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Compliance Audit
Buying Peace of Mind

The views expressed are those of the author and donot reflect the Institute.
A growing number of companies are implementing with do-more-with-less movement to merge corporate compliance and internal audit functions into a single reporting structure. Compliance and internal audit staff are creating closer ties due to economic pressures. They are looking for ways to leverage resources and become more efficient. They’re establishing more collaboration and put a broader focus on identifying and mitigating risk.

The role of internal audit is expanding as it guides the enterprise beyond traditional attitudes about financial risk management, risk mitigation, and monitoring and toward evaluating a broader spectrum of compliance activities. Today’s auditor must have a full understanding of the risks the company faces and how they relate to each other, and needs to rely on well-constructed and well-executed risk management, control, and governance processes in order to provide assurance that controls are designed appropriately and operating as designed.

Presently compliance is developing as it goes beyond the traditional roles of building an ethical workplace culture, identifying and managing regulatory and legal obligations, and implementing and monitoring policies, controls, and training. The compliance officer, beyond being devoted to the business and shareholder requirement of building and maintaining an ethical organizational culture, must have an active role in risk identification, management, monitoring, and mitigation.

Audit and compliance—working together—are uniquely positioned to help the board and management understand the importance of an integrated approach to compliance that enables wise resource use, prevents undesirable outcomes, and grasps advantages while achieving business objectives.

Companies complain that becoming and staying compliant is expensive, time-consuming and difficult to maintain. But compliance with industry and other regulations is not only non-negotiable, it can keep the company more secure. As the board and executive management bring assurance to all stakeholders of the strategic and organizational effectiveness of the enterprise and continue plans to both preserve and create value, an effective standard approach to providing assurance related to compliance and ethical risk is critical.

Adnan Zaman, FCA
The advent of new regulations enforcement has heightened the need for connected governance, risk and compliance well beyond the internal audit and compliance departments. Executives, corporate boards, risk management and business line managers are all under increased oversight and scrutiny by regulators, shareholders and external auditors. As a result, internal audit and compliance professionals are faced with ever increasing information requests, new compliance requirements, and are under constant pressure to do more with less.

Corporate compliance and internal audit functions are best served by being independent of the operations they assess. To achieve independence, proper governance, lines of reporting and authority, organizational placement and organizational access are key to the success of both functions. Both functions are also cost centers of an organization, as they are not designed to contribute directly to the financial bottom line. While both functions often identify cost-saving or revenue-enhancing opportunities, neither should carry that as their primary role. Since they are cost centers, functional resources are limited. Both functions best serve their organizations with these limited resources by fulfilling their responsibilities through focus on the priority or highest risk areas.

The foundation of an effective compliance program is an overarching compliance culture at the firm — a culture of honesty and integrity that permeates the firm, not simply a superficial, technical compliance with the letter of the law. It is the firm’s overall responsibility to ensure that the compliance program is taken seriously. An effective compliance program is substantive and compliant not only with the letter, but the spirit, of the law.

Risk assessment is also a key component of both corporate compliance and internal audit functions. Risk assessment involves the application of a methodical process for identifying key risks that face the organization. Both corporate compliance and internal audit address corporate level risk, governance and control.

In short, compliance audits are an excellent investment for companies who take their compliance programs seriously, devote sufficient resources to make them work, strive for a culture of compliance that does not tolerate wrongdoing at any level, and, in today’s climate especially, understand – and want to competently navigate – the daunting regulatory and enforcement minefield in which they are operating.

Ahmed Saeed, FCA
This issue’s topic is
As a nation, we’ve witnessed dramatic financial swings over the last few years - from boom times to economic lassitude. Most frustrating of all, there’s no foolproof way to predict the economy’s next move. The only thing that is certain is Change. A good way to survive these changeable times is to practice smart money management, and to position yourself to help provide maximum financial security, regardless of where the economy goes.

✦ Does your company have the growth mindset, needed to prosper in a Volatile Economy?

✦ Is Volatile Economy a threat or opportunity? Share some ideas to bridge the control-growth divide.

Humayun Habib, ACA
R-5111, Karachi

Every business is in business for growth and to make money. Volatile Economy is reflection of and it changes in direct relation to volatility in other factors including governance, law n order, efficiency and taxation matters. Generally business men are smart in money matters but their foremost concern is ‘Security’, ‘Growth’ - Case in point frozen bank accounts of a telecom (Mobilink), frequent shut down of mobile service in the name of security measures, levy and then suspension of Distributor Tax apparently without enough homework, frequent power break downs. Way forward seems to benchmark business regulations and facilitation with successful economies and industrial projects; engage more actively and transparently with Trade and Industrial Bodies. Like it is said ‘Nothing Succeeds Like Success’. Further, towns/cities/districts/provinces need to come forward to attract investors through incentivising to set up offices and production facilities in their area for job creation. Individuals and agencies may be incentivised to bring in Investment (read FDI other than portfolio investors). In this relation, focus should be to engage second generation of expat Pakistani community because they can gel in more effectively.
Syed Imtiaz Abbas Hussain, FCA  
R-1676, Karachi

Volatile Economy of Pakistan is an opportunity because since many decades economy managers had no choice but to make plus/ minus in existing shape of our economy due to pressure from vested interested and influential people as a result our economy is hundred years backward and now showing signs of economic collapse due to termite eaten. So now volatile Economy has created room for changing and revamping political, economical, social and environmental culture by Mr. Khumaini type Leader as a result our black economy which is more than doubled our white economy will be put in main stream, corruption less society, revival of lost traits of mankind - ethics, honesty and discipline, and negligible zakat will convert into huge funds resulting Pakistan will face economy boom, foreign aid free nation, no below poverty people around, high security and much more good things. Prosperity, prosperity and prosperity.

Tameez-ul-Haque, FCA  
R-973, Karachi

Volatile economy can be a threat as well as an opportunity. It entirely depends on how the economic team manages and performs under the guidance of Team Leader. The recession of 1930s faced by USA and how Roosevelt dealt is an classic example. The recent case is Indonesia where economy was in bad shape when Suharto departed and within few years converted into healthy economic nation even it lost the dominance on one part of the country. The positive result from the extreme negative in USA & Indonesia and many others. This was only possible due to the skill, caliber, dedication, sincerity, vision and courage of the team leader & members. The supreme factor was "ownership" to the country. Unless the governing team of a country "owns the country" and works with the spirit that they owe to the nation which bestowed them the highest offices & reputation nothing can be achieved and change in real sense shall be a dream and nothing can be predicted.

Zeeshan Khurram, ACA  
R-6056, Dammam, Saudi Arabia

Volatility affects different mindsets differently. One of these is a control mindset, where executives see performance as an outcome of predictability and control. All energies are directed towards predicting demands and improving controls over current systems and operations. For these executives volatility implies risk since any variation in actual demand in future might result in loss of committed resources. This control obsession makes them increase their focus on improving accuracy of forecasts and enhancement of efficiencies in existing processes. This, as a result, makes them more fragile in the face of unexpected shocks and events.

On the other hand, the executives with growth mindset recognize the unpredictability inherent in external environment. They realize that no matter how much efficiency they extract out of their current systems, they have little control over the changes happening around them. So, instead of trying to resist volatility, they try to make sense of the changing environment and look for innovative ways of dealing with it. For example, some organizations have been able to restructure their operations to achieve higher levels of flexibility in expanding and contracting their outputs with changing demands. For those organizations the same volatility drives opportunity and acts as growth multiplier.
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The need for compliance audit

In recent years increasing emphasis is being placed on the “compliance” aspects of any business. A lot is being written about the importance of compliance function in entities and we see that compliance officers and departments are being set up in organizations and compliance audits are being carried out. The concept of compliance audit was conceived during the 20th century but it gained momentum afterwards, particularly with the collapse of Enron which brought into question the accounting practices and activities of many corporations in the United States and was a factor in the creation of the Sarbanes-Oxley Act of 2002. The scandal also affected the greater business world by causing the dissolution of the Arthur Andersen - one of the top five global audit and accountancy firms. It emerged that not only companies representing corporate sector but firms auditing and providing advisory services to such companies also need to have a compliance function in place to manage business risks. Hence, the emergence of such compliance function as a distinct type of auditing coincides with the rapid growth of business after the industrial revolution and the concurrent growth in efforts by organizations and governments to direct and control business practices. Laws, regulations, policies, and procedures were implemented to ensure control. It became the responsibility of auditors to verify that these rules were indeed being followed. Several distinct groups of “auditors” emerged and grew—external auditors in public accounting firms; attorneys specializing in particular regulatory domains; “compliance auditors” employed within organizations such as internal auditors; technical compliance specialists (for example, radiation safety officers), quality assurance evaluators, auditors employed by state, local, or federal governments, agencies, or regulatory bodies.

Methodology of compliance audits

Compliance auditing essentially determines whether or not processes and transactions have followed the applicable rules. If rules are violated, the auditor determines the cause and recommends ways to prevent future deviations. The rules being tested can be those created by the organization for itself (standard operating procedures) through corporate by-laws, policies, plans, and procedures, those imposed on the organization through external laws and regulations or can be those external standards that the organization has chosen to
follow (e.g. ISO 9000 quality management systems, or ISO 14001 environmental management systems). It also includes a comprehensive review of an organization’s adherence to regulatory guidelines. Independent accounting, security or IT consultants evaluate the strength and thoroughness of compliance preparations. Auditors review security polices, user access controls and risk management procedures over the course of a compliance audit.

Compliance audits can be performed by employees of the organization, public accountants or attorneys hired by the organization, or governmental auditors assigned by a regulatory agency. Compliance audits are often done by internal auditors or staff attorneys in advance of an external compliance audit so that any potential problems can be detected and corrected in advance. When internal auditors have already audited activities and management has taken action to correct noncompliance, external examiners may request that documentation as evidence of the organization’s good-faith effort to correct noncompliance.

