market during 2006 after a gap of almost five years.

**Expected trends in 2007:**

- Looking at the strong demand of GDRs across the globe, a robust growth of GDRs could be anticipated in 2007. It is also anticipated that GDRs will dominate the market viz-à-viz ADRs in 2007 which is mainly due to the expected reporting and compliance regulations for global issuers as a result of U.S. Sarbanes-Oxley requirements.
- Further, DR markets will be dominated by countries from South America and Asia in 2007 where Brazil, Russia, India and China will dominate the new GDRs issues.
- Rise in demand of specialized DRs and DR-based investment and fund vehicles.

Source: JP Morgan DR Report, January 2007



Company. In recognition of the implications of this growing demand of Depository Receipts (DRs) by Pakistani companies, and the preference to raise funds from international capital markets, State Bank of Pakistan (SBP) has issued detailed guidelines for banks and Development Finance Institutions (DFIs) for issuing and listing of DRs in the international market. The scrutiny of bank/DFIs

through these rigorous requirements is seen to be a prudent and proactive measure, targeted to ensure that only financially sound and stable banks/DFIs would go for GDR issuances.

\* Headroom is the number of GDRs available for convertibility, as a result of cancellation.

## Global Depository Receipts (GDRs)

# Structure and Properties

For those who are not familiar with the structure of GDRs, these represent a block of shares of a company that are deposited with a trustee in an internationally convenient location. The trustee then issues certificates/receipts (can be in dematerialised form) representing the right to one or more underlying shares. Thus, a GDR should have the same properties as the underlying share. However, GDRs can have some restrictions such as a time period before these can be converted to the underlying shares.

The GDRs are listed on an internationally active stock exchange and are traded in a currency that is preferred in terms of international trade. The GDR should normally trade at a price close to that of the underlying share converted at the prevailing exchange rate between the currency in which these are listed and the home currency of the company. However, it should be understood that the investor is effectively taking exposure to the underlying stock and the home currency (and not the currency of trade in which the GDR is issued). Arbitrage is likely to ensure that any deviation in price is brought down very quickly.

This arrangement allows the issuing company to get

virtually listed on a foreign stock exchange and access international investors, who are able to trade the GDR during their normal working hours and settle the trade in a currency and clearing system of their convenience.

### ■ Pakistan's Experience

Pakistan entered into GDR market through the launch of PTCL GDR in September 1994, Hubco in October 1994 and Chakwal Cement (currently Pakistan Cement) in April 1995. After a decade Pakistan reentered the GDR market with the launch of GDRs of MCB Bank Limited, the largest private sector bank, OGDCL and United Bank Limited and raised US\$1.53 billion on the London Stock Exchange.

### ■ MCB Bank GDR Performance

With the listing of the MCB Bank GDR in 2006, a Pakistani issuer returned to the international market after a decade. The US\$150m GDR issue for MCB received an overwhelming response from international investors and was well oversubscribed, attracting a demand of over US\$700m. Offering price of US\$17.397 for the GDR,



constituting four ordinary shares, was around 2.9% discount to local spot price at that time. Local spot price on the GDR date had risen 22% since pre-marketing began in September 2006. See graph below.

#### ■ MCB Bank vs. KSE100 Index

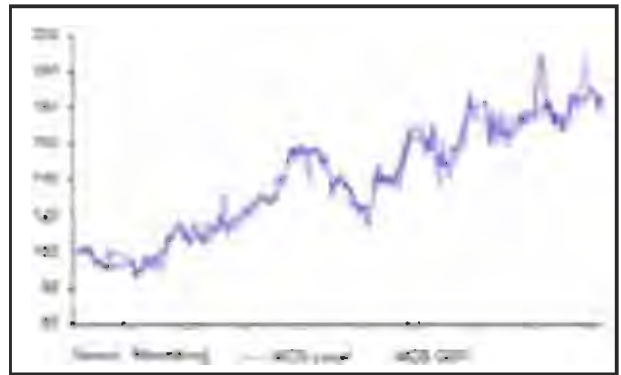
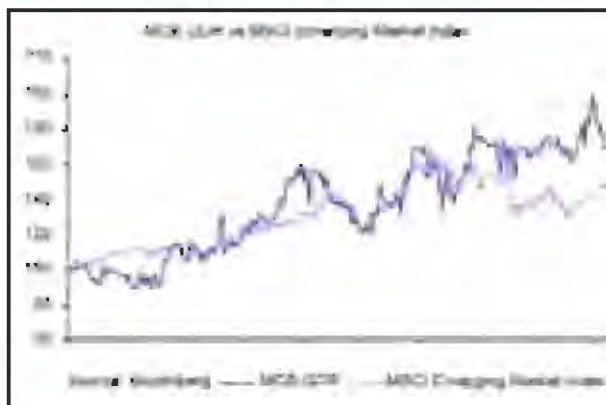


With a well run roadshow, on the back of impressive growth in the economy and the banking sector, the first equity transaction out of Pakistan

after 11 years attracted investors to the transaction. An added feature, this time around, had also been the two way convertibility of the GDR, although this conversion option is restricted to the number of GDRs issued at the time of offering. Before the GDR issue, MCB's stock was trading at P/E multiple of 11 times, which shot up to a multiple of 14 times at the time of the GDR issuance and currently it is trading at P/E multiple of 17 times. As a result of this international exposure Maybank of Malaysia is taking up a strategic stake in MCB Bank.

The Financial Stability Report of the State Bank has benchmarked the MCB GDR performance with Morgan Stanley Capital International (MSCI) Index, which shows MCB GDR has been successful in drawing the attention of foreign investors. Over the period, MCB GDR prices have also closely tracked the local prices with investors clearly taking advantage of the two way convertibility to quickly eliminate any arbitrage opportunity available in the dual listing.

#### ■ MCB GDR vs. MSCI Emerging Market Index



#### ■ OGDCL GDR Performance

The Privatisation Commission of Pakistan (PC) launched a dual tranche equity offering of OGDCL in December 2006. It was the largest ever GDR for a Pakistani company where the PC had been looking to sell 15% of the company's capital. However, only 9.5% of company's capital was offered to international and domestic institutional investors to ensure that there was a decent

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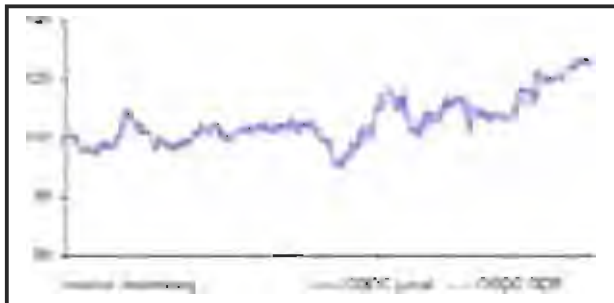
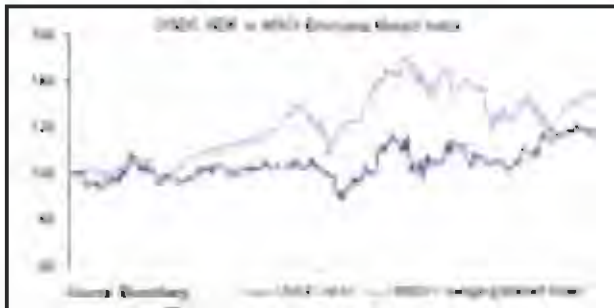
aftermarket performance. It was the first ever transaction from the country in which domestic investors participated in an international book building offering for a publicly traded Pakistani listed company. The deal was priced at Rs 115/share and US\$18.90/GDR representing 10 ordinary shares per GDR. The price represented 9.5% discount to the company's closing price of November 2006. The PC and international lead managers and book runners conducted roadshows for two weeks with OGDCL management meeting with 80 institutional investors. As a result, the deal was two times covered, attracting US\$1.5b against targeted US\$713m with

demand from investors in the UK, US, Middle East and Asia. The PC accepted US\$813m from the issue, offloading 10% of OGDCL shareholding.

