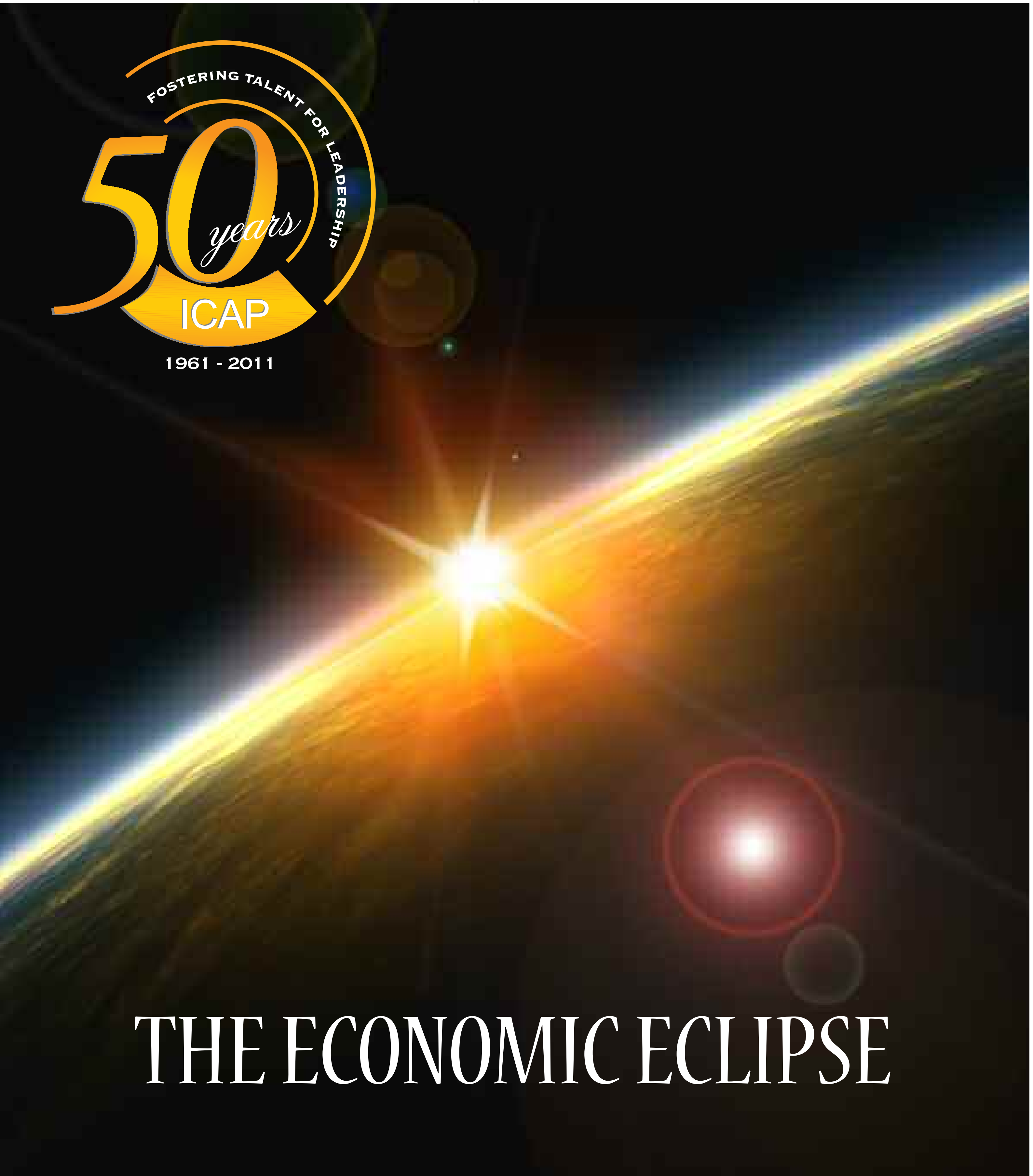
THE PAKISTAN ACCOUNTANT

OCT - MAR 2011

Magazine of The Institute of Chartered Accountants of Pakistan



THE ECONOMIC ECLIPSE

Volume 43/44 Issue 4-1 OCT - MAR 2011

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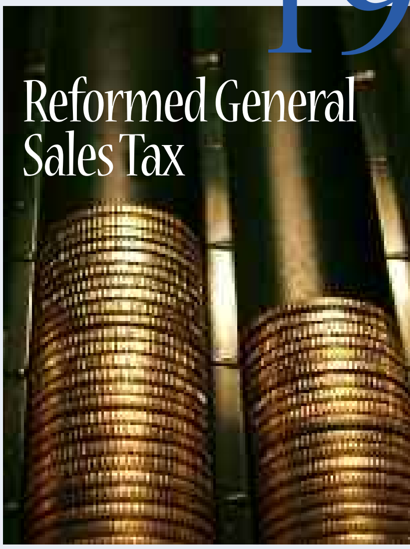

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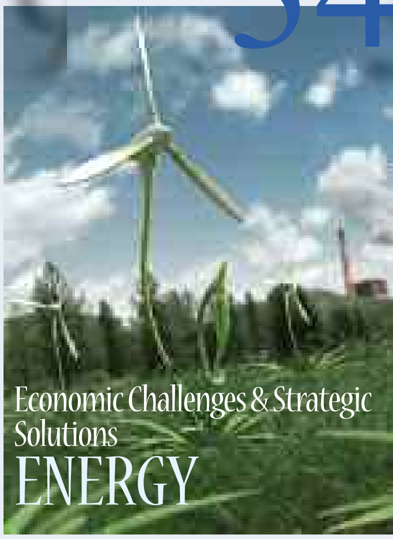

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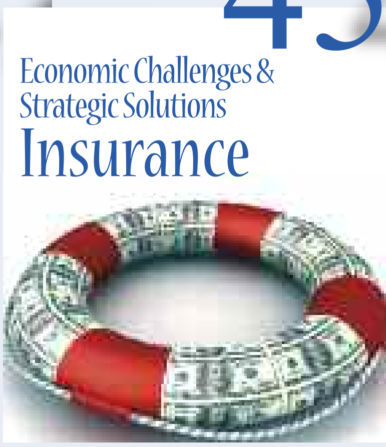

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Editor's Letter

The Economic Eclipse

For the people associated with the Institute the Year 2011 is very close to their hearts, being the year in which the Institute celebrates fifty years fostering talent for leadership.

On the occasion of ICAPs' Golden Jubilee in accordance with its glorious history, the Year 2011 has been declared as the Golden Jubilee Year with festivities and celebrations planned year round. The determination and resolve of not compromising on quality has led the Institute and its members to pinnacle of excellence.

With the chances of Global Economy recovery dim according to the UN report, 2011 did not start on a promising footing. On the local front the economy with impending taxes looming over it is still struggling, with ominous dark shadows hovering on the economic revival causing an Economic Eclipse.

Whereas eclipses usually last for lesser durations and are a natural phenomena, we can't wait this one out! In order to quicken the progress towards light we need to take concrete steps to improve the frail economy. I feel we accountants can play an important role in improving financial discipline and accountability to contribute towards better business environment. According to Business Monitor International Pakistan's business environment ranks a 114 out of 167 emerging markets, stronger financial controls and transparent systems can improve the ranking.

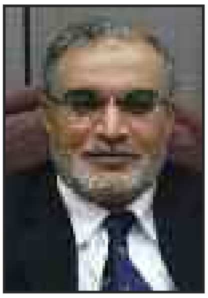
While the current economic solution looks bleak, the challenges can be turned into opportunities with the foresight and innovation. The services market globally has a lot of untapped potential, the option of exporting accounting services can be explored as a viable and innovative solution with the technical expertise and acumen of our accountants being recognized worldwide. I believe that in order to bring about the improvement in the economy we as a nation need to be unified in our approach and aware of the challenges presented before us.

Adnan Zaman

President's Page

The Economic Eclipse

The last year tested the nation at nearly all fronts and challenges ranging from politics, natural disasters and economic downturn. As I look back the year 2010 was undoubtedly the year of the fighter, embodied by the resolve and the sprit to succeed. With speculations floating left and right we as a nation Alhamdolillah managed to rise and face the challenges ahead.



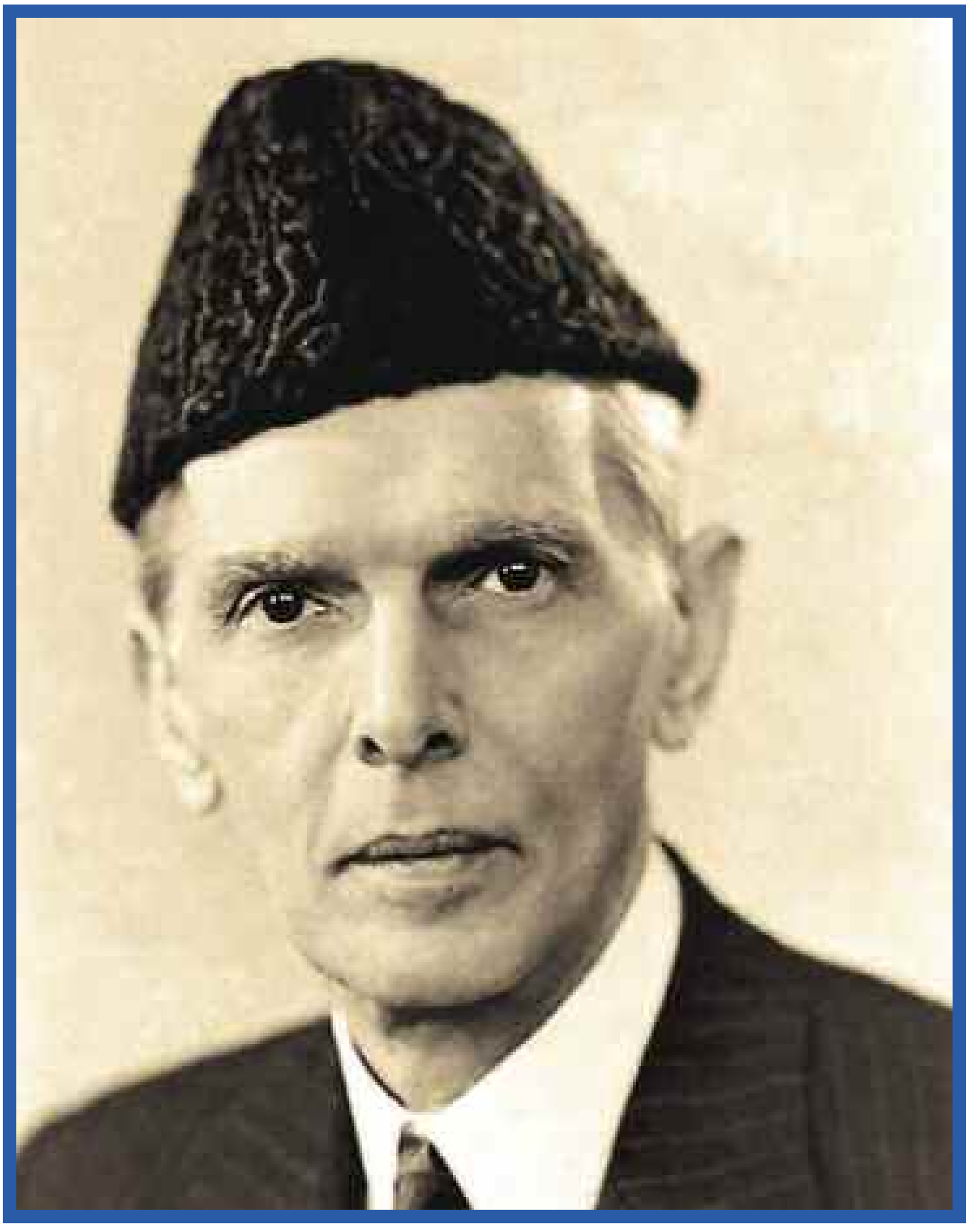
The dark shadow cast upon the global economy by the financial crisis still lingers on, at the local front we have withstood the pressure with faint signs of improvement and glimpses of light appear signaling the nearing of the tunnel end. With the macroeconomic challenges, the lingering issues of increasing tariffs, taxes and interest rates and escalating fiscal deficits portraying the darker side of 2011, all hopes rest on global economic recovery, which will help generate trade along with stimulating aid to our nation's fragile economy. However I believe firmly in Richard Nixon's *"The finest steel has to go through the hottest fire."*

Although the global recovery in 2011 is expected to be slow, the developing countries in Asia continue to promise strong growth performance. I feel that we should focus on regional cooperation to promote intra-regional trade and rebalance the region's sources of growth. Asia's swift recovery from the recent global crisis is also drawing foreign investment to the region. Another silver lining is the entrepreneurship trend in the country, creating more employment opportunities and contributing towards the economy.

For long term success the need is to get rid of the dependence, somehow along the line we have gotten the dependent syndrome- the first step is to reignite the self confidence belief and start the journey. We need to invest in our youth and for that education is the investment which guarantees the greatest return. At the time like this we need to take the time out for introspection and the starting of the New Year presents an ideal opportunity to make resolves and try to make a difference in our individual capacity.

While the New Year brings with it, new challenges, hopes, it carries great significance for the members of the Institute being the 50th Year of its establishment. For five decades the Institute and its professionals have etched their mark and created Chartered Accountancy as symbol of professional excellence. I look forward to your continual support and participation in the Golden Jubilee activities to market our brand.

Shaikh Saqib Masood



Saying of

Quaid-e-Azam Muhammad Ali Jinnah

(In Ziarat, Balochistan, 1948)

“We Musalmans in general and young men in particular do not know the value of money. A paisa saved today is two paisa tomorrow, four paisa after that and so on and so forth. Because of our addiction to living beyond means and borrowing money we lost our sovereignty over this Sub-continent”

THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF PAKSITAN

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKSITAN

2011 - GOLDEN JUBILEE YEAR

FOSTERING TALENT FOR LEADERSHIP

50 years

ICAP

1961 - 2011

FIVE DECADES OF UPHOLDING INTEGRITY,

INCULCATING PROFESSIONALISM AND ENHANCING QUALITY

Message from Maj. Gen. (Retd) Rehmat Khan, Chief Executive Officer, Lafarge Pakistan Cement Ltd.

I take this opportunity to extend facilitation to ICAP on this highly significant occasion of its 50th Anniversary - a milestone which surely deserves recognition. In fifty years of its existence, it has rendered tangible contribution by providing professional chartered Accountants to the business houses adding sophisticated culture.

Apart from its core function of accounting and supporting businesses, ICAP contributes in promoting corporate governance and formulating economic policies of the Government. Also it is a prominent participant of professional activities at the international level.

ICAP deserves the credit of laying down excellent standards for its graduates and also retaining dynamism by remaining abreast with the systems and procedures followed in the developed and advanced countries of this world.

I truly feel privileged to acknowledge ICAP's achievements. I wish ICAP many more years filled with success.

Message from Mr. Zameer M. Choudrey, Group Chief Executive, Bestway Group

It gives me immense pleasure to congratulate ICAP on the occasion of its Golden Jubilee being celebrated in March 2011. The foundation stone of the Institute was laid in difficult times half a century ago, during which period ICAP has established itself as a truly professional body of distinguished Chartered Accountants and has achieved its well deserved highly respected position amongst its international peers. I wish them Godspeed in the next 50 years.

Message from Mr. Atif R. Bokhari, President & Chief Executive Officer, United Bank Ltd.

UBL congratulates The Institute of Chartered Accountants of Pakistan (ICAP) on the auspicious occasion of Golden Jubilee celebrations.

Over the last fifty years, The ICAP has made historical contribution to the Pakistani corporate world and has played a fundamental role in producing financial ambassadors to not only local but also the international market with highest standards of integrity, professionalism and competence. In doing so it has contributed significantly to shaping the development of the global financial village.

Today, The ICAP is a widely recognized corporate body with over 5000 members and acts as a benchmark of professional excellence upholding the principles of integrity, transparency and accountability which is further strengthened by its membership of the International Federation of Accountants (IFAC). Corporate sector in Pakistan is proud of the golden journey of The ICAP which has transformed the image of the country in the international financial community.

I look forward to seeing ICAP embark on the road to success in future with fresh confidence, and I wish the Council every success in its efforts to support our common endeavour.

Message from Mr. Nasser. S. Jaffer, CEO, Jaffer Brothers

It is my great pleasure and privilege to extend congratulations to ICAP on this momentous occasion of its Golden Jubilee. In fifty years of its existence, it has turned students into competent and committed professionals who are making their mark in various organizations around the globe.

ICAP is one of those fortunate institutes in the country that have a competent and dedicated faculty and staff. I appreciate the vision and enthusiasm of all concerned who have brought ICAP this far in its achievements.

On behalf of Jaffer Brothers and on my own behalf I sincerely wish that ICAP continues to produce professionals who would play a dominant role in the economic and social development of the country.

JOIN THE DISCOURSE

The Discourse Topic for the current issue is:

2011 - The Year of ICAP Golden Jubilee

'The Institute turns 50 in July 2011, with the glorious heritage of accolades the Institute is celebrating the milestone in its history with great fervor and splendor!!

The strong silent partner in all your endeavors leading you to your destiny is your Institute. On the occasion of Golden Jubilee peak into your hearts and share with us your thoughts on reaching this grandiose landmark and on the road ahead'

COMMENTS

The Institute of Chartered Accountant has been a parent figure for me, nurturing, taking me through all stages, supporting me whenever I needed a strong finger to hold while walking on the path to professional prosperity. Now as I run on these routes, I stop for a moment and look back, the Institute is standing tall, smiling with joy on every milestone I achieve, ready to embrace and support me even now, if I stumble at some difficult route.

Fozia Hussain, ACA
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Finance Manager, DP World, Karachi.
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ICAP, I am proud to be your member

I qualified in 1973 and moved to Dubai in 1975. In those days the passport used to show the profession of the holder. There were no scanner machines at the airports, and one had to go through the interrogation process of the custom officers.

I remember they used to take one look at my profession and their attitude used to change. At several occasions I was asked how I passed the CA examination at such a young age. This is the respect enjoyed by the ICAP members.

However, the situation has changed over the past years. All the Institutes are trying hard to increase their membership by making their examination processes more transparent and providing education material and training to the students.

I believe that ICAP has to do more to increase the facilities and educational material available for the greater benefit of the profession. It has to incorporate a stronger outreach program aimed at creating better awareness of the profession.

I feel that although the number of students qualifying is increasing but an equal number is retiring from the active profession thus the growth in the ICAP membership is very low.

Mohammad Nafees, FCA
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MY ICAP
Life would have been different without your support - I and my family stand obliged.

Muhammad Iqbal, ACA
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CFO, Alinma Bank,
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The Institute has entered a momentous period this year: the Golden Jubilee Year. I consider myself privileged to be a member of the institute.

I feel that the Institute has been able to meet the increasing demands of employers, regulators, and public at large by maintaining high quality of the profession through its examination system and training requirements. The Institute has contributed a lot in the implementation and improvement of governance and financial reporting in the Pakistani corporate sector.

I wish that the institute prospers in the future and rises to even greater heights.

Shah Rukh Memon, ACA
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I congratulate ICAP members on the Golden Jubilee of the Institute. It is heartening to see the achievement of ICAP for maintaining professional standards and getting international recognition. However in the area of transparency and elimination of corrupt practices through accumulating wealth and tax evasion, I feel ICAP and we members could have done better in reforming industrialists, bankers and businessmen. This is the right time for ICAP to develop a ten year plan to against unprofessional practices.

Mustafa Ahmad, FCA
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I congratulate ICAP on the occasion of its Golden Jubilee. On the basis of my experience, I can say without exaggeration that no other Institute in Pakistan as well as in most of the countries of the world has provided the level of service to the accounting profession, the industry and the community as a whole that has been provided by ICAP in 50 years.

Jamil Ahmed, ACA
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Looking back at the 50 years of ICAP, one gets immense satisfaction that while decrying weakening Institutions and falling standards in our country, ICAP stands out as a shining example of advancement, improving standards and uprightness. ICAP has proved that despite decay in the society around, it has been able to keep itself an example for others to follow. Pakistani nation needs to take heart from the example set by ICAP.

I offer my sincerest congratulations to all fellow members, especially those involved with running the affairs during the last 50 years.

Asif Jamal, FCA
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CAs benefit from the experiences of working in positions of substantial governance-visibility. We thus have an obligation to contribute more towards making the next Adam Smith, Bertrand Russell and Ayn Rand of our time and therefore the next generation of politico-economic ideology that will replace both capitalism and socialism. At the occasion of the Golden Jubilee, I believe there is a desperate need for having more collective efforts in this area.

Muhammad Faraz Naseer, ACA
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1st July 2011 is the beginning of a golden chapter in ICAP's history, with the Institute completing 50 years of its glorious existence. It is indeed a truly momentous occasion, an occasion to bask in the glory of our five-decade long tradition of excellence and service to the nation. As we celebrate our Golden Jubilee, it is also time for a new beginning, a time to look beyond. There is never room for complacency.

I would like to take this opportunity to extend my heartfelt congratulations to all our members, students, President, Vice Presidents, Council, Regional Committees, staff and ex-staff of the Institute for embarking upon this historic event, as it is always a team effort. On a personal note, I must confess that without ICAP (both as a member and ex-staff), I would not have been at the stage where I am today, by the grace of Allah.

As I had the opportunity to serve my mother Institute for around eight years, I would like to suggest Establishment of a full time Research Directorate

Muhammad Asif Iqbal, FCA
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It is because of the vision of the ICAP, that we are celebrating its Golden Jubilee this year. This is an occasion for celebration as well as the time for all of us to look forward towards the next fifty years - it would be wise to introspect and identify lessons that we have learnt as students and members to help implement the best practices of accounting and governance in corporate and non corporate environment.

Mubeshir Ali Kazmi, ACA
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Surviving 50 years with quality and recognition is something which we Chartered Accountants should be proud of. This is a time of reflection as well as celebration. Maintaining the same worth, quality and demand of Chartered Accountants in the industry and world wide recognition should be the resolve for the years to come.

Ebrahim Yakoob, ACA
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DGM/ Head of Financial Reporting
Financial Control Division, Habib Bank Limited
Karachi

The year 2011 marks the 50th anniversary of ICAP and on this occasion the Institute is poised for a future which is even greater than its magnificent past. Congratulations to all ICAP members and students on this occasion. Completing 50 years is by no means an ordinary achievement but a true reflection of the strong vision of the professional accountants of that past era.

While we are proud of ICAP's achievements, we must give a serious thought to our future. A long term strategic plan must be in place setting goals for professional education (syllabus, examination, and research), general awareness about the profession, technology, members' professional development and job diversification. Annual plans should be derived out of the strategic plan and evaluations against the plan should be performed with sharing of results with the members.

Efforts should be equally diverted to give more visibility locally, of accountancy profession to the general public, and globally, of our Institute and professionals. The efforts for modernization should be continued but minimum conservatism should be restored.

We have complete trust in the honorable members of the present council and their proactive approach in taking our journey further.

Let's celebrate the Golden Jubilee with renewed zeal and impetus.

Syed Raheel Hashmi, ACA
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Internal Audit & Business Risk Review
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We welcome the Institute and its management in the Golden Era where we admit that age of achievements has exceeded the age of the Institute. We admire the management and team of the Institute for their contribution on the success of the Institute and its members. I feel a magnificent edge between my past-present-future.

Muhammad Furqan Uddin Shaikh, ACA
Chief Internal Auditor
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It has been a privilege to have had association with the Institute in the different phases of my life, starting as a student, as an employee and a member. I feel happy that I embarked into my professional career at the Institute and have had a chance to serve the mother organization. Further, it has been a learning experience seeing the other side of the picture. All of us in our student life have had some grievances over exam results but being on the other side you realize that there is no bias, quota etc these are all just misconceptions.

I wish the Institute progresses in its journey further to become a hall mark of professional excellence at par with the international professional bodies. And I hope we all are proactively involved in the celebration and festivities of the Golden Jubilee year, a time for making history.