What, precisely, is examined in a compliance audit will vary depending upon the corporate status of the organization i.e whether it is a public or private company, what kind of data it handles and if it transmits or stores sensitive financial data. For instance, Sarbanes Oxly Act requires any electronic communication to be backed up and secured with reasonable disaster recovery infrastructure. Healthcare providers that store or transmit e-health records, like personal health information, are subject to the Health Insurance Portability &Accountability Act (HIPAA) requirements. Financial services companies that transmit credit card data are subject to Payment Credit Card Industry Data Security Standard (CCI-DSS) requirements. In each case, the organization must be able to demonstrate compliance by producing an audit trail, often generated by data from event log management software.

Compliance auditors will generally ask Chief Information Officers (CIOs) or Chief Technology Officers and IT administrators a series of pointed questions over the course of an audit. These may include what users were added and when, who has left the company, whether user IDs were revoked and which IT administrators have access to critical systems. IT administrators prepare for compliance audits using event log managers and robust change management software to allow tracking and documentation authentication and controls in IT systems. The growing category of GRC (governance, risk management and compliance) software enables CIOs to quickly show auditors (and CEOs) that the organization is in compliance and will not be not subject to costly fines or sanctions.

In present times, more and more regulatory compliance audits are being performed by the private sector. In response, public accounting firms and law firms have significantly expanded their compliance services. That expansion has been further stimulated by requirements of independent compliance audits as a condition for disbursement of funds by grantors. The requirement for an external compliance audit frequently becomes a condition for receiving federal and other funds. Organizations should be aware that under these arrangements the external compliance auditor may be acting as the agent of the regulator, even though the organization is paying the audit fee.

The person or organization requesting the compliance audit plays the key role in determining the objective, scope, and time period to be reviewed and who will do the work. They may also control the audit process itself by outlining detailed procedures and prescribing methods for judging results.

Before beginning a particular compliance audit, the auditors must be properly qualified through education and experience to perform the work. Also, the auditor must have a clear understanding of the nature, purpose, objectives, and scope of the compliance audit. Next, the auditor should obtain a thorough understanding of the laws, policies, or standards being evaluated, decide how to recognize when a deviation has occurred, and how to evaluate evidence obtained through audit tests. This means that the auditor must figure out, for each event to be tested, just what evidence signifies compliance and what evidence signifies noncompliance. In addition, it is important for the auditor to find out the degree of deviation from standards that is considered tolerable by the audit sponsor. Detailed information about key compliance audit questions often exists in the form of independently published compliance audit guidelines and generally accepted auditing standards. Otherwise, the auditor should make sure that key questions and issues are clarified with the audit sponsor.
Assessing compliance may be simple, requiring a brief inspection to find out whether rules were followed or not. At the other extreme, making a judgment may require extensive research of regulatory requirements, interpretations, and technical materials before a valid conclusion about one event or a single transaction can be made. If the auditor is not sufficiently experienced in very specialized compliance topics then the opinions of an expert should be sought. The auditor will usually choose a sample of events or transactions for testing when it is not practical to examine every one that falls within the scope of the audit. Compliance audit tests can incorporate statistical sampling techniques and measure sampling risk when the following conditions can be reasonably assumed: the population must be large enough to permit the mathematical laws of statistics to operate; errors must be distributed randomly throughout the population; and, evidence of such randomness must exist. More often than not such assumptions cannot be made and a non-statistical sampling approach (“haphazard sampling”) is used. Estimates of sampling risk are not valid with non-statistical sampling. At the conclusion of testing, the auditor evaluates evidence from audit tests as a whole. If testing evidence indicates, within tolerable limits, that rules have been followed and prohibitions have not been violated, the organization is deemed to be in compliance with respect to the activities audited. If incidents of noncompliance exceed tolerable limits, the frequency and severity of deviations should be studied. Penalties and sanctions may be imposed in serious cases of noncompliance. Identification of corrective measures that could be applied to bring activities back into compliance becomes important.

Buying peace of mind?

After expounding in detail about the functionalities of compliance audit what we now need to dwell on is whether it really does buy peace of mind. There may be numerous compliance audits but as mentioned above that audits usually involve sampling with the results of procedures extrapolated to the population which could lead to some non compliance to remain undetected. Consequently what is imperative to the success of compliance function within organizations is the sincerity and seriousness of owners/ mangers to be and to remain compliant with whatever set of rules and regulations they are required to be compliant with. Entities shall be as compliant as the people responsible for managing it would want it to be. Compliance is a state of mind and if those running the show in organizations have a crystal clear mindset about earnestly being compliant with the relevant set of laws then it should be considered that half the battle is already won. The tone at the top of the organization has a trickledown effect with all members of the entity irrespective of their level are mindful of playing their part towards ensuring compliance within their arena of responsibilities. While at compliance another important aspect is the seriousness with which the whistle blowing system is maintained and responded to in an organization since it could unearth corrupt and alarming practices which could be nipped in the bud as soon as they raise their ugly head. In conclusion it could be said that compliance audit could buy peace of mind if the mind would be prepared to buy it. After all, the old adage “God helps those who help themselves” has not been coined for nothing!

Compliance audit reporting

Compliance audit reports must communicate in a fashion that is relevant to the person or entity sponsoring the audit. Reports issued to federal regulators must often follow guidelines prescribing form and content. Reports usually describe the objectives of the compliance audit, the number of conditions examined during the time period considered, the frequency of events conforming to conditions, and the number of exceptions. When a statistical sample of events has been tested and required assumptions are appropriate, results from the sample may be used to predict the level of compliance for all events or transactions within the scope of the audit. Compliance audit reports often indicate reasons for deviations from standards, describe implications of those deviations, and recommend actions that strengthen control procedures for assuring compliance.

About the Author:

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One of the challenges invariably faced by Audit Committee members is: “what is your foremost expectation out of compliance auditing?” The response to this challenge is elimination of surprises or "Peace of Mind". This article has been written to present a theme for compliance audits – “Peace of Mind” for Audit Committees. By “Peace of Mind,” the chairmen and their fellow audit committee members require that internal/compliance/external auditing should identify issues before they became a major problem for the company — and by extension — the audit committee.

One methodology for compliance audits has been developed under the auspices of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework. A high-level perspective of the COSO framework in the context of compliance is explained as follows:

1. **Control environment:** The tone of the organization influences the control consciousness of its people. Examples include the integrity, ethical values and competence of employees; management’s philosophy; and input provided by the board of directors.

2. **Risk assessment:** Identification and analysis of risks relevant to achieving corporate goals, determination of how such risks should be managed and implementation of a process to address risks associated with change.

3. **Control activities:** Policies, procedures and processes that help ensure a company carries out management directives. Examples include approvals, verifications, reconciliations, review of operating performance, security of assets and segregation of duties.

4. **Information and communication:** Communication within the company and with external parties such as customers, agents, suppliers, regulators and shareholders. For example, reports that contain operational, compliance or financial data or that share ideas or events across lines of business are generated from a company’s information systems.

5. **Monitoring:** Assessing the quality of a company’s internal control systems. This is done through ongoing monitoring (manual and automated) of activities within the business unit and an independent evaluation of existing controls by internal/external auditors and or compliance personnel.
The COSO framework has been utilized by multi-nationals. The accounting firms have also established external audit services providing certification for compliance reporting in accordance with the COSO framework. One of the challenges for the implementation of the COSO framework is managing the “Cost of Compliance”. In order to do achieve this, one can consider using “Lean Six Sigma” and “Automated Controls” in compliance. These concepts are explained below:

**Lean Six Sigma and Champions - Definitions**

“**Lean**”, applied in the context of compliance, is the elimination of **waste**, where **waste** is work that adds **no value** to a compliance process or control.

“**Six Sigma**” relates to the number of mathematical deviations in a compliance process. Six Sigma practitioners focus on systematically eliminating the deviations to get as close to “**zero deviations**” as possible. Done properly, Six Sigma ensures that compliance processes are running at optimum efficiency with regard to qualities such as speed, quality, accuracy, and latency of data.

People trained on Six Sigma will recognize **DMAIC** as a phased methodology with which to improve existing compliance processes:

- **Define** – the problem, the voice of the internal or external compliance monitor, and the compliance goals, specifically
- **Measure** – key aspects of the current compliance process and collect relevant data
- **Analyze** – the data to investigate and verify cause-and-effect relationships. Determine what the relationships are, and attempt to ensure that all factors have been considered. Seek out root cause of the non-compliance under investigation
- **Improve** – or optimize the compliance process based upon data analysis techniques
- **Control** – the future state compliance process to ensure that any deviations from policies and procedures are corrected before they result in non-compliance

Business Leaders sponsoring Six Sigma compliance projects are called “**Champions**”. Champions are responsible for supporting, aligning, and integrating the Six Sigma Compliance Launch into their organization. Champions are trained in the essentials of the Six Sigma Methodology, especially focusing on how to select compliance projects that are aligned with business goals. Champions in turn select and mentor Six Sigma project leaders who are called “Belts” and ensure the Belts have the training and resources they need to successfully lead Six Sigma projects.

<table>
<thead>
<tr>
<th>Six Sigma Leader Roles for DMAIC</th>
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<tbody>
<tr>
<td>Establish project selection criteria</td>
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<tr>
<td>Approve projects – ensure linkage to strategy and key needs</td>
</tr>
<tr>
<td>Select Project Champions</td>
</tr>
<tr>
<td>Provide needed resources and training</td>
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<tr>
<td>Review Black Belt and Green Belt projects monthly</td>
</tr>
</tbody>
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“**Automated Controls**” extend the reach of Six Sigma efforts:

- Increase the accuracy of the compliance process measurements.
- Improve the design and decision of compliance professionals.
- Shed cumbersome, manual, inconsistent, and error-prone manual efforts.