Before the GDR issue, OGDCL's stock was trading at P/E multiple of 12.2 times and was offered to the investors at multiple of 10.8 times. The Financial Stability Report of State Bank compared the OGDCL GDR performance versus the Morgan Stanley Capital international (MSCI) Index, which shows OGDCL's GDR did not perform as well as MCB's GDR and attributes this performance to high volatility in international oil prices.

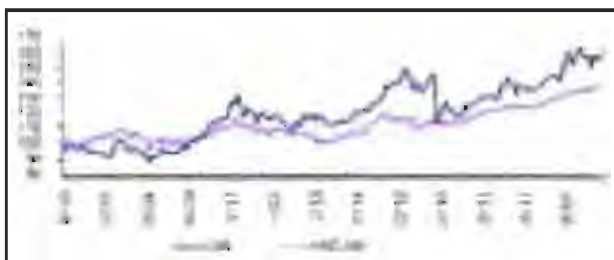
In addition to international comparison, OGDCL GDR prices movement is also compared (in the State Bank report) with domestic share price and result showed OGDCL GDR price remained close to domestic price and performed reasonably well versus the international market.

#### ■ OGDCL GDR vs. MSCI Emerging Market Index



#### ■ UBL GDR Performance

The Government of Pakistan raised US\$650 million



through GDR of UBL, by divesting of 25% of total paid-up capital. The GDR issue was offered to international investors at US\$12.85 which equates to Rs195/share (each GDR represents 4 underlying shares of UBL). The GDR was issued at very high price to book multiple of 5 times as compared to similar transactions elsewhere globally.

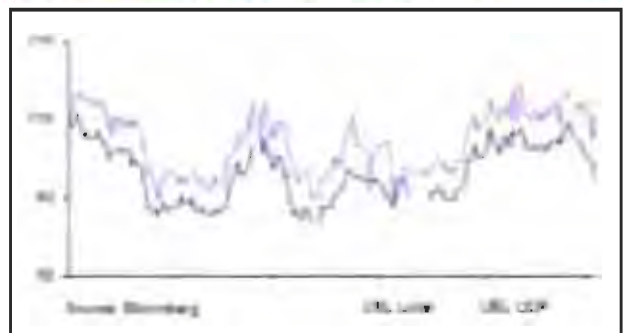
#### ■ UBL vs. KSE100 Index

For the purpose of evaluation, the Financial Stability Report of the State Bank compared the UBL GDR performance versus MSCI Index, which shows that UBL's GDR did not perform as well as MCB's GDR.

In addition to international comparison the UBL GDR prices movement has also been compared with domestic share price which shows some price divergence in international and domestic prices.

#### ■ UBL GDR vs. MSCI Emerging Market Index

It will be seen that Pakistan has been able to get good exposure from the GDRs in terms of attracting foreign portfolio investors. This has also resulted in foreign



brokerage houses re-establishing their presence here as well as foreign banks being attracted to Pakistan. One should expect more of the GDR activity out of Pakistan as soon as economic and political conditions settle.

**Nasim Beg, FCA**  
Arif Habib Investments



## GLOBAL DEPOSITORY RECEIPTS:

# Pakistan's Experience in International Markets

In the 1920s, a group of investors in the United States introduced the American Depositary Receipt (ADR) as a way of making another investment channel for them to register their purchases of foreign stocks and collect their dividends. Over the years, international companies eventually discovered the advantages of broadening their shareholder base in the US and actively encouraged investors to hold ADRs. They discovered that ADRs are a great vehicle for raising capital in the US and the instruments have become one of the hottest financing mechanisms available to corporations from emerging markets.

The concept of ADR has gone global. Through securities called Global Depositary Receipts (GDRs), companies from Asia, Latin America and other developing countries have found a way to tap into capital markets in Europe and the United States. The growth of GDRs has been driven by the same forces behind the ADRs. Companies around the world need money to finance modernization and expansion, and investors in Europe as in the US are bullish on emerging markets. Most of the growth is coming from countries where the sophistication and the openness of the financial markets has not caught up with the growth of local companies and their need for financing.

### Pakistan's Experience in GDRs

GDRs are an important source of foreign exchange earnings that help finance the widening fiscal, poverty and trade and current account deficit. In the last few years the Government of Pakistan



has changed its policy for privatization. The government has implemented multidimensional and broad-based structural reforms covering political, economic and social sectors. Economic reforms are based on privatization, deregulations and liberalization accompanied by transparency, good governance and continuity and consistency in policies. The government has focused on development of sound regulatory policies of modern and efficient corporate sector with increased capitalization and larger investor base through vibrant capital market. Structural reforms are strengthening risk management at the stock exchanges, increased transparency and investor protection, improved market efficiency and introduction of code of corporate governance.

The government is now focusing more on global depository receipts of state owned enterprises. According to Privatization Commission officials, GDRs are meant for foreign investors since local investors do not have the financial strength to participate in GDRs; they are more interested in initial public offerings (IPOs) while foreign investors go for GDRs.

The idea behind offering GDRs is that the international investors should start investing in Pakistan's equities. Private sector companies should also come forward for international enlisting. It also gives an opportunity to institutional investors to invest in Pakistan's equities for diversification. This is an important link which is essential for Pakistan.

#### **Oil & Gas Development Company Limited (OGDCL)**

Recently, OGDCL, the largest oil exploration company in Pakistan successfully tapped the international capital markets, raising \$613 million and enlisting on the London Stock Exchange. It was the largest equity offering of a Pakistani company in international markets in over a decade. The issue attracted more than \$1.5 billion in demand from the United States, Europe, Middle East and Asian investors. The offer

was priced at \$18.9 per GDS, with each GDS representing 10 shares. The offering price represented almost 9.5 percent discount to the prevailing market price on Karachi Stock Exchange, which compares favorably with debut GDS offerings for other Asian companies at a discount of 12.5 percent.

The GDS pricing values OGDCL at more than \$8 billion. The offering represents 10 percent of OGDCL's outstanding share capital. In a press statement the Chairman and Chief Executive of OGDCL said, "We were delighted to welcome a broad range of the world's leading institutions as shareholders in our company and were pleased that the offering enhanced our profile in the international markets."

#### **MCB Bank Limited**

MCB Bank Limited successfully issued \$150 million worth of GDRs to international institutional investors, priced at \$17.4 with each GDR representing four underlying equity shares. The GDR attracted more than \$700 million from global investors. The formal opening was held at the London Stock Exchange on October 18, 2006.

#### **United Bank Limited (UBL)**

The Government of Pakistan raised proceeds of approximately US\$ 650.3 million from the sale of shares overseas in United Bank Limited through GDR offering. This launch marked another landmark transaction of the privatization program of Pakistan in the international market after the listing of OGDCL on the London Stock Exchange. International investors from US, UK, continental Europe, Middle East and Asia bought GDRs equivalent to UBL shares priced at PKR 195 a piece, amounting to disinvestment of a 25 percent of the total paid up capital of UBL. The GDRs were priced at US\$ 12.8543 each. The transaction attracted gross demand of over US\$ 2.5 billion from a mix of quality global funds, Asian funds, and financial sector dedicated specialists.

Encouraged by the successful GDR offering of OGDCL, MCB Bank Limited and United Bank Limited, the government has decided to launch GDRs for other leading financial institutions including Habib Bank Limited, National Bank of Pakistan, Lucky Cement Limited and Kot Addu Power Company.