Saira Shamsie, ACA
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Manager Technical Services
The Institute of Chartered Accountants of Pakistan
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On this auspicious occasion I congratulate all the past and current council members and management of our Institute on completion of 50 years.

I still remember when I got a referral in my module F exams, I was very upset and on the verge of missing my next attempt when my husband told me (who is also a Chartered Accountant), "this is the qualification through which you will get immense respect in life". And how true is that, every CA cherishes the awe from people that the mention of this qualification brings. It's all because of the fair examination system of the Institute and its up-to-date and internationally compatible syllabus.

I later on decided to work for my Institute so that I can become a part of a system which has the potential to change the life styles of people.

May our Institute complete 1000 years and every year has 50,000 days.

Shumaila Halo, ACA
Senior Manager, Eduation & Training
ICAP, Karachi

It is said "If you stand for nothing you will fall for anything". ICAP stands for honesty, integrity, professionalism, wisdom, and ethics and it is these standards that have paved the way for ICAP.

Completing 50 years is a milestone on which we should be proud however, at the same time prepare for the challenges ahead. The future can be paved by ICAP only through determination and direction enabling us to shine and rise in the era of global village.

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Economic Challenges & Strategic Solutions
Pakistan Perspective

Prof. Dr. Khawaja Amjad Saeed, FCMA, FCA

Prelude

The whole world is grappling with the problem of identifying a model for Socio-Economic Development. So far, several models were tried yet success is a far cry. Focus on GNP (Gross National Product) was stressed and any increase in it meant that its growth was in gross national poverty rather than Gross National Product. The distribution of income has been iniquitous and countries achieved GNP growth as part of economic development without social justice. Consequently, there has been a yawning gap between haves and have nots. Prosperity across the board continues to be a wish list. Based on recent news released in USA, every 14th person out of hundred is living below poverty line. In India which is claiming to grow at faster rate in her GDP, poverty constitutes 40% of her population. The entire African countries are struggling to come out of the poverty trap. The entire Economic Union countries are now suffering from very heavy debt ridden economies – beyond their control. China is struggling to grapple with poverty problems. South Asia has big challenges on economic developments. In this backdrop, we in the democratic set up of Pakistan, need to develop a strategy for our economic development so that we can meet the basic objectives of a healthy economic development with sustainable outlook and with widespread prosperity. This paper looks at some of the issues of developing Pakistan on economic front with strategic initiatives. Our ardent hope is that all stakeholders in general and the economic managers of Pakistan in particular will get some guidance and embark upon practical work to translate the strategic initiatives as suggested in this paper to the advantage of the people of Pakistan.

GDP Review

Pakistan emerged as a sovereign state on the political map of the world on August 14, 1947. During 1950's, political uncertainty prevailed and even the First Five Year Plan of Pakistan (1955 – 1960) was approved in the middle of 1957. Her performance with time series analysis is summarized in Table 1:

Table 1
Pakistan GDP Growth

Year	Percentage Growth
1960's	6.8
1970's	4.8
1980's	6.5
1990's	4.6
2000's	4.8

The decade of 1960's saw a great rise of Pakistan on the economic development front. However, to our misfortune, social justice was not delivered. Consequently, there were wild cat strikes and besides many other reasons due to concentration of wealth and income in few hands, social destabilization took place and we lost East Pakistan which is now known as Bangladesh. The democratic Government of Pakistan took over in the early part of 2008 and its GDP growth during 2008-09 was only 1.2%. Besides, many reasons two fundamental problems which were faced by the above government included escalation of import price of oil as high as US$ 147 per barrel. Since Pakistan is substantially dependent on import of oil due to meeting her energy needs to the extent of 80%, consequently the price of food also went high abroad and as the country was short of wheat and other agricultural commodities, our foreign exchange reserves were substantially spent to tackle the above problems. The year 2009-10 saw GDP growth of 4.1%. The forecast for GDP growth for 2010-11 announced during the budget announcement was 4.5%. Unfortunately, floods devastated the economy of our country. According to initial estimates of Asian Development Bank the direct economic losses to Pakistan were estimated at US$ 10.0 billion. However, the indirect losses as a domino effect were estimated as US$ 40.0 billion. The expatriates of Pakistan residing abroad, resident Pakistan's together with the government support and backed up through financial assistance from abroad, the country is still trying to overpower the consequential adverse effects of the floods. Therefore, the GDP growth estimates for 2010-11 have been forecasted as under:

1) Pessimistic Forecast	:	**0 – 2%**
2) Realistic Forecast	:	**2 – 3%**
3) Optimistic Forecast	:	**4%**

Suggested Economic Strategy

The democratic Government of Pakistan, with stakeholders support, should hold a moot for developing a comprehensive economic strategy. Total involvement from the grass root from the top and with the assistance of expatriates from abroad be solicited so that Pakistan is put on sound economic footing to earn an economically sovereign status based on self-reliance for ushering in an era of prosperity across the board including looking at the plight of poverty stricken, down-trodden and improvised strata of society. This paper suggests some strategic initiatives to be undertaken to achieve the foregoing goals.

In Search of Strategy

Clarity should exist in defining the following:

1) A clear-cut Vision Statement which should represent our dream to achieve at least for a period of ten years.

2) Developing Mission Statement with focus on economic development and backed up by social justice which ought to be the manifesto of all political parties of the country.

3) To develop operational strategies to implement the spirit of 1 & 2 above.

Some productive thoughts, based on sectoral analysis, are shared in this paper.

For developing strategies, focus should be on the following three sectors which constitute as the components of economic development:

A) Agriculture
B) Manufacturing
C) Service Sector

Guidelines for developing strategies for economic development in the above three components of GDP are now briefly reviewed.

A) Agriculture:

It must be clearly understood that, as against the misperception, agriculture is not the name of crops only. Agricultural sector which has a weight of 22% in the GDP of our country consists of four components. Vibrant and dynamic priorities with high sense of priorities and well backed delivery system are needed to achieve high growth in agriculture. In this respect, strategic initiatives need to be undertaken as suggested below:

1) **Live-Stock:** Live-Stock constitutes 50% of the total weight in agriculture and a weight of 11% in the GDP of Pakistan. We need a major breakthrough in milk production, meat production, poultry farm development and related activities. Back home we can acquire a successful technology from the military farms of our country and from New Zealand. A synergistic approach at the federal and at the provincial levels can give us a wake up call to achieve high growth in the development of live-stock sub-sector of agriculture. This can not only meet our domestic needs through a major increase in its supply side and declining inflationary pressure but will also help Pakistan in boosting exports to several countries of the world.

2) **Crops:** To our misfortune, in the last 63 years of history of Pakistan, we have concentrated only on four major crops namely; Wheat, Rice, Sugar-cane and Cotton. The quality of our wheat is one of the finest in the world and through a breakthrough approach we have achieved self-sufficiency in wheat, particularly in Punjab Province and have started exporting the surplus wheat. We must continue our efforts in this direction with devotion and sincerity. Our Basmati Rice is unrivalled in length and sweetness and is of high quality taste to the consumers. A niche approach of developing its production can give the farmers high prosperity and boost our exports. The production of sugarcane has been volatile. The relationship between the tiller of the soil and the owner of the farm land and the sugar mills is a hot agenda for discussion so that all these three parties work in collaboration with each other rather than develop a sense of antagonism due to which sugarcane is not produced and consequently, sugar mills are also in trouble and our balance of trade is adversely affected as we are forced to import sugar to meet local demand. This

has happened several times in the history of Pakistan but we have still to learn a lesson. Technological breakthrough in the cotton production is the crying need of today. Increase in yield is the main item of agenda to be addressed with use of informal ways and techniques of educating the farmers and providing the delivery system of effective use of agriculture inputs. At present minor crops shortages (vegetables, potatoes, tomatoes, ginger, onion etc.) have been instrumental in a very high food inflation. Agro-based industry should be established to reduce the losses due to seasonal shortages of minor crops and the provinces in Pakistan should develop strategic plans for increasing supply side of the minor crops. The Provincial Government extension departments of agriculture must rise to the occasion and accept the above challenge.

The democratic Government of Pakistan, with stakeholders support, should hold a moot for developing a comprehensive economic strategy. Total involvement from the grass root from the top and with the assistance of expatriates from abroad be solicited so that Pakistan is put on sound economic footing to earn an economically sovereign status based on self-reliance for ushering in an era of prosperity across the board including looking at the plight of poverty stricken, down-trodden and improvised strata of society.

3) **Fish:** The crying need of today is to develop coastal areas for catching the fish, processing, canning and exporting the same. The monetary policy should motivate commercial / development banks of the country to sizably divert their resources in this respect so that high standard of living and affluence is the outcome amongst the poverty stricken and down-trodden people of Sindh and Balochistan. Moreover, On Farm Fish development should be immediately addressed so that the production of fish throughout Pakistan is increased substantially and consequently white meat is available to ensure healthy food to the people of Pakistan. A comprehensive plan is the urgent need of the day.

4) **Forestry:** Unfortunately, there has been negative growth in forestry area during 2009-10 requires focused and critical attention of the Government of Pakistan. Development of forestry and social forestry should be given proper attention. A wake up call is the crying need of the day.

B) Manufacturing:

Manufacturing constitutes 26% of the GDP of Pakistan. Its four constituents include: industry, minerals, electricity and construction. Full-time attention and a dynamically well backed forward looking leadership is the crying need of today to help develop manufacturing sector which unfortunately has been badly affected due to shortages of electricity and gas and other problems including poor infrastructure.

All these components together with strategies to be followed are suggested below:

1) **Industry:** Large scale manufacturing (LSM) is mainly in the private sector. Due to shortage of gas in particular and electricity in general, industrial production has suffered recently. The Government of Pakistan should tackle all the legal and logistical hurdles on various production points of gas on an urgent basis including import of gas from Qatar, Iran and several Balkan countries. Several agreements / MOUs were signed in the past without practical implementation. Unemployment can be avoided by keeping the industries on optimal use of their capacity. The biggest looser has been Province of Punjab where gas supply was not available on an average 100 days out of 365 days in a year. This has badly affected the industrial production with consequential effects. Expansion of LSM is yet another challenge. The government in general and financial institutions in particular are urged to develop a healthy outlook of their mindset for providing substantial financial resources to SMEs which are the engine of growth in our country. We need new breed of bankers to visit sites of SMEs and cottage industries to ascertain their needs at their door steps. This change is the crying need, failing which we will degenerate in terms of deceleration in economic growth and SMEs will not have an opportunity to rise to the occasion as economic driver of the country. All institutionalized set ups including small scale business finance and support organizations should be provided significantly greater and greater financial resources so that they can meet the needs of SMEs and help develop an era of prosperity emanating from the grass root for the betterment of people of Pakistan across the board.

2) **Minerals:** The father of nation, Quaid-e-Azam, Muhammad Ali Jinnah, in his message on the first anniversary of Pakistan delivered on August 14, 1948 stated:

"Nature has given you everything. You have got unlimited resources. The foundation of your state has been laid, and it is now for you to build, and build as quickly as well as you can. So go ahead and I wish you God-speed."

Moreover, in his radio speech delivered on October 03, 1947 he said:

"Pakistan is blessed with enormous resources and potentialities: Providence has endowed us with all the wealth of nature and now it lies with man to make the best of it".

To our misfortune, mineral development has a weight of only 3% in the GDP of Pakistan and unfortunately there was a negative growth during 2009-10 in mineral development. Mineral development, as a prosperity driver in Pakistan, has yet to be addressed. God has blessed us, in all four Provinces of our country including Azad Kashmir and Gilgat – Baltistan, with tremendous hidden resources including Thar Coal reserves, copper and golden reserves in Reko Diq mountains of Balochistan and northern Wazirastan. An excellent work for turning mineral development into a prosperity economic driver has been spelled out in the 8th Five Years Plan (1993 – 1998) specifying nine areas and with identification of 22 priority areas. We must get up from the third cycle of Rip Van Winkle sleep and focus our attention on mineral development as part of our strategy for achieving high economic growth.

3) **Electricity:** Short-term measures should be undertaken on high priority basis to enable the country to have environmentally free, uninterrupted and at affordable prices electricity throughout Pakistan. In the long run, the hydel electric resources which constitute a potential of 58,000 MW should be exploited with financial assistance from all over the world in a hassle free style so that the people of Pakistan, its agricultural components and industrial sector of the country alongwith commercial set ups may enjoy the basic need of receiving electricity on foregoing three fundamental principles.

4) **Construction:** The construction area is very interesting to boost economic development. Its acceleration results in backward and forward linkages. A breakthrough in this area is needed on the following lines:

a) A shelter policy in Pakistan be announced with low cost housing.

b) No housing policy with fabulous amounts as advertised in press and proposed to be financed by financial institutions be encouraged.

c) A construction policy with full details be spelled out as an integral part for over all economic development of the country to strengthen housing and manufacturing sectors of Pakistan.

C: Service Sector

There is a general belief amongst economists that if infrastructure is developed, increase in economic development follows. Development of service sector has four dimensions namely; physical, social, financial and intellectual. Development in all these four dimensions requires immediate strategic move by the concerned persons (Government and Private Sector).

1) **Physical:** Physical infrastructure includes: development of roads (metalled and un-metalled, farms to main roads etc.) for reducing marketing losses of vegetables, fruits and enabling greater mobility for domestic, commercial and improving transportation and construction of old bridges. The provincial governments should attach high priority to this area as in the 7th NFC Award funds allocated were big amounts from the Federal Revenue Budget 2010-11 and around 50% of the funds of ADP 2010-11 have also been allocated to them. Operational details need to be developed in this respect.

2) **Social:** Unfortunately, social sector (health and education) have yet to receive high priority. All provinces are urged to allocate atleast 25% of their revenue budget to education for qualitative improvement and boost the functional literacy front with emphasis on development of high technologies through higher education and on practical orientation to vocational and technical skills.

3) **Financial:** Financial sector consists of banking, insurance, leasing, modarabas and mutual funds. To our misfortune, this sub-sector made a negative contribution to the GDP growth in 2009-10. Major problems facing banking sector are austerity measures to be adopted in expenditure, reduction of spread, substantial decline in non-performing loans (NPLs) and optimal utilization of their financial resources. Insurance makes an insignificant contribution of 0.48% to the GDP of Pakistan. It totally remains neglected area both in life and non-life fronts. Insurance culture needs to be cultivated resulting into vibrant growth and its use for promoting employment in the country. Other financial sectors are also under performing and they require major supervision and vigilance by regulatory bodies and be manned by professionally qualified personnel.

4) **Intellectual:** Emphasis on innovation, new inventions and strengthening HRD frontiers requires immediate attention with funding and managerial commitments. The Government, public and private sectors must make a significant contribution.

Way Forward

Pakistan has a great potential to be developed as an economically vibrant and economically strong country. Strategic areas for attention have been highlighted in this paper and it is now for the stakeholders to address the issues raised in this paper and develop strategies for implementation to contribute to the golden chapter of economic prosperity of the country with widespread gains across the board so that the vision of the thinker and founder of Pakistan is accomplished through our democratic government. The challenges are big but delivery system is needed to logistically well-equip the institutions to deliver the goods in a befitting manner.

Given commitment, dedication and devotion to the country as a periodically inspired and spiritually fired nation, we can achieve great heights. Therefore, let us be on the move and achieve the vision and mission of our country with the slogan of economic development with social justice. The democratic set up of Pakistan is urged to accomplish this objective.

Reformed General Sales Tax:

Present State of Pakistan economy- Need for Composite Tax Package

Syed Shabbar Zaidi, FCA

Preamble

Pakistan is an unfortunate country. Common man is deprived of basic education, medicine housing, employment and physical security. This is the direct consequence of national spending, for these heads, in the last sixty four years being less [as a percentage of resources generated] then all other countries of the world except certain Sub-Saharan African nations. This persistent and consistent lack of investment in human capital has brought us to the present social, political and economic chaos. Widespread corruption, at all levels, erosion of authority of institutions and degradation of value standards is the natural outcome or result of these intellectually flawed national priorities.

The result is natural and tertiary resolutions, like impartiality of higher judiciary can not bear sustainable fruitful results unless fundamental corrections are made in national priorities. There is effectively a vicious circle similar to chicken or egg first scenario. We do not have funds therefore we do spend on human capital. As defective human capital is being produced therefore a paradigm to change socio-economic system and a critical mass is not being created that could lead to sustainable pressure against corruption and degradation in values. This circle will go on as usual unless there is a social revolution to break the same. Minor corrections are no more relevant. There is pathetic low Tax to GDP ratio *[in simple terms being tax collection, especially direct taxes]* that leads to huge government borrowing even for non-development expenditure effectively leaving nothing for development expenditure. Resultantly, we are heading towards a big public finance chaos that in its worst form can even lead to local currency default. Economic condition can not improve in sustainable manner without investment in human capital for which we have no money. *[In the short run, whatever we will additionally collect even from the levy of RGST will effectively be eaten up by interest payments on borrowings]*. Present situation is not encouraging. This is the outcome of the political and socio-economic paradigm that prevailed in this country in the last 65 years. There can be lengthy but necessary debate on this topic, however the present article is restricted to the causes of present state of affairs in the taxation system of Pakistan, being a vital part of overall economic system. In order to identify the solution we need to seriously undertake a broad based analysis.

However, this is not the subject of discussion of this article. Nevertheless, few glimpses may appear naturally in the course to follow. This article is focused on the particular subject of **consumption tax** and attempts to identify the relevant issues that are necessary to be studied for any non-political, impartial and transparent debate on the subject.

Is RGST a recipe in the present state of affairs?

Managers of Pakistani economy, including the lenders (IMF and others), firmly, but not wholly correctly, believe that 'one' and the only step to improve the Tax to GDP ratio is implementation of broad-based **Consumption Tax** in the form of **Value Added Tax**, now renamed a **Reformed General Sales Tax [RGST]**. On the other hand, businessmen, various economic analysts and some major political parties, including PML(N) representing commercial centres of Lahore, Faisalabad and Rawalpindi and MQM representing Karachi, Hyderabad and Sukkur believe it to be a wrong or misplaced 'Recipe'. Notwithstanding the arguments on the other side [government] it appears to be a half hearted attempt only being a compliance of dictation by the lenders. I would refrain to pass any view or judgment at this moment. Any sensible reader would be able to conclude, on his own, if the issues raised are patiently understood and there is a will for long term resolution.

In my view the biggest tragedy is that common man of Pakistan, who is going to be directly affected, positively or negatively, as the case may be, is ignorant and is not represented in all the economic policy decisions affecting their lives. This can only happen in Pakistan. There is a social disconnect. Even now Pakistan is a non-participative democracy that may be worse than any dictatorship. Even now establishment [bureaucracy] is firing the shot whereas people believe, or at least they are being told, that they are represented. Solution lies in increasing the participation, direct or indirect, rather than looking again towards other solutions including re-emergence of some form of dictatorship. In my personal capacity I have been directly involved in the implementation of Sales Tax, since 1990, including present legislation.

Furthermore, I have been the member of almost all bodies and task forces formed for the improvement of taxation system [policy and administration] in Pakistan after 1985. In my professional capacity, I have represented clients in implementation, appeals and dispute resolution. This three pronged experience is relevant and the purpose of this article is to try to give an independent view on the subject. I firmly believe that there had been effectively no homework on issues that are relevant to the subject. We are trying to introduce a law, directly affecting every citizen of this country, poor or rich, agriculturists or city dwellers on borrowed knowledge and experiences. Discussions on this important issue are generally either based on incomplete knowledge with political orientation or a legal review of various provisions. Means to achieve effective and practical implementation or economic implications are rarely thrashed out. Following paragraphs contain a small attempt towards that objective.

Contents of the discussion

This discussion paper includes the following:

(1) History of evolution of consumption tax in Pakistan;

(2) Experiences in post 1996 period after the introduction of VAT;

(3) Zero-rating of export oriented sectors;

(4) Possibility of removing the distortions - preparedness;

(5) Present System, VAT and RGST – Old wine in a new bottle; and

(6) Way forward and solutions.

1. History of evolution of consumption tax in Pakistan

Originally, sales tax, both on goods and services was a provincial subject. In 1948, sales tax on goods was taken [temporarily] to be a Federal (Central Government) for 'one' year. Subsequently, consumption tax that on 'Goods' constitutionally became a federal subject. Incidence on 'services' was retained as a provincial matter under the 1973 Constitution. Original migration, its continuation and distribution of particular taxes and duties between federation and the provinces is not based on empirical studies or people's mandate. It is effectively a bureaucratic decision. There are very few countries in the world [being federations under the constitution] where across the board consumption tax, on value added basis is levied on national [federation] basis. It is so as a comprehensive VAT system requires commonality in charge and centralization of collection, which is not easily attainable in a federation. This unique 'divisive' [where right to levy consumption taxes on goods and services lie with the provinces and federation and vice versa] constitutional right does not exist anywhere in the world except countries like Canada, Australia and New Zealand. These exceptional kind of federations all represent well documented economies with clear distributive process for collection of revenue on national basis. Can that be modeled in Pakistan? It is yet an untested proposition.

Across the board VAT, in practical sense, implies a consumption tax on both goods and services with 'input adjustment', in all situations, horizontally and vertically. Input on goods and services to be available against levy on goods and services and vice versa.

From 1948 to 1996, Sales Tax on goods was levied as a **'Production tax'** by the federation. Tax was payable by the manufacturer at the time of removal of goods from the factory, [in India this system still continues] In almost all the cases value for the purposes of this levy was notional market value; not being the actual consideration.

Consumption tax on services has effectively never been introduced. A Federal Excise Duty was aggressively [technically unconstitutionally] and extensively used to trespass the provinces' sphere, right and ambit of taxation. This trespassing was existent specially in the sectors of telecommunication, insurance, advertising and banking. In summary, in Pakistan across the border consumption has never been imposed. In the following paragraphs, I will explain the deliberate and non-deliberate distortions introduced in the hybrid form of consumption tax system over the time. The crucial point to discuss is whether or not as a society, with the present tax culture, and fractured documentation structure, would we be able to actually apply and implement an across the board consumption tax. Is it not a case of introducing a tax without political will with an 'intentional discreet agenda' to provide another excuse for intellectual, political, bureaucratic corruption that would disguise and camouflage the actual reasons of low Tax to GDP ratio? The real problem lies in direct taxation.

No country can impose an effective and equitable tax system unless there is an inherent minimum documentation in the system and all the stakeholders are on board. RGST may be a very good recipe, however, unless all the stakeholders are on board it can never be effectively implemented. We should learn from the past experiences. An imperfect implementation is more dangerous than no implementation as it dilutes the government's writ of taxation.

There is no legacy of value added based consumption tax in this region. India, though much better organized then us in taxation and documentation system, due to its federal structure is still struggling. Bangladesh has done fairly better in this sphere; however, constitutionally it is a unitary system of government. One of the primary reason of ineffective implementation, especially at retailers and wholesalers level is non-participative and impotent role of provincial and district governments and an apparent lack of trust between provinces and the federation.

2. Experience in post 1996 period after the introduction of VAT

In 1996, one major change was introduced in the consumption tax system in Pakistan. Production based tax was converted into a tax at the time of sales. with input-output adjustment. This was the beginning of VAT; however, from 1996 through 2010 continuity of the following features resulted in a state where real VAT system could not be enforced.