**Lean Six Sigma – Evaluate and Understand Compliance Gaps – Case Studies:**

*Resources should be applied according to the biggest benefit, or in case of compliance processes, the largest risk. In order to prioritize where Lean Six Sigma process efforts are necessary, the company should gain an understanding of where the biggest risk and gaps exist.*

**Case Study 1:**

Experience tells us that most **master vendor files** contain large numbers of entries that are no longer active, or are duplicates, or otherwise aren’t worth the trouble. At the same time that you develop your relationship types and apply some form of **risk** scoring, it would be prudent to de-dupe your **master vendor files** and combine any duplicates into single entries. Any inactive entities with which your organization hasn’t transacted in two years or more should be deactivated on the system.

Subsequent to **risk** scoring, a second round of thinning out the third party ranks may well be in order. Any third
party that has been designated as high risk but isn’t worth the trouble and is either redundant or easily replaced with a less risky alternative should likewise be deactivated. And, if after due diligence investigations are performed, serious red flags are raised that cannot be resolved to your satisfaction, it may be prudent to exit some of those relationships as well.

Figure 1 shows a high-level process diagram with Potential Risks and Control Gaps for a third party risk.

Another Lean Six Sigma tool that can be used to focus on compliance risks is the “cause-and-effect” diagram. When you have a compliance problem, it’s important to explore the cause, before identifying a solution. Cause and Effect Analysis gives you a useful way of doing this. This diagram-based technique, which combines Brainstorming with a type of Mind Map, pushes one to consider all possible causes of a problem, rather than just the ones that are most obvious.

Case Study 2:
- Step 1: Identify the Problem
- Step 2: Work Out the Major Factors Involved
- Step 3: Identify Possible Causes
- Step 4: Analyze Your Diagram

Another compliance process analysis approach is to measure and analyze how time is spent in a process, focusing on the time spent on “Value-Added” (VA) versus “Non-Value-Added” (NVA) activities.

Case Study 3:
Figure 3 shows a picture of analysis method used by the compliance team. The method correlates compliance process steps with a table that summarizes the time for each step, separating VA from NVA time.

When looking at activities in a compliance process, we must determine if the activity is effective and efficient. We must also determine if the activity can be improved to provide a better result for compliance e.g.:

- Assessing country, industry, people and relationship risks
- Using knowledge of local culture and local business environment
- Recognizing that inherent risk cannot be eliminated
- Mitigating inherent risk and cost benefit analyses
Case Study 4:

- Companies spend a lot of time and effort on compliance around corporate hospitality and facilitation payments, and not enough on the issue of third-party due diligence – what agents, intermediaries, introducers and joint-venture partners are doing in their name.
- Third-party risk, is constant and ongoing. You can’t prevent other people breaking the law, but you are liable if they do.

The compliance audits have also to consider “Third Party” risks:

A broad range of third parties should be assessed, across each country of operation.

Figure 4: Some examples of Third Parties Used by Multi-Nationals

<table>
<thead>
<tr>
<th>1. Accountants/Accounting Firms</th>
<th>19. Trade Associations</th>
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<tbody>
<tr>
<td>2. Agents/Distributors</td>
<td>20. General Contractors</td>
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<tr>
<td>3. Authorized Dealers</td>
<td>21. Engineering, Procurement</td>
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<td>5. Commercial Consultants</td>
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<td>6. Construction Firms/Sub-Contractors</td>
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<td>7. Consultants</td>
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<td>8. Customs Agents/Brokers</td>
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<td>9. Distributors</td>
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<td>10. Environmental Consultants</td>
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<td>11. Freight Forwarding Agents/Brokers</td>
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<td>12. Tax Agents Specialists</td>
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<td>13. Marketing/Advertising</td>
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<td>14. Pure Resellers</td>
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<td>18. Lobbyists</td>
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Watchdog versus Bloodhound

In the final analysis, the modern day compliance auditor has also to determine, whether the role of compliance audits is one of Watchdog or a Bloodhound.

In the famous UK case Re: Kingston Cotton Mills Co. (1896), Lord Justice Lopes (UK) defined an auditor’s duty of care as follows:

QUOTE “It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably careful, cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said to approach his work with suspicion, or with a forgone conclusion that there is something wrong. He is a watchdog, not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and rely upon their representations, provided he takes reasonable care.” UNQUOTE

Each institution / organization / corporation and its compliance auditors need to assess for themselves what appropriate role is necessary to Provide Peace of Mind for the company—and by extension—the audit committee.

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Introduction

Accounting for employee benefits is a complex area and so is the International Accounting Standard (IAS 19). IAS 19 is always been criticized for its complexity and the choices it provide for the accounting of employee benefits. The presence of complex rules and alternate treatments not only hampers the very objective of the introduction of globally accepted accounting framework i.e. to enhance the comparability of the financial information provided by the entities around the globe, it is also a common observation that the information generated through the application of IAS 19 is difficult to understand by many users of financial statements. This might be the reason why this standard is subjected to various amendments right from the very beginning when it was first issued in 1983.

The latest addition in the long list of amendments in IAS 19 is the issuance of revised IAS 19 in June 2011, by the International Accounting Standards Board (IASB). The revised IAS 19 introduced several fundamental changes in the accounting for retirement benefits with the objective to generate financial information that is more useful and easily understandable by the users of the financial statements and to bring it more closer to the conceptual framework of IASB.

The key changes in the revised IAS 19 include the following and the same will be the focus of this article:

i. immediate recognition of actuarial gains and losses
ii. introduction of net interest approach for measuring the financing cost component of defined benefit cost
iii. the regrouping of employee benefit cost into service cost, finance cost and remeasurements.

The revised IAS 19 is applicable on the financial reporting period beginning on or after January 01, 2013.

No More Smoothing - Removal of Corridor Approach for Deferred Recognition of Actuarial Gains and Losses

Actuarial gains and losses can be defined as gains or losses resulting due to changes in the actuarial estimates in determining the values of defined benefit obligation and the plan assets and comprise of experience adjustment i.e. the effect of differences between the previous actuarial assumptions and what has actually occurred and the effects of changes in actuarial assumptions.

The existing IAS 19 currently allows three options for the recognition of actuarial gains and losses.

a. Immediate recognition in profit or loss
b. Immediate recognition in other comprehensive income, and
c. No recognition if they are within the corridor limit and deferred recognition of amount outside the corridor in profit and loss.

The option ‘C’ is widely adopted many entities as it
provides a smoothing mechanism whereby actuarial gains or losses are not recognized if they are within the corridor limit and a certain portion of actuarial gains and losses are recognized as income or expense if the net cumulative unrecognized actuarial gains and losses at the beginning of the financial period exceed the 10% corridor limit.

As evident the treatment adopted in option ‘C’ above, for the recognition of changes in the defined benefit liability is different from the treatment of recognition of changes in other asset and liabilities. There are several reasons why IAS 19 adopted this treatment and can be summarized as follows:

- Since the estimation of the defined benefit obligation is a complex process which involves various actuarial assumptions i.e. salary levels, length of service, mortality, retirement ages etc. the estimation of which is not always accurate, therefore any revision in the estimates of defined benefit obligation which is within the acceptable range (i.e. 10% corridor) cannot be treated as an actual change in the liability and therefore are not recognized however, any change beyond the acceptable range is recognized.

- The recognition of period to period changes in the value of plan assets and defined benefit obligation would not be relevant to the users of the financial statements. This notion is based on the view that plan assets are held for a long period therefore any gains or losses in the value of plan assets may reverse or offset each other in future. Similarly the long period before the settlement of defined benefit obligation provides an opportunity for the reversal of any gains or losses in the value of defined benefit obligation.

- Immediate recognition of actuarial gains and losses might result in volatile fluctuations in the balance sheet and profit and loss of the entity which will hamper the year on year comparability of the financial statements and as a result the decision making ability of the users of the financial statements will be impaired.

The following simplified illustration explains how the smoothing mechanism under the corridor approach works under the existing IAS 19.

**Illustration 1**

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual Present Value of Defined Benefit Obligation – End of the Period</td>
</tr>
<tr>
<td>Projected Present Value of Defined Benefit Obligation – End of the Period</td>
</tr>
<tr>
<td>Actuarial Loss</td>
</tr>
</tbody>
</table>

Under the corridor method the total actuarial loss of 1,000 is not recognized immediately in the profit & loss account rather it is accumulated with the existing unrecognized actuarial gains and losses and the amount outside the corridor is then recognized in the future periods.

<table>
<thead>
<tr>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrecognized Actuarial Loss – Beginning of the Period – (a)</td>
</tr>
<tr>
<td>Fair Value of Plan Assets – Beginning of the Period – (b)</td>
</tr>
<tr>
<td>Present Value of Defined Obligation – Beginning of the Period – (c)</td>
</tr>
<tr>
<td>Corridor Limit – 10% of &gt; of b or c – (d)</td>
</tr>
<tr>
<td>Unrecognized Actuarial Loss to be Amortized (a-d) – (e)</td>
</tr>
<tr>
<td>Average Future Working Years of the Employees under the Plan – (f)</td>
</tr>
<tr>
<td>Annual Amount to be Charged in Profit &amp; Loss – (e/f) – (g)</td>
</tr>
<tr>
<td>Unrecognised Actuarial Loss – (a-g) – (h)</td>
</tr>
<tr>
<td>Unrecognized Actuarial Loss – Current Period – (i)</td>
</tr>
<tr>
<td>Total Unrecognized Actuarial Loss – (h+i)</td>
</tr>
</tbody>
</table>

As evident from the above that there is a two way smoothing mechanism in place whereby firstly amount within the corridor limit is not recognized and secondly the amount outside the corridor is recognized over the average future working years of the employees.

The revised IAS 19 now requires that all actuarial gains and losses should be recognized immediately in the other comprehensive income. This means that financial statements will now reflect the full funded status of the benefit plans i.e. the actual assets and liability of the reporting entity with respect to the benefit plan will be reported in the financial statements.
The immediate recognition model is the natural outcome of criticism on the corridor method for the recognition of actuarial gains and losses, which is being criticized on the following grounds:

- The Framework for the Preparation and Presentation of Financial Statements (Framework) requires that most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognize them in the financial statements; for example, although most entities generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognize items and to disclose the risk of error surrounding their recognition and measurement.