**Saqib Jaleel Malik**

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# RISK BASED INTERNAL AUDITS

## INTRODUCTION

Regulations governing banks in Pakistan require an independent internal audit department with functional reporting of the head of department to the audit committee. However, these regulations do not require any specific audit methodology to be used by the internal audit department while performing the audits for e.g. whether it is risk based or not it is left to the discretion of the management and the Board of Directors.

As a result, internal audit departments in most banks follow conventional methods and processes with full scale transaction testing without focusing on the risk involved in the business.

With more than 80 percent of banking assets in private hands, there is a need for banks to redirect and widen the scope of internal audit to evaluate the adequacy of risk management procedures and internal control systems with a gradual move to risk based audit systems.

Under risk based audits the focus will shift from the present system of full scale transaction testing to risk identification, prioritization of audit areas and allocation of audit resources in accordance with risk assessment.

It means that greater emphasis will be placed by internal audit on mitigating the risks while focusing on effective risk management and controls. In addition to appropriate transaction testing the risk based audits would not only offer suggestions for mitigating current risks but also anticipate potential ones and play an important role in protecting banks from various risks.

Here one should not confuse risk management department with risk based audits. The risk management function of the bank focuses on the identification, measurement and monitoring of the various risks faced by banks. For this purpose they use various models, policies and methods. Whereas risk based internal audit 'undertakes an independent risk assessment solely for the purpose of formulating a risk based audit plan' keeping in view the various risks inherent in a business/ activity and the effectiveness of internal control system for monitoring those inherent risks. It must be noted also that while formulating a risk based audit plan, risk management department is also subject to risk assessment by the risk based internal audit.

## RISK ASSESSMENT PROCESS

As mentioned earlier, Risk Assessment by internal audit is done solely for the sake of formulating a risk based audit plan. It should be an independent activity which covers risks at various levels and has a control environment in place to mitigate those risks. The internal audit department needs to devise a detailed methodology for this keeping in view the size and complexity of the banking organization.

Typically, risk assessment process should include the identification of inherent risks in various activities undertaken by the bank, an evaluation of the effectiveness of the internal controls for monitoring the inherent risks in business activities, and preparation of a matrix taking into

account the inherent risks and controls.

A detailed step-wise approach that is consistent with the approach to risk analysis of the Institute of Internal Auditors is listed below.

1. Define 'The Audit Universe' and identify the auditable units within the entity for which these analyses will be carried out.
2. Identify appropriate Risk Factors applicable to the business and support functions.
3. Select an appropriate format for evaluating risk factors so that the more important risk factors play a more prominent role in the risk assessment process than less important risk factors.
4. Develop a combination rule for each audit unit which will properly reflect the level of risk based on the factors and controls in place to counter those risks.
5. Once audit units have been rated according to their level of risk, it is important to have a mechanism for assigning them to audit frequency categories; that is, to identify which units will be audited how often, say once in a year, once in two years, or continuously monitored, and so on.
6. Having carried out these analyses, it is useful to produce an audit plan which indicates which audits will be conducted at what times throughout the planning process.

To explain the process let us first discuss some of the key terms listed above in more detail.

## AUDIT UNIVERSE

Organizations are getting bigger and more complex nowadays with more than one line of business. Some are organized on functional basis while others may be on product basis. In order for the auditor not to get lost in the complexity of the structure, it is recommended to have an organized inventory of all the auditable units.

This is an important process and should be undertaken carefully. The auditor should view the organization in the same manner as management. This will help in identifying the appropriate definition of audit universe.

Analysis of business process, organizational relationship, information systems and interviews with the management could help in establishing appropriate definition of auditable units.

## RISK FACTORS

Another critical factor in any risk assessment approach is to identify the risk factors which will be used for assessing the risks. Risk scores derived from the risk factors is the potential of the auditable unit for causing loss to the enterprise, including the likelihood and the magnitude of the loss.

It is easy for a banking organization to classify the risks as business, credit, market, legal/regulatory, technological etc., but these are broad categories and for determining the applicability of these risks on individual auditable unit, a well defined criteria should be established which can consistently be applied to all the auditable units.

To access the control environment following can be made part of a risk assessment process, and the auditor can use it in conjunction with the risk score to determine overall risk, with a little flexibility in the score arrived at:

- a. results of previous internal audits and status of compliance of previous audit reports;
- b. level of management attention to close the audit observations;
- c. results of last regulatory examination report;
- d. results of last external audit report/management letter;
- e. time since last audit;
- f. complexity and volume of transactions taking place in auditable unit;
- g. total income/ total cost / total revenue of the auditable unit;
- h. overall importance of the auditable unit in the organization;
- i. any change which is significant in business line, introduction of new product, change in focus;
- j. targets given by the management and the status of those targets, both revenue and cost;



- k. level of staff turnover and availability of skilled staff;
- l. the unit's dependency on some outsider; and (outsourcing), nature of the services and its impact on the unit if not provided effectively.

## METHODOLOGY

After risk factors have been identified, the next step is to use these factors in conjunction with the assessment of the control environment in an organized form or methodology to arrive at a risk score for each auditable unit.

Two different methodologies can be used, it could be either objective or subjective or a combination of two. I believe that a methodology that includes both objective and subjective criteria is suitable.

While the quantum of credit or market risks in the activities of a banking organization can be determined through quantitative criteria, qualitative criteria may be used for assessing the quality of controls and the overall control environment in the auditable unit. It is important that process should be so designed that the auditor uses qualitative criteria in sufficient detail considering other relevant risks that cannot be captured through objective criteria.

## EXAMPLE:

*Where amount of fund and non-fund based exposure or accommodation in an auditable unit is used as quantitative criteria for determining the credit risk. Conduct of accounts, outstanding documentation may be some of the factors that can be used as qualitative criteria to determine and adjust the score determined through the objective criteria.*

For risk assessment to be accurate it is very important to have in place proper MIS which can be used for this purpose. Internal audit function should be kept informed of all the developments such as introduction of new products, changes in reporting lines, changes in accounting practices/ policies, creation of new departments/ units, new systems etc. Without instituting a process where internal audit function has access to timely and thorough MIS, risk assessment process cannot be effective.

Here is a very basic example of a matrix/combination rule (risk assessment process) where the results of a risk assessment is plotted in a form combining control environment and risk scores for an auditable unit/activity to determine the audit frequency and allocation of the audit resources.

Risks/Control environment	HIGH	MEDIUM	LOW
Business Risk			
HIGH	Very High Risk	High Risk	Medium Risk
MEDIUM	High Risk	Medium Risk	Medium Risk
LOW	Medium Risk	Medium Risk	Low Risk

## VERY HIGH RISK:

Audit frequency of this unit/activity may be twice a year

## HIGH RISK:

Audit frequency of this unit/activity may be once in a year

## MEDIUM RISK:

Audit frequency of this unit/activity may be once in two years

## LOW RISK:

Audit frequency of this unit/activity may be once in three years

## KEY DECISIONS AIDED BY RISK ASSESSMENT

Following key decisions could be generated from the above process. Some of them can also be used as Key Performance Indicators (KPIs) by the audit department.

1. Audit frequency
2. Audit intensity
3. Audit timing
4. Internal audit department's size and capability

The audit plan that is generated from the above process will provide a roadmap for the internal audit department for managing staff skills so that they are available to carry out audits of appropriate scope and intensity whenever required to. It will also provide a basis for scheduling audits in such a way as to ensure a balanced workload and the availability of resources when needed. An important part of the planning process is to establish the appropriate department size for the internal audit department commensurate with its mandate and responsibility.

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Head of Internal Audit, Deutsche Bank



# BUDGET 2008

## Medium Term Budgetary Framework (MTBF) IN PAKISTAN

### What is MTBF

Medium Term Budgetary Framework (MTBF), as its name implies, is a new budgeting approach commonly known as Medium Term Expenditure Framework (MTEF). MTBF is a budget system that aligns expenditure to policy priorities, within the total resource available, over a rolling three-year planning period to bring fiscal discipline in the government's expenditure.