(a) Levy of tax at notional price by the retailer

For almost all the consumer items, sales tax was recovered at Retail Price at the manufacturing stage. Thus intervening sectors (retailer, distributors and wholesalers) remained outside the net. This system was supported by the legislation in the form of Third Schedule to the Act. In a cursory way, this seems to be a minor distortion only, however, from the practical viewpoint it is a very vital aberration in the system. Big revenue spinners like Cigarettes, Beverages, and general consumer items fell under this regime. Under this system government revenues were guaranteed at the production stage. There is a security of a guaranteed collection of revenue for government, which impliedly discourages incentive to implement the law at the secondary stage. Furthermore, as a necessary consequence, since general consumer items were so taxed therefore a tendency developed to remain outside the tax net for other items amongst the retailers and wholesaler community;

(b) Erosion of writ of government by retailers and wholesalers

In addition to this deliberate act, being a measure adopted to achieve revenue without efforts i.e. the operation of the Third Schedule, there was complete failure in bringing into tax net the retailers, wholesale and distributors for all other products even for non Third Schedule items. It is a daylight reality that all locally manufactured or imported products irrespective of the quantum of turnover for prescribed threshold are 'traded' without sales tax by wholesalers and retailers. We all know that present threshold for a retailer or wholesaler to be in the tax net is Rs 5 million per annum whereas almost all such almost whole of the market enjoy an 'unconstitutional implicit exemption'. Now this implicit challenge of writ of government is being attempted to be brought back in this fragile environment. This leads to the important socio-economic question about timing of implementation of new taxes or a new regime. There are various empirical studies on the matter and they all favor the view that best time for such measures is flourishing economy. The other important prerequisite is collaborative political will on national level and consensus to tame the spoilt and pampered child being the trading community not ready for documentation;

(c) No tax on imported products
Imports were effectively placed under **'Presumptive VAT'.** This is a curse of the highest order. This an implicit acknowledgement for non-documentation, under-invoicing and availability of Afghan Transit Goods in the country with a recognition that there is no practical measure to document and sale of imported products; and

(d) Non serious and non-collaborative approach of Federation and Provinces for services taxation
There was no serious coordinated [Federal, Provincial and District level] effort to bring services section into the tax net. Main revenue generators, being telecommunication, banking, insurance etc. remained trespassed by Federal Excise duty. Other service like 'Advertising' etc. remained in such a mess that one of the major group engaged in that sector obtained a stay against payment on legal plaint from the High Court.

All these factors revealed that by default, even after 1996 amendments, sales tax remained under a hybrid system where consumption tax was, in principle being collected at a single stage of manufacturing or import. Other intervening sectors being retailer and wholesaler continued to enjoy 'unconstitutional' immunity. This resulted in an implicit encouragement for business of 'trade' as against manufacturing for the reason that there was effectively no direct tax on income from trading. In laymen's terms there is effectively no 'direct tax' on such businesses. For such people Pakistan is a heaven though they may not admit it. In this situation, it is totally unnecessary to complain that there are huge unaccounted assets and non-documented wealth in the country. We allow it legally and deliberately. Can there be any country where virtually for the last 20 years [post presumptive tax regime] there is no 'direct taxation'? Do we realize the gravity of this error? The ghost of presumptive taxes will haunt our system for a long time unless we exorcise the same with full force. We do not want to do that even now. With this new vigor and enthusiasm [only within the Board Room of Federal Board of Revenue and Block 'Q" of Secretariat in Islamabad] for RGST, the important practical question is the change in psyche and socio-political structure. This is effectively a fight against a well grown monster with strong financial muscles. Though being a hardcore optimist in such matters, even to the extent of an illusionary, I feel that it is a difficult but an essential task. Our Economic Managers either do not have full knowledge of the ground realities or they are compelled by a misunderstood notion presented by lenders. We want across-the-board consumption tax, however, an unprepared exercise will lead to more negative consequences than maintaining the status quo. Even positive revenue impact will not arise. In the following paragraphs I list down the impediments which have lead to the present ineffective implementation of the current law. The first exercise should be to create the enabling environment so that excuses do not lead to effective impotency of legislation, as is being done at the moment. What I have repeatedly questioned are the changes at the grass root level that would enable an effective implementation. Escape routes for tax evaders can only be stopped when not only the doors but also all the attached windows are closed.

3. Zero-rating of export oriented sector

In 2005 the biggest distortion in the consumption tax was introduced. I should admit that I was a part of the decision making process. Under this regime five export oriented industries being textiles, carpets, leather, sports and surgical equipments were zero-rated instead of zero-rating for actual exports. These sectors contributing a substantial part of total manufacturing GDP of the country were taken out of the tax regime. Accordingly, Tax to GDP ratio was naturally bound to be

disturbed. Whether this action was correct or not will be decided by the history, however, it is important to accept that this action lead to the introduction of the biggest aberration in the system. At the outset, it has to be accepted that there was no technical basis for such policy and we should accept that we had adopted an extreme negative action leading to complete failure in implementing tax system specially managing refunds on exports which is a natural corollary for consumption tax.

It is reiterated that this distortion was created as the refund system had totally failed. During this period business of fake and flying invoices flourished. As a result of that, total refunds issued for actual imports in these sectors exceeded the total amount of tax collected from that sector. It is important to note that total taxes collected included local sales out of such sectors also. The quantum of misappropriation can be judged from the fact that whole taxes collection from local consumption out of these sectors [which would be around 20 percent at least] was swollen up by non-genuine refunds. There is no doubt that correct answer to clear up this menace or mess was effective implementation rather than zero-rating the sector, however, as stated earlier, due to incorrect commercial expediency and pressure from the vested interest, an intellectual crime was committed.

Economic consequence of this aberration is exemplified by a case that in Pakistan almost everything is taxable, but carpet being a luxury item is zero-rated, being a part of export oriented sector. This is only an example. This position is true for almost all such products.

Furthermore these sectors represent a substantial part of total manufacturing sector of the country. Keeping that segment out of tax regime implicitly meant that across the board implementation is not desired or possible. If is it so, then the corrective relationship between Tax to GDP will never emerge.

From practical viewpoint of the genuine stakeholders of the system, this intellectual crime was undertaken due to the following reasons:

(i) Mushroom growth of commercial export sector
Genuine exporters were at a disadvantageous position on account of delay in the issue of refund; whereas mushroom non-genuine commercial exporters in connivance with the corrupt government officers flourished, changing the real dimension of industry; In short, instead of the government, corrupt officers, became a silent partner in businesses.

(ii) Broken supply chain
In reality, a substantial portion of manufacturing and processing for industries is undertaken at small and medium scale units. As that segment is not required to be documented, therefore **'VAT Chain'** is broken and exporters are not able to re-claim the whole amount of taxes incurred at different processing stages. This either leads to bringing in of intervening fake records or loss for genuine exporters on account of higher costs if tax is levied at each stage where the chain is broken.

(iii) Over reliance on Automation
Release of refunds, unless properly documented, carry a risk of abuse for the government. Automation is not the answer to all the irritants and problems. It is only a tool. Automation can only be effective when whole chain is documented and there is possibility of 'cross matching'. Cross matching looks very easy in theory, however we all know that refunds in Income tax regime were stopped [which led to the introduction of the curse of presumptive tax regime], as refunds of taxes in Karachi were being made for taxes non-genuinely deemed to have been deducted at far off places, not being verifiable like, Khuzdar or Mastung etc. Proper system can only work where there is a nationally integrated data base and there are very strong controls at all places where inputs are placed in the system. This, in my view does not exist, even now.

(iv) Non-genuine claim against local sale of export oriented sector.
Fourthly, it should be considered that around 20 percent of such sectors are local sales which are taxable. Genuine input related to that segment (legally not claimable) may be claimed as refunds arising on exports. No automation or system can check or stop the same. Only real check against the same is effective 'audit', which we all accept has failed.

(v) Availability of Smuggled Afghan Transit Trade Products
Lastly, the factor that is being totally ignored is the availability of smuggled and Afghan transit trade product in the market, for the similar sector [especially textiles]. All the local markets of textiles are flooded with smuggled products or the products imported by abusing Afghan Transit Trade. It is practically not possible for the businessman in that sector to operate under two systems and at the same time it is not possible for the administrator to manage that kind of trade practices. The other stream has to be dried up before implementation of a new regime. You can find 'fake' or non-documented products in the alleys of Oxford Street, however, the shop within the street cannot afford the same. In our country the situation is reverse. If it is so, then can we copy and admire UK VAT system?

4. Possibility of removing the distortions - Preparedness

An important question that is being dragged into unnecessary political and economic debate is the possibility of removing the distortions. This is nothing but an implementation issue. Position will remain the same, whether or not we bring the new law, or retain the old one or we call it VAT, RGST or any other name. My initial reaction for the same, based on grass root study is that in the present structure this wish list is not attainable unless major 'irritants', described in the following paragraphs are removed.

For the sake of clarity these irritants are again placed for record:

(a) Recovery of tax at manufacturing stage on ultimate retail price on major FMCG items. This has effectively placed retailers and wholesaler [being a vital link in the VAT implementation] out of the tax net. These sectors contribute over 20 per cent of GDP and are flourishing at the cost of all other stakeholders. Other than having no direct taxation, this creates disequilibria in price control (due to non-documentation) when allegations and realities for hoarding and price manipulation arise, as is happening now-a-days in the case of sugar prices.

(b) Imports remained under Presumptive Indirect Tax Regime. This effectively means that trail for documentation remained officially not required under the law. In practical terms, it means that sales tax is charged at import stage like custom duty, with immunity from all direct taxes for all subsequent stages of business. For that purpose at present an amount equal to 2 per cent of the import value is deemed to be the ultimate price. Relevance and significance of this distortion can be gauged by looking at the quantum of imports as a part of GDP of Pakistan and the trade in that sector.

(c) Zero-rating for export sector as against zero-rating for actual exports; and

(d) Special procedures for various sectors such a petroleum, CNG etc. wherein in all cases an attempt has been made to exclude traders or dealers from the net of taxation and even if there is any incidence, it is in the form of indirect taxation at single stage.

Chicken or egg first?

All these facts end up in one conclusion that as 'policy' we have deliberately abolished all kinds of 'direct taxation' from Pakistan taxation system for the entire trade, import and service sector. Do we realize the effects and consequences of this biggest intellectual mistake? Now consumption tax, named as VAT, RGST or whatever we call it, is being considered to be a remedy to bring back some 'sense' in the system. This approach again leads to a chicken or egg scenario. The vital question is whether direct taxation policy mistakes are to be corrected first that would eventually force such businesses to concede to documentation to dilute the resistance against indirect taxation, or indirect taxation system is to be imposed in complete sense which will lead to increase in direct taxation collection. It appears that government is adopting the latter approach. At this stage, there is no point to give judgment on the method to be selected; however, it appears that proper homework is required to study the irritants which have choked the system. The possibility of effective removal of distortions can only arise if the irritants which are natural and mostly created by us, are removed. This aspect has been discussed as under:

(i) Issue of Minimum Threshold

At present, the threshold for being subject to tax is Rs. 5 million (turnover by annum) which is proposed to be increased to

Rs 7.5 million. We all know that a lot of businesses in the country are undertaken by entities having declared turnover less than this amount. This creates a natural blockade in the system whereby two price mechanisms appear in the market. Nobody would like to buy from a retailer charging 15 percent as against a next door neighbor not subject to tax. To equate the same FBR personnel in very low tones sometimes talk about a 'further tax' of 3 percent [which I disagree totally] for sale to non-registered person. Notwithstanding the technical side this is a practical problem that needs to be solved before any other action. We are discussing all philosophies and economic theories without first resolving this primary market mechanism. Karachi Income Tax Bar Association has come up with the solution that all intervening sectors be brought into the tax net and 'retailers' be treated as consumer. In their view, this will complete the chain in or certain sense. I do not totally agree with this solution, as the same may create problems for purchases of products by the manufacturing sector and others. The ultimate solution lies in the internationally acceptable principle that threshold be lowered and all retailers brought into the tax net. For that matter, comparative study is made of the countries where VAT is being practically applied. Thus, removal of this distortion is directly related to implementation and the present suggestion [threshold of Rs. 7.5 million] will increase the intensity of the irritant rather than removing the same.

(ii) Completing the Supply Chain

At discussed earlier, a major 'value addition' for the products for exports, is undertaken by the sectors outside the tax net being small and medium sized enterprises. There is no change in the character of such industries and processes over the time (from 2005 to 2010). Any change in the system [abolition of zero-rating] would either result in creation of non-genuine inputs or effective financial loss to export sector. This is an economic issue and needs resolution even if it is assumed that refunds are correctly and speedily issued.

(iii) Refund Management

There is no tested system of refund. It is agreed that processes have been automated in the most meaningful manner. However, what is not being considered is that delay in refunds and abuse of discretion arises on account of the fact that nation wide data and cross matching with the present framework and apparatus is not possible. This would either require human intervention or delay in the issue of refunds.

(iv) Inundation of Under-invoiced, Smuggled and Afghan Transit Trade Products

Markets continue to be inundated by under-invoiced, smuggled and Afghan Transit Trade products. In this situation it is virtually impossible to implement consumption tax at the retail or wholesale trade. What we are saying is that the same shop selling "Bata" or "Servis" shoes will charge sales tax on such products, whereas no tax would be charged on under invoiced imported, smuggled or Afghan Transit Trade product by the same entity. Even if, as an agent of angels, traders agree to charge sales tax on regulated products what would stop them to recover same sales tax on other products and increase price for the consumers in the name of sales tax. In other words, the charge for the consumers would increase without any increase in the revenue for the government. This would be a case of double jeopardy.

5. Present System, VAT and RGST- Old Wine in a New Bottle

It is our duty to let the nation know that there is no difference between the present system, VAT and RGST. In short, it is the reinstatement of the Sales Tax Act, 1990 after removing the distortions. The question is then why it is being said that a new tax is being levied. This is a political mistake of the government that it has not been able to present the case properly to the nation. It is being presumed that all 'exemptions' contained in the present law would be withdrawn. This is not a correct assertion. There are certain items which are not presently taxed, which would be brought into tax net in future, however, exact position can only be ascertained on a comparative study of present Sixth Schedule to the Act with the First Schedule to the New Act. There are many items with regard to which there can be an economic debate that the exemption should continue. On the other hand there may be various items which are presently exempt which would be better off if the same are zero-rated, so that input tax is recouped; for example 'medicine'. The biggest folly the government has made in this regard is that a totally wrong perception has been allowed to be prevail. It is strongly suggested that a critical review of the present First Schedule [relating to exemption] be made with a clear policy that all food items, education, and health related subjects be zero-rated. Furthermore there should be exemption for items affecting the consumer basket of a common man. The unfortunate part of present position is lack of homework and non-participative role of economist, leaving taxation to be a subject of either politics or law.

The other residuary issue is, whether or not there is a need for a new legislation to incorporate the intended changes. In strict technical sense there is no such requirement and all the objectives can be achieved by appropriately amending the present law. I am one of the people, proposing a new law for the primary reason that there should be a proper debate in assemblies on economic issues. Notwithstanding, through the delay, deferment, or abduction of the RGST a very reasonable objective has been achieved. Debate on the subject of RGST, has raised many subjects which were considered as **'taboo'** in the past. Now assemblies, media and general public are talking about 'tax' and 'equitable distribution of wealth'. Notwithstanding the delay, this process will not stop now and there will be betterment provided the debate is carried through positively.

6. The Way Forward and Solution

In a nation's life, deferment of a proposal for the cause of bringing about consensus is a good omen. There is no sacroscent date for the implementation of RGST. It would be damaging to bring a new law, without preparation and consensus, just to obtain a 'tranche' from the lenders. Even if it is done for this reason, the ultimate result will be negative even for the lender, as it is bound to fail. I am sure that if RGST is introduced in this manner then within one or two months, following changes will be inevitable:

(i) Reintroduction of Third Schedule for FMCG items; and
(ii) Relaxation for the export sectors, especially for release of refunds.

If it is so then again we will repeat the past mistakes. The solution lies in a **Composite Tax Package**. An outline of the same is given as under:

(i) Amendments in the Protection of Economic Reform Act [PERA] to stop whitening of money, including circularization of money for funding under-invoiced imports;

(ii) Abolition of Section 111(4) of the Income Tax Ordinance, 2001 and all other sections, that prohibit enquiry about sources of money;

(iii) Amendments in Provincial Agricultural Income Tax [Sind and Punjab] to the effect that rate of tax and basis of levy shall be similar to that as laid down in the Income Tax Ordinance, 2001;

(iv) Abolition of right of maintaining 'Dual Nationality' for Pakistanis and restriction on maintaining foreign currency accounts by Pakistanis in Pakistan over a small limit;

(v) Reintroduction of Wealth Tax with a low rate [not for collection of revenue but for asset documentation) with proper valuation tables including foreign assets but excluding business assets.

(vi) All credits in the bank statements above a certain amount to be reportable to State Bank of Pakistan as to the source;

(vii) Review of the Afghan Transit Trade Agreement;

(viii) Introduction of Provincial Capital Gain Tax with the rate equal to Federal Income Tax Ordinance, 2001. Revision of Valuation Tables;

(ix) Introduction of Pre-Emptive Right of acquisition by the Provincial Governments for underpriced properties;

(x) Gradual process of elimination of presumptive taxes from all sectors; and

(xi) Reducing the corporate rate of taxation to 25 percent with exemption to dividend income, to promote corporatisation and documentation.

All these changes are to be introduced from **March 31, 2011.**

After the implementation of the aforesaid action, then from June 30, 2011, the proposed RGST should be introduced with following fundamental changes:

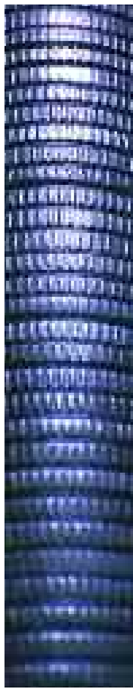
(i) Decreasing the threshold to Rs. 2.5 million;

(ii) Decrease the rate of tax to 7.5 percent; and

(iii) Zero-rating all items of consumer basket of a person having income less than Rs. 15,000.

Furthermore after the introduction of the law an **'Implementation Commission'** be made consisting of representatives of all major political parties and other stakeholders. Implementation is to be undertaken and monitored through a participative process instead of non-effective regulations.

There is a way forward for our nation. We carry a heritage of civilization that is over 2500 year old, where 1947 is a small milestone. Temporary deviations in our thought process which emerged after some wrong decisions in the past should not be taken as a cultural shortcoming. We are a nation of young people carrying a great past and potential for a great future. We, only need to adjust our priorities.

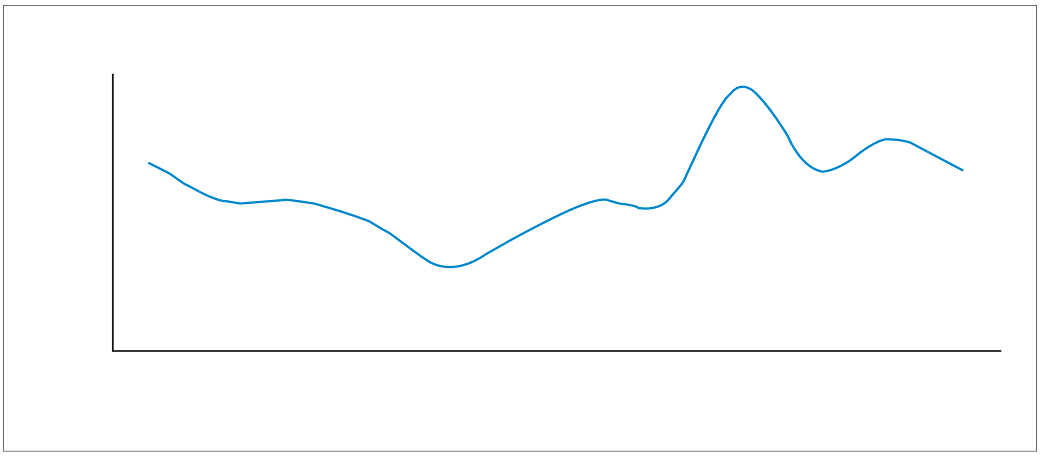


Economic Challenges & Strategic Solutions
Financial Sector

Muhammad Farid Alam, FCA

While Pakistan's economy was coming out strongly post the global financial crisis of 2008, the recent floods have again severely impacted its growth trajectory. In response, there is a need for both short-term measures and long-term initiatives with lasting benefits. The Financial Sector, particularly Banking, has been the star performer of the past decade, led by strong regulatory support and foreign investment (acquisition multiples of 5x or higher). However, it can be more effectively harnessed to play its due role for the economic betterment of the nation.

Many of Pakistan's economic problems can be traced to the persistent fiscal deficit, and the consequent measures utilized to plug the fiscal gap. Deficit monetization or the printing of money is a key concern where the federal government has already borrowed PkR336bn from the SBP since Jun 30'10 against commitment with the IMF for net zero budgetary borrowing. While the fiscal deficit can be tackled by addressing the revenue side, and indeed the government is attempting to usher in tax reforms through the Reformed GST, alternative attempts should also be made to shift the structure of the government borrowing mix. This can be achieved through the Financial Sector, specifically via greater focus on financial inclusiveness. Financial inclusiveness refers to the maturity of the Financial Sector, gauged by the participation of the various segments of society. Considering the interlinkages within the financial sector, a visionary policy needs to be implemented, which accounts for financial intermediaries such as Banks as



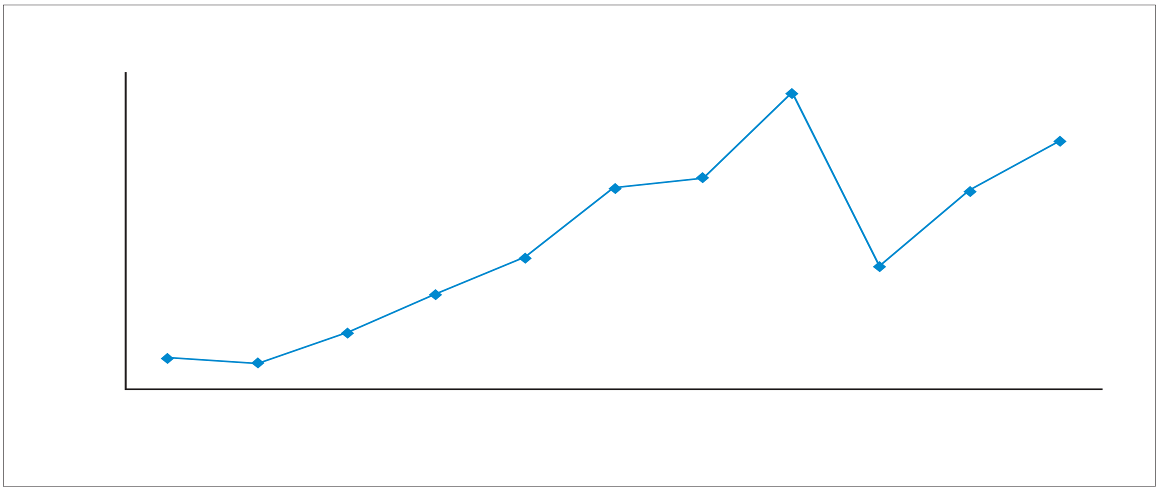
well as Insurance companies and the Capital Markets.

Pakistan is not a nation of savers. According to the World Bank, gross savings are 20% of GDP in Pakistan vs. an average of 35% of GDP for South Asia. The number of bank accounts in the country, at ~25mn vs. a population of 175mn, adequately captures the low savings rate and inadequate degree of financial inclusiveness. A low savings rate is due to a myriad of reasons including lack of awareness, preference for interest-free (Shariah-compliant) investments and cultural preference for maintaining liquidity. In this regard, it is necessary that the regulator, in this case SBP, take steps to engender national savings. Some measures in this regard have been taken, e.g. the move to impose a floor of 5% on savings deposits (~40% of the systemic deposit base) and more recently allowing the general public to invest in government securities e.g. T-bills, but bank funding costs continue to be on the lower side (spreads are 7%+). Addressing this issue would require wide scale changes in the banking dynamics of the country. While a natural trimming in banking sector spreads (through higher deposit rates) should occur over time, steps can be taken to aid the process. These include greater awareness programs for the general public particularly with respect to the available alternative investment avenues.

platforms. However, it is important to point out that government and regulator (SECP) support is imperative for the continued development of capital markets. In this regard, it is emphasized that market-friendly policies be implemented which include the much awaited leverage product and lower interest rates. Note that because of the prevalent high interest rate environment, the risk appetite in the market is low, indicated by only a few listings in the course of the last 2-3 years. If the interest rate environment is eased, it is felt that the market would be able to perform an important function i.e. as a source of raising capital, which can generate confidence for the entire economy through price discovery.