On the basis of above requirement of the Framework the critics of the corridor approach contends that difficulty involved in the estimation of defined benefit obligation is not of such extent that justifies its non recognition because actuarial techniques used in the estimation enable an entity to reliably measure the defined benefit obligation that justifies its recognition.

- The notion that future gains and losses offset each other is arbitrary, therefore not recognizing changes in the defined benefit liability on the possibility of future offset would not be appropriate.

- The elimination of volatility through deferred recognition approach on the ground that it will impair the year on year comparability of the financial statement is not justified because if a transaction or event is itself volatile its measure should also be volatile.

The IASB has clarified from the very beginning of their review process of IAS 19 that they wish to eliminate the smoothing mechanism as it generates confusing and misleading information with respect to the true financial position of the plan as smoothing could result in:

- Recognition of an asset when in fact the plan is in deficit or recognition of a liability when in fact the pan is in surplus.

- Gains and losses that arise from events occurred in the past period may be recognized in profit and loss for the current period due to deferred recognition.

Immediate recognition of actuarial gains and losses is also consistent with the Framework which requires that the effects of transactions and other events are recognized when they occur and are recorded in the accounting records and reported in the financial statements of the periods to which they relate.

The following illustration explains how the corridor approach could result in misleading amounts to be recognized in the financial statements. Scenario - 1 illustrates a situation where despite the plan in deficit an asset could be recognized whereas Scenario - 2 depicts a situation where the plan is in surplus however, a liability could be recognized in the balance sheet.

<table>
<thead>
<tr>
<th>Scenario – 1</th>
<th>Scenario – 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>IAS-19</td>
<td>IAS-19</td>
</tr>
<tr>
<td>Present Value of Defined benefit obligation – (a)</td>
<td>12,000</td>
</tr>
<tr>
<td>Fair value of plan Assets – (b)</td>
<td>11500</td>
</tr>
<tr>
<td>Deficit / (Surplus)</td>
<td>500</td>
</tr>
<tr>
<td>Unrecognized Actuarial (Losses) / Gains – (c)</td>
<td>(1000)</td>
</tr>
<tr>
<td>Net Defined Benefit (Asset) / Liability – (a-c-b)</td>
<td>(500)</td>
</tr>
</tbody>
</table>

The immediate recognition of actuarial gains and losses will result in more volatility in the balance sheets of the entities however the profit and loss will become less volatile as actuarial gains and losses will permanently bypass profit and loss and will be recognized in Other Comprehensive Income (OCI). By isolating actuarial gains and losses in OCI the volatility arising from unpredictable changes in the profit and loss will be removed which will enhance period to period comparison of profitability. Similarly depending on the amount of unrecognized actuarial gains and losses the immediate recognition can significantly impact the balance sheet position of the entities and could result in increase in liability or reduction in assets recognized in the balance sheet.

Above all it will reduce significant complexity involved in the accounting and reporting of defined benefit obligation not only for the accountants but also for the users of the financial statements who can now better understand the actual status of defined benefit plans.

The financial impacts of immediate recognition of actuarial gains and losses in a simple situation would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>IAS 19</th>
<th>Impacts of IAS 19R</th>
<th>IAS 19R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
</tr>
<tr>
<td>Deferred Tax Asset (Tax Rate 35%)</td>
<td>200</td>
<td>35</td>
<td>235</td>
</tr>
<tr>
<td>Total Assets</td>
<td>1200</td>
<td>1235</td>
<td>1235</td>
</tr>
</tbody>
</table>
The Pakistan Accountant | Jan-Mar 2013

Defined Benefit Asset or Liability – A New Measure to Determine the Financing Cost Component of Defined Benefit Cost

The financing component of the defined benefit cost under the existing IAS 19 comprises interest cost on the defined benefit obligation and the expected return on plan assets. The interest cost is determined by multiplying the defined benefit obligation with the discount rate and expected return is based on market expectation for returns on plan assets over the entire life of the related obligation. The difference between the actual and expected return on plan asset forms part of actuarial gains and losses and are accounted for in accordance with the policy selected by the entity for the recognition of actuarial gains and losses.

The revised IAS 19 introduced a new measure for the financing component i.e. ‘Net Interest on Net Defined Benefit Asset or Liability’ which is calculated by multiplying the net defined benefit asset or liability with the same discount rate that is used to determine the present value of defined benefit obligation. This net interest therefore represents the changes in the net defined benefit asset or liability during the year due to passage of time. This treatment is based on the view that changes in the fair value of the plan asset during a period can be bifurcated between changes due to passage of time and all other changes. Similarly interest cost on defined benefit obligation representing the unwinding of the discount also arises due to passage of time. The IAS 19 therefore takes the view that the financing component should comprise not only the changes in defined benefit obligation due to passage of time but it should also include the changes in the fair value that arise due to passage of time and this part of the change in fair value (interest income) should offset the interest cost that arise from the defined benefit obligation.

Some of the respondent of the exposure draft of IAS 19 raised their concern that since plan assets comprises of assets with varying risk profile and return, the use of discount rate therefore does not fairly represent the return an entity expected from the plan assets. The IASB also acknowledged the difficulties in identifying changes in the fair value of plan assets due to passage of time, however after considering various ways for the estimation of changes due to passage of time IASB concluded that interest income should be calculated by applying the same rate that is used to discount defined benefit obligation.

This conclusion is based on the IASB view that net interest approach is a practical measure that will eliminate the need of subjective judgments to determine the changes in plan asset due to passage of time and the profit and loss will reflect the effect of time value of money on both the defined benefit obligation and plan assets. Further this approach will also address the IASB concern about the availability of observable information to determine the expected return on the plan assets.

With the introduction of net interest concept the expected return on plan asset will no longer form part of the financing component of the defined benefit cost. This will increase the charge to the profit and loss account as normally the expected return on plan assets is

| Net Defined Benefit Liability | (200)* | (100) | (300) |
| Net Assets | 1000 | (65) | 935 |
| Equity | 1000 | (65)* | 935 |

* Reconciliation of Net Defined Benefit Liability

Present Value of defined benefit obligation | 1200 |
Fair Value of Plan Assets | 900 |
Deficit | (300) |
Unrecognized Actuarial Losses | 100 |
Net Defined Benefit Liability | 200 |

* Net of deferred tax
on the higher side as compared to the discount rate. The following illustration explains the net interest approach to determine the financing component:

<table>
<thead>
<tr>
<th></th>
<th>IAS 19</th>
<th>IAS 19R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Present Value of Defined Benefit Obligation – Discount Rate 10%</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Fair Value of Plan Assets – Expected Return 12%</td>
<td>800</td>
<td>800</td>
</tr>
<tr>
<td>Net Defined Benefit Liability</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Interest Cost – a</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Expected Return – b</td>
<td>96</td>
<td>80</td>
</tr>
<tr>
<td>Financing Cost in P&amp;L / Net Interest on Net Defined Liability – (a-b)</td>
<td>4</td>
<td>20</td>
</tr>
</tbody>
</table>

**Components of Defined Benefit Costs and their Recognition**

The existing IAS 19 requires various elements of defined benefit cost such as current service cost, interest cost, expected return on plan asset and actuarial gains and losses to be recognized in profit and loss or other comprehensive income depending on the accounting policy selected by the entity. The IAS 19 revised introduced the concept of defined benefit costs. It requires that the defined benefit costs should be grouped into the following elements:

- **Service Cost**
- **Finance Cost i.e. Net Interest; and**
- **Remeasurements**

The IASB believed that these components have different characteristics therefore these items needs to be presented either in the profit and loss account or other comprehensive in accordance with the nature of each element.

**Service Cost**

Service cost comprises of current service cost, past service cost and any gain or loss on settlement. Service cost represents the underlying cost of the entity due to services rendered by the employee in current and prior periods. These are required to be recognized in the profit & loss account.

**Finance Cost – Net Interest**

Net interest comprises of interest cost on defined benefit obligation and interest income on plan assets. This represents the change over the period in the net defined benefit asset or liability due to passage of time. It is required to recognized in profit & loss account.

**Remeasurements**

Remeasurements include actuarial gains and losses on defined benefit obligation, actual return on plan assets excluding the amount included in the net interest calculation. These are required to be recognized in other comprehensive income. IASB believes that the separation of unexpected and uncontrollable elements of defined benefit cost through remeasurements in other comprehensive income provide useful information to the users of the financial statements regarding future uncertainties regarding the cost and cash flows of the entity with respect to the defined benefit plan.

The following table illustrates the existing and revised structure of recognizing employee benefit costs:

<table>
<thead>
<tr>
<th></th>
<th>IAS 19</th>
<th>IAS 19R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Service Cost</td>
<td>P&amp;L</td>
<td>P&amp;L</td>
</tr>
<tr>
<td>Net Interest</td>
<td>N/A</td>
<td>P&amp;L</td>
</tr>
<tr>
<td>Remeasurements</td>
<td>N/A</td>
<td>OCI</td>
</tr>
<tr>
<td>Actuarial Gains and Losses</td>
<td>P&amp;L or in OCI</td>
<td>N/A</td>
</tr>
<tr>
<td>Interest Cost</td>
<td>P&amp;L</td>
<td>N/A</td>
</tr>
<tr>
<td>Expected Return on Asset</td>
<td>P&amp;L</td>
<td>N/A</td>
</tr>
</tbody>
</table>

**Conclusion**

The current amendment to IAS 19 represents fundamental changes in the accounting for employee benefits that will improve the accounting for employee benefits and result in generation of financial information that will be easy to understand by many users of the financial statements. The IASB also believe that the revised IAS 19 will improve financial reporting of the employee benefits as:

- Entities will report changes in the carrying amounts of defined benefit obligations and changes in the fair value of plan assets in a more understandable way.
- The amendments eliminate a number of accounting options currently allowed by IAS 19, thus will improve comparability.
- Entities will provide improved information about the risks arising from their involvement in defined benefit plans.