Conceptually, MTEF is the ideal tool for translating Poverty Reduction Strategy Papers (PRSPs) into public expenditure programs within a coherent multiyear macroeconomic and fiscal framework. The MTEF provides the "linking framework" that allows expenditures to be "driven by policy priorities and disciplined by budget realities" (World Bank, 1998a: 32). If the problem is that policy making, planning, and budgeting are disconnected, then a potential solution is an MTEF. Given that this disconnect between policy making, planning, and budgetary processes is a common condition of developing country governance, the MTEF has increasingly come to be regarded as a central element of Public Expenditure Management (PEM) reform programs.

### Concept of MTBF/MTEF

According to the World Bank's Public Expenditure Management Handbook (1998a: 46), "The MTEF consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy and, ultimately, the matching of these costs with available resources...In the context of the annual budget process, The "top-down resource envelope" is fundamentally a macroeconomic model that indicates fiscal targets and estimates revenues and expenditures, including government financial obligations and high cost government-wide programs such as civil service reform. To complement the macroeconomic model, the sectors engage in "bottom-up" reviews that begin by scrutinizing sector policies and activities (similar to the zero-based budgeting approach) with an eye toward optimizing intra-sectoral allocations.

The value added of the MTEF approach comes from integrating the top-down resource envelope with the bottom-up sector programs. It is at Stage III that the policy making, planning, and budgeting processes are joined (see Table 1). Once the strategic expenditure



**Table 1. The Six Stages of a Comprehensive MTEF**

Stage	Characteristics
I. Development of Macroeconomic/Fiscal Framework	■ Macroeconomic model that projects revenues and expenditures in the medium term (multi-year)
II. Development of Sectoral Programs	■ Agreement on sector objectives, outputs, and services ■ Review and development of programs and sub-programs ■ Program cost estimation
III. Development of Sectoral Expenditure Frameworks	■ Analysis of inter- and intra-sectoral trade-offs ■ Consensus-building on strategic resource allocation
IV. Definition of Sector Resource Allocations	■ Setting medium term sector budget ceilings (cabinet approval)
V. Preparation of Sectoral Budgets	■ Medium term sectoral programs based on budget ceilings
VI. Final Political Approval	■ Presentation of budget estimates to cabinet and parliament for approval

Source: FBM Handbook (World Bank, 1993a: 47-51) adapted

framework is developed the government defines the sectoral resource allocations which are then used by the sectors to finalize their programs and budgets.

Under the MTEF/MTBF system, the budget is prepared for three to five years instead of just one year, and it includes the estimates and projections of revenue receipts and expenditures. Once the MTEF/MTBF has been developed it is rolling in the sense that the first outward year's estimates become the basis for the subsequent year's budget, once changes in economic conditions and policies are taken into account. The MTBF links the spending plan and policy objectives of the government. One major purpose of this system is to prepare the reliable estimate of available resources, both domestic and foreign, the medium term and institute balance between policy priorities and overall availability of resources. A MTBF involves a radical change in the business of budgeting. Consequently, without political commitment, it has little chance of succeeding.

### Objectives of MTBF

Better macroeconomic balance; enhanced inter- and intra-sectoral resource allocation; greater budgetary conviction for line ministries; and more efficient use of public monies. Improved macroeconomic balance, including fiscal discipline, is attained through good estimates of the available resource envelope, which are then used to make budgets that fit directly within the envelope. It involves building domestic macro-economic and sector modeling capacity. Also, even if the whole of the government's budgeting system is not working well, each sector is better off managing itself with a medium term perspective.

Under MTBF line ministries are given enhanced responsibilities and authorities for allocation and utilization of resources. The MTBF consists of top-down resource ceilings and bottom-up estimation of cost of current and medium term programs/activities in line with existing policy. Ultimately these estimates are matched with the resource pocket of the economy/government. The principal objectives of the MTBF are:

- Improving macroeconomic stability by matching expenditure and resources as projected in Medium Term *Macroeconomic Framework* (MTMF);
- Ensuring stability in budgetary management in the short term, keeping the public expenditure within the sustainable limit in the medium and long term and accelerating pro-poor economic growth at the same time;
- Enhancing the role and participation of the line ministries in the budget preparation process;
- Improving the predictability of policy as well as funding by providing a medium term view of policy objectives and resource availability, so that line ministries can prepare and plan for forward expenditure;
- Allocation of resources between and within sectors/ministries according to strategic priorities;
- Ensuring proper, efficient and effective use of resources by establishing a more explicit linkage between the PRSP and other policy documents and line ministries' objectives, policies and resource allocation;
- Removing the demarcation between the current and development budget;
- Establishing a system for measurement of performance of ministries/divisions, so that clear

indication of desired output from inputs provided through the budget can be shown; and

- To further strengthen fiscal discipline in the management of the budget of the federal government.

### **Difference between existing budgeting system and MTBF**

There are some fundamental differences between the existing budgeting system and The Medium Term

Budgetary Framework. These differences are illustrated, in brief, in the following table:

### **Procedure for preparation of budget under MTBF**

The following is a generic guideline for preparing budget under Medium Term Budgetary Framework:

1. Developing/ updating the Medium Term Macroeconomic Framework

Existing budgetary system	Medium Term Budgetary Framework
Budget is prepared only for one year. So, there is short term focus.	Instead, of one year it consist of the estimates of three five years. However, only the first year's estimate is sent to parliament for approval.
Current and development budget is prepared separately, which results in duplication and overlapping in public expenditure planning.	As the budget is prepared under single ceiling, duplication and lack of coordination can be avoided; and the demarcation between current and development is removed.
Generally, the receipt and expenditure estimates are determined considering the actual for the previous period and by adding a margin on top of that. The linkage between the strategic objectives or the policy priorities and resource allocation decision is not explicit.	Instead of taking the previous year's actual receipts or expenditures as the basis, the resources are allocated considering the priorities of the programs or projects necessary for achieving the strategic objectives of the government.
Detailed information on expected results from the allocated funds is not provided in the budget document nor is the output target fixed explicitly. Therefore, it is difficult to evaluate whether the target output is achieved or not.	It clearly indicates the expected output from the input for the relevant ministry and its subordinate department/offices and provides an opportunity to know about the output achieved. Thus, it helps in developing performance indicators and institutionalizing performance measurement.
Ministry of Finance and Ministry of Planning play the dominant role in budget preparation. So, if fund is not allocated according to the need and priorities of the ministries, the implementation of relevant project or program may be hampered.	The line ministries and divisions are given enhanced responsibility and authority for budget preparation and resource allocation. Consequently, the relevant ministries have the opportunity to allocate and utilize the fund according to specific need and priorities.
Link between policy, planning and budgeting is very weak because policy choices are made independent of resource realities. Thus policy is not sustainable and spending patterns may not reflect the priorities articulated by government.	Policy making is tightly disciplined by resource realities. Thus, a much stronger link exists between policy making, planning and budgeting. Spending reflects the stated priorities of government.
Incentives for results in term of outputs and outcomes are generally low because emphasis is on input control.	Emphasis is on delivery of agreed outputs and outcomes with available resources. Incentives are structured to increase the demand for evidence of good performance. Consequently, service delivery should improve.



2. Developing/ updating the Ministry Budgetary Framework
3. Reviewing the Budgetary framework of the line ministries/divisions
4. Finalizing and approving the ministry-wise/ division-wise indicative budget ceiling and revenue target
5. Preparing and issuing Budget Call Circular (BCC)
6. Preparation of estimates by line ministries/divisions
7. Reviewing/finalizing the estimates/projections prepared by the line ministries/divisions

### MTBF in Pakistan

MTBF was started in Pakistan in 2003 and the technical assistance is provided by national and international consultants (Oxford Policy Management (OPM), London; and Abacus Consulting Pakistan) having expertise in

2005 has recently been approved by the parliament, which lays down the framework for sound fiscal and debt management.