Similarly, the insurance industry in Pakistan is also underserved relative to its potential; according to a study by Swiss Re, the insurance penetration (premiums as % of GDP) in Pakistan currently stands at 0.8%, with non-life insurance penetration at 0.5% compared with emerging markets average of 1.3%. Greater awareness for the general public is needed through promotional campaigns, particularly with the advent of Takaful (Islamic Insurance).

Other alternative investments are real estate (lack of liquidity is an issue but this may be resolved through

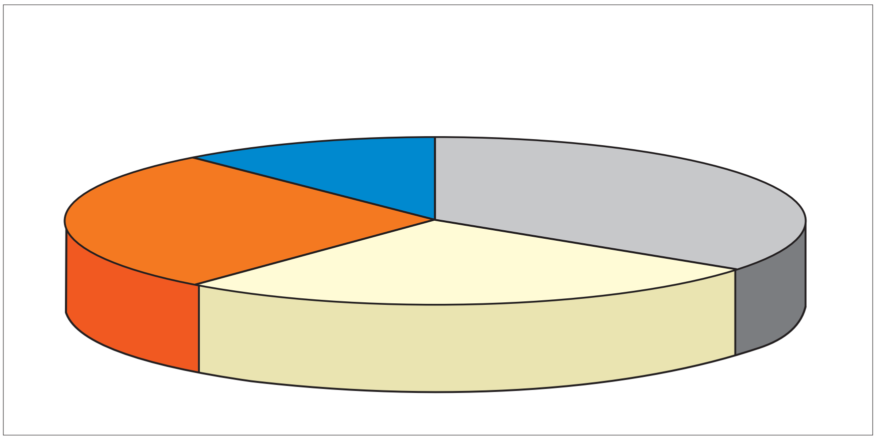


REITs) as well as commodities (through the NCEL). Going forward, introduction of derivatives may also serve to enhance the investment options available to the public.

As an asset class, the capital markets can provide a viable alternative to banking deposits. In the domestic financial system, capital markets remain under penetrated despite a CAGR of 50% in asset management AUMs since 2001. To put it differently, the number of mutual fund investors is estimated at just 200,000 (less than 1% of working age population), most of whom come from urban areas. Compared to banks, investment in asset management companies is ~10% of banking sector deposits vs. more than 20% in India and more than 100% in developed economies. Considering that the KSE-100 Index has returned 23% p.a. on average over the last 10 years, and offers an interest-free investment alternative, there remains immense potential to inculcate a culture of savings with the added charm of capital gains. With more and more users now frequenting the internet, growth can also be achieved the electronic medium through online trading

Given the importance of the highly documented Financial sector, it will remain in the eyes of the government with particular reference to revenue generation. That said, there must also be a realization that the Financial sector needs to be facilitated. For example, for all the hue and cry over high spreads, for Banks the issue of allowance of provision against Non Performing Loans (NPLs) (doubtful and loss) for tax deduction has not been resolved to the expectation of the industry. This is particularly relevant given that spreads are mitigated by high stock of NPLs (13% of loans or PkR509bn vs. total banking sector equity of PkR679bn and total paid-up capital of PkR357bn). At the same time, provision against substandard NPL is still not adjustable against tax payable which implies that effective tax rate for Banks remains high.

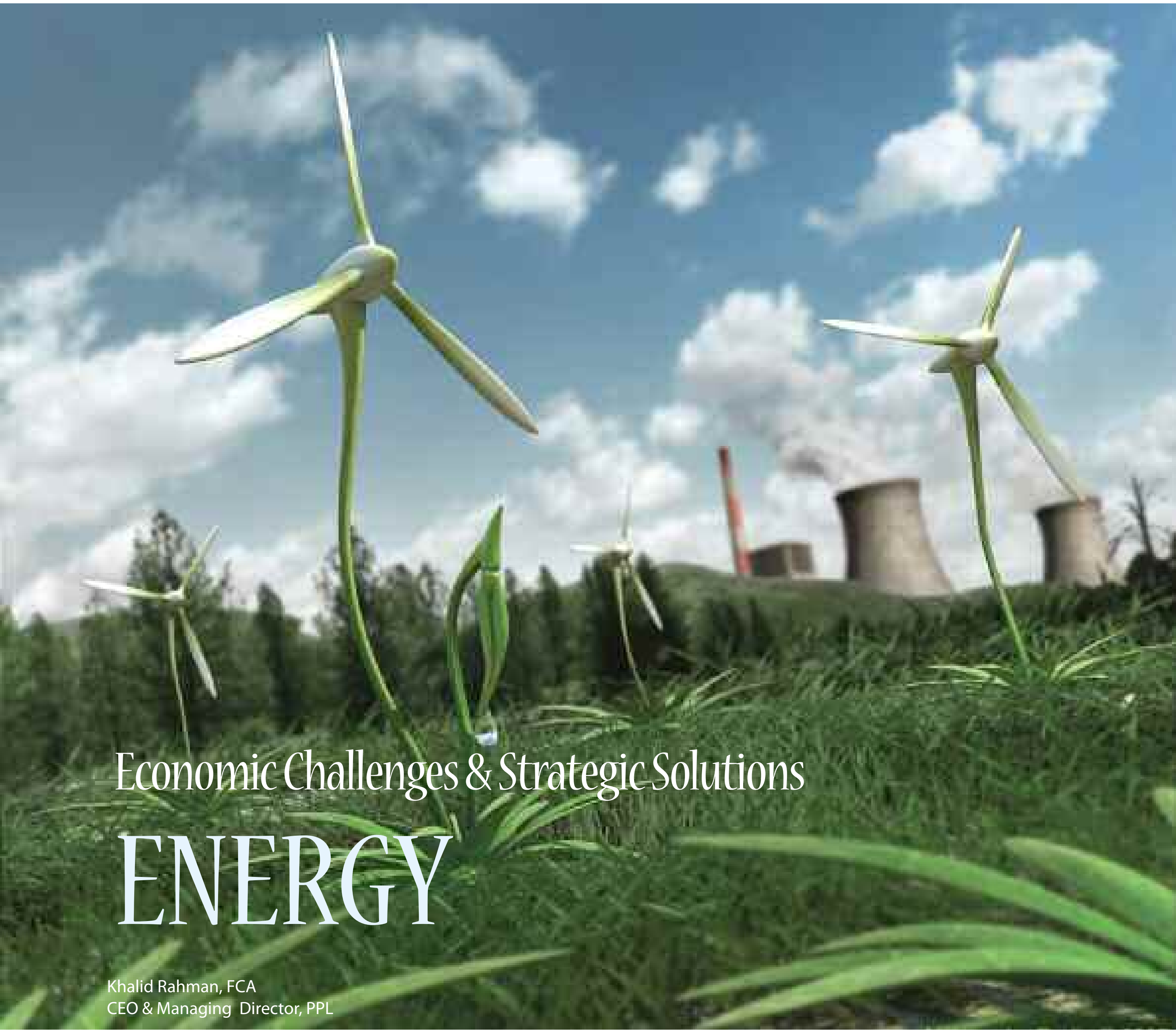
More importantly, for banks to truly function as an intermediary between depositors and borrowers (particularly the Private Sector), there is a need for the interest rate environment to come down. Although Pakistan was the first economy to adopt a hawkish monetary policy stance, but even with economic variables allowing for a softer monetary tone, the Discount Rate was not reduced on one pretext or the other (including cost-push inflation). As a result, there has been a change in risk concentration for banks where the banking sector's credit to the public sector now accounts for 44% of total credit (largely through T-bills) vs. just 26% two years back. The implications for private sector credit growth are quite obvious where low liquidity in the private sector raises concerns for long-term economic growth. At a tangent to this, an outstanding issue with the Banking Sector is also the asset-based lending structure at the expense of cash flow-based lending, which remains negligible. What this means is that bank credit within the private sector is channeled to blue-chip corporates while entrepreneurial enterprises and even the SME sector are largely ignored. Going forward, it is recommended that Banks gradually focus on cash flow-based lending so that the pool of borrowers is diversified and more sectors receive the required liquidity especially the Services sector which has depicted resilience even during tough economic conditions.



Moreover, considering that the Financial sector does not function in isolation (unlike Agriculture for example), there is an acute need to rectify issues in other sectors of the economy. In particular, the power crisis and the outstanding circular debt issue need to be resolved on an urgent basis as these have the potential to eat up financial sector liquidity (already Banks are funding circular debt through large TFC issuances). Governance and political will are key inputs to resolve such issues.

To sum up, a greater degree of financial inclusiveness will lead to a higher pool of national savings which the government can tap without impacting price dynamics by printing more money. A mature domestic financial system will thus enable the government to shift its borrowing mix away from the central bank and foreign sources. This would in turn help induct price stability (inflation presently above 15%) leading to monetary easing (the SBP has consistently stated that high inflation and accompanied printing of money are the key reasons for monetary tightening). Lower inflation and lower interest rates would help restore private sector growth, crowded out of late. In tandem, we can expect improved export performance (on the back of lower cost of borrowing) which would aid Pakistan's Balance of Payments profile and increase foreign exchange reserves. Greater fiscal freedom would also allow the government to focus on long-term development projects (PSDP) to lay the groundwork today for future growth. While it is acknowledged that tax reforms are important, the measures outlined above can ease some of the pressure on economic managers and enhance confidence in the financial system and the overall economy.

It is thus recommended that the economic policy makers follow a dual policy focused on revenue enhancement and a shift in the government's borrowing profile. However, these policy measures are likely to bear fruit over the medium term. In the shorter term, Pakistan needs to find a way to meet debt repayment requirements (particularly IMF loans). This can be achieved through the privatization process which, based on the projects on offer, can attract locals and foreigners. Timing appears opportune for the revival of the privatization, process, which has been on hold for the last few years, considering the sharp drop in Credit Default Swap (CDS) spreads for Pakistan and enhanced global liquidity. For effective reinstallation of the privatization program, it is suggested that our economic managers opt first for Listing and then offer Strategic Sale (26% of shareholding under Public-Private Partnership structure, alongside management control to qualified strategic partners). In doing so, the economy can benefit through a multiplier effect in public finance and equity markets, while the government would ably signal its intent to push ahead with its structural reforms agenda. This would allow the government to reap the benefits of better underlying entity performance in coming years.



Economic Challenges & Strategic Solutions

ENERGY

Khalid Rahman, FCA
CEO & Managing Director, PPL

Background

Pakistan faces a number of significant challenges that are dampening our economic growth. These include public debt, energy shortages, low domestic savings, low export growth, fiscal deficit, weak governance structure, security risks and political instability. The overall impact of these macroeconomic factors is reflected as trickle-down effect in the form of rising poverty, unemployment, inflation, security risks and disincentive for both local and international investors.

Pakistan has witnessed decades of internal political disputes and policy changes affecting socio-economic conditions. GDP growth of 5-8% during 2004-07 was spurred by gains in the industrial and service sectors - despite severe electricity shortfalls - but finally growth slowed in 2008-09 and unemployment rose significantly. Inflation remains the top concern among the public, jumping from 7.7% in 2007 to 20.3% in 2008, and 14.2% in 2009. In addition, the Pakistani rupee has depreciated significantly since 2007. Textiles account for most of Pakistan's export earnings, but Pakistan's failure to expand a viable export base for other manufactures have left the country vulnerable to shifts in world demand. Other long term challenges include expanding investment in education, healthcare, and electricity production, and reducing dependence on foreign donors.

GDP growth of 4.1% was witnessed in 2009-10 – the third year in a row of low growth. Inflation was lower than 2009 but still at 11.7% per cent. Inflation has been continuously on the rise since start of current financial year. Data available up to November, 2010 shows that CPI (Consumer Price Index) has increased by 14.44% during July-November, 2010 against an increase of 10.26% during similar period last year. Main reasons for increase in inflation are the price hike due to supply shortages especially of food items, unprecedented floods, government borrowing for budgetary support as well as rise in prices of commodities in International market. Exports (Gross) during the 1st quarter of 2010-11 has increased to $5,129.23 million compared to $4,437.94 million in the corresponding period of last year showing an increase of 16.7%. However, at the same time imports have increased to 9,029.44 million from $7,586.76 million in the previous year registering an increase of 19.02%. Therefore, the trade deficit has surged by 22.3%.

Growth - Driver of Energy Demand

Pakistan today, a nation of 180 million people, stands at the beginning of the 21st century facing a myriad of challenges. Population growth and economic activity backed by external funding has provided impetus to growing energy demand leading to acute shortages, resulting in CNG holidays and frequent power shortages throughout the country. After the modest growth of 1.2% in 2008-09, the economy grew by 4.1% in the outgoing year. Although, there is a sign of improvement, comparatively, however, the growth looks fragile.

Sustainable economic growth requires improvement in multiple factors including prudent policy making, domestic resource mobilization, promoting higher productivity in Country, improving internal security situation and removing energy crisis. This Article focuses on the energy scenario and its future potential.

Pakistan's Energy Environment

Primary energy consumption in Pakistan has grown by almost 80% over the past 15 years, from 34 million Tons of Oil Equivalent (TOEs) in 1994-95 to 61 million TOEs in 2009-10 and has supported an average GDP growth rate in the country of about 4.5% per annum. However, since 2006-07 energy supply has been unable to meet the country's demand leading to shortages. This is despite the fact that per capita energy consumption in Pakistan at under 0.5 TOEs/capita remains only one-third of the world average.

Consumption of indigenous natural gas has grown rapidly in all sectors of the economy over the past 15 years, driven by growing availability of gas and a low gas price as compared with alternate fuel prices. However, the country's natural gas reserves are declining and a low gas price has become a significant disincentive in attracting new gas supplies. *(Table 1)*

Table 1 Comparison between Pakistan's and the World's Primary Energy Sources for the year 2009

	Pakistan	World
	%age	
Oil	32.2%	35%
Natural Gas	48.9%	24%
Coal	7.6%	29%
Nuclear	0.7%	5%
Hydro	10.6%	7%
Total	**100%**	**100%**

Primary Energy - Demand Supply Deficit

Pakistan, a country with very small oil reserves, is also heading fast towards a serious gas crisis as its major reservoirs are depleting and the demand and supply gap is widening. According to the latest estimates the future Demand/Supply scenario is forecasted. *(Table 2)*

Table 2 Forecasted Demand/Supply

	2009-10	2016-17	2019-20	2022-23	2025-26
	Million TOEs				
Demand					
Natural Gas	30	47	55	61	71
Oil Products	23	27	28	31	34
Hydel	8	9	10	14	16
Coal	5	7	10	12	13
Nuclear + Renew	1	2	2	3	3
Total	**67**	**92**	**105**	**121**	**137**
Local Supply	40	42	37	34	34
Deficit	**27**	**50**	**68**	**87**	**103**
Deficit %	**39%**	**55%**	**65%**	**72%**	**76%**

Although the latest Petroleum Policy provides incentive to local as well as foreign companies to increase exploration and production (E&P) activity in the country, investors are still reluctant to invest in Pakistan due to the security concerns in the Country. Due to a deficit of indigenous sources of Primary Energy, Pakistan largely depends upon importing crude oil and oil products at an enormous cost to its forex reserves.

Solutions to the Energy Crisis

In view of the existing ground realities and constraints, first and foremost there is a need to make the best use of existing energy sources by taking conservation measures at individual, community and national level. The situation requires not only simultaneous short and long-term planning but also out-of-the-box solutions that are innovative, cost effective, and adaptable, and have the potential to tap private sector investment. The energy crisis is not unmanageable but requires a high level of commitment from the Government to address it on priority. For the purpose of this article, I would like to focus on following three measures which if implemented can provide the nation with the desired long-term solution to the energy crisis.

(i) Development of Coal as a significant contributor of fuel in the Energy Mix;
(ii) Incentives for the upstream oil and gas sector for the exploitation of unconventional resources of hydrocarbon; and
(iii) Import of Natural Gas (Piped Gas and LNG).

Potential Contribution of Coal in the Energy Mix

The energy mix of Pakistan shows only 7.6% utilization of coal while the contribution of the coal in the power generation is only 0.29% whereas coal is responsible for 72% of power needs in China, 56% in India, and US utilizes more than 50% of coal in its power generation. Globally, the share of coal in power generation is 38%. According to Statistical Review of World Energy 2010 published by British Petroleum, Pakistan is currently ranked 28th in the list of coal-producing countries whereas in terms of reserves the country stand second with 186 billion tones after United States' 238 billion tones of coal reserves.

Pakistan's total Coal reserves are estimated to be 186 billion tonnes, with the largest coal reserves found in Sindh: *(Table 3)*

Table 3 Region wise breakup of Pakistan Coal Reserves

Region	Coal (Million Tonnes)
Sindh: Lakhra, SondaThatta, Jherruck, Thar, Others	185,457
Punjab: Eastern Salt Range, Central Salt Range, Makerwal	235
Baluchistan / Khyber Pakhtunkhwa / AJK: Khost-Sharig-Harnai, Sor Range / Degari, Duki, Mach- Kingri, Musakhel, Abegum, Pir Ismail Ziarat, Chamalong	316
Grand Total	**186,008**

Pakistan's total coal reserves are equivalent to 50 billion tones of oil (more than Iran and Saudi Arabia combined oil reserves) or over 2,000 TCF of Gas (42 times greater than total gas reserves discovered in Pakistan so far).

Thar Lignite Coal reserves, spread over 9,600 square-kilometres, are 175.5 billion tonnes and its power generation potential is 100,000MW consuming 536 million tonnes coal/annum over more than 3 centuries.

According to the research conducted by EMR in collaboration with the Petroleum Institute of Pakistan, the contribution by coal utilization to GDP through plants, products, services, employment, etc. would be in the range of $200 - $300 billion, which clearly exceeds the total current GDP of Pakistan. Cambridge Energy Research Associates estimates the Net Present Value of savings at Rs. 3.2 trillion over a period of 60 years. The fuel replacement from oil to coal will save Pakistan $87 billion from one block of the Thar Coal fields alone till 2070.

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Under the current crisis, development of Thar Coal has the potential to take Pakistan to self sufficiency in electrical power generation. Accordingly, the leaders of our country should appreciate the importance of coal for Pakistan and measures should be taken for expeditious development of the resource.

Incentives for Upstream Oil and Gas Sector

The oil and gas sector attracts the highest level of foreign direct investment in Pakistan and is the biggest source of government revenues in the form of taxes. So far the Government has been able to make substantial progress in the restructuring and reform of the oil and gas sectors particularly through deregulation of prices and privatization of selected assets which enabled exploitation of the country's conventional hydrocarbon resources.

The Gas potential of Pakistan is far from being realized, as significant discoveries are made frequently in the Central Indus Basin, Pakistan's most prospective area, as well as other parts of the country such as Khyber Pakhtunkhwa. Moreover, certain potential areas (such as Western Balochistan and the offshore) have remained largely unexplored.

During the last five years the addition in the Country's hydrocarbon reserves was only

1.4 billion barrels of oil equivalent which is almost half the addition witnessed during the five year period prior to that i.e. 2.5 billion barrels, whereas the indigenous daily production of hydrocarbon has almost doubled during the last 10 years from more than 400,000 barrels of oil equivalent to almost 800,000 barrels of oil equivalent. Accordingly, there is a need to focus on unconventional sources of natural gas and oil which represents a large volume of undeveloped hydrocarbons as these are accumulated in such geologic environments that differ from conventional petroleum traps. These include Tight Gas occurring in very low permeability formations, Shale Gas, Coal Bed Methane, Deep Gas and Heavy Oil Sands.

The U.S. currently produces more than 25% of daily gas production from tight and unconventional reservoirs and over 25% of daily Canadian oil production is from heavy oil sands. Other countries, such as Venezuela, and Russia, produce substantial volumes of heavy oil, while countries such as Australia, Argentina, Egypt, Canada, and Venezuela produce gas from low-permeability reservoirs.

As large and easy-to-find oil and gas fields have already been discovered, E & P companies around the world have started exploration and exploitation of unconventional gas reservoirs. Higher gas price and a mature service industry providing cheap, portable and affordable solutions with optimized technologies, are key to the exploitation of Tight Gas. As in most of the world, the exploration and development strategies of these unconventional resources have not been developed in Pakistan either. Producing unconventional gas is a great challenge and now is the time to examine these long ignored reservoirs and employ the new and unconventional technologies being used elsewhere to produce natural gas. A review of different tight gas reservoirs of the world suggests that the Tight Gas resources could be present in most of the Petroliferous Basins of Pakistan.

In view of the above, Ministry of Petroleum & Natural Resources and E & P companies operating in Pakistan have worked together for the past 2-3 years to analyze the incremental technological efforts involved and price incentive required to encourage the production of this great energy asset of the country. As a result of that, the Ministry of P&NR has prepared a "Draft Tight Gas Reservoirs (TGR) Exploration & Development Policy 2010" which is under review for implementation. The Tight Gas Policy aims to provide incentives for the exploration, development and production of Tight Gas by laying down the guidelines, procedures, and fiscal regime.

However, the exploitation of unconventional hydrocarbon is not free from challenges. For conventional reservoirs, years of study and experience have provided the industry strong tools and methods for predicting new well and field performance, as well as a good understanding of risk. Equivalent tools and experience do not yet exist for unconventional gas reservoirs, in large part because very low permeability makes it difficult to accurately model overall reservoir pressure with decline. The future challenge for the professionals of E & P companies (Geologists, engineers, log analysts, and other professionals) is to combine their efforts to better understand and predict reservoir properties in low-permeability reservoirs and use that information in resource evaluation, reservoir characterization, and management.

Import of Natural Gas

In order to keep the wheel of the industries spinning and to fuel the growth prospects thereof, in addition to filling the gap between demand and the supply of nationwide electricity, import of natural gas is the most favorable option owing to its availability in terms of quantum in different parts of the world.
Apart from discovering new indigenous gas reserves, other feasible options are as follows:

i. **Import of gas on fast track basis through pipeline from neighboring countries:**

Iran-Pakistan-India (IPI) Pipeline:
In June 2010, Pakistan finalized a $7.5 billion gas pipeline deal with Iran, considered crucial for averting the national energy crisis. Under the gas

sale and purchase agreement (GSPA), Pakistan will import 750 million cubic feet/day (mmcfd) with a provision to increase it to 1 billion cubic feet/day (bcfd). The volume of imported gas will be about 20 per cent of Pakistan's current gas production and the agreement is for a period of 25 years, renewable for another five years. The gas is envisaged to be provided to the power sector to generate about 5,000 megawatts of electricity.

The construction of the pipeline on Iranian side is on pace and expected to be completed by 2011. However, certain complexities in the implementation of the Project may delay the completion of the project.

TAPI (Turkmenistan, Afghanistan, Pakistan and India) Gas Pipeline

In December 2010, Agreement has been reached on TAPI gas pipeline, estimated to have a potential of 14-22 trillion cubic meters of gas. According to a preliminary breakdown, Pakistan and India would each get about 42 percent of the gas i.e. 1.325 bcf per day, while Afghanistan would receive the remainder. However, security for the pipeline and during the construction phase can possibly delay the project's near-term feasibility.

Although efforts are being made on import of gas through pipeline from Iran and Turkmenistan, however, keeping in view the security situation in the country's western borders and neighborhood, the most viable option that needs to be pursued to meet short term demand could be import of Liquefied Natural Gas.

ii. Import of LNG

The current policy in vogue is LNG Policy 2006, under which a private or public sector party joint venture or consortium (to be known as LNG Developer) can step in the LNG import business, who shall after re-gasification sell it to a re-gasified LNG (RLNG) Buyer.

The LNG Policy 2006, allow both Integrated or Unbundled Project Structures and the investors are given freedom to market and transport RLNG in Pakistan at their own risk and cost. Accelerated depreciation and waiver of import duty are allowed to give the necessary incentives. In order to expedite the process, OGRA is required to issue all the requisite licenses within 90 days.