Although the current amendments in the IAS 19 are limited in scope as compared to what was envisioned in the discussion paper of 2008, nevertheless the IASB considers that a comprehensive review of IAS 19 is inevitable in the near future.

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Funds and companies with financial assets either listed or unlisted on stock exchanges are required to provide for any diminution in the value of its investment at the reporting period, under International Accounting Standard (IAS) 39 nowadays referred to as IFRS 9. Failure to do so would require external auditors to qualify their opinion.

International Accounting Standards, as the name suggest itself, has prima facie objective of uniform accounting policies throughout the world. Whether a fund is registered in USA or Pakistan, the accounting policies should be such that the user of the financial statements, in any country, would arrive at the same conclusion for their investment decisions.

Modarabas, a homemade peculiar business industry, being fund, has investments in both listed and unlisted securities, are severely affected by this particular IAS. Modarabas governing law requires that, it has to distribute 90% of what it earns during a year. Let me be very clear on this, initially it was to claim income tax exemption but later on, due to inclusion of words “shall” in the Prudential Regulations specifically for modarabas, it became mandatory on every modaraba to distribute whether or not it claims income tax exemption, flexible to exclude uneconomical distribution.

If a modaraba provides for diminution in the value of investment in year 1 and in year 2 able to sell the same below its original cost of acquisition then it should tantamount to distribution from capital, contradicting the basic accounting principle/companies law for distribution from profits only.

We will take the following example to understand the issue.

A Modaraba invest Rs. 80 m in listed securities in Year 1 and sells those in Year 2. At end of year 1, the market value of the investment is Rs. 35 m resulting in an unrealized loss of Rs. 45 m which, under the existing rules, has to be provided in the profit and loss account as per Table A:

<table>
<thead>
<tr>
<th>Table A</th>
<th>Year 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit and loss account</td>
<td>Rupees</td>
</tr>
<tr>
<td>Provision for diminution in the value of investments</td>
<td>(45,000,000)</td>
</tr>
<tr>
<td>Loss for the year</td>
<td>(45,000,000)</td>
</tr>
<tr>
<td>Management fee</td>
<td>0</td>
</tr>
<tr>
<td>Net loss</td>
<td>(45,000,000)</td>
</tr>
<tr>
<td>Statutory Reserves @ 20%</td>
<td>0</td>
</tr>
<tr>
<td>Distributable profit</td>
<td>0</td>
</tr>
<tr>
<td>Loss c/f to balance sheet</td>
<td>(45,000,000)</td>
</tr>
</tbody>
</table>

In year 2, market improves and Modaraba sells the entire investment (original cost: Rs 80m) at Rs. 70 m and under the existing rules, it has to distribute 90% of the profit for the year as per Table B:

<table>
<thead>
<tr>
<th>Table B</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit and loss account</td>
<td>Rupees</td>
</tr>
<tr>
<td>Capital gain on sale of investments</td>
<td>35,000,000</td>
</tr>
<tr>
<td>Net profit available for distribution</td>
<td>35,000,000</td>
</tr>
<tr>
<td>Management fee</td>
<td>3,500,000</td>
</tr>
<tr>
<td>Profit available for appropriation</td>
<td>31,500,000</td>
</tr>
<tr>
<td>Statutory Reserves @ 20% (minimum)</td>
<td>6,300,000</td>
</tr>
<tr>
<td>Distributable profit</td>
<td>25,200,000</td>
</tr>
<tr>
<td>Distribution minimum 90%</td>
<td>22,680,000</td>
</tr>
<tr>
<td>Profit carried forward</td>
<td>2,520,000</td>
</tr>
<tr>
<td>Accumulated losses brought forward – Year 1</td>
<td>(45,000,000)</td>
</tr>
<tr>
<td>Accumulated loss carried to balance sheet</td>
<td>(42,480,000)</td>
</tr>
</tbody>
</table>
By simple combining two years, it will be clearly evident that in real terms Modaraba incurred a loss of Rs. 10 m as per Table C, yet provided management fee Rs. 3.5m, statutory reserves and has distributed profit, in shape of cash dividend, to its certificate holders amounting to Rs. 23 m i.e. total of Rs. 26m from its own sources without any cash inflow and/or real gain/profit. It is clearly evident that this payment has actually been made from the capital fund of the Modaraba.

Table C     Year 1 & 2

<table>
<thead>
<tr>
<th>Rupees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of investment</td>
</tr>
<tr>
<td>Sale proceeds</td>
</tr>
<tr>
<td>Loss on sale</td>
</tr>
</tbody>
</table>

Did we noticed that merely a book entry at the reporting date compelled modaraba to distribute what it never earned and that distribution is from capital fund?

Furthermore, if modaraba invest in unlisted securities or float its own unlisted public limited company than the gravity is much more than the aforesaid investment in listed securities.

Unlisted securities are accounted for using break-up value at the reporting date. Reductions, if any, from the par value, are required to be charged to profit and loss account and appreciations, are taken to equity.

Now if a modaraba purchase, say 25m shares @ Rs. 10 each of an unlisted company and at the reporting date the break-up value comes to Rs. 4 per share than it has to provide Rs. 150m as provision for impairment in value of investments. Similarly, in year 2 if the break-up value at the reporting date comes to Rs. 9 per share than it has to show reversal of Rs. 125m in its profit and loss account and by compulsion has to distribute 90% of it, after management fee and statutory reserves which is 65% or Rs. 81m from Rs. 125m.

Did we noticed that merely a book entry at the reporting date compelled modaraba to distribute what it neither earned nor received? No cash movement at all yet cast outflow of Rs. 81m.

Last but not the least, modarabas are also not allowed to adjust carry forward losses of Year 1 and in its presence are compelled to distribute 90% without any consideration of prudence as to the financial health of the fund. These accumulated losses carried to balance sheet would only be adjusted from the future profit for the year after adjustment of management fee, statutory reserves and distribution which as shown in the above Table 2 is a meager sum of Rs. 2.5 m only and will take years' to restore.

This accounting treatment gives rise to the following unattended factors:

1. Basic accounting concept of Prudence is being jeopardized;
2. How can a Modaraba distribute what has not been earned;
3. Just a book entry that has forced Modaraba to distribute dividend;
4. No cash inflows through true profitability; and
5. How can dividends be paid out of capital;

Furthermore, currently, if a Modaraba does not take provision in P&L and take it to Equity than the External Auditors qualify their opinion for non compliance of IAS. Hence, Modarabas suffer on both sides. If it provides in P&L and than reverse subsequently, it is required to pay cash dividends out of its own sources and capital. If it does not provide than External Auditors qualify their opinion on the financial statements.

The dilemma is that SECP has adopted IAS 39 as amended upto year 2009 and has not considered latest amendments translated in IFRS 9. Had this been proposed by ICAP and adopted by SECP this issue would have been resolved.

It is the IASB's intention that IFRS 9 will ultimately replace IAS 39 in its entirety. Although Board deferred the mandatory effective date from 1 January 2013 to annual periods beginning on or after 1 January 2015 with early application encouraged.

Governments all over, adopts IAS generally but flexible enough to put in abeyance applicability of those standards which are detrimental to it s local homemade industry.

In view of the above, it is strongly recommended that to save our peculiar homemade industry from this accounting fiction:

1. IFRS 9 be adopted as amended upto date; or
2. Applicability of IAS 39 be put in abeyance; or
3. Certain relaxation on the applicability of IAS is given by the regulators.

Modarabas may be given special permission to account for any impairment in the value of investments as part of Equity rather than charging off and/or reversals in profit and loss account. This treatment would also address the true and fair view of the financial statement.

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Defining Professional Judgment

“Professional judgment is a process used to reach a well-reasoned conclusion that is based on the relevant facts and circumstances available at the time of the conclusion. A fundamental part of the process is the involvement of individuals with sufficient knowledge and experience. Professional judgment involves the identification, without bias, of reasonable alternatives; therefore, careful and objective consideration of information that may seem contradictory to a conclusion is key to its application. In addition, both professional skepticism and objectivity are essential to the process and to reaching an appropriate conclusion”.

ISA 200.13(k) defines professional judgment as, “The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.” More commonly, judgment is the process of reaching a decision or drawing a conclusion where there are a number of possible alternative solutions. Often judgment occurs in a setting of uncertainty, pressures, and risk. “Professional judgment” refers to aspects of professional work that are not strictly controlled by rules. In such cases, the professional has discretion to choose among several alternatives and must take many factors into consideration.

The phrase “professional judgment” is not new to the accounting and auditing profession. Recently, there has been an increased emphasis on the importance of professional judgment as a result of regulation, standard setting, inspections and a move toward more principles-based accounting and auditing standards. The meaning of professional judgment and its application in an audit environment continue to be subjects of interest and discussion by auditing and accounting faculty, students, standard setters, regulators and auditing professionals alike. As accounting frameworks continue to call for increased judgment by preparers of financial statements, the auditor assessing those judgments will, in turn, need to apply professional judgment. With the move toward a more principles-based financial reporting framework and increased emphasis on fair value measurement, the ability to consistently make high quality professional judgments is increasingly important.

It used to be that exercising good judgment largely meant “using common sense.” But today, while common sense is still essential, exercising good judgment – consistently -- in a business environment that is increasingly complex and dynamic, volatile and uncertain and under high pressure requires a disciplined process. It also requires an understanding of common traps and biases, like “groupthink,” that can undermine the judgments of even seasoned professionals and boards. Good judgment requires discipline, awareness of traps and biases. Professional judgment is not an arbitrary decision, a substitute for professional skepticism, or a method to rationalize a particular result. Performing the process in “form” without focusing on the substance does not constitute well-reasoned professional judgment.