The MTBF will strengthen the government's ability to meet its poverty targets in Pakistan. Taking maternal health, for example, if the government is able to reach its targets, maternal mortality will fall from 500 to 200 per 100,000 live births by 2011. Neonatal mortality rates will fall from 54 per 1,000 to less than 40 over the same time period. Serious ill health and disability will be avoided for around 3.5 million women. But it won't meet these targets unless it is able to prioritize its spending into its key strategic priorities. The MTBF is a key contribution towards this.

In particular, the MTBF approach for Pakistan ties in very closely with the first four of the six Public Expenditure



**The MTBF will strengthen the government's ability to meet its poverty targets in Pakistan. Taking maternal health, for example, if the government is able to reach its targets, maternal mortality will fall from 500 to 200 per 100,000 live births by 2011.**

macroeconomic and public financial management areas. These experts provide policy advice to the Government of Pakistan, and draw on international best practice to improve the budgeting system in Pakistan.

Pakistan's public sector is undergoing a comprehensive restructuring. The reforms range from the establishment of Securities and Exchange Commission of Pakistan (SECP) for overseeing the governance of corporate markets, to an ambitious high-tech countrywide full accrual basis accounting network that will link the financial system of all levels of government (federal, provincial and districts). The Fiscal Responsibility and Debt Limitation Act

and Financial Accountability (PEFA) Program 'dimensions'. These are 1) a credible budget; 2) which is comprehensive and transparent; 3) which links pending to policy; and 4) is executed in an orderly way. Several PEFA indicators make up the objectively verifiable indicators (OVIs) for this program. Clearly improvements in these areas are crucial in developing Pakistan. But they also improve confidence in the ability of the Pakistani system to deliver value.

**Kamran Abbas**

*Consultant, Government of Pakistan for MTBF System*

# How XBRL Works

This is the second of a series of articles on XBRL. While the first article attempted to give a brief account of XBRL, its importance and its use for accountants, the second article deals with the methodology of XBRL.

Figure 1 depicts how XBRL would be used. Suppose a public company, Tesco Inc., wishes to provide financial statements to analysts.

1. After the company prepares its financial information using its internal accounting system, a XBRL document is created by mapping the financial information to XBRL taxonomy elements. A number of new software packages can do this automatically. The created XBRL document is automatically checked to ensure it is proper XBRL. Then, the validated XBRL document is placed on the company's web site or FTP server. (➡)
2. When users need the information contained in the XBRL document for their analysis, they obtain it on the Internet. (➡ and ➡➡)

3. Users use the XBRL document for their analysis. If they want to translate the document into HTML, a spreadsheet or database, they can do so with appropriate style sheets developed by them or by outside software developers. (➡➡) (Boritz and No, 2003)

## **XBRL TAXONOMY AND XBRL INSTANCE DOCUMENT**

A XBRL document is created by mapping financial information to a XBRL taxonomy that describes financial "facts" and the relationships among them. Taxonomy is a dictionary of the financial terms used in preparing financial statements or other business reports and the corresponding XBRL tags. XBRL taxonomy defines elements corresponding to concepts that can be referenced in XBRL documents; for example, the element with the name "nonCurrentAssets.property PlantAndEquipmentNet" represents such a concept. A XBRL document has a hierarchical structure that is

defined by the taxonomy. Figure 2 contains a graphical illustration of the hierarchical structure of a XBRL document and taxonomy as seen through a "taxonomy viewer." (Boritz and No, 2004)

A company's financial statements, created by using XBRL, are an instance document in which various XBRL elements are embedded based on a specific taxonomy. A common taxonomy enables users to compare several firms' financial statements (assuming they use the same accounting guidelines). Since the same tags are used by all "publishers" of XBRL documents who rely on the same taxonomy, all users of those documents will recognise the tagged data the same way. For example, the tag <group type="ci:balanceSheet.assets"> indicates that the data after the tag relates to assets on the balance sheet.

At present, several taxonomies have been developed such as US GAAP CI, the XBRL taxonomy for Business Reporting of Commercial and Industrial



Companies under US GAAP, the XBRL GL (General Ledger) taxonomy and the IAS (International Accounting Standards) GAAP CI taxonomy. Also, several jurisdictions and organisations within the XBRL Consortium have taxonomies under development: Australian GAAP, Credit Risk Business Information Report (FLIPA), and United Kingdom Corporation Tax Funding<sup>1</sup>.

### STYLE SHEETS

Although XBRL documents can be easily handled by software applications,

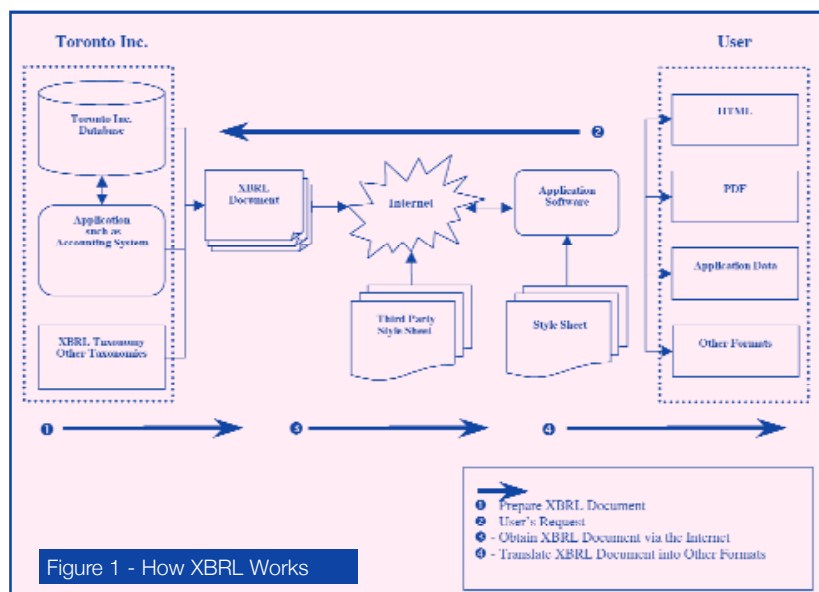
Transformations (XSLT) are the two most popular style-sheet languages. CSS and XSLT overlap to some extent. CSS is more broadly supported than XSLT. Most web browsers support CSS, but only a few accept XSLT. Although many HTML users and developers are familiar with CSS, it only provides for formatting of contents. It does not allow users to change or reorder contents.

XSLT is more complicated than CSS and is not well supported. Nevertheless, it is a more powerful and flexible style sheet language than CSS. In addition,

most major office suite software supports the storage and manipulation of XML documents. Microsoft Office XP, for example, supports XML document files. Therefore, with XML support built into Excel, users can load data from a XBRL document into Excel and apply their own analytic procedures on the data.

### REFERENCES

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they are not easily readable by people. However, XBRL documents can be transformed into user-understandable formats such as web pages, text documents, and other XBRL documents with the help of style sheets (Zarowin and Harding, 2000). Web browsers such as Internet Explorer do not have built-in semantics that enable them to process a labeling tag like <Assets.CurrentAssets>. Therefore, for a XBRL document to be displayed by a browser it must first be transformed to create a document, which the browser can, then render.

Cascading Style Sheets (CSS) and Extensible Stylesheet Language

XSLT can add new elements into the output file, or remove elements. It can also rearrange and sort the elements.

A XBRL document can be shown in a web browser by including an instruction in the XBRL document to specify the XSLT style sheet to be used (<?xml-stylesheet type="text/xsl" href="XBRL-example.xsl"?>).