The LNG industry is capital-intensive and requires a multi-billion dollar investment across the supply chain. LNG import projects therefore need to be planned in such a manner that quality project developers, with the technical expertise and the requisite financial resources are available for their successful implementation. Pakistan's current environment is not supportive to facilitate fast-track development for import of LNG. In addition, lack of LNG import infrastructure hinders fast-track mobilization of such projects.

The LNG is transported by specialized transport ships, as the gas is liquefied at cryogenic temperatures. Therefore, to facilitate import of LNG on fast-track, Government needs to set up Merchant LNG import terminals on fast-track through the private sector. In addition, capacity utilization guarantees need to be given to enable short-term LNG imports. Development of ports need to be undertaken by the Government, in order to provide accessibility for large LNG vessels. In addition, efforts to improve Pakistan's credit rating would favour chances and implementation of long-term LNG contracts.

Besides the above, the country also has to focus on alternative energy sources such as hydel (run-of-the-river), renewable (wind and solar) and other latest technologies like coal gasification etc.

Conclusion

Pakistan economy has made a substantial progress during the last sixty years but it has lagged behind other Asian countries in realizing its full potential. The ongoing energy crisis has not only hampered the industrial growth but is also leading to the huge Inter-Corporate Circular Debt (ICCD). As per latest statistics, the amount of ICCD has reached Rs. 300 billion. This is in addition to Rs. 301 billion that the Government has parked in a holding company.

Poor recoveries by electric power companies and their line losses have emerged as the main reasons of ICCD. Major losers of Circular Debt are Refineries and Exploration and Production (E&P) Companies. Pakistan's public finance has come under increasing strain over the past two years due to substantial outlays on electricity subsidies. Despite sharp rise of more than 100% in the last two years for consumer categories, electricity tariffs have still not reached cost recovery for the public sector utilities. The Government needs to devise a comprehensive mechanism to resolve this issue to put the energy sector on the path of recovery and future progress.

The current economic difficulties have arisen due to a variety of internal factors, reliance on foreign aid and policy and management lapses. The stabilization program introduced in November 2008 with the assistance of the IMF is on track. But the main challenge facing the country is how to sustain the high growth trajectory that Pakistan had achieved during past several years. The constraints are formidable but opportunities do exist both domestically as well as externally whereby this goal can be attained. But this demands transparent and sound governance, security, creation of competitive markets, conducive investor environment, dynamic energy supply to fuel industry demands and shift from dependence on foreign aid to external trade and investment.

CORPORATE GOVERNANCE

A stitch in time.............

Fuad Azim Hashimi, FCA
Currently President & CEO, Pakistan Institute of Corporate Governance

My earliest encounter with the beginnings of good governance practices for the corporate sector was during my articleship period when preparing for the final examination in May 1964. The UK Institute's members' handbook carried one paragraph on how qualified members who found themselves employed in the corporate world should display the highest standards of integrity in carrying out the finance function of their organization. Even though that was more than 45 years ago that single paragraph has never been more significant and important than it is today. Join me as I take you down memory lane to show you how various events began embedding in us good governance practices.

The sixties – yes, it was the swinging sixties, rock and roll, the Beatles, hot pants! Our Institute was incorporated by Charter in 1961 as an independent self-regulatory body. This heralded the beginnings of discipline for the auditing profession. Soon thereafter, the Banking Companies Ordinance was formulated in 1962 and I would like to believe that our senior members had a significant contribution in its development and especially the auditors' report.

Becoming proud member of ICAP in 1966, I remember fondly frequent trips to its humble premises to the top floor at El Markaz Building on Bunder Road. More importantly, as fresh associates, we witnessed and imbibed the first ever Code of Ethics for the profession, known affectionately as the Green Book. Credit goes to its author, the late Jamshed Peshotan Patel, or JPP as he was known, then Senior Partner of A. F. Ferguson & Co. I believe that despite changes made since, it still is one of the best Code of Ethics that I have read and I and others have endeavored to put into practice. **(The First Stitch)**

The seventies – a brief war that became an embarrassment, nationalization and devaluation of the rupee! Rapid industrialization had taken place, the responsibility on auditors was increasing and the usual financial "scams" had started. Every conceivable financial product was available and the stock market in Pakistan was active. Globally, the first scandal – Lockheed – hit the headlines and the Foreign Corrupt Practices Act was passed as a US Federal Law in 1977. This became known primarily for two of its main provisions, one that addressed accounting transparency requirements and the other concerning bribery of foreign officials. We were introduced to the concept of "facilitating payments".

During this period in Pakistan, we had been struggling with the format of the balance sheet and the profit and loss account and the auditors' report thereon based on the Companies Act 1913 and amendments thereto and this left a lot to be desired. It was therefore very opportune that the Securities & Exchange Ordinance was introduced bringing with it the Fifth Schedule that standardized disclosure requirements for the annual accounts of listed companies. Finally, we had a credible and accepted reporting standard that put us at par with global best practices. **(The Second Stitch)**

The eighties – military interventions and Islamization began to change our lives! People found an opportunity to maneuver bureaucracy and get loans against new industrial projects at considerably inflated prices. This would invariably result in losses to the banking sector which later became high NPLs threatening the very foundation of Pakistan's financial system. Internationally, Polly Peck International become the first poster child for the rapid corporate boom and bust story we would witness again and again in the decades to follow. (PPI was a small and barely profitable United Kingdom textile company. It expanded rapidly in the 1980s and became a constituent of the FTSE 100 Index before it collapsed in 1990 with the then colossal debts of £1.3bn).

At home, the textile industry began to get similar ideas and many financial institutions extended easy credit which would later become sour. The ICAP Council was however very active during this period and enforced the implementation of International Accounting Standards which was an attempt to standardize the quality of accounting disclosure. We became the first nation in Asia to do so. It also greatly facilitated the introduction of the new company law, the Companies Ordinance 1984 that brought in the concept of cumulative voting for election of directors. This laid the foundation for board level governance as counterbalance to company management. **(The Third Stitch)**

The nineties – the gradual melt-down of manufacturing and the growth of the trader mentality (that unsettled the nation's 5-year and 10-year economic plans), another devaluation and the freeze of foreign currency accounts seeing the flight of capital away from Pakistan! What took place was quite out of character for our nation. There were frequent changes of governments, no consistency in policies – chaos where stability was so badly needed to arrest the sliding economy. Whereas in the United Kingdom, following the corporate failures, Sir Adrian Cadbury expressed concerns over internal controls and came out with the Cadbury Report. This was soon followed by the Hampel Committee and resulted in the first unified code of corporate governance, the UK Combined Code in 1998. Always alert to global trends, the ICAP Council brought such issues to the front by identifying Corporate Governance as the theme of its 5th All Pakistan Chartered Accountants Conference in immediately following thereafter. **(The Fourth Stitch)**

The new millennium – with much concern over possible information technology and software mess-ups, it was supposed to be a big bang but came in with a whimper! This decade has seen some of the worst corporate scandals across the globe and a couple in Pakistan. Following the Enron failure, the United States passed the Sarbanes-Oxley Act or SOX in 2002. This Act was also known as the "Public Company Accounting Reform and Investor Protection Act" (in the US Senate) and the "Corporate and Auditing Accountability and Responsibility Act" (in the US House of Representatives). There continued to surface a string of failures, Adelphi, Tyco, Lehman Brothers etc. Closer to home, we experienced the failure of Crescent Standard Investment Bank and Call Mate and across the border, Satyam Computers.

ICAP pioneered the introduction by the Securities & Exchange Commission of Pakistan of the Code of Corporate Governance in 2002 and followed this by being one of the main founding institutions that set up Pakistan Institute of Corporate Governance in 2004. Yet again, we were one of the first nations in Asia to implement the Code of Corporate Governance and make it mandatory to have a Board Audit Committee. **(The Fifth Stitch)**

The oft heard saying goes like this **"A stitch in time saves nine".** Over these fifty years, ICAP has been making the stitches at appropriate times. What lies ahead? I close with a cautionary tale that I about recently in the International Herald Tribune. A lawsuit has been filed, more than two years after Lehman Brothers collapsed, against the longtime outside auditors who had certified the bank's financial statements from 2001 until Lehman filed for bankruptcy in September 2008. The suit focuses on the auditor's approval of a much-criticized accounting maneuver that shifted debt off the books before the close of financial quarters. The complaint said that the transactions involved "the surreptitious removal of tens of billions of dollars of securities from Lehman's balance sheet to create a false impression of Lehman's liquidity, thereby defrauding the investing public". The lawsuit seeks the return of more than $150 million in fees that the outside auditors had collected for work performed for Lehman from 2001 to 2008, plus massive investor damages. Let us resolve to conduct ethical practices in all our endeavors and if any of you does not have a copy, I can provide you the Green Book!

P.S. On the anvil, amongst pending revisions to the Code of Corporate Governance 2002 are:

- Separation of the Chairman & the Chief Executive
- More Independent Non-Executive Directors
- Human Resources & Remuneration Committee of the Board

Economic Challenges & Strategic Solutions

Insurance

Omer Morshed, FCA

Insurance and Economic Growth

Linkages between economic growth and deepening of the financial sector have long been recognized, but have mainly focused on the banking sector. Of late, however, the role of insurance in economic growth has been recognized. Interestingly life and non-life insurance contribute in different ways.

Non-life insurance supports entrepreneurial initiatives which otherwise may not be taken due to underlying risks viewed as being unacceptably high by investors. Examples in our country can be found in the agricultural sector which continues to be the most significant sector of our economy. Serious investment in the sector will not be attracted without the availability of instruments to mitigate risks of crop failure due to natural calamities like floods, crop disease or pest attacks. And without such investment growth in the sector will be limited.

At the retail level non-life insurance provides stability to the economic status of families through products protecting their homes, health and lives.

Life insurance also contributes to economic development by encouraging savings, thereby facilitating the accumulation of funds which are then available for investment in long term avenues including, indirectly, a country's infrastructure. In developed countries (and in many developing ones) life insurance is the leading contractual savings vehicle for mobilizing funds from individuals.

The development of the insurance sector and increase in insurance penetration should, therefore, be a key part of government economic policy.

Status of Insurance in Pakistan

Having recognized insurance's potential role in economic growth, let us see where this sector is in Pakistan today. The table below sets out gross premiums and insurance penetration (the ratio of insurance premiums to gross domestic product) in some of the leading countries in the world as well as some regional countries (including from South Asia).

Table 1

	General Insurance		Life Insurance		Total	
	Gross Prm 2009 (US$ m)	Penetration (Prm / GDP)	Gross Prm 2009 (US$ m)	Penetration (Prm / GDP)	Gross Prm 2009 (US$ m)	Penetration (Prm / GDP)
South Africa	8,085	2.83	28,773	10.07	36,858	12.90
United Kingdom	95,446	2.98	216,719	9.94	312,165	12.92
United States	648,083	4.55	501,675	3.52	1,149,758	8.07
India	7,970	0.66	57,114	4.73	65,084	5.39
Malaysia	3,303	1.63	6,503	3.21	9,806	4.84
Sri Lanka	366	0.87	243	0.58	609	1.45
Bangladesh	205	0.23	636	0.71	841	0.94
Pakistan	521	0.33	508	0.33	1,029	0.66

It is clear from the table 1 that Pakistan's performance in developing the insurance sector has been dismal. Just comparing ourselves to our immediate neighbor, India, the penetration in the non-life sector is half while that in the life insurance sector is one-fifteenth. In life insurance our penetration is also less than half of Bangladesh.

Given that the existence of a robust insurance sector is important for economic development, it is important to identify the reasons behind the lack of development of insurance in Pakistan. This article first of all provides a summary of the sector and the regulatory environment, then identifies reasons behind the sector's lack of development and finally makes suggestions to remedy the situation.

Overview of Insurance Sector

Until the year 2000 insurance was regulated by the Ministry of Commerce through the office of the Controller of Insurance under the Insurance Act 1938 and the Insurance Rules 1958. In the year 2000 there was a major change in the regulatory environment with the promulgation of the Insurance Ordinance 2000 followed by two sets of rules in 2002 and the transfer for regulatory supervision to the Securities and Exchange Commission of Pakistan (SECP) which considerably strengthened the regulatory capacity (although, as discussed below, not to the desired level). New capital requirements, solvency rules and financial reporting mechanisms (the latter being developed by the Insurance Committee of the Institute of Chartered Accountants of Pakistan) were introduced and significantly enhanced the financial strength of insurers, with a large number of small players exiting the market. In 2005 the SECP issued the Takaful Rules 2005, thereby introducing the concept of takaful in Pakistan.

Soon after the Insurance Ordinance was promulgated, the actuarial profession, which had existed as a collection of actuaries working independently, organized itself and formed the Pakistan Society of Actuaries (PSOA) as a S42 company in 2001. Since its formation and recognition as the representative of the actuarial profession in Pakistan, the PSOA (which is a full member body of the International Actuarial Association) has played a pivotal role in the development of insurance regulation in Pakistan, working very closely with the SECP.

The life insurance/family takaful sector currently consists of eight entities registered under the Insurance Ordinance 2000 and a government agency (Postal Life) which is totally unregulated, despite competing actively in the market. A summary of the sector. **(See Table 2)**

Table 2

Company	2009		2008	
	Total Premiums	% Share of Market	Total Premiums	% Share of Market
EFU Life Assurance Ltd	7,226.88	17.07%	7,250.51	20.72%
East West Life Assurance Company Ltd	235.77	0.56%	194.54	0.56%
NJI Life	4,363.16	10.31%	3,435.12	9.82%
ALICO	1,349.48	3.19%	1,155.39	3.30%
State Life Pakistan	28,582.23	67.53%	22,826.11	65.23%
Adamjee Life Assurance	51.97	0.12%	First Accounts to December 2009	
Pak-Qatar Family Takaful Limited	466.65	1.10%	129.68	0.37%
Dawood Family Takaful Limited	49.82	0.12%	3.40	0.01%
Industry Total	42,325.95	100%	34,994.75	100%

There is one other company registered as a life insurer (Asia Care) but which operates as a specialist health insurer, and has therefore been excluded from the table above.

As is apparent life insurance continues to be dominated by State Life (which is fully owned by the Government of Pakistan) formed in 1972 through nationalization of the life insurance industry.

The non-life sector consists of 34 direct companies and one specialist reinsurer (Pakistan Reinsurance Company Limited) which benefits from regulatory provisions requiring direct insurers to offer up to 35% of risks above their retention to them. The top five companies (which make up almost 75% of gross premiums written) along with their premium volumes and market share. **(see Table 3)**

Table 3

Company	2009 (Rs. Million)	Market Share %	2008 (Rs. Million)	Market share %
Adamjee Life Insuracne Company Ltd	10,321	24.54%	10,205	25.31%
EFU General Insurance Company Ltd	9,614	22.86%	9,699	24.06%
National Insurance Company Ltd	6,034	14.35%	5,492	13.62%
New Jubilee Insurance Company Ltd	4,031	9.59%	3,526	8.75%
IGI Insurance Company Ltd	1,152	2.74%	1,035	2.57%
Other	10,903	25.93%	10,356	25.69%
Industry Total	**42,055**	**100.00%**	**40,313**	**100.00%**

There is no analysis of the extent of corporate versus personal lines in the figures published by insurers or the regulator, but the share of personal insurances is insignificant. Even specialist health insurers have focused on group policies with individual premium volumes being minimal.

Issues and Initiatives

The lack of development of the insurance sector can be attributed to a number of factors. Some of these are generic, affecting all sectors of the economy, mainly emanating from the low level of documentation in our economy. Others are more specific to the industry itself and are discussed in this article.

Historically the major issue with the sector was lack of government focus. Although the government did set up an insurance commission in 1987, most of the recommendations were not implemented. The introduction of the Insurance Ordinance was driven not by government or the insurance industry but by external pressure from the Asian Development Bank (ADB).

In 2007, however, the Ministry of Commerce undertook a serious and comprehensive exercise to develop an Insurance Policy with the following objectives, the driving force being the then Minister of Commerce, Humayun Akhtar Khan, himself a qualified actuary:

- Removing impediments in the development of the insurance industry, including anomalies in the regulatory framework
- Improving the capacity of the insurance industry by encouraging the creation of large professionally managed companies
- Improving the public image of insurance by removing spurious companies and discouraging small and inefficient players
- Encouraging personal lines, and especially life insurance, by giving incentives for individuals to invest in life insurance policies
- Encouraging the spread of insurance to rural areas
- Reviewing the regulatory framework for Takaful to ensure greater penetration

The policy was developed in coordination with the insurance industry and the PSOA and presented to and approved by the Prime Minister in April 2007. Important policy decisions included the following:

a) Ensuring that motor insurance policies which were compulsorily required under the Motor Vehicles Act were only issued by registered insurers, replacing the practice of issuing bogus policies outside Excise and Taxation offices which are prevalent today.

b) Allowing Takaful windows, thereby improving takaful penetration.

c) Increasing insurance penetration in rural areas by introducing separate regulations for micro-insurance.

d) Reviewing the Insurance Ordinance and remove anomalies.

e) Rationalizing solvency regulations.

f) Introducing a tax credit for life insurance premiums paid by individuals along the same lines as tax credits on investments in open ended mutual funds (this being a major anomaly, as both compete for the same funds but tax incentives are only given to the latter which only require the investor to hold the investment for a year, whereas life insurance policies have an average actual average duration of 7 to 8 years).

g) Ensuring that senior management of public sector companies were professionals and not bureaucrats.

h) Rationalizing other anomalies in the tax law relating to insurance.

Although a few of the policy decisions were implemented, the major ones never were, the current status of some of these (three years and eight months later) being as follows:

- The Insurance Association of Pakistan (IAP) designed a scheme for implementing the policy to remove bogus motor third party liability insurance policies but, due to total non-cooperation from the provincial Excise and Taxation departments, no change has come about to date.
- Tax credit for life insurance has not been introduced. Despite the fact that the then chairman of the Federal Board of Revenue was a chartered accountant (and therefore would have the capacity of understanding the proposal as well as the anomaly due to the tax credit for mutual funds) and was present in the meeting in which the Prime Minister approved the policy, the change was not made in 2007. Ithas not been made to date, although this proposal has been included by the IAP in their budgetary proposals each year.
- Takaful Rules still have to be revised to allow window operations. It is understood that these rules are currently lying with the legal division of the SECP.
- The Solvency Rules still have to be finally issued

(although they were issued for public comment in March 2010).

- Micro-insurance has been only recently taken up by the SECP as a separate project.
- No major review of the Insurance Ordinance has been initiated, although such a review is essential.
- Public sector insurance corporations continue to be managed by career civil servants seconded by the Ministry of Commerce or political appointees. The result of lack of implementation of the policy to only appoint professionals can be best illustrated by the recent scam in the National Insurance Company where a political appointee with no background of insurance caused significant financial loss to the company.

As is apparent from the above status, the lack of focus on insurance within the SECP is a significant contributory factor in lack of progress on various policy proposals. Although there is no doubt that the SECP has been a significant improvement over the office of the Controller of Insurance, it is also clear that the SECP's main focus areas are the capital markets and corporate regulation as a result of which insurance has received step-motherly treatment. Even routine processing of regulations within the SECP taking significant time, largely due to the Insurance Division not receiving due support from other departments. This lack of focus on insurance has also impacted the ability of the SECP to attract insurance professionals.

As a result of the above, the insurance industry is increasingly demanding that the government establish a separate regulatory body for the development and regulation of insurance along the lines of the Insurance Regulatory and Development Authority in India which has been very effective in developing the insurance industry as well as effectively regulating it. At a number of conferences held over the past couple of years under the aegis of the PSOA, senior insurance professionals have called for the establishment of the Pakistan Insurance Regulatory and Development Authority.

The Way Forward

The insurance policy adopted by the government in 2007 continues to be valid to date. There is, therefore, no need to prepare a new policy immediately – all that is required is implementation for which the key initiative needed is institutional change – which is setting up of a separate regulatory authority to supervise and develop insurance.

In parallel with this, two policy initiatives formulated in 2007 need to be implemented on a priority basis:

- Tax credit needs to be introduced for individual life insurance policies along the lines which exist for investment in open ended mutual funds.
- IAP's scheme for ensuring that only genuine motor insurance policies are accepted for motor vehicle registration purposes.

Challenges and Opportunities in Textiles Sector

Waqar Masood Khan [1]
Secretary Finance,
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Introduction

Textiles sector occupies a pivotal position in Pakistan economy. It has the most intensive backward and forwarded linkages compared to any other sector. Linking our agriculture through industry to exports is a distinction that is unique perhaps to textiles sector. A single crop, when processed through various segments of the longest industrial chain, contributes nearly 8% of country's GDP, produces 24% of industrial value-added, employees 40% of industrial work force, consumes 40% of bank credit to manufacturing and accounts of nearly 60% of our exports. We have an international standing in this sector, as we are the 4th largest producer of cotton and 3rd largest consumers of cotton.

However, having said that, we are not fully exploiting country's enormous potential in this area. Just to cite one statistic in this regard, we are earning a multiple of less than one compared to the multiples of two and four that our immediate competitors have been able to earn. In this article we will highlight what are the challenges the textiles sector is facing and what opportunities exist for realizing country's true potential.

Cotton:

From the very outset, we face challenges in protecting the value of the cotton crop.[2] From picking of cotton and its processing at the ginneries and subsequent transportation to spinning mills, we experience significant degradation in its quality.

First, the picking and storing techniques are primitive, unmindful of both accumulation of trash and contamination of alien materials. Until recently, great care was exercised in this area and trash and contamination ratios were not as dismal as these are at present. We will discuss in a while the reasons behind this development.

Even though Pakistan Cotton Standards Institute (PCSI), a body established under the PCSI Ordinance, 2002, has developed cotton standards for different qualities of cotton, in conformity with international standards, yet these standards remain dormant as a system of country-wide grading of cotton and certification is lacking.

One reason why cotton standards are not observed in practice is the absence of active cooperation between provincial and federal governments. While standards are formed at the federal level, cotton control laws, that enable government to enforce those standards, are provincial. Only through a well coordinated action on the part of two governments one can hope to see the evolution of fully graded and certified cotton market. Federal Government also needs to make new investments in opening testing labs (presently only 12 labs exist) which will facilitate this process.

The absence of standards and certification result in lack of premium on quality cotton despite the fact that Karachi Cotton Association (KCA) regularly publishes quality premiums for different grades of cotton. The breakdown of the market provides no incentive for farmer to exercise care in the picking and storing of cotton. In fact, much of cotton cleaning work is done at the mill level, whenever the mill is faced with compliance considerations. Clearly, this must be a costly affair compared to what it will cost if a fully graded and certified cotton market were functioning. Accordingly, the mill sector has a major stake in the emergence of a proper cotton market and should come forward to play its due role for this purpose.

To be sure, Pakistan produces cotton with natural properties fully compatible with international properties. Table-1 gives a comparative position of Pakistan cotton properties relating to staple length, micronaire (compound measure of fineness and maturity), fiber strength, ginning out-turn (GOT), maturity and uniformity ratio (UR):

Table-1: Cotton Fiber Properties

	Staple Length (mm) 28.54	Mic Value	Fibre Strength (g/tex)	GOT %	Maturity %	UR %
Pakistan	28.54	4.4	28.7	37.7	80.0	47.6
India	27.76	4.3	27.6	-	71	48
USA	27.46	4.5	27.6	34.4	-	-
China	29.88	4.6	27.0	-	-	-

Note: Study Based on Average Cotton properties of 5 varieties each of Pakistan, India, USA, China. Source: i). ICAC, USA ii). CIRCOT, India iii). CCRI, Sakarand/Multan

Evidently, Pakistan cotton is as good as any other on a comparative basis. The question arises, then, what is the problem with our cotton. We have already noted the problems of trash and contamination. It is these foreign elements that damage our cotton. Add to this, highly primitive ginning practices – using mostly outmoded technology based on saws that are as old as 50 years. Such ginning practices often damage the fiber with the same consequences for the downstream industry as ensue from the damage of animal skin due to wrong cutting for the leather industry.