According to the Harvard Business School course, “Art of Critical Decision Making,” bad decisions are usually made because of a poorly thought-out decision-making process. If decision makers put more emphasis on how
Moreover, importance of professional judgment is requires accountants exercise of professional judgment. This use of professional judgment in IFRS is emphasized by the “substance over form” approach in the IFRS framework (IASB 2007). The substance over form approach follows the idea that attention should be placed on the “substance” of business transactions rather than their legal form, which requires accountants exercise of professional judgment. Moreover, importance of professional judgment is reinforced by standards requiring fair value approaches and discretionary decisions, such as IAS 39, which have been discussed extensively in the international accounting literature.

Because they are viewed as principles-based, International Financial Reporting Standards (IFRS) raise pervasive judgment issues (such as going concern, materiality and related disclosures) and application judgment issues (including presentation and disclosure, classification, recognition, de-recognition and measurement) for financial statement preparers, auditors and regulators. In fact, the need to exercise sound professional judgment on a continuous basis (perhaps 100,000 times a day around the world) was noted by Mr. Robert P. Garnett (Ex-Chairman of International Financial Reporting Standards Interpretations Committee (IFRSIC).

“Principles-based accounting standards are based on a conceptual framework, consist of a clear hierarchy of overriding principles and contain no ‘bright-line’ or anti-abuse provisions. Such an approach requires the use of judgment by preparers, auditors and regulators. With the safeguards afforded by such an approach, all parties should be more able to accept the consequences of exercising judgment in a principles-based accounting world.

Professional judgment is critical to efficiently and effectively planning, performing and concluding in an audit. Auditors use professional judgment to focus on the most important aspects of an audit; to determine the nature, timing, and extent of audit procedures; and to appropriately challenge the accounting, reporting, and other conclusions reached and financial statement assertions made by management.

In many professions, the difficulty of making judgments is recognized. However, the question that arises is whether auditors are being held to a higher level of accountability than other professions. This is particularly important where the scope of audits is constrained by the price society is willing to pay for such services. It is suggested that even a well-conducted audit, following all appropriate audit standards, can fail to detect a material fraud in the financial statements, particularly where management has gone to great lengths to cover up the fraud. Bell et al. provide the following quote from Sunstein (2002), p 77:

‘Of course experts make mistakes… But precisely because they are experts, they are more likely to be right than ordinary people. Brain surgeons make mistakes, but they know more than the rest of us about brain surgery; lawyers make mistakes, but they know more than most people about the law.
Where does this leave us? It suggests that many of the disagreements between experts and ordinary people stem from the fact that experts have more information and are also prepared to look at the benefits as well as the risks associated with controversial products and activities. Ordinary people often make judgments on the basis of quick, intuitive assessment, in which affect plays a larger role.

While the importance of professional skepticism and sound judgment is well recognized in most professions, knowing about it is not always enough. To understand judgment, it is crucial to focus on the quality of the judgment itself in light of the conditions under which it is made. Is it the result of the best possible thinking given what is known and unknown, the likely consequences, the objectives involved, and what is at stake? The work of auditors involves a continual effort to obtain the facts and to evaluate those facts within International Financial Reporting Standards (IFRS), Generally Accepted Accounting Principles (GAAP) and other professional rules, standards, and customary practices. This process requires the frequent application of professional judgment.

A good judgment process followed consistently can help improve decision-making and oversight, but “traps and biases” can undermine the process. “Thinking you know when in fact you don’t is a fatal mistake to which we are all prone”. Unlike the professional judgments that made the difference between tragedy and success—the tragedy of the Challenger space shuttle and the heroics of Apollo 13, judgments that auditors make do not affect life and death outcomes. They, nevertheless, can be consequential to the continued viability of organizations, the livelihoods of the people employed by them, and the investors who rely on them—not to mention the effectiveness and efficiency of our capital markets. Audit judgments—both big and small—matter. It matters, then, how well or poorly such judgments are made. Those individuals, teams and organizations known for making good judgments will distinguish themselves in the professional services marketplace. At the same time, the effects of challenging economic times, increased use of fair value measurements, and ever expanding regulations, among other things, have raised the threshold for what is considered effective judgment and decision-making skills.

The Center for Audit Quality (CAQ) indicates that “skepticism—a questioning mindset and an attitude that withholds judgment until evidence is adequate—promotes risk awareness and is inherently an enemy of fraud”.

The terms professional judgment and professional skepticism often go together in discussions about obtaining audit evidence or evaluating support for management’s accounting estimates. Professional skepticism is an objective attitude that includes a questioning mind and a critical assessment of audit evidence. Professional skepticism is not synonymous with professional judgment, but rather, it is an important component or subset of professional judgment. Professional skepticism refers to the ability of the auditor to approach issues in an objective, balanced way, with a questioning mind and an appropriate level of critical evaluation. It is important to understand that professional skepticism does not mean that auditors should adopt a cynical attitude toward client management. To the contrary, professional standards indicate that auditors should neither assume that management is dishonest nor assume unquestioned honesty. Auditing standards define professional skepticism as “an attitude that includes a questioning mind and a critical assessment of audit evidence.” Professional skepticism is term that grown up in academic and auditing literature which is associated with two common definitions.

One is the neutral definition, and that is you neither presume – the auditor neither presumes that management is honest or dishonest. It’s a neutral approach, and that means that the auditor will go in with a critical mindset, with a questioning mindset, and look at the evidence that’s presented to him or her. The second definition is one of “presumptive doubt,” and as that implies – that is one where there might be a presumption that the auditor should be more skeptical, more critical of management. One definition is not superior to others because they both require a critical assessment of audit evidence.

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New Publication from IFAC Helps Professional Accountants Implement Effective Business Reporting Processes in Organizations

Principles for Effective Business Reporting Processes

High-quality internal and external reporting is critical for all organizations. High-quality reports promote better internal decision making and high-quality information is also integral to the successful management of any organization.

Therefore, it is clearly in organizations’ best interest, for their internal decisions and management issues as well as external stakeholder needs, to provide stakeholders with high-quality business reports. The most effective way to accomplish this is to implement effective reporting processes throughout an organization. When done correctly, effective reporting processes ensure that all internal and external stakeholders receive appropriate high-quality business reports in a timely fashion.

Principles for Effective Business Reporting Processes, new International Good Practice Guidance from the Professional Accountants in Business (PAIB) Committee of the International Federation of Accountants (IFAC), helps organizations enhance their reporting processes. This guidance was written for all organizations, regardless of their size or structure, private or public, to address the need for effective reporting processes to produce high-quality reports.

Professional accountants in business are often involved in the implementation—including design, planning, execution, audit, evaluation, and improvement—of their organizations’ reporting processes. The key issues professional accountants in business need to address when implementing effective reporting processes in their organization are discussed in the guidance.

At the heart of the new guidance are 11 key principles for evaluating and improving business reporting processes (see below). These principles are complemented by practical guidance that outlines the critical arrangements that need to be in place for effective business reporting.

The guidance also includes a limited list of relevant resources from IFAC, its member bodies, and other relevant organizations. It can be downloaded free of charge from www.ifac.org/paib.

Key Principles for Effective Business Reporting Processes

These principles do not prescribe a specific approach but highlight a number of areas for consideration when implementing or improving business reporting processes.

A. Senior management should assume leadership for high-quality reports through effective reporting processes. The governing body should demonstrate commitment to high-quality reports and provide strategic input into, and oversight over, the organization’s reporting processes.

B. The organization should determine the various roles, responsibilities, and consequential capabilities in the reporting process, appoint the appropriate personnel, and coordinate collaboration among those involved in the reporting process.

C. The organization should develop and implement an effective planning and control cycle for its reporting processes in the context of, and in alignment with, its wider planning and control cycles.

D. To ensure the provision of high-quality information, the organization should regularly engage with its internal and external stakeholders and understand their information needs with regard to past, present, and future activities and results of the organization.
E. Based on the outcomes of its stakeholder engagement, and taking cost-benefit considerations into account, the organization should define the content to be included in its reports and also decide on the audience, layout, and timing of its reports.

F. The organization should have a process in place to ensure that the most appropriate reporting frameworks and standards are selected and that the requirements of those frameworks and standards are aligned with stakeholder information needs.

G. The organization should determine what information needs to be captured, processed, analyzed, and reported, and how to organize the information processes and related systems for effective reporting.

H. The organization should (a) identify, analyze, and select appropriate communications tools and (b) decide how to optimize distribution of the organization’s reporting information via the various communications channels.

I. The organization should ensure that reported information is sufficiently analyzed and interpreted before it is provided to internal and external stakeholders.

J. When obtaining internal or external assurance is not a matter of compliance, the organization should consider voluntary internal or external assurance on its reports and reporting processes.

K. The organization should regularly evaluate its reporting processes and systems in order to identify and carry out further improvements required for maintaining reporting effectiveness.

The figure below illustrates how the various principles relate to each other.

**About International Good Practice Guidance**

International Good Practice Guidance (IGPG) issued by the PAIB Committee cover areas of international and strategic importance in which professional accountants in business are likely to engage. In issuing principles-based guidance, IFAC seeks to foster a common and consistent approach to those aspects of the work of professional accountants in business not covered by international standards. IFAC seeks to clearly identify principles that are generally accepted internationally and applicable to organizations of all sizes in commerce, industry, education, and the public and not-for-profit sectors. Previously issued IGPGs are available on the IFAC website, including Preface to IFAC’s International Good Practice Guidance.

**About the PAIB Committee**

The PAIB Committee serves IFAC member bodies and professional accountants worldwide who work in commerce, industry, financial services, education, and the public and the not-for-profit sectors. Its aim is to promote and contribute to the value of professional accountants in business by increasing awareness of the important roles professional accountants play, supporting member bodies in enhancing the competence of their members, and facilitating the communication and sharing of good practices and ideas.

**About IFAC**

IFAC is the global organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC is comprised of 173 members and associates in 129 countries and jurisdictions, representing approximately 2.5 million accountants in public practice, education, government service, industry, and commerce.