However, users might want to move data in and out of special applications such as database and spreadsheet software. For example, users might want to view, update, and review the data in a spreadsheet as an intermediate step in the context of a larger business process. Currently,

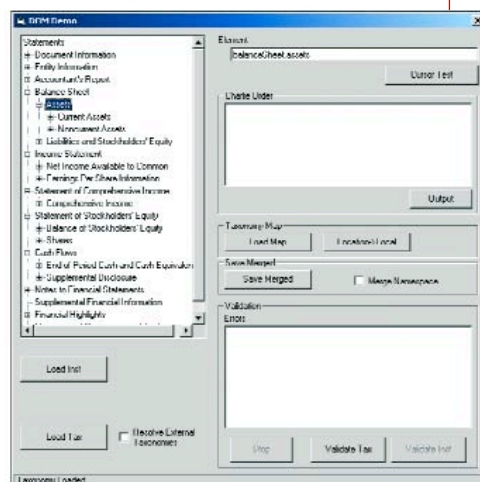


Figure 2 - XBRL taxonomy as seen through a taxonomy viewer

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Zarowin, S. and Harding, W.E., 2000, finally business talks the same language, Journal of Accountancy, 24-30

<sup>1</sup> derived from official XBRL website: [www.xbrl.org](http://www.xbrl.org)

**Syed Athar Hussain Zaidi, FCA**



# How Islamic is ISLAMIC HOME FINANCING in Pakistan



Home ownership is every individual's dream. This dream may become a nightmare in the wake of rising property prices, increasing inflation, unpredictable future income, rapid rural urban migration etc. Pakistan is facing a shortage of 6.25 million units of houses especially for low and middle income groups. The backlog is growing at the rate of two hundred thousands units each year.

Financial institutions can play a vital role to meet the growing demand for housing. They allow individuals to own a house and repay the outstanding debt in installments. Unfortunately, long term nature of home financing against the short term nature of available funds does not allow banks in Pakistan to grab this opportunity. Home financing currently represents only 2 percent (US \$ 800 million) of total banking sector loans.

The idea of home financing was initiated in Pakistan with the incorporation of House Building Finance Corporation (HBFC) in 1952. Since then HBFC plays an important role in meeting the domestic housing requirements especially for low and middle income groups.

HBFC is also considered a pioneer in the development and adoption of the idea of Islamic home financing in 1979. A committee, then, was set up under the chairmanship of I. A. Hanafi (former governor of the State Bank of Pakistan) to advise HBFC on 'Interest Free Housing Finance Scheme'. After surveying various localities in rural and urban areas, the



committee introduced a rent sharing scheme. The scheme allowed HBFC to share rent with the owners of the houses in proportion to its investment in the total cost of the houses. Various rental slabs were determined under this scheme where the rents were reassessed after every three years in respect to all types of localities.

HBFC operated the Islamic home financing scheme up to 1988 when it found that the rate on investment was dropped to a mere 4.8 percent and Rs. 10 billion (US \$250 million) were in arrears. The Corporation decided to suspend the rent sharing scheme and switched to markup/predetermined rate of return. It was in the year 2000 when HBFC re-launched the Islamic home financing scheme under the original concept of rent sharing. Currently along with other deductions the Corporation charges 5 percent flat on its investment in terms of rent which is increasable at the rate of 25 percent after every three years.

Similar to HBFC, Islamic banks also offer Islamic home financing schemes under the concept of rent sharing. The buyer is allowed to repurchase Islamic bank shares in the ownership at predefined price and time intervals. Simultaneously, the bank reduces the rent in accordance to each party's shares in the property till the buyer

becomes the sole owner.

Theoretically, Islamic home financing looks attractive and very much Islamic. However, realities in practice are different and raise many doubts.

Firstly, Islam does not recognize any contract as valid where the terms and conditions are ambiguous. Buyers with some knowledge of Islamic financing become immediately suspicious when Islamic banks inform them about the rental slab of 13 to 14 percent for the first year while the future rent is to be adjusted both ways, up and down, as per market conditions. It is common knowledge that rental returns from properties in Pakistan are not more than 5 percent. How can then the bank charge 13 to 14 percent upon their investments? Even if Islamic banks desire to lend at 5 percent it would be practically impossible for them as their average deposit return is 3.2 percent. Further, uncertainty about future rental charges, without explicitly mentioning benchmark criteria, declares Islamic home financing schemes as un-Islamic from the very start.

Secondly, Islamic banks are considered sleeping partners in case of Islamic home financing. It is the buyer who holds the real possession and is responsible for repair and maintenance of the property. Jurists from Hanafi School do not allow



**Islam does not recognize any contract as valid where the terms and conditions are ambiguous. Buyers with some knowledge of Islamic financing become immediately suspicious when Islamic banks inform them about the rental slab of 13 to 14 percent.**



sleeping partners to charge profit of more than their shares in the actual investments. For example, if Islamic banks contribute 50 percent of the total investment they are allowed to charge a maximum of 50 percent rent as income. Any deduction over and above their investment proportion would be considered un-Islamic. This argument also raises doubts about Islamic banks' current practices of charging 13 to 14 percent returns on their investments.

Thirdly, Islamic home financing scheme allows buyers to purchase

conventional banking branches of a domestic bank which operates 195 branches including 23 Islamic banking branches. The information relating to Islamic and conventional home financing in Table 1.1 was collected during this visit. The Table clearly indicates that the bank's return on Islamic home financing are linked with one year KIBOR (Karachi Interbank Offer Rate). KIBOR is an interest based index. It has nothing to do with the rental value of the properties especially when the total share of Islamic home financing is not

development of a separate Islamic money market. Though Malaysia has developed an Islamic money market, but it has its own limitations.

The monetary authorities in Pakistan should understand the fundamental difference between assets based Islamic banking and the interest based conventional banking before developing any separate Islamic money market index. Asset prices increase with the increase in GDP while the interest rate decreases at the same time and vice versa. In short, asset prices and interest rates



**Table 1.1 HOME FINANCING SCHEME**

	Islamic banking	Conventional banking
Maximum contribution	70%	70%
Maximum tenure	20 years	20 years
Minimum Interest/rent	1 year KIBOR + 2%	1 year KIBOR + 2%
Penalty in case of late payment	2% of the installment	Rs 500 per installment
Recovery in case of default	Original amount + outstanding rent	Original investment + outstanding interest

shares of Islamic banks at predefined future dates. Islamic banks guarantee buyers that no extra amount in terms of appreciation in property prices and rental value will be charged. This offer is valid as per Islamic law, but in practice it is similar to interest based home financing. Regardless of property prices, conventional banks only recover the principal amount along with outstanding interest from their clients.

I recently visited the Islamic and

even 1 percent of the total home financing in Pakistan.

Sadly, since the inception of Islamic banking in the country, Islamic jurists have come forward with more arguments in favour of using interest based index as benchmark under the 'law of necessity' than developing any separate Islamic index. Islamic home financing schemes can not be effectively launched unless the monetary authorities in a country put some serious efforts in to the

have opposite relation with each other in relation to GDP.

Finally, it is recommended that the monetary authorities should develop a separate Islamic home index based on property prices and rental slabs prevalent in various parts of the country, at initial level, to ethically market Islamic home financing schemes.

**Dr Ahmad Kaleem**

*Associate Professor,  
Lahore School of Economics*



# REMEMBRANCE

**Abdul Hameed Kasbati died on March 18, 2008 of protracted illness.**

He became a member of ICMAP in June 1977 and of ICAP in February 1980. His post qualification experience included services as Manager Cost and Projects to the PIDC until January 1983. In 1983 he entered into professional practice under the name and style of Abdul Hameed & Co. He re-entered professional practice in December 1999 under the name and style A.H. Kasbati & Co. and in between held various positions in the public sector in NICVD, PTCL AND PSO. He finally settled into practice in August 2003.