The costs of such losses are significant. First, although discontinued recently, until it was in the field, Pakistan cotton is quoted in Index B in the international market unlike index A where quality cotton is quoted. With the suspension of B-index, Pakistan is no longer quoted, partly due to the fact that Pakistan is not a major exporting country, as its own consumption exceeds domestic production. However, historically, this had the implication that we were priced, on average, at 3 cents lower than the prices for Index A. Presently, market sources report that since Pakistan is not quoted, its cotton is sold on a negotiated basis, and keeping in view further deterioration in quality, it is at a straight discount of about 10 cents. At this rate, the value of Pakistan cotton implicitly lost due to mishandling at different stages is about $400 million, 4% of the total exports of the textiles sector last year.

Table-2: International Cotton Prices

Period	A-index	B-index	Difference
2004-05	53.52	51.18	2.34
2005-06	57.07	54.92	2.15
2006-07	60.49	56.73	3.76
2007-08	72.94	68.85	4.09
2008-09	61.20	N.Q	-
2009-10	84.80	N.Q	-
Average Price Difference of A & B indices			3.08

Accordingly, our first challenge is to adopt appropriate measures to improve upon the current practices in cotton picking, storing, transportation, ginning, grading and certification. Clean cotton programs undertaken by government on pilot basis have yielded highly encouraging results testifying to the fact that with concerted efforts, the objective of achieving clean cotton can be achieved with substantial gains for all stakeholders in the textiles chain.

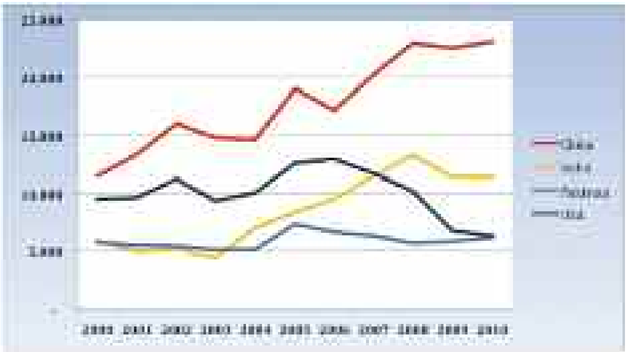
Before we leave this section, it is also important to recognize that we have fallen behind significantly vis-à-vis our competitors or with international bench-marks in the production of cotton and productivity of our farms. Table-3 shows the comparative position of major cotton producing countries in terms of area under production, production, yield and consumption.

Table-3: Global Area, Production, Yield and Consumption of Cotton

	World	Australia	China	India	USA	Pakistan
Area (million ha)	30.15	0.20	5.30	10.26	3.05	3.00
Production (M. Bales) 170 Kg	130.00	2.35	41.18	30.00	15.88	12.35
Yield (Kg/ha)	732	1,932	1,315	492	871	697
Consumption (M Bales) 170 Kg	151.76	-	64.12	24.71	4.71	14.12

A more vivid depiction is provided in the following chart where, unlike China and India, our production of cotton has been virtually stagnant.

Chart-1: Cotton Production by Major Producers



Textiles Value Chain

Chart-2: Textiles Value Chain

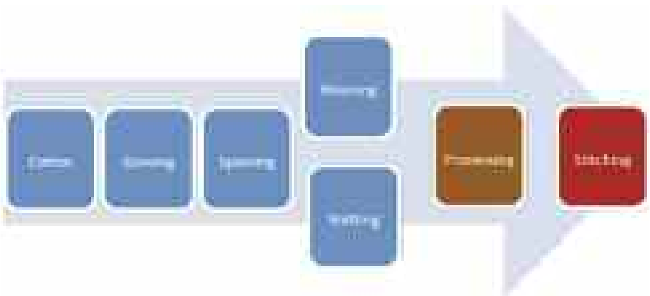


Chart-2 spells out the textiles value chain that begins with cotton and going through ginning, spinning, weaving, knitting and processing, culminating either in home textiles or in garments. Clearly, value is added consecutively as we move through the chain with minimum leakages at every stage – through exports of raw material or semi-finished goods – the more the value country can realize from its agriculture crop. At present, it is estimated that nearly 50% of our fiber is pre-empted in stages that are shaded blue and misses the brown and red color stages. We will say more about this is in a while.

Preemption of Country's Potential

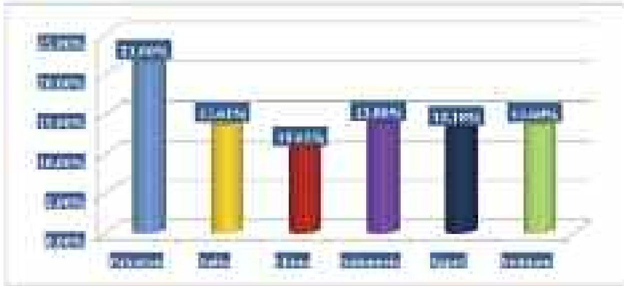
Table-4: Selected Statistics on Cotton and Products

	Percent	Rank
Production	9.5	4th
Consumption	10.0	3rd
Yarn Production	9.0	3rd
Yarn Export	26.0	2nd
Cloth Production	7.0	3rd
Cloth Export	14.0	3rd

As given in Table-4, and as already noted, the country occupies 4th and 3rd position globally regarding production and consumption of cotton. But we are also the 2nd and 3rd largest exporter of yarn and cloth, which is reflective of preemption of our true potential as such exports reduce our value-added exports.

The preemption of our potential starts with the wrong picking, storage and ginning practices. The following chart shows that we lose around 21.60% revenue at the pre-spinning stage due to these erroneous practices whereas these losses are almost half in other countries.

Chart - 3: Losses Due to Cotton Contamination and Trash



Shortage of Fiber Varieties

The global demand has shifted from the use of cotton to manmade fibres. Manmade fiber now shares more than 60% of the global consumption. Keeping in line with the market trends, China and India have made considerable investments in the manmade fiber industry. Following table shows that India and China shares more than 67% of the World production of manmade fiber.

Table-5: Production of Manmade Fibre

	World	China	India	Pakistan
Production (Million Bales) 170 Kg	259.41	159.41	16.06	2.53

Given the natural uncertainties associated with natural fibers, local availability of manmade fiber strengthens the availability of raw materials and also provides venues for production of diverse varieties and qualities of value added products. With low usage of manmade fiber, Pakistan, is totally dependent on its cotton crop and requires import of fiber and other raw materials for optimal utilization of its production capacity and thus losses competitiveness in the global market.

It is curious to note that Pakistan had initially started big in promoting the development of manmade fiber industry in the 80s and within a decade or so its combined capacity was heading for a million tons mark. But then significant revisions in the tariff regime had a major adverse effect on the industry leading to widespread closures. Additionally, management problems associated with a leading player in PSF industry resulted in the closure of nearly 1/3rd capacity in this sector. All told, the industry needs a major revival. The recent announcement of a long term tariff policy effectively July 1, 2010 for the sector under the Textiles Policy 2009-2014 holds the promise to reverse the declining trends in the investment and new expansion plans have been announced by the key PSF producers, which will significantly augment the local availability of MMF. What is also encouraging is the realization on the part of the spinning industry to diversify their current raw material base which poses high risks of vulnerability. This is increasing the demand for MMF and should be reassuring for those currently working in expanding their capacity.

Supplier of Semi-processed Industrial Products

As discussed earlier, Pakistan is one of the top exporters of yarn and fabrics which are semi-processed industrial products and are thereafter processed further for final consumption by other foreign producers. The level of preemption of country's value added potential through such leakages is very high. The following chart shows the extent of this leakage. For 100 Kg of cotton available in Pakistan, 50 Kg of it is exported in the form of yarn, greige and processed fabric.

Chart - 4: Preemption of Potential

The rest of the 50 Kg fiber is then used for both the consumption of the local market and the export of consumer products. The figures in the blue blocks show the quantum of value addition available at each stage and reveal that half of our acquired raw material is exported without value addition. It can be safely estimated that around US$ 12 billion more can be earned from the same amount of fiber if all is converted into consumer products.

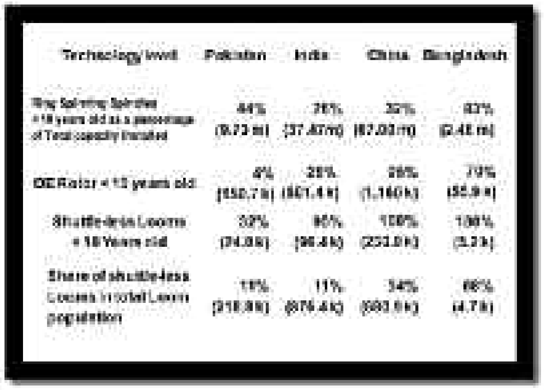
It needs to be emphasized that even within the value-added segment (consumer products) we are presently heavily dominated (as much as 2/3rd) by the home-textiles which fetch a significantly lower value compared to garments where values are significantly higher.

Outmoded Technology and Machinery

With the exception of the spinning industry, in almost all sub-sectors the state of plant and machinery is mostly outmoded. This poses a huge challenge in producing quality products that can capture the best prices internationally.

Spinning is the only sub-sector of the textiles industry which comes in the formal sector of the economy. The investment has also remained skewed towards this sector. The following chart shows a comparison with our competitors in the spinning and weaving sector.

Table-6: Age of Machinery and Technology



Technology level	Pakistan	India	China	Bangladesh
Ring Spinning Spindles < 10 years old as a percentage of Total capacity Installed	44% (9.73 m)	76% (37.47m)	32% (87.03 m)	83% (2.48 m)
OE Rotor < 10 years old	4% (150.7 k)	28% ([illegible])	28% (1,160 k)	79% ([illegible])
Shuttle-less Looms < 10 Years old	32% ([illegible])	86% ([illegible])	100% ([illegible])	100% ([illegible])
Share of shuttle-less Looms in total Loom population	11% ([illegible])	11% ([illegible])	34% ([illegible])	66% (4.7 k)

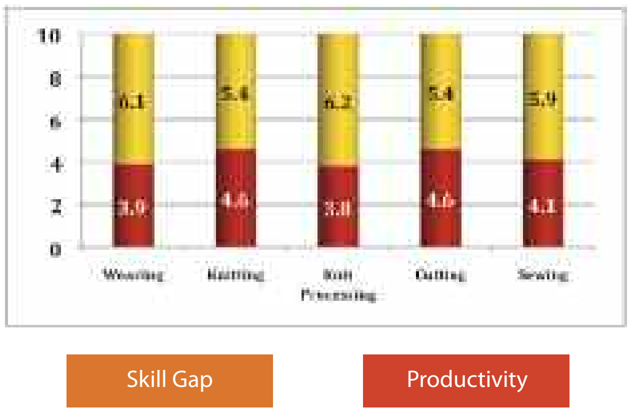
It is evident that Pakistan is lagging way behind in terms of investment in the rotor technology in the spinning sector which is more energy efficient and has higher productivity levels. Similarly, investment in shuttle-less technology is old and meager compared to our competitors.

The need for major investments in technology up-gradation is inescapable. The new Textiles Policy has provided necessary incentives to encourage investments in all segments of the textiles industry. These investments will have major impact on both employment and exports.

Low Labor Productivity

Low labor productivity also accounts for the inefficient use of local fiber base. The following chart which is based on Werner Benchmarking Study shows that our labor productivity levels are around 40% if compared to international benchmarks across the value chain.

Chart - 5: Labor Productivity



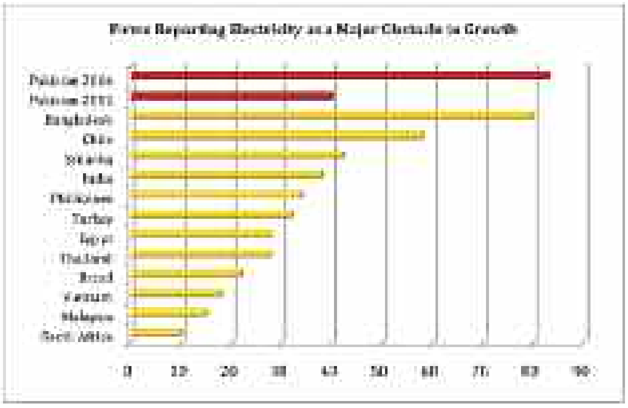
To address the productivity gap, under the new Textiles Policy, a major effort is being launched to train 500,000 stitching machine operators over the next five years. It is estimated that the country will need some 2.5 million additional skilled workers in the textiles sector to push country's exports to $25 billion over the next five years. Accordingly, more efforts will be required to fill the needs of the industry.

Lack of Infrastructure Facilities

An area that is a source of perennial problems for the industry is absence of reliable and dependable infrastructure facilities. Availability of energy, especially, is a major handicap our industry faces. This is an input whose uncertain supplies renders the entire value chain vulnerable to risk of default in meeting their commitments to foreign buyers. More importantly, additional costs borne by the industry during periods of load-management render our exports uncompetitive, thereby adversely affecting our exports.

The extent to which the industry has been affected by lack of infrastructure is reflected in a survey by the World Economic Forum that depicts that firms reporting electricity as a major obstacle to growth in Pakistan increased from below 40% in 2002 to above 80% during 2006. Clearly, things have not changed for good since and accordingly the government policy is centered in on radically altering the existing capacities in the power and gas sectors. In the years ahead, Pakistan is poised to leave behind power and gas shortages as major additions in supplies are in the pipeline.

Chart - 5: Labor Productivity



Low Export Values and Marketing Issues

The problems we have listed ultimately show up in the poor exports performance the country is registering. Even though we are the fourth largest producer of cotton and third largest consumer, yet our status amongst the leading exporters is unenviable. Table- shows the world ranking of leading textiles exporting nations.

Table-7 gives the ranking of nations in global textiles at two different periods in time, 2004 and 2009. This is the period after the abolition of Multi Fiber Arrangement (MFA) and opening of the world markets for textiles exports. The world textiles exports have undergone a staggering 15% growth during this period. It will be noted that Pakistan is at the bottom of the top 15 countries capturing nearly 75% of the global trade in textiles. The growth rate of under 8% in our exports compared to 75% for China, 71% for Bangladesh and 46% for India is a pittance. This is a performance vastly below the potential Pakistan possesses. Occupying a position at the bottom of the table by a country with such strong comparative and competitive advantages is at least an enigma if not an outright squandering of such advantages.

Table-7: World Ranking in Global Textiles Market

Rank	Reporter	2004	2009	Growth	Share 2004	Share 2009
0	World	457,850	526,676	**15.03%**	100.00%	100.00%
1	China	95,284	167,082	**75.35%**	20.81%	31.72%
2	Hong Kong, China	39,393	32,802	-16.73%	8.60%	6.23%
3	Italy	33,588	31,400	-6.51%	7.34%	5.96%
4	Germany	25,915	28,982	11.83%	5.66%	5.50%
5	India	14,109	20,559	**45.72%**	3.08%	3.90%
6	Turkey	17,621	19,278	9.40%	3.85%	3.66%
7	France	15,395	15,684	1.88%	3.36%	2.98%
8	Belgium	13,905	14,634	5.24%	3.04%	2.78%
9	United States	17,048	14,117	-17.19%	3.72%	2.68%
10	Bangladesh	6,893	11,797	**71.14%**	1.51%	2.24%
11	Spain	7,786	10,571	35.77%	1.70%	2.01%
12	Korea, Republic of	14,230	10,551	-25.85%	3.11%	2.00%
13	Netherlands	9,084	10,448	15.02%	1.98%	1.98%
14	Viet Nam	4,891	10,444	113.54%	1.07%	1.98%
15	Pakistan	9,151	9,867	**7.82%**	**2.00%**	**1.87%**

To understand where we are missing our potential Table-8 is reveals some important facts. Textiles and Clothing is a broad distinction between highest value added products (clothing) and the rest of the products (textiles). The distribution of world trade between these categories is shown in Table-8. Notice that nearly 60% of world trade is in the clothing, and our competitors are enjoying even a bigger share this. On the other hand, we have less than 40% share of clothing in our exports.

Table-8: Shares in Textiles and Clothing

Rank	Reporter	Textiles	Clothing
0	World	40.07%	59.93%
1	China	35.80%	64.20%
2	Hong Kong, China	30.41%	69.59%
3	Italy	37.54%	62.46%
4	Germany	42.90%	57.10%
5	India	44.29%	55.71%
6	Turkey	40.06%	59.94%
7	France	35.83%	64.17%
8	Belgium	42.91%	57.09%
9	United States	70.35%	29.65%
10	Bangladesh	9.08%	90.92%
11	Spain	33.64%	66.36%
12	Korea, Republic of	86.77%	13.23%
13	Netherlands	41.39%	58.61%
14	Viet Nam	17.38%	82.62%
15	Pakistan	65.98%	34.02%

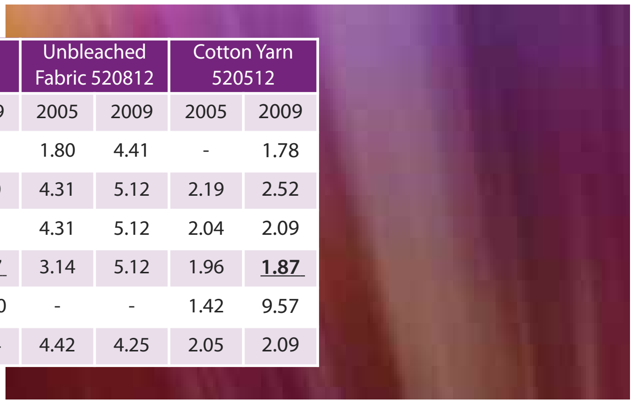
It is also equally important to compare what values our products are capturing relative to our competitors. For this purpose, we find Table-9 most illuminating. Here unit values of exports during the two periods 2004 and 2009 are given both for Pakistan and its competitors in selected exports items.

Evidently, in almost all the products we are significantly lagging behind our competitors as their prices, for comparable quality, are higher than ours. This is yet another reflection of how we are losing out in our comparative advantage.

A multitude of factors are responsible for this loss in exports values. Undoubtedly, the factors we have listed earlier have a role. But here we would like to highlight two other factors which are not related to production efficiency and management of value chain. The first is marketing issues. Pakistan, unfortunately, is not carrying a good image despite phenomenal costs the country is incurring in fighting the war on terror. The ways in which this war is affecting our economy includes production disruptions due to law and order problems as well as the challenges we face in marketing our products.

Table-9: Changes in Unit Values of Selected Exports for Pakistan and Competitors

	T-shirts 610510		Men Bottoms 620342		Bed sheets 630231		Towels 630260		Unbleached Fabric 520812		Cotton Yarn 520512	
	2005	2009	2005	2009	2005	2009	2005	2009	2005	2009	2005	2009
B'Desh	2.56	4.08	2.61	6.23	5.38	7.52	4.00	4.13	1.80	4.41	-	1.78
China	2.68	4.22	3.92	5.60	9.31	10.85	7.84	9.40	4.31	5.12	2.19	2.52
India	4.47	4.46	5.81	7.43	8.68	8.74	4.31	6.55	4.31	5.12	2.04	2.09
Pakistan	3.63	3.75	6.93	4.85	5.64	5.67	3.75	3.57	3.14	5.12	1.96	1.87
Srilanka	7.07	7.02	7.29	8.12	5.27	6.32	3.63	16.70	-	-	1.42	9.57
Turkey	7.95	9.52	13.06	14.51	8.05	8.40	7.28	8.04	4.42	4.25	2.05	2.09



From almost all leading exports destinations buyers have travel advisories so that they find it difficult to visit Pakistan. To seek orders outside Pakistan, adds to the cost of doing business, besides huge inefficiencies in obtaining approval of samples.

The second aspect is market access. Pakistan, despite a much smaller size compared to China and India in production and consumption of cotton, is bracketed with them and hence faces limited market access to key exports markets, namely USA and EU. Our dependence on these markets, compared to these countries is too high. Nearly 62% of our exports are concentrated in USA and EU markets (Table-10) which aggravates the consequences of limited access. On other hand, some of other competitors are enjoying preferential access on different accounts, such as free-trade agreements on special country status.

Table-10: Exports Concentration

	USA	EU	Others
China	15.26%	26.56%	58.18%
India	19.52%	38.04%	42.44%
Pakistan	29.23%	32.78%	37.99%

Little support is given to Pakistan on account of war on terror that is imposing considerable burden on the economy. Given the labor intensity of value-added products in the textiles sector, provision of market access will have salutary effects on country's employment situation and young people will not fall pray to extremist agendas.

A Measure of Value Added Loss

As we have argued in this paper, Pakistan is losing immensely in realizing its true potential from the textiles sector. In Table-11, we have attempted to generate an index that could capture the extent of the lost potential. Here we have considered the total consumption of cotton by four countries which are in the same vicinity and looked at the total value of production made, exports volume and finally calculated the value per bale of consumption. Evidently, China is converting every million bale into $4 billion, while India is converting every million bale into about $2 billion and Pakistan is converting every million bale into less than $1 billion. The case of Bangladesh is somewhat different as it is not a primary producer of cotton, and yet it is interesting as it has created a niche for itself in clothing where it offers perhaps the cheapest labor in the world. Much of its clothing is made through the imports of fabric from other countries mostly notably from Pakistan.

Table-11: A Measure of Value Added Loss

	Cotton Consumption (Million Bales)	Value of Production (US$ Million)	Exports (US$ Million)	Value per million bales (Billion)
China	61.7	238,920	171,205	3.87
India	25.3	49,000	19,100	1.94
Pakistan	15.2	14,360	11,177	0.94
Bangladesh	2.9	14,500	10,778	4.93

What Table-11 tells us is that for the same amount of cotton in Pakistan (about 12 million bales) the present level of value-added is $15 billion will by double in India and quadruple in China. This is a staggering loss of value. If we can prevent it, it will relieve the country of much of its economic woes. Policy makers have to take notice of this loss and design policies and strategies so that this hemorrhaging of national potential.

1. I am extremely grateful to Mr. Kanwar Usman and Abbas Mehdi of Research and Development Cell of Ministry of Textiles, who have helped me in the preparation of this paper. All mistakes are mine.

2. Although critical, we will not discuss here the issues relating to farm productivity in cotton, due to space limitations. However, it is to be noted that significant progress needs to be made in this area as well, and the adoption of Bt Cotton is the most basic requirement in this regard. Positive steps are already under way to fill this gap which will result in major augmentation in the size of country's cotton crop.

Circular Debt Crisis in Pakistan

ICAP Research

The state of affairs of the Islamic Republic of Pakistan is at a very critical juncture; the political situation is in disarray, the economy has recovered from a global financial crisis that in essence should not have had any direct impact on Pakistan, and socially the country is muddling through very dangerous waters. The state of the economy is in an abysmal state not so much because of the global economic slide but because of three very pressing and pertinent issues: the strenuous fiscal deficit, acute energy shortage and its rising costs and the huge inter-corporate circular debt of the energy sector.

According to the latest figures published by the State Bank of Pakistan in its 'Second Quarterly Report on the State of the Economy', the economy has shown a moderate yet fragile recovery in the first half of the current fiscal year. The positive is largely because of a gradual increase in the aggregate demand, supplemented by improvement in various key economic indicators.

The most discernible expression of this has been in the recovery of the manufacturing activity in the country. The manufacturing sector, after performing fairly poor over the last fiscal year, has managed to post a 2.3% growth rate during the first half (July-Jan FY10). This sector managed to do well, in spite of continued energy shortages and rising costs of production; especially on imported raw material inputs and electricity. Inflation, on the other hand has maintained a rather rigid stance. It had gone down to 8.9% [1] in October 2009 but then reached 12.6% [2] in February 2010 and 13.3 % in April 2010. [3] This rigidity in inflation is largely due to:

- Inflationary trends (rising commodity prices) in the global markets;
- Rupee value depreciating against the dollar;
- An increase in the aggregate demand resulting in a moderate recovery in the domestic economy; and
- An upward adjustment in administered prices of power and key fuels.