*Copyright © January 2013 by the International Federation of Accountants (IFAC). All rights reserved. Used with permission of IFAC. Contact permissions@ifac.org for permission to reproduce, store, or transmit this document.*
A- Background

In today’s global environment, the business transactions in multinationals have become increasingly dynamic and complex. The transactions could be external with third parties/customers or internal within group companies. The internal transactions are within the organization, say from one department to the other or from one company to the other company. These transactions are normally referred to as “intercompany transactions”.

B- What are Intercompany Transactions?

In the context of IFRS, these transactions within group companies are referred to as related party transactions. According to Paragraph 9 of IAS 24, “A related party transaction is a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.” Some of the examples of related party transactions are purchase/sale of goods/services, transfer of assets, settlement of liabilities etc.

C- The Intercompany Policy

Globally the organizations have set out detailed intercompany policy guidelines to govern the transactions between group companies. Whilst some organizations prefer to keep margins on the cost, however others do not add any margin to the cost.

D- The Key Building Blocks of Intercompany Transactions

There are no hard and fast rules with respect to identifying the key building blocks as far as intercompany transactions are concerned. In practice, this would largely depend on the nature of entity’s operations, complexity, geographical spread and other factors. Generally, the following blocks are relevant regardless of the intricacies of the entity’s business and geographical spread:

1- Supply Chain

The supply chain process involves management of supply of goods and services covering activities from ordering until delivery. In most of the global organizations, the supply chain function is kept central with a view to achieve economies of scale by demonstrating group’s ability to negotiate better prices and volume discounts. Therefore, group purchasing coordinate the supply of goods/services on behalf of group entities. Besides that group purchasing also facilitate in seamless working of supply chain function with consistent results at each stage of the process. Some of the key success factors for supply chain to work as building block are:

- The administrative requirements (e.g. global master agreement)
- The customs duty and other associated issues
- Can the invoices be recharged to specific countries without administrative burden (some countries requires detailed documentation for recharges)
- The tax implications i.e. local tax compliance for the service provider, Withholding tax (WHT) on such payments
2- **Group Financing**

In some cases, the group (or central treasury) provides financing to the group companies for a specific project. Sometimes, this is in accordance with the requirements of the project and the debt spread as agreed and approved by the management. These loans are normally injected for working capital purposes. The key questions are:

- Does the local regulations allow financing by a foreign (wholly or partially) shareholder? If yes then what are the restrictions, limits on amounts, purpose of financing?
- There may be detailed administrative requirements (e.g. approval of central bank/investment authorities) for such disbursements/repayments due to international nature of these transactions
- From tax perspective, the withholding tax on interest payments (with and without Double Tax Treaty), deduction of interest cost, thin capitalization are relevant

3- **Transfer of Assets**

This involves transfer of assets or equipment used in business from one entity to other depending upon the requirements. Some of the key factors that need to be considered are:

- The duration for which the asset is being transferred (temporary import or permanent import into other country). Accordingly, the customs duty implications would be worked out as the case may be.
- If the asset is being transferred on permanent basis then this could mean that the asset will become the part of fixed asset and accordingly will be depreciated in the books of the receiving entity.
- The transaction could be carried at cost or at cost plus margin. This may require extra documentation (transfer pricing documentation) in respect of transfer of the asset

4- **Treasury**

If the group has set up centralized payment factory then the payment on behalf model will mean that parent or other group treasury company pays on behalf of the payer group company. The relevant factors are:

- The administrative burden at global payment factory level
- Anti money laundry checks
- Tax compliance if such transactions attract WHT and extra documentation to claim DTT benefits
- Smooth payments to suppliers based in countries specifically under the radar of global regulatory authorities

5- **Management Services**

The recharges for management services can include administrative, accounting and legal services to group entities.

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**E- Payments of Intercompany Transactions**

As the intercompany transactions are in between group companies, they carry cash flow challenges for the group in terms of meeting financial obligations to external suppliers. There are two possible routes to manage cash flows:

1- **Cash Pooling /Cash Concentration**

Cash pooling is a technique where cash balances in various bank accounts across the groups' bank accounts are collected/transferred into one central bank account.

Let’s assume that the group company is coordinating provision of goods or services for subsidiary company. Accordingly the group pays for those services/goods to the third party. This would leave maximum ‘funding’ of subsidiary being managed from group. Besides that the subsidiary is provided with funds sufficient to meet remaining working capital/ expenses. On the other side the client of the subsidiary will pay directly into the bank account of the group company. There could be regulatory/ administrative constraints restricting payments by the client directly into bank account of group
based in another country (or even in the same country).

2- Direct Payments

The direct payment from subsidiary to parent in respect of provision of goods or services is simple as compared to cash pooling. The key challenge for subsidiary will be to efficiently manage cash flows and be able to continuously transfer excess funds to the group.

F- Measuring Effectiveness of Intercompany Policy

The effectiveness, for instance, can be measured by comparing the cost of obtaining those designated services locally against those provided by the group. In case if the ‘local cost’ is minimal and adopting intercompany route could create more compliance and administrative burden, it may be worthwhile to avoid intercompany route. Some of the likely examples of distribution of economies of scale/performance improvements are:

a- Supply Chain
i- Volume discounts on group purchasing
ii- The quality and specification are according to the global standards and less chances of rejection of material/services etc

iii- Increase in operational efficiencies at local country level (for instance, more efforts directed towards sales/marketing than supply chain function)

b- Group Finance
i- Comparatively cheap loans as cost of financing could be low at group level when compared with obtaining finance locally
ii- Increase in operational efficiencies at local country level (as administrative part is being dealt with at group level)

c- Intercompany Transfer of Assets
i- Cost control history of existing assets
ii- Immediate deployment of idle asset (better than selling asset at one location and buying the same asset at the other location) unless the same asset cannot be used at other locations

d- Treasury/Management Services
i- Central processing would mean no extra overheads at individual country level thereby resulting in cost savings
ii- Standard processes would reduce chances of error, for instance, reducing banking cost of the transactions

G- To Recharge or Not – Punch List for Intercompany Recharges

The below are general points that could be considered for recharging items through intercompany route:

Group’s Perspective:
✦ Routine transactions or not?
✦ Economies of scale?
✦ Cost savings passed on to group companies

Local Perspective:
✦ Jurisdiction to which recharges are being made (drives complex regulatory and tax requirements)
✦ Local regulations/ease of funds transfer
✦ Tax expense deductibility and requirement for transfer pricing
✦ Pay-back?

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21st century is said to belong to Asia. Currently, Europe is in big financial problems. Several European Union countries have resorted to very heavy borrowing resulting into economic difficulties, if not collapse. Greece has suffered a lot. Ireland is in big trouble and European Union is struggling to offer some bail out packages. The struggle is on and one wonders how long it will take before European countries will come out of the woods. Starting with sub-prime crisis in USA, the economic and financial problems assumed greater heights. Over three hundred banks became bankrupt. The grand umpire of Leyman Brothers came to a grinding halt. Enron met with a big debacle and USA leadership is struggling to offer series of bail outs for financial and economic rehabilitation of USA. Unemployment has already reached around 10%. Their leadership is wondering what to do to pull USA out of the financial crisis. As against this backdrop, silver lining exists in Asia with high performance of Asian Tigers, great success achieved by Japan and recent sustainable growth of GDP of high order in China and India with other Asian countries also trying to perform well. The paradigm is now changing and the landscape of Asia through their solid leadership which is much better providing better results. In this background, this paper presents a brief of Western Theories of leadership which now need to be revisited and the Divine guidance provided by God (occasionally referred to Allah) will be presented for the readers to explore new heights with outstanding dimension of leadership revealed to us by Allah through Holy Prophet (PBUH) based on guidance included in Al-Quran.

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OTHER ARTICLES

Understanding Asian Perspectives on Leadership: Western Theories and Divine Guidance

Presented at: ELLTA Conference 2011-Malaysia 1st Academic International Conference 'Exploring Leadership and Learning Theories in Asia'

Prof. Dr. Khawaja Amjad Saeed, FCA

Constituents

This paper has been divided into following parts:


Part – II: Western Leadership Theories.


Each of the above aspects are now reviewed.

Part-I: Asian Scene

Asia is hydrogenous. Poverty levels are different. There are varying in literacy rates. Even there are large size populated countries like China and India having a population of one billion people and a small country like Maldives having a population of around three hundred thousand persons. Some of these countries, are maintaining sustainable high growth rates namely; China (9-11%), India (7-8%), Pakistan (around 7% on an average of 4 years during 2003-2007 etc. Several civilizations live in Asia. Lord Budhah’s guidance on leadership is driving many countries to achieve high success e.g. Taiwan and Thailand etc. Confucis School of Thought is being propagated and practiced in several Asian countries e.g., South Korea and Singapore etc. Leadership in India is driven by Hinduism and Jainism. Muslim world is also scattered e.g., Indonesia, Malaysia, Bangladesh, Pakistan, Afghanistan and Middle Eastern countries etc. Leadership in general is influenced by their
great leaders who are playing role models. Comparative study of these requires extensive and independent research. However, this paper will review basic Western Leadership Theories and also present Divine guidance to shape the leadership styles in their roles as effective and dynamic leaders on a comparative basis.

The author has been greatly inspired by a message which emanated from World Economic Forum, Davos, Switzerland which called for a study of Inter-faith Dialogue. With this background, this paper presents a humble effort on initial lines to embark upon a debate for studying the Western Theories of Leadership and the gift of God through the last book Al-Quran revealed by Him through the Holy Prophet (PBUH) before 1432 years.

**Part – II: Western Leadership Theories**

The concept of leadership is generally believed to include organizing a group of people for achieving common goals for an enterprise.

Several Western Theories alongwith the redeeming features are summarized (see Table 1).

**Western Leadership Theories**

The current emphasis is on thinking, feelings & inter-relationship and outward behaviour characteristics. Some of the power bases used by leaders include: legitimacy reward, coercion, referent and expertise.