He leaves behind his wife, son and daughter.

**Minoo Rustomji Patel died on January 31, 2008 from cardio-respiratory failure.**

He became a member of ICAP in February 1964 and fellow member in July 1974. His post qualification experience included services with various companies including M/s. General Tractors & Machinery Co. Ltd., Pakistan Tourism Development Corp. and M/s. Fateh Group of Companies. In February 1988 he joined M/s. Shahid Sami & Co. Chartered Accountants as Manager Audit where he continued for sometime.

Minoo Rustomji remained single.

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Magazine of The Institute of Chartered Accountants of Pakistan

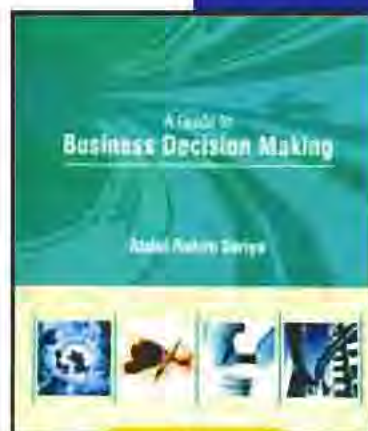
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### **A Guide to Business Decision Making**

**Abdul Rahim Suriya FCA, FCMA**

In the current knowledge economy, the focus is on the process of organizational decision making. A Guide to Business Decision Making clarifies the basic concepts of decision making including differential cost, opportunity cost and sunk cost, and differentiating between relevant and irrelevant costs.

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**Khawaja Amjad Saeed FCA, FCMA**

Khawaja Amjad Saeed's, Principal Hailey College of Banking & Finance, new book is the revised 2007 edition of Management: Concepts & Cases which dwells on management in developing countries in general, and in Pakistan in particular.

The book includes case studies developed by several South Asian scholars under the aegis of the Association of Management Development Institution of South Asia (AMDISA). The book is recommended for students in accounting, management, cost and management accounting and business.

Paperback pp. 384  
Price Rs.300/-





# SAFA CONFERENCE 2008

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# CA STUDENTS' CONFERENCE 2008



# FLYING ON A GOLDEN PARACHUTE

The strategy of Stan O'Neal, former chairman and CEO of Merrill Lynch, the world's largest brokerage, was to put greater emphasis on riskier bets, rather than just selling stocks. That strategy handed Merrill Lynch record results during the market's peak, but forced the

company to post a \$2.24 billion third quarter loss, following the global credit crisis. This was the company's biggest loss since being founded 93 years ago.

The bank posted \$14.6 billion in write downs. Stan O'Neal resigned. By calling his departure 'retirement',

O'Neal was allowed to hold on to deferred compensation worth an additional \$90 million, with stock options, unvested shares, deferred compensation, pension payments and other benefits bringing his total leaving payment to \$161 million.

Only a month before the credit





crunch hit Citigroup, CEO Charles *Chuck* Prince had said in an interview that the bank was "still dancing". In November last year the bank announced \$11 billion in write downs and Prince quit as CEO leaving with a \$10 million bonus and share options worth \$28 million. Angelo Mozilo, CEO of the mortgage lender Countrywide and at the center of the American property market debacle, received more than \$120 million in pay and from selling shares in the company.

It was widely reported that while Bear Stearns was about to collapse from the hedge fund crisis on Wall Street, CEO Jimmy Cayne was playing in a bridge tournament in Nashville, Tennessee. Cayne had already received hundreds of millions of dollars from the bank in pay, bonuses and stock options. When the bank was finally sold to JP Morgan, the value of Cayne's personal holding in the bank was \$13.4 million.

In March this year, Stan O'Neal, Chuck Prince and Angelo Mozilo appeared before a US House of Representatives investigative committee where they were told by committee chairman Henry Waxman, "You're in the middle of an enormous debacle. It seems like everyone is hurting except for you."

Surging severance packages, or 'golden parachutes' as they are called, are sparking a heated debate in the US, including backlash from President George W. Bush who, on a visit to Wall Street last year, urged corporate boards to tie lavish CEO pay and bonuses to job performance.

Golden parachutes have become part of the world of mergers and acquisitions (M&A), and takeovers. Golden parachutes are severance agreements that provide cash and non-cash compensation to senior

executives upon an event such as termination, demotion or resignation following a change in control. Golden parachute provisions are usually introduced as clauses in the CEO compensation contract and do not

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require shareholder approval, but the board needs to approve them. Benefits written into the executives' contracts include stock options, bonuses, liberal severance pay and so on. A report by US Institute for Policy Studies and Citizens for a Fair Economy shows CEO pay was 411 times that of an average worker in 2005, up from 107 times average pay in 1990.

The issue was brought to the forefront last year after Pfizer chief Henry McKinnell walked away with \$200 million despite a 49 percent slide in the value of the pharmaceutical group's stock, and Exxon Mobil chief Lee Raymond left

with \$357 million, followed by a \$210 million golden parachute given to former Home Depot CEO Bob Nardelli as he left the struggling retail giant.

Defenders of corporate CEO 'pay for performance' argue that in a corporate world driven by top talent, high executive compensation merely reflects market forces at work. Since the United States is home to half of the world's largest and most profitable businesses, their CEOs are paid more.

But critics charge that compensation decisions are often made by boards of directors that are not accountable to shareholders. In too many instances, extravagant CEO pay packages are not based on great returns and value for shareholders because they are not based on great performance. Incentives are primarily in the form of stocks and stock options, prompting CEOs to invest heavily, and often imprudently, as in the recent sub prime mortgage securities that failed to yield the anticipated massive returns.

The calls for a more performance aligned compensation system, based on current year company performance, are growing louder in the US, including one proposal requiring shareholders to vote on certain pay deals. In a good year the bulk of compensation would be held back as payable, and in the event of a subsequent bad year this credit balance would be substantially reduced.

Robert Frank, a Cornell University economist and coauthor of a 1995 book, *The Winner-Take-All Society*, suggests that instead of trying to regulate CEO pay, policymakers should consider taxing them more heavily and use the money to pay for healthcare and other social programs.

# WORLD IN FOCUS

## ■ Gulf Investors to Enter Pakistan's Agri-Dairy Sector

UAE and Gulf investors have pledged to invest \$3 billion (Dh 11 billion) in the agriculture and dairy sector in Pakistan. Abraaj Capital has announced investments in dairy farming and value-added dairy products from a \$250 million fund. Abu Dhabi Group will set up sugar mills and make additional agri-dairy investments. Saudi Arabian Al Rabie has expressed interest in sourcing tomato paste, citrus pulp and packed beans from Pakistan. Chairman of Abu Dhabi Group said international investments in Pakistan are increasing owing to a wide range of reforms in taxation, trade and tariffs, banking, fiscal transparency and governance.

## ■ Indonesia Wants to Quit OPEC

Indonesia says it might quit OPEC citing a decline in crude oil output on account of ageing wells, lack of investment, and absence of major oil fields, that has reduced its influence in the group. Indonesia is the only member of Opec from the Asia-Pacific region, and its current status as a crude oil importer means it would benefit from lower prices pitting it against other Opec members who favor an increase.

Fuel is heavily subsidized in Indonesia, but with oil trading at a record \$120 per barrel, fuel and energy subsidies are forecast to cost the state as much as \$20 billion this year.

## ■ ADB Offers \$500m to Fight Food Crisis

The Asian Development Bank (ADB) will give US\$500 million in immediate budgetary support to member nations hit hardest by soaring food prices, announced ADB President Haruhiko Kuroda. This money will be available to cushion the impact of rising fiscal burden owing to rising food prices.

Meanwhile ADB's managing director general, Rajat Nag, told the Foreign Correspondents' Association that 'the era of cheap food is over'. Nag said rising oil prices, production costs, conversion of arable land to urban

development and biofuel production were the main causes of food shortage and inflation.