On the plus side however, key fiscal indicators improved in the second quarter of FY10 over the previous quarter, resulting in a cumulative fiscal deficit for H1-FY10 of 2.7 [4] percent of the annual estimated GDP. The second quarter of FY10 also registered an improvement in the revenue growth largely due to better direct tax collections. Moreover, the tax collections were also supplemented by a revival in the economy and a rise in rupee value of imports. Similarly, on the expenditure side, the government was able to contain growth in total outlays during the quarter. However, given the stickiness in the current expenditure on account of the need to address the piling energy sector circular debt, security related expenditure etc, the government has had little choice but to cut development spending, if pledges by Friends of Democratic Pakistan (FoDP) are not realized and lags in reimbursement of Coalition Support Fund continue.

Selected Economic Indicators

(Source: State Bank of Pakistan Indicators

		FY08	FY09	FY10
Growth rate (percent)				
LSM	Jul-Jan	5.6	-5.4	2.3
Exports (fob)'	Jul-Feb	7.4	3.5	2.7
Imports (cif)'	Jul-Feb	21.9	-1.5	-8.2
Tax Revenue (FBR)	Jul-Dec	6.0	27.3	5.1
CPI (12 Month ma)	Feb	8.4	21.7	12.6
Private sector credit	Jul-Feb	11.7	4.6	4.7
Money supply (M2)	Jul-Feb	7.4	2.0	5.7
billion US dollars				
Total liquid reserves[2]	end-Feb	14.1	10.1	14.8
Home remittances	Jul-Feb	4.1	4.9	5.8
Net foreign investment	Jul-Feb	2.8	1.9	1.0
percent of GDP'				
Fiscal deficit	Jul-Dec	3.5	1.9	2.7
Trade deficit	Jul-Feb	8.2	8.1	6.3
Current A/c dificit	Jul-Feb	7.7	6.8	2.2

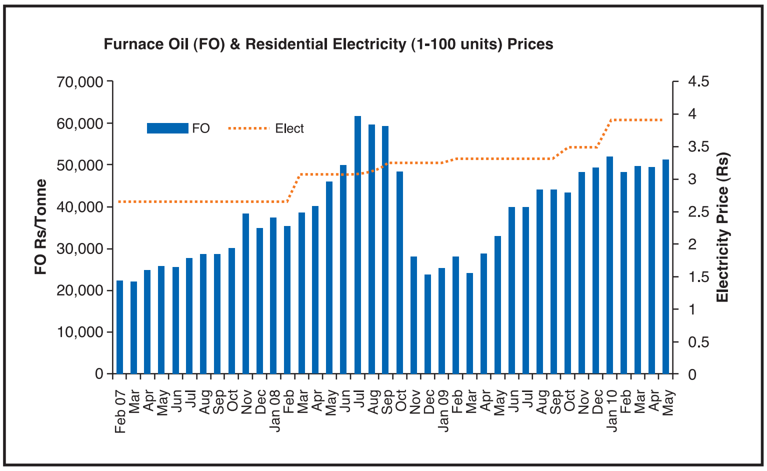
1. Trade data compiled by FBS.
2. With SBP & commercial banks
3. Based on full-year GDP in the denominator. For FY 10. estimated full Year GDP has been used.

Keeping all things considered, there stands an acute need for serious policy efforts to achieve sustained high growth. This needs both macroeconomic stability and political stability and a need of reduced government intervention in the market systems. These, complimented with reforms centered on institution building and governance might just do the trick.

WHAT IS CIRCULAR DEBT?

By Definition, Circular debt refers to a chain effect whereby funds of one company get blocked with another company, thereby making it difficult for the first company to pay off its creditors. In Pakistan, the Circular Debt crisis has affected most companies that make up the energy sector. The debt circle begins with PEPCO, a government-owned entity as the biggest debtor and ends with public / government owned entities such as OGDCL and local refineries as the biggest creditors.

HOW DID IT ARISE?



The problem stemmed in 2007 because of a disparity between generation costs and tariffs of Energy whereby the Government of Pakistan kept energy tariffs constant even though generation costs kept on increasing giving rise to a substantial cost-tariff differential. The situation further aggravated during 2008 because of phenomenal increases in the international oil prices.

As this differential kept increasing, power producing companies became increasingly unable to collect receivables from distribution companies, in turn disabling them in making payments to their fuel suppliers, thus resulting in a circular debt situation.

The country's largest electricity generator and supplier, PEPCO, is the main source of generating the circular debt crisis.

WAPDA T&D Losses As % of Net System Energy	
Year	T&D Losses (%)*
2000-01	24.3
2002-03	24.4
2005-06	22.4
2007-08	21.3
2008-09	21.1
July March	
2008-09	19.4
2009-10	19.6
* T&D= Transmission & Distribution	
	Source: PEPCO

Latest energy statistics show that WAPDA produces 24% of its electricity from gas; bought from SSGC and SNGPL; and 17% through Furnace Oil; bought from PSO and other Oil marketing Companies. WAPDA also purchases costly power from Independent Power Producers (like HUBCO, KAPCO, and few small IPPs).

Thus being at the hub, the entire energy supply chain gets affected whenever PEPCO delays payments.

According to an estimate circulated by the Pakistan Electric Power Company there currently stands a gap of 4480 MW in the electricity demand (14680 MW) and supply (10200 MW).[5] The Transmission and distribution (T&D) losses as a percent of net system energy remain stagnant at around 21 to 25 percent, from 2000-01 to 2008-09.[6]

WHO ARE THE MOST AFFECTED?

The entities most adversely affected by the Circular debt crisis are the Power Producers such as HUBCO, KAPCO, Oil Marketing Companies (OMCs) like the Pakistan State Oil (PSO) and refineries and E&P companies like Pak-Arab Refinery Ltd (PARCO) and OGDCL. As a result, the primary focus of the energy sector companies has shifted from energy business developments to energy crisis management.

Local refineries and E&P Companies are operating at lower capacities. E&P companies have reported a 22% decline in their drilling activities, thereby causing a decline in refinery capacity utilization (to below 80%) during last one year. This has already taken heavy toll on the indigenous production of energy resources.

All OMCs except PSO kept themselves at a distance to any FO arrangement with PEPCO, resulting in an increased burden on PSO's cash flows to fuel the energy chain. Resultantly, energy companies, particularly PSO, have touched their borrowing limits resulting in an exorbitant increase in financing cost of the entire energy sector thereby hurting profitability.

In addition, the masses are struggling to cope with high inflation, scarce employment opportunities and several hours of load shedding.

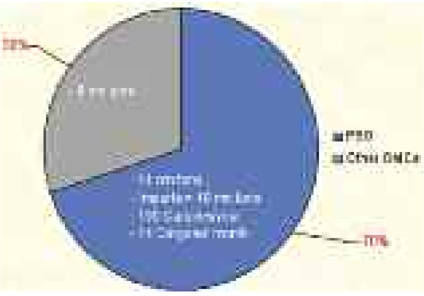
SITUATION AS ON APRIL 30, 2010

Despite gradual payments by the government through TFCs, energy companies still face liquidity constraints, thereby affecting their business operations. Since then this amount has been growing; reaching to around Rs 104 billion in the month of April 2010 [7] as no major payments were made by the government during 1H2010. According to other estimates being regularly quoted in various forms of media, the circular debt amount has risen to between Rs. 120 billion and Rs. 150 billion.

Country's Fuel Consumption

Out of 20 million tons of total fuel, PSO handles 14 million tons which is 70% of liquid fuel demand of the economy. Out of 14 m, PSO imports 10mn tons with 160 cargoes per year (14 cargoes a month).

Total Liquid Fuel demand of Pakistan = 20 mn tons



Receivable / Payable Trend of PSO

The receivables of PSO stood at Rs 129.5 billion which is increasingly being financed by bank borrowings of Rs 42.8 billion and PSO's own funds i.e. profits available for distribution as dividends. The reason for this was that monthly receipts against supply of fuel were substantially less than the amount receivable for such supply. The company was becoming increasingly leveraged and this could potentially affect the ability of the company to open Letters of Credit with banks. PARCO and other companies supplying fuel to the power generation sector were also facing the similar crisis.

In the overall scenario, Rs 250 billion was the net payable required from the Government through PEPCO. The current year shortfall projections by PEPCO are of Rs 250 billion of which only Rs 30 billion has been reflected in the federal budget. It is also noted that a 35% to 48% increase in power tariff would be necessary to eliminate the gap.

Recent situation of Circular debt as on 24th December 2010 [8]

The circular debt of the energy sector has been hovering around Rs180 billion that has crippled the financial health of entities operating in this field. The federal government attempted to tackle this crisis by floating the Term Finance Certificates and also formed a banking consortium, but the debt issued continued to undermine this sector that could make the companies engaged in this business unviable. [9]

The government is a major defaulter in the circular debt accounting for more than Rs 140 billion in the shape of price differential and non-payment of utility bills. The ability of energy companies to cope with this crisis is getting worse with the passage of time. The energy debt has been prevailing in the country several years, but it has been aggravated in recent times after the government introduced the price differential framework. A strong political will and good governance were essential to eliminate the debt issue. The formula of price differential, sky-touching line losses (about 40 percent), subsidy to FATA/non-payment of bills, outdated power plants, low efficiency and generation of high cost of electricity have dragged this sector into an unending financial crisis.

The oil marketing companies were the key victims of the circular debt dilemma as they had to import fuel for the domestic consumption and to maintain 21 days strategic reserves. The Federally Administered Tribal Areas (FATA) were inflicting a tremendous loss of Rs 80 billion a year in due to the subsidy on the supply of the electricity and non-payment of the bills. The oil refineries were running at 60-65 percent due to the debt crisis and in order to avoid more losses. The refineries should be facilitated in enhancing their production capacity to the highest possible level so that imports can be reduced leading to a decrease in the drain of foreign exchange and congestion at ports.

The line losses in Pakistan were the highest in the world. The average line losses around the world were about 5-7 percent, but in Pakistan this ratio was 40 percent out of which the share of the theft of electricity remained around 32 percent. The international crude oil prices could surge further from the current level of $93 dollars a barrel that would further augment price hike and aggravate the energy debt and crisis.

In the past the resources of generating cheaper electricity like nuclear, wind, solar, coal and hydel, have been neglected that ultimately landed the country and energy sector into serious trouble. According to the governmental statistics with nuclear technology the country can generate one unit of electricity for only 80 paisas as against the current thermal rate of 8-14 rupees a unit. About 15 years ago China gave Chashma Nuclear Power Plant to Pakistan and similar options could have been explored to produce inexpensive electricity.

For a way out of the current crisis the lines losses should be brought to the affordable level, low-cost electricity should be produced, efficiency should be increased in the generation and transmission system, hydel and alternative energy sources should be explored instead of buying the world's most expensive electricity from the rental power plants.

WHAT IF THE CIRCULAR DEBT ISSUE IS NOT RESOLVED?

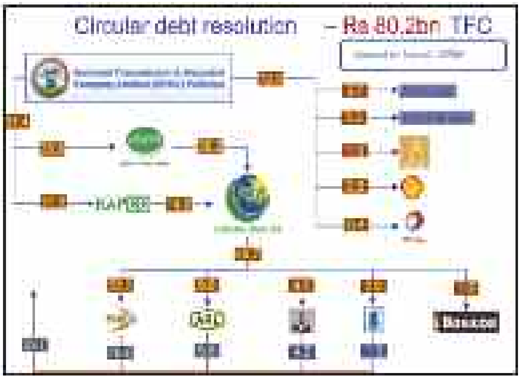
If the circular debt issue is not resolved at the earliest, chances are that the following events might take place:

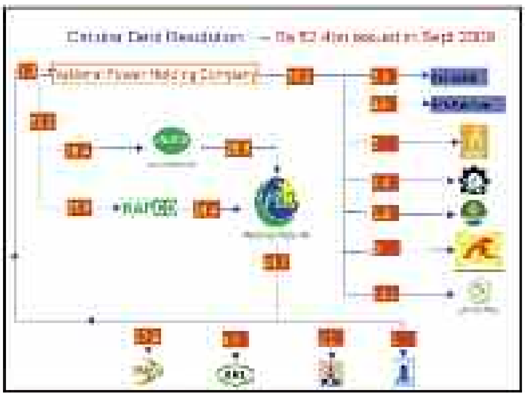
- Refineries and PSO in particular might default on their import L/Cs, which would result in a deterioration of credit rating of the country.

- Consequently, the L/C confirmation risk will fall on the energy sector companies rather than the foreign banks, leading to rise in fuel costs.
- In addition, it would become very difficult to open fresh L/Cs and make further imports.
- The resulting shortage of furnace oil in the country will lead to an even more severe power crisis and an altogether halt in industrial production.

MEASURES TAKEN BY THE GOVERNMENT- TO DATE:

In order to provide some relief to the energy sector from the issue of circular debt, the Government of Pakistan has so far issued two Term Financing certificates; one in March 2009 worth Rs. 80.2 billion and the other in September 2009 worth Rs. 82.4 billion.





In June 2010, the Prime Minister had ordered the relevant ministry to issue Rs. 41 billion to the sector to lessen the debt burden of the energy sector.

THE ENERGY SUMMIT 2010 AND ITS AFTERMATH:

A three day energy conference was held in April 2010 by the government, including key stakeholders of the industry. The Prime Minister, Mr. Yousuf Raza Gillani, addressed the conference promising the people of the country that there would be no unscheduled power interruptions and a 33 percent cut in scheduled load shedding. Unfortunately, his promises have not yet seen any daylight as the country is still facing unscheduled load shedding while circular debt is on a continued rise. However, reducing load shedding is not something the government can readily do as the power generation capacity; that needs to be enhanced at a priority basis; cannot be enhanced anytime in the near future for several reasons. Power generation, in fact, has further reduced after the promises made after the energy summit and therefore, the 500 MW savings plan [10] through conservations method could not bring in desired results.

According to the plan presented, the government had also planned to undertake four-pronged measures including conservation - to save 500 MWs; short-term measures: to make operational 10 IPPs for an immediate addition of 300 MWs and 1305 MWs by end of year, while, 605 MWs to be added through rental power; Financial measures to ensure payment of Rs 116 billion to reduce the circular debt and to ensure no recurrence in future; and long-term measures: Addition of 21,000 MW through hydel power, 30,000 MW through coal and 15,000 MW through other sources.

ENERGY CONSERVATION

- According to the study in 2001-02 Pakistan had 3000 MW of energy surplus and in 2002-03 Government gave this surplus to agriculturist at subsidized rates for the conversion of their broad based diesel engines to energy, but this consumes a lot of energy as calculated.
- The country has 90 million cellular phones and every set consumes 5 watts during charging. If everyone charged their mobile at night it takes 500MW of the total energy.
- Energy towers which are supported by electricity panels and generators by different mobile companies consume a lot of energy. There should be one company to provide this facility to all the cellular companies.
- ATM machines and their cooling units also use a lot of electricity
- Dumped Monitors from all over the world imported in the country which consumes a great part of the electricity production. So Government should stop these kind of imports on priority basis.
- 20% of the total demand goes in lighting. Energy savers need to be placed to save 30% of the total energy i.e 800MW
- Inefficient second hand appliances should be banned.
- Occupancy sensors should be introduced and propagated.
- Cement industry has shifted to coal since last 5 years which is imported mainly from South Africa and Indonesia. If that coal is used by HUBCO or any IPP on the coastal line by using coal fired engine we can generate energy on cheap rates. Example: In Khushab Imperial Chemicals generated 5MW of energy through coal.
- Inefficiencies of the IPPs in energy production.

HOW CAN IT BE RESOLVED?

There seems to be no quick solution to the circular debt problem. The country needs a nationalistic reform or rather a nationalistic revolution whereby the needs of the country are addressed on priority basis. Rather than playing political volley with the issues of the country, serious and honest attempts need to be made to align national and personal agendas in the interest of the country as a whole. The proposed solution should come in two parts:

a) How can the bleeding be stopped as of today? and
b) How to resolve the outstanding debt?

Better fund management mechanisms need to be introduced within the industry, both by the government and the energy sector. PEPCO's collection system is the biggest hole in the sector's cash flows, which needs to be improved on a top priority basis through implementation of efficient ERP / Accounting systems and through the hiring of professionals:

- Distribution and transmission losses need to be stringently controlled, thereby bridging the demand supply gap and thus enabling efficiencies and improvement in cash flows.
- Continue 4-6 hours load shedding and to stick to the scale will provide a cover up to supply demand gap. There should be restriction of power usage by timely business activities.
- Construction of more dams in order to conserve the rapidly depleting water resources. Similarly, the energy sector needs to experiment with alternate, renewable energy sources for production of electricity, thereby ridding dependence on scarce non-renewable resources. The government should also relook Gas allocations and find alternative ways to conserve and use this cheap resource.
- Increase gas allocation rather than oil as the fuel for IPPs
- Globally, almost 40 per cent of electricity generation is currently based on coal. Pakistan's coal resources are estimated at 184.5 billion tones (82,700 MTOE), 95 percent of which are in the Thar in Sindh. Currently, the share of coal in the energy mix is less than 7%. Only one 150MW Lakhra Power Plant is operating on coal. The local coal can be used more effectively if mining sector is re-organized and mining is developed in the Thar region.
- Both of Pakistan's natural gas companies (Sui Northern Gas Pipelines Ltd and Sui Southern Gas Company) should make it a priority to produce an additional 300-400 million cubic feet of gas which is quite possible if gas tariffs are raised to economic levels. This will provide enough gas to fuel an additional 2,000MW of electricity.
- The power infrastructure should be upgraded with a modern efficient grid. Without such an investment there will be little improvement even if major new generation facilities are built.
- Timely recovery of receivables of state owned Power distribution company PEPCO from Provincial/ Federal governments and departments including FATA and private sector, enabling PEPCO to maintain sufficient liquidity in the energy sector through timely payments. The existing net balance position should be specifically determined and cleared through issue of debt instruments by the Government. Further, to prevent future increase in the circular debt, the hemorrhaging between the sale price (tariff) and the cost to the Distribution companies should be eliminated.
- Prices of all energy products should be rationalized through cross-subsidization.
- Price subsidies on all energy products should be eliminated and fuel prices be linked to prices quoted internationally. Targeted subsidies should be offered only if required for social reasons and paid for out of government revenues not by energy producers.
- Petroleum Levy collected by GoP on POL products should instead of being accounted for as another source of government revenue, be utilized to support the power sector for settlement of their debts. As an alternative to commercial borrowing (TFCs), the government should consider issuing Tax-free Energy Bonds to the general public to raise funds for periodic resolutions of circular debt.
- As was the case in the 90s, when initially the circular debt issue had arisen on a smaller scale (Rs. 4.4 billion), the Government and 3 companies namely PSO, KESC and NRL had settled the issue by netting off receivables and payables of the involved parties. If the same is done today, the cumulative debt burden can be reduced by some Rs. 40-50 billion. Central co-ordinating office to set off the existing debt.
- Import LNG from Qatar, which is cheaper than crude oil.
- Disposal of inefficient units by WAPDA and encouragement of efficient production by IPPs by providing incentives.
- Finally an increase in the Direct tax collection will help the revenues situation of the government; thus increasing their ability to pay off their obligations timely.

The issue of circular debt is becoming chronic as days progress. The government has been trying in vain to prevent this inter-corporate debt from blowing out of proportions but their short-term measures are rendering no fruit.

The government should immediately stagger this problem, which is going to put more burden on consumers already reeling under high food and fuel costs. To strike a balance between consumer interests and the government's budgetary problems, power utilities will have to be restructured along professional lines to enable them to recover their dues from consumers without any discrimination. At the same time, the distribution companies need to be told to control transmission losses and theft that results in the wastage of 40 per cent of electricity. Only then will the government be able to wipe out the circular debt permanently and bring down power tariffs.

1. The State of Pakistan Economy – State Bank of Pakistan Second quarterly report.
2. The State of Pakistan Economy – State Bank of Pakistan Second quarterly report.
3. Pakistan Economic Survey 2009-10.
4. The State of Pakistan Economy – State Bank of Pakistan Second quarterly report.
5. As Quoted by Dawn- May 11th 2010.
6. Economic Survey of Pakistan 2009-2010.
7. Economic Survey of Pakistan 2009-2010.
8. Pakistan Today Tuesday, December 28, 2010.
9. The President, Petroleum Marketing Business of Byco Kalim A Siddiqui Press Conference on 28 December 2010.
10. Details Annexed – Appendix C.

Project on Business Reporting June 2010

IFAC project on business reporting

In response to the report, Financial Reporting Supply Chain: Current Perspectives and Directions (March 2008), IFAC established a project group* to study progress in the areas of governance, financial reporting, and auditing. Developments in the Financial Reporting Supply Chain—Results from a Global Study among IFAC Member Bodies was issued in February 2009. This study indicated that, although progress had been made, several unresolved issues remain. In the final phase of this project, the project group has interviewed 25 key leaders from around the globe on what should be done to improve these areas.

In upcoming months, the interviews, including overviews of the recommendations, will be available on the IFAC website, grouped in the following themes:

- Good governance and sustainability fundamental to improved business reporting
- Business reporting: beyond the crisis
- Business reporting through the lens of the investor
- A global language for business reporting
- Towards a broader view of business reporting

Subsequently, the project group will develop an action plan, based on the recommendations of the interviewees and taking into account the reader response.

* *The project group consists of Charles Tilley (Chief Executive Officer of CIMA and Project Chair), Graham Ward (Senior Partner at PricewaterhouseCoopers and past IFAC President), Norman Lyle (retired Group Finance Director of Jardine Matheson Holdings Limited and Chair of IFAC's previous Financial Reporting Supply Chain Project), and Al Anderson (Managing Principal Accounting and Assurance Services of Larson Allen and Chair of the Assurance Services Executive Committee of the AICPA). The steering group is assisted by Stathis Gould and Vincent Tophoff (both IFAC), and Amy Pawlicki (AICPA).*

Good Governance and Sustainability Fundamental for Improved Business Reporting

"In times like this, the basic elements of managing a company, such as governance, accounting, and auditing, should stand out like a rock in the storm," says Joe Kaeser, chief financial officer of Siemens, the Germany-based global company engaged in electronics and electrical engineering, in an interview with the International Federation of Accountants (IFAC). In light of the corporate challenges it has faced in recent years, Siemens has implemented a company-wide transformation program that brought about two significant mindset changes: seeing integrity and performance as not mutually exclusive ("clean business always and everywhere"), and defining corporate governance in a way that provides space for entrepreneurial behavior, focused on long-term sustainable value creation for all stakeholders. The result is greater transparency and high-quality business and financial reporting.

The interview with Mr. Kaeser, alongside interviews with Guy Jubb, investment director and head of corporate governance at the Edinburg, UK-based leading global investment company Standard Life Investments; professor Mervyn King, author of the King Code on Corporate Governance for South Africa (King III); and Masayasu Uno, member of the board of corporate auditors of Daito Construction and Trust in Japan, forms the first part of an interview series on improving business reporting conducted by IFAC with 25 key leaders from around the globe.

From different perspectives in the business reporting supply chain, the four interviewees provide their insights into how good governance and increased sustainability are fundamental for achieving long-term social, environmental, and economic performance, and for enhancing investor and other stakeholder confidence. The key findings from these interviews were:

The Business Reporting Supply Chain

The business reporting supply chain refers to the people and processes involved in the preparation, approval, audit, analysis, and use of business reports. All links in the chain need to be of high quality and closely connected to supply high quality business reporting.

Governance should focus on longer-term sustainable value creation

"Corporate governance defines the mandatory boundaries," explains Mr. Kaeser. However, he highlights the idea that corporate governance also needs to focus on longer-term, sustainable value creation. Focusing on longer-term sustainable value creation requires governance and sustainability to be better integrated into the strategy, operations, and stakeholder communications of an organization, according to South African governance expert Professor King: "Directors have to realize that their ultimate responsibility is social, environmental, and economic performance. That requires a mindset change at the top and then the top has to make sure that the message is carried further down the organization. You all have heard of 'the tone at the top.' I talk about 'the tone at the top, the tune in the middle, and the beat of the feet at the bottom.' If you get your strategy right and you get buy-in, you get ordinary people to achieve the most extraordinary things!"