Asia is home to two-thirds of the world's poor, with inflation set to rise to 5.1 percent this year. Spending on food accounts for 60 percent of total average expenditure.

## ■ Germany Exports Jobless

Plagued by high unemployment owing to reunification and rigid labor laws, Germany is now helping thousands of its skilled and less skilled jobless workers relocate in search of employment across the European Union, Australia and Canada. All relocation and travel costs are borne by the German Labor Office's International Placement Service (ZAV) in Bonn which offers a 'mobility bonus'.

Germany had an unemployment rate of 8 percent in February, about one percentage point higher than the euro zone average; 3.6 million Germans are jobless and more than 155,000 emigrate each year.

The relocation subsistence is drawing controversy from economists and industry leaders who say paying people to leave a country with heavy depopulation and one of the lowest birth rates in the world spells disaster as shortages of skilled labor become acute in the engineering, auto making, retail, healthcare and finance sectors of the economy.



## BOOKS


**Blue Blood and Mutiny: The Fight for the Soul of Morgan Stanley**

Patricia Beard

In less than four months a group of eight retired executives orchestrated a stunning revolt within Morgan Stanley, the venerable and – until recently – most successful financial services firm on Wall Street.

Acclaimed journalist and historian Patricia Beard brings together the



inside story of the fight for dominance between two competing business cultures – one, the collegial meritocracy handed down

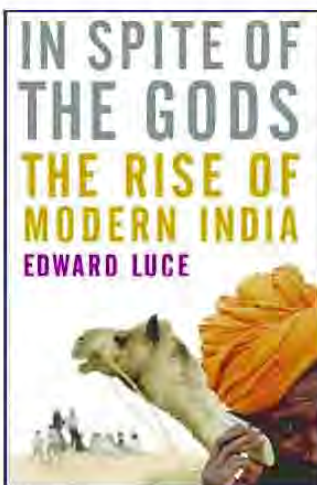
from the days of J. P. Morgan, and the other, a cold, contemporary corporate model. A must-read book for anyone who wants to understand the future of American business.

Available at [amazon.com](http://amazon.com)

Price: \$17.79

**In Spite of the Gods: The Strange Rise of Modern India**

Edward Luce



Edward Luce, a onetime New Delhi correspondent for *The Financial Times* graphically describes the conflicting forces at work in modern India, as he visits Infosys' plush offices in Bangalore, bustling call centers in Mumbai, and impoverished farmers in the state of Uttar Pradesh. He reveals that less than 10 percent of India's 470 million workers are employed in the formal economy, while more than 300 million live in squalor in the country's 680,000 villages.

Available at [amazon.com](http://amazon.com)

**Knowledge Management Case Book: Siemens Best Practices**

Thomas H. Davenport and Gilbert J. B. Probst



This book provides a perspective on knowledge management at Siemens – an internationally recognized benchmark – by presenting the

reader with the best of the corporation's practical applications and experiences, together with instructive case studies from different areas.

Most of the cases have been updated for the second edition. New cases have been added.

The *Knowledge Management Case Book* provides a comprehensive account of how organisational knowledge assets can be managed effectively. Specific emphasis is given to the development of generic lessons that can be learned from Siemens' experience. The book also offers a roadmap to building a "mature knowledge enterprise", thereby enhancing our understanding of the steps that need to be taken in order to sustain competitive dominance in the knowledge economy.

Hardcover available at [amazon.com](http://amazon.com)

Price: \$56.00

# Putting a Price on Beauty

*She is older than the rocks among which she sits;  
Like the vampire, she has been dead many times,  
and learned the secrets of the grave;  
And has been a diver in the deep seas,  
And keeps their fallen day about her . . .*

Walter Pater on Mona Lisa, 1869

This January German academic experts at the Heidelberg University library eliminated "all doubts about the identity of the Mona Lisa", a subject of numerous interpretations and speculations since as far back as the 16th century, and confirmed that she was indeed Lisa Gherardini (Lisa del Giocondo) wife of a wealthy Florentine merchant, Francesco del Giocondo.

The mystique surrounding the identity of the woman in the painting has received much attention in recent years adding to Mona Lisa's international

fame. It was believed to have been painted from 1503 to 1506. In the 16th century, Mona Lisa became the property of the French King Francois I who was an acquaintance and admirer of Leonardo da Vinci for 4,000 gold écus, or about \$105,000. The painting has remained in the French Louvre since 1797.

On August 21, 1911, Vincenzo Peruggia, an Italian carpenter employed at the Louvre, stole the painting from the wall of the Salon Carré where it hung. It was recovered two years later in 1913 when







*In 2006 a distinctive, gold-covered Gustav Klimt masterpiece, Adele Bloch-Bauer 1, known as the 'Mona Lisa of Austria' became the world's most expensive painting selling in New York for more than \$135 million.*

Peruggia attempted to sell it to Alfredo Geri, a Florentine antique dealer.

It is said that the 'Mona Lisa is famous mainly for being famous'. Guinness listed the painting as the most valuable in the world, based on an assessment of \$100 million in 1962. However, that appraisal was made for an insurance coverage that was never taken. As a matter of fact less famous paintings, such as Van Gogh's *Irises* were sold for \$53.9 million in 1987 making them financially more valuable.

Now *La Joconde*, as the French call her, has some serious competition. In 2006 a distinctive, gold-covered Gustav Klimt masterpiece known as the 'Mona Lisa of Austria' became the world's most expensive painting selling in New York for more than \$135 million. The painting is *Adele Bloch-Bauer 1*, a 1907 portrait of the wife of a Viennese sugar

magnate, sold to Ronald S. Lauder, the cosmetics magnate and owner of Neue Galerie in Manhattan, New York. It surpassed Pablo Picasso's *Garçon à la pipe* (Boy with a Pipe) which was sold for \$104.1 million in 2004. 'This is our Mona Lisa,' Lauder told *The New York Times*.

And who says you can't put a price on art? Unconfirmed rumors in the art world have now placed another painting at the top of the list. No.5, an abstract expressionist painting by Jackson Pollock, representative of an American post World War II art movement characterized by the subconscious and the mind, has been valued at \$140 million, the highest price ever for a painting.

Meanwhile the real Mona Lisa is today estimated to be worth almost a billion dollars. But Louvre officials disagree; they say she's priceless!



# VARIATION IN CALCULATION OF GROSS DOMESTIC PRODUCT



The Economist Intelligence Unit\* (EIU) estimates Cuban gross domestic product (GDP) in 2007 at US\$45 billion which varies significantly from the Cuban government's official figure of US\$54 billion. Reasons for this significant variation are:

- (a) lack of availability of economic data;
- (b) the Cuban authorities' decision, since 2003, to value government services at market value, in contrast to the international standard of valuing government services at cost.

The EIU estimates that adjusting for this makes a cumulative 11 percentage point difference to the real GDP growth from 2004 to 2006. Based on purchasing power parity (PPP) the US Central Intelligence Agency (CIA) estimates 2007 Cuban GDP at \$51 billion. Cuba has parallel exchange rates valuing the local currency peso at either 0.93 or 22 to the US dollar. Based on 22 and official peso GDP figures, the Cuban economy is worth \$2.3 billion.

Similarly, the value of former communist countries' assets was also grossly overestimated. Before reunification, East Germany's economy was considered to be the tenth largest in the world. The net value of East Germany's economic assets at reunification, initially estimated at \$1,000 billion, was finally revised down to a net liability of \$280 billion.

\*Economist Intelligence Unit (EIU) is part of The Economist Group. It is a research and advisory company that provides country profiles, monthly country reports, five-year country economic forecasts, country risk service reports and industry reports, and latest management strategies and best practices. 2006 marked the 60th anniversary of EIU.



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