Business reporting should be integrated as well

Mr. Jubb extends the theme of integration by pointing out that business reporting at the moment is very compartmentalized, with governance, social responsibility, and sustainability reports often churned out independently. "As these aspects are integral to the longer-term wealth and health of the company and to its reputation," he advises companies to "bring them more together in one integrated business report." Mr. Uno adds to this by recommending that "increased consciousness about corporate social responsibility should lead to the development of more comprehensive corporate reports."

With the benefit of hindsight on the financial and economic crisis, however, Mr. Jubb points at the scars we all bear from not holding boards accountable for their stewardship of the assets under their control. In the interview, he therefore also recommends putting the governance concept of stewardship at the heart of the business reporting system, "focusing on what the board has been doing and how it has been doing."

Cultural background and history should not be ignored

The governance arrangements that can lead to improved business reporting do not necessarily have to be completely uniform around the globe, argues Mr. Uno. He points out how the Japanese corporate governance system differs from the western model, since it has evolved while preserving Japanese Good Governance and Sustainability Fundamental for Improved Business Reporting culture and history. He therefore suggests that one not ignore cultural background and history when developing and implementing global standards, regulations, and oversight: "In further improving the business reporting supply chain, we must keep our eye on the unique situations in various countries."

The complete interviews with Guy Jubb, Joe Kaeser, professor Mervyn King, and Masayasu Uno can be downloaded, free of charge, from the IFAC website at www.ifac.org/frsc. Readers are encouraged to respond to the recommendations of the interviewees, which are also available on the website.

For information about IFAC's business reporting project, please contact Vincent Tophoff via VincentTophoff@IFAC.org.

Business Reporting Beyond the Crisis: How to Make Sure That We Don't Tumble Into Another Black Hole

"My general conclusion is that everyone is guilty," says Jules Muis—former Ernst & Young partner, controller of the World Bank, and director-general audit of the European Commission—about the financial crisis. "The whole implosion is based on negligence by senior management of banks and other financial institutions, by investors, by auditors, as well as by regulators."

The interview with Muis—alongside interviews with John Coombe, chairman of Hogg Robinson Group plc, non-executive director of HSBC, non-executive director of Home Retail Group plc, and former chief financial officer of GlaxoSmithKline plc; Jane Diplock, chairman of the Securities Commission of New Zealand, chairman of the Executive Committee of the International Organization of Securities Commissions (IOSCO), and member of the Financial Crisis Advisory Group; and Richard Petty, associate dean and professor at the Macquarie Graduate School of Management, Sydney, chairman of a Hong Kong-based investment company and president of CPA Australia—forms the second part of an interview series conducted by IFAC with 25 key leaders from around the globe on improving business reporting.

From their different perspectives in the business reporting supply chain, the four interviewees provide their insights into how the financial crisis developed and what should be done in the areas of governance, financial reporting, and auditing to prevent such a crisis from happening again.

What went wrong?

The interviewees generally agree on the main issues that caused—or at least exacerbated—the financial crisis, including governance failures by all stakeholders in the financial reporting supply chain, such as a short-term focus and flawed risk management.

According to Jane Diplock, "Corporate governance is really at the core of the global financial crisis," because the links between risk management, performance, and remuneration "all influence the behavior of company management." John Coombe adds, "Too many people were gambling with other people's money and getting huge bonuses when it worked, but losing nothing when it went wrong." On the other hand, as Jules Muis points out, investors are also part of the problem because "a lot of the pressures on management have come from 'short-termism' by investors, turning up the heat on management to seek short-term, ever more high-yielding, hence riskier business models, at the expense of long-term, sustainable performance."

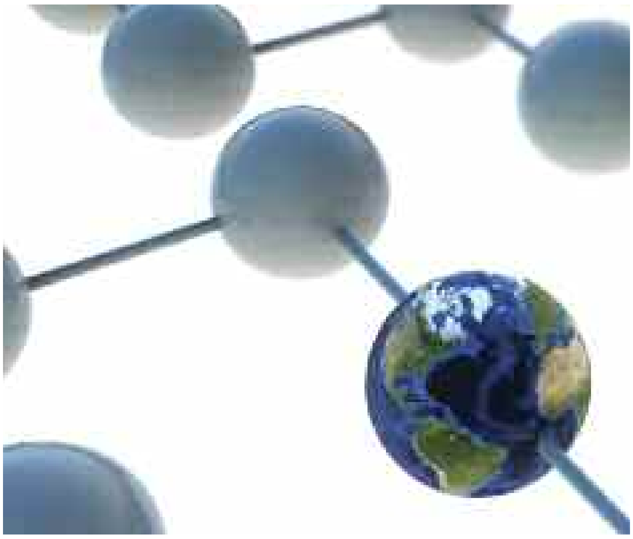
Risk management practices were also flawed, according to the interviewees. "You cannot imagine anything more inimical to the interest of the company than management and boards of directors engaging in such risky activities that could bring the company to ruin," says Jane Diplock. "The fundamental error was in not pricing risk appropriately when the original investments were made," says Richard Petty. "Far too few people had a proper understanding of derivatives and their inherent risk: no one on the board understood it, the CEO did not understand it, nor did other people in the organization." The same was true for many auditors, Richard Petty continues: "I think that too few auditors currently specialize in the type of work that needs to be done to accurately assess risk for complex entities." Jules Muis points out that this is not only a private-sector issue: "Regulators allowed themselves to be ideologically held captive by the in-vogue deregulation mode with no effective accountability constructs—not even for systemic risk."

How to get it right?

One valuable lesson with respect to risk is that black swans do exist, according to John Coombe: "We are all now much more alert to the fact that—even when the potential for risk is low—things can actually happen." He recommends that directors increase their focus on risk, and engage more in a detailed understanding of the risks in their company's products and services. Richard Petty agrees, emphasizing the need for more education across the whole range of parties involved in this complex business.

"Especially on the buy side," he says, "there should be much clearer guidance and advice given to people along the lines of: 'You will lose money if you invest in things you don't understand.'" He also sees the rise of a specialist class of auditors "who really can pull apart the various financial products and process the risk independently of the company," so that their impact in terms of value and risk can be expertly assured.

In addition, Jules Muis would like to see securities regulators, the central banks, and the other financial regulators across the globe providing assurance



statements on the existence (or nonexistence) of systemic risk. According to him, that would really help the private sector, because "you cannot expect banks and their auditors to identify and analyze systemic risk of the magnitude we have seen over the last couple of years."

"The biggest risk going forward," continues Jules Muis, "is a continuation of the disjointed international financial architecture." He explains, "The various nations don't want to sacrifice their autonomy. But they are out of sync with the reality that we have global fund flows but no global regulator. We need a 'supra-national' oversight body. A more solid international architecture of oversight bodies [would be] good for the total environment in the areas of governance, financial reporting, and auditing."

Jane Diplock argues, however, that much of this financial crisis has to do with behaviors and cultures, which cannot be changed by regulation and oversight alone. She says, "What we need in corporate governance are more constraints on self-interest. The strongest form of defense comes from within the organization, its culture and its behaviors." In addition, she continues, "Shareholders—and especially institutional investors—should more actively pursue their ownership responsibilities. For example, they should intervene if they believe that the remuneration framework is not aligned well enough with the performance of the organization." John Coombe agrees: "Executive remuneration should be better aligned with the longer-term real performance—in terms of profitability, not sales volume—of the organization they lead: for example, deferred remuneration in the form of shares."

In spite of recommendations regarding the initiatives the private sector should follow, the interviewees expect more regulation because of the crisis. As Richard Petty puts it, "There will be not only tighter corporate governance, but also more restrictions around what companies can do—for example, in accounting and in capital market regulation."

The complete interviews with John Coombe, Jane Diplock, Jules Muis, and Richard Petty can be downloaded, free of charge, from the IFAC website at www.ifac.org/frsc. Readers are encouraged to respond to the recommendations of the interviewees by completing a brief survey found at the conclusion of each interview transcript.

Business Reporting Through the Lens of the Investor

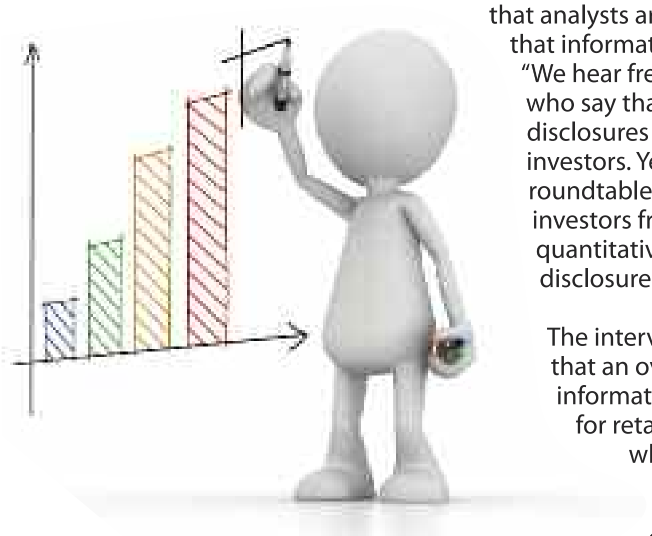
For the third part in its series on business reporting, IFAC interviewed six specialists with close ties to the investment community to get their recommendations on how to improve business reporting.

From their different perspectives, the six interviewees provided their insights into a number of significant business reporting issues, such as complexity, information overload, fair value accounting, operational performance, convergence of accounting standards, real-time reporting, management commentary, and sustainability reporting. According to Tanya Branwhite, executive director, strategy research at Macquarie Securities, all these reporting issues indicate that "there is an urgent need for users to get more involved in the discussions and decisions about the presentation of financial accounts." She adds to that: "We can't be critical of the accounting standard-setting process unless we get involved and try to put forward solutions to some of the issues.

From the investor's perspective

The investors agreed that financial statements must serve the needs of a broad range of stakeholders. "Shareowners are entitled to information about the company they own. And it is only with that information that they can effectively engage with the company," says Michael McKersie, assistant director, capital markets at the Association of British Insurers (ABI), the largest single group of investors in the UK. Matthew Waldron, director of the Financial Reporting Policy Group at US-based CFA Institute, quotes the first principle in his institute's Comprehensive Business Reporting Model (2007): "The primary financial statements must provide the information needed by equity investors, creditors, and other suppliers of risk capital."

According to those interviewed, directors and management may not realize how critically important their financial reports are to investor confidence and decision making, and the overall stability and growth of their business. "Senior executives and board members need to recognize that, essentially, they are working for the benefit of the shareowners," according to James Allen, director of capital markets policy for CFA Institute. "Companies and boards need to have their feet held to the fire both by shareowners (and by regulators) to make sure that they are governing themselves the way that they said they would." Hong-Kong-based investor and shareholder activist David Webb adds, "It is the job of directors to tell the truth, to provide the information that investors need to make informed decisions." Many directors realize that "the largest part of their company's intangible value is the confidence investors have in the management team," says Carlos Madrazo, head of investor relations at Mexico-based Grupo Televisa. "Unfortunately," says Ms. Branwhite, "the way financial reporting has developed has been more from the accounting perspective than the user perspective."



Premise of financial reporting

"If you are reporting on a business, you need consensus between the corporation and the investor community to determine what is relevant and what is not," says Mr. Madrazo. Ms. Branwhite makes a start: "In my view, the very basic premise of financial reporting is to provide an unbiased, complete, and well-informed view of the financial performance of a business, based on a well-defined set of standards, which are used consistently across a whole range of companies." According to Mr. Waldron, disclosures are relevant to financial statements, emphasizing that they should be "prepared in a high-quality manner."

Complexity of financial reporting

Respondents to IFAC's previous studies from March 2008 identified complexity as one of the main difficulties in financial reporting. According to interviewees, complexity continues to pose a challenge. Ms. Branwhite says, "Things like off-balance sheet accounting, warehousing of financial instruments, mark-to-market valuation, and all those other issues that made financial information so opaque have increased the complexity of financial accounts such that it has become difficult for many investors to trace the financial performance of a business." She warns that "if financial accounts are not prepared with the users in mind, then we risk a whole area of unaudited 'shadow reporting' being provided directly to investors that doesn't go through the rigorous financial accounting process." Mr. McKersie adds, "If complexity is masking real issues, however, that is a real concern because that might result in less confidence. Therefore," he says, "companies should genuinely try to produce financial accounts that are informative. In our opinion, this is a better way forward than introducing new regulations."

Information overload

"Investors don't necessarily think bulkiness is an issue as long as can they can find what they need," says Mr. McKersie. Ms. Branwhite concurs, indicating that reports are long by necessity: "As the accounting standards themselves have gotten more complex, analysts have needed more information to understand the numbers that they are looking at. Hence, you then end up with about 400 pages in financial reporting, so that analysts are able to peel back that information." Mr. Waldron adds: "We hear frequently from preparers who say that the expanded disclosures aren't used by investors. Yet when we go to roundtables or in other forums, investors frequently ask for more quantitative and qualitative disclosures."

The interviewees realize though that an overload of detailed information provides a problem for retail investors, many of whom lack the financial expertise or the time for proper analysis. One solution might be to engage third parties. "We work with banks that market to retail investors via their branches throughout the country. These retail brokers receive exactly the same presentation as do larger, institutional investors," says Mr. Madrazo. Ms. Branwhite explains, "Part of our job is to help the wider investor base to better understand what is happening."

Fair value

"Fair value accounting is very important," says Mr. Webb, "certainly on the fixed assets side, because we need comparability between companies in a sector, between companies in a market, and between companies in different markets." Mr. Waldron also strongly favors fair value. In fact, he "believes that it is the most decision-useful measurement basis for investors." Mr. McKersie notes that "fair value is without doubt of interest for investors," but that "the reliability of these fair value measurements" is important for investors to consider. According to Mr. Waldron, however, "Investors feel that relevance has primacy over reliability, so combining high-quality disclosures with the fair values presented in the financial statements presents more decision-useful information."

Direct cash flow method

According to the interviewees, the direct cash flow method might help (retail) investors better understand the performance of a company. Mr. Madrazo recommends that "standard setters and regulators … better distinguish the impact on earnings that results from changes in fair value, versus those changes that we see from the day-to-day running of the business." There is merit to the use of a direct cash flow statement, according to Ms. Branwhite, "because the wider investor community will be able to see more clearly the operating performance of the business, the investing decisions being made by the business, as well as how the business is being financed and any changes in the value of the assets and liabilities." According to CFA Institute's Comprehensive Business Reporting Model, "The cash flow statement provides information essential to the analysis of a company."

International convergence of accounting standards

"International convergence of accounting standards is valuable and desirable because it increases international comparability," says Mr. McKersie. Mr. Waldron agrees: "We believe that the global capital markets would be best served if accounting standards in jurisdictions around the world evolved to a point where there was one set of high-quality, understandable reporting standards. This would enhance comparability and analysis of investment opportunities globally." International convergence to one set of accounting standards would also benefit multinational corporations, as Mr. Madrazo makes clear: "Like any other Latin American company listed in the US, Televisa must comply not only with our own local rules but also with US rules. This is a very time-consuming task."

Although convergence is admirable, it should not be attained at the expense of the quality. "The priority of both the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should be to make the information in the accounts more relevant, reliable, transparent, and consistent," says Ms. Branwhite. "If convergence is not the outcome yet, we have not lost too much as long as those other quality criteria are met."

Management commentary

Additional disclosure, for example, in the form of management commentary, is desirable but still has a ways to go according to the interviewees. Mr. McKersie says "investors like directors to talk in good faith on how they see matters in order to make better quality investment decisions. Preparation of useful management commentary is an opportunity for the board to confirm that it is on top of what it is doing and the direction it is going." Mr. Webb agrees, but has some reservations: "If we had an independent election system for independent directors, then they would have more authority. In that case, I would favor giving them their own section of the annual report and an obligation to report any issues that they are concerned about, and any issues on which they have disagreed with the rest of the board."

Mr. Waldron sees gaps in the quantity versus the quality of information provided: "When companies include models, estimates, assumptions, principles applied, sensitivity analysis, and aggregated disclosures, they need to make sure that all of the qualitative factors, such as understandability, completeness, relevance, and comparability are considered." Ms. Branwhite recommends the use of key performance indicators (KPIs): "Knowing what management has set as its KPIs is critical information, as it provides an insight as to how aligned the company's long-term performance objectives are with those of its shareholders."

Sustainability reporting

The interviewees held mixed views on the usefulness of sustainability reporting. According to Mr. Madrazo, "Investors are increasingly seeking information on a company's environmental, social, and governance performance because they see these as indicators of good overall corporate management and often superior performance." Mr. Webb disagrees, saying, "Sustainability reporting is of no real value to investors. We shouldn't expect companies to try to make the world a better place at the expense of their shareholders." Instead, Mr. Webb sees a role for governments: "If everybody is required to clean up their waste, companies will economically price it into their products." Ms. Branwhite points out that "as there are going to be very clear financial implications on social and environmental aspects, they should become integrated into mainstream financial reporting."
IFAC supports the integration of sustainability reporting.

IFAC's CEO Ian Ball will co-chair the newly formed International Integrated Reporting Committee (IIRC), whose objective is to create a globally accepted integrated reporting framework, bringing together financial, environmental, social, and governance information.

To read the complete interview transcripts, including summaries of interviewees' recommendations, see the IFAC website at www.ifac.org/frsc. Readers are encouraged to respond to the recommendations of the interviewees by completing a brief survey found at the conclusion of each interview transcript. For more information about IFAC's business reporting project, please contact Vincent Tophoff at VincentTophoff@IFAC.org.

Third ICAP-Inter Firms T-20 Cricket Tournament 2010

Spectators enthralled by the ongoing cricket match

One of the most effective methods for inculcating team spirit, pursuing excellence, motivation and healthy acceptance of failure is perhaps Sports!!

Continuing its tradition, the Institute of Chartered Accountants of Pakistan held the **3rd ICAP-Inter Firms T-20 Cricket Tournament**. The Tournament commenced from Saturday, 1 January 2011. The eight participating teams were divided in two pools as follows:

Pool: A	Pool: B
A.F. Ferguson & Co.	Ernst & Young Ford Rhodes Sidat Hyder
Rahman Sarfaraz Rahim Iqbal Rafiq	KPMG Taseer Hadi & Co.
The Institute of Chartered Accountants of Pakistan	Anjum Asim Shahid Rahman
BDO Ebrahim & Co.	M. Yousuf Adil Saleem & Co.

The tournament commenced from the first day of the Golden Jubilee Year, with ICAP, KPMG and RSRIR emerging victorious. The participating teams committed to giving their best in each match won appreciation from the crowds and set the tone for the tournament. With every team vying for the sparkling crystal trophy the competition got intense as the matches progressed with some very close finishes.

Date	Match	Results
1 Jan	Pool A (ICAP vs A. F. F)	ICAP won by 27 runs
1 Jan	Pool B (KPMG vs MYASCO)	KPMG won by 4 Wickets
1 Jan	Pool A (RSRIR vs BDO)	RSRIR won by 115 runs
2Jan	Pool B (EYFRSH vs AASR)	EYFRSH won by 3 Wickets
8 Jan	Pool A (A. F. F vs BDO)	AFF won by 8 Wickets
8 Jan	Pool B (EYFRSH vs MYASCO)	EYFRSH won by 2 wickets
8 Jan	Pool A (ICAP vs RSRIR)	RSRIR won by 63 runs
8 Jan	Pool B (KPMG vs AASR)	KPMG won by 8 wickets
15 Jan	Pool A (A. F. F vs RSRIR)	RSRIR won by 18 runs
15 Jan	Pool B (AASR vs MYASCO)	MYASCO won by 5 wickets
15 Jan	Pool A (ICAP vs BDO)	ICAP won by 90 runs
15Jan	Pool B (EYFRSH vs KPMG)	EYFRSH won by 38 runs

Team RSRIR - Winner of Third ICAP Inter Firms T-20 Cricket Tournament 2010

Mr. Abdul Rahim Salim Bhai presenting the runners up trophy to ICAP Captain Mr. Shoaib Ahmed

Mr. Abdul Rahim Salim Bhai presenting the Winners trophy to the RSRIR captain Mr. Abdul Hakeem

Team ICAP - Runnerup of Third ICAP Inter Firms T-20 Cricket Tournament 2010

Team EYFRSH - Semi Finalist

Team KPMG - Semi Finalist

Team EYFRSH, KPMG, ICAP and RSRIR qualified for the semi finals. On 22nd January morning RSRIR and KPMG met to decide the fist finalist of the tournament. Both the teams gave an all out performance with the first tie of the tournament , the fate of the match was decided by the super over which RSISR won with two wickets. In the second slot ICAP faced the defending champions E&Y for the second spot in the finals, due to the explosive batting of Shoaib Ahmed managed to achieve what seemed impossible, a place in the finals for the first time in the history of the tournaments.

Friday 28th January 2011 saw Team ICAP and RSRIR battling it out for the Crystal trophy at the Asghar Ali Shah Cricket Stadium under flood lights. ICAP on winning the toss decided to bat first and test RSRIR bowlers. RSRIR struck early putting pressure on ICAP. However, the trusted Shoaib Ahmed being leading run scorer of the tournament and the new found talent Riaz Nawaz stood their ground and put on a 90 runs partnership for second wicket. The partnership was an interesting balance of moods with Riaz thoroughly entertaining the spectators with his delightful cover drives to reach his first 50 and a watchful Shoaib carefully ticking the scoreboard with ones and twos. The two led ICAP to the 100th mark in 14 over and looked set to pose a dangerous total. At this moment Muneeb the slow left-arm orthodox and Tahir Hanif (leg break) changed the direction of the game with their variation and immaculate line and length. Muneeb eventually made inroads in the ICAP batting line up by picking up 4 crucial wickets, while fast bowler Danish Waseem continued creating havoc with his pace and accuracy and eventually rewarded with 2 wickets for his excellent spell. The excellent fielding and the consistent breakthroughs by the bowlers restricted ICAP t o145 at the end of the 20th over. Riaz Nawaz and Shoaib Ahmed, Secretary ICAP topped the ICAP scoreboard with 52 and 44 respectively.

In reply RSRIR openers took full advantage of field restriction and blasted 60 runs in the first 6 over, however after giving the flying start both openers shortly fell down. The duo Shahzad Suleman and Yasin, wicket keeper took charge and consolidated the position. Shahzad capitalizing on his good form made runs with ease with Yasin supporting him well. RSRIR managed to reach the target with 2 over to spare with Shahzad Suleman and Yasin both remaining unbeaten on 61 and 33 runs respectively. Hasan Jaffri, Member ICAP was the only successful bowler taking 2 wickets for 34. Shahzad Suleman was declared man of the match for his unbeaten match wining knock.

A sizeable crowd with banners and drums had gathered at Asghar Ali Shah Cricket Stadium, supporting their team and enjoying the flood light match. Prize distribution ceremony was attended by Senior Partners of RSRIR, Mr. Abdul Rahim Salim Bhai, Mohammad Waseem and Muhammad Iqbal Sumar. Mr. Mazhar Saleem, partner of KPMG announced the following awards to the exceptional players of the tournament:

- Winner trophy received by Abdul Hakim,
- Captain, RSRIR
- Runner trophy received by Shoaib Ahmed, Captain, ICAP
- Man of Final, Shahzad Suleman, RSRIR
- Best player of the tournament, Shoaib Ahmed, ICAP
- Best Batsman of the tournament, Shoaib Ahmed, ICAP
- Best Bowler of the tournament, Shahzad Suleman, RSRIR
- Best Fielder of the tournament, Talal Rishi, EYFRSH
- Best Wicketkeeper of the tournament, Asad Khan, KPMG

As an endeavor to encourage all the participating teams, the Participation awards were given to the representatives of teams present at the final match. The tournament was greatly appreciated by the participants and the crowd with ICAP being appreciated for its role in providing such healthy activity to its students and members. Mr. Shoaib Ahmed, Secretary ICAP announced that as a part of the Council initiative to celebrate the Golden Jubilee Celebrations the 4th ICAP T20 Cricket Tournament will take place in September this year.