Generally three styles of leadership are operating namely, autocratic, participative and paternalistic. Decision techniques include application of statistics, optimizing models, information models and simulation. Personal qualities of leaders for decision-making are influenced by experience, judgment, innovation and quantitative techniques.

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<tr>
<th>S/No</th>
<th>Theories</th>
<th>Main Features</th>
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<tr>
<td>1.</td>
<td>Trait Theory</td>
<td>There is a comprehensive list of traits which ought to be possessed by a Leader. Four traits include physical, intellectual, personal and social. Common consensus is on five traits namely; intelligence, social maturity, inner-motivation, achievement drive and human relation attitude.</td>
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<td>2.</td>
<td>Behavioral Approach</td>
<td>The emphasis is on the result of effective role behaviour. The leader is expected to have three skills namely; Technical, Human and Conceptual.</td>
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<td>3.</td>
<td>Situational Approach</td>
<td>The emphasis is on the situation in which leadership is exercised. Basically four factors are important namely; cultural environment, difference between individuals, difference between jobs and difference between organizations.</td>
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<td>4.</td>
<td>Elective Approach</td>
<td>This approach considers three variables namely; traits of leaders, situational variables, types of followers. The effort is to integrate all the above three variables to study a leadership pattern.</td>
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**Part-III: Divine Guidance for Leadership**

Islamic guidance for leaders has many sources. The vital ones are Al-Quran, the Last Revealed Book from God and Sunnah, Seerat of Holy Prophet (PBUH). However, for interpretation and further advice, scholars continue to seek guidance known as “Ijtehad”. An extensive research is needed for reviewing tremendous amount of knowledge which is available from the foregoing sources. However, this paper is an initial effort to draw God’s directives and guidance drawn from Al-Quran regarding some important aspects of leadership. In this respect, the author plans to continue research in other areas focusing on leadership in future. This paper has been exclusively developed from Divine guidance included in Al-Quran.

In Al-Quran, God has stated that He sent Torah and Gospel earlier and later sent upon Prophet Muhammad (PBUH) Al-Quran in truth. The relevant verse in this respect is quoted below.

“He has sent upon you [ O Muhammad ], the Book in truth, confirming what was before it. And He revealed the Torah and Gospel” (1)
From the above Quranic verse, while recognizing the earlier revelations through the foregoing two revealed books, God has clearly mentioned the last Book Al-Quran from which guidance for leadership is to be sought as He emphasized that this Book is in truth. Therefore, this paper has been developed seeking inspiration from the Divine guidance in respect of leadership.

Eighteen dimensions have been identified with twenty four citations from Al-Quran. These are reviewed with brief commentary now.

Dynamic and forward looking role from managerial angle has been spelled out by God in Al-Quran by giving candid emphasis in respect of the following:

1: **Aim for the Leader**

God encourages that a leader must have a clear cut aim so that he spells out his vision and mission for the guidance of his followers. Inspiration in this respect has been drawn the following verse:

“And We did not create the heaven and the earth and that between them aimlessly. That is the assumption of those who disbelieve, so woe to those who disbelieve from the Fire”. (2)

2: **Leaders - Men of Understanding**

The quality of understanding of a leader is a prerequisite from God’s viewpoint. Indeed, He has promised to give wisdom to such people. In this respect, relevant verse from Al-Quran is quoted below:

“He gives wisdom to whom He wills, and whoever has been given wisdom has certainly been given much good. And none will remember except those of understanding”. (3)

3: **Global Leadership**

God has emphasized that there should be a nation in the world who should invite people to undertake all such steps which are right and forbids them what are wrong. Accordingly, if this spirit is implemented by national leadership, success will follow.

In this respect, relevant verse from Al-Quran is quoted below:

“And let there by (arising) from you a nation inviting to (of that is) good, enjoying what is right and forbidding what is wrong, and those will be successful”. (4)

Based on the above verse, it is clear that there is a Divine guidance for establishing organizational aspects for encouraging and persuading people across the board to implement all actions which are in the right direction and demotivate people by forbidding them not to resort to wrong actions. A leader’s role is significant in this dimension.

4: **Leadership – Maintaining Balance**

God has guided us to maintain a balance during our behaviour as a leader. This ought to be reflected in decision-making roles by a leader. In this respect, relevant verse from Al-Quran is quoted below:

“And the heaven He raised and imposed the balance”. “That you not transgress within the balance”.

### Part-IV: Leadership In Islam: Selected Dimensions

Study of leaders have several dimensions. These, broadly speaking has multi faceted aspects – Some significant ones have been selected for developing this paper from Al-Quran. These include:

#### Leadership In Islam: Selected Dimensions

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<th>S / No</th>
<th>Dimensions</th>
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<td>Honesty as a Trait for Leader</td>
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<td>18</td>
<td>Leader – Born out of Command of Allah</td>
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</table>
“And establish weight in justice and do not make deficient the balance”. (5)

5: Shaping Leader’s Behaviour

God has guided the one who fears from Him. According to many scholars, if this spirit is indoctrinated in the leader and subsequently reflected in the behaviour of followers, the outcomes will be very positive namely; self-control, no frauds, no corruption, no act of immorality, healthy life and rational behaviour. Indeed, fear of God is a Panacea for several ills which we find in the society. In this respect, relevant verse from Al-Quran is quoted below:

“And remember the favour of Allah upon you and His covenant with which He bound you when you said, “We hear and we obey”, and fear Allah Indeed, Allah is knowing of that within the breasts”. (6)

6: Accountability

Self-accountability has been encouraged in Islam. The foundation of this is a belief in Hereinafter. In several Quranic verses God has stated that every action / deed which is performed by anyone (whether good or bad) is being recorded and accounted for. Moreover, on the Day of Judgment, balance sheet in this respect will be transparently presented by God to everybody. God has stated that on the above Day of Judgment, mouth will be sealed, the hands will speak to God of whatever actions were taken in the past and the feet will stand testimony to what had been done in the life time by an individual.

In respect of the above two thoughts namely; proper accounting and presentation of balance sheet, two relevant verses from Holy Quran are quoted below:

“So whoever does an atoms* weight of good will see it. And whoever does an atoms weight of evil will see it”. (7) (* or weight of small ant )

“That Day, we will seal over their mouths, and their hands will speak to Us, and their feet will testify about what they used to earn”. (8)

Another verse from Al-Quran in respect of guidance of self-accountability is quoted below:

“For each [ religious following ] is a [ prayer ] direction toward which it faces. Source to [ all that is ] good. Wherever you may be. Allah will bring you forth [ for judgment ] all together. Indeed, Allah is over all things competent”. (9)

Another verse from Al-Quran is also quoted below:

“To Allah is your return …. He [i.e. Allah] knows what they conceal …and what they reveal … Indeed, He is knowing of that within the breasts… All is in a clear register”. (10)

7: Leader’s Role for Change

A leader is expected to serve as a catalyst for change. Rather than living with status-quo, improvements and innovation only follow if change is introduced. A leader must prepare the followers, in this respect, and seek guidance from Allah. In this respect, relevant verse from Al-Quran is quoted below:

“… Indeed, Allah will not the change the condition of a people until they change what is in themselves” (11)

Based on above, leadership role in transformation will be the outcome.

8: Leader’s Role: Avoiding Wastage

One major cause of loss in business and industry is waste. There is a tremendous scope of eliminating and uprooting the causes of wastage which can beef up bottom line of an enterprise. Wasteful practices are anti-productivity and reduce profits. There is a Divine guidance to leaders to ensure that a framework is developed whereby wastage is avoided. In this respect, two verses from Al-Quran are quoted below:

“And give the relative his right, and [ also ] the poor and the traveler, And do not spend wastefully” (12)

“Indeed, the wasteful are brothers of the devils, and ever has Satan been to his Lord ungrateful”. (12)

Accordingly, the zero defect philosophy is borne out of above.

9: A Criteria for True Leadership

Allah likes leaders who are the most righteous ones. This is a singular criteria spelled out by Him in Al-Quran. Accordingly, the liking of Allah is not being extra rich or dirty rich who plunder wealth and accumulate it through wrongful methods. Quranic verses in this respect, is quoted below:

“O mankind, indeed We have created you from male and female and made you peoples and tribes that you may know one another. Indeed, the most noble of you in the sight of Allah is the most Righteous of you. Indeed, Allah is Knowing and Acquainted”. (13)

Based on the above spirit, God promises to raise some above the others in their ranks as they emerge as outstanding leaders. In this respect, relevant verse from Al-Quran is quoted below:

“… And have raised some of them above others in degrees [of rank] that they may make use of one another for service”. (14)

10: Leadership Through Consultation

Rather than behaving in dictatorial / authoritative style, Allah encourages the leaders to resort
to consultation. Accordingly, Consultative Management is in accordance with the Islam. In this respect, relevant verse from Al-Qurah is quoted below:

“… So pardon them and ask forgiveness for them and consult them in the matter. And when you have decided, then rely upon Allah. Indeed, Allah loves those who rely [upon Him].” (15)

11: Leaders to Rely On Allah

Allah encourages lenient behaviour rather than dealing followers with rudeness. He encourages people to rely upon Him. Therefore, the believers are encouraged to inculcate the spirit in them so that favour of Allah may be showered on them through His blessings. In this respect, relevant verse from Al-Quran is quoted below:

“So by mercy from Allah, [O Muhammad], you were lenient with them. And if you had been rude [in speech] and harsh in heart, they would have disbanded from about you. So pardon them and ask forgiveness for them and consult them in the matter. And when you have decided, then rely upon Allah. Indeed, Allah loves those who rely [upon Him].” (16)

12: Leaders Achieving Success

Allah encourages leaders to obey Him and to obey his Messenger (Prophet Muhammad) (PBUH) and those in authority among you. However, in case of any disagreement over anything, He directs leaders to refer the matter to Allah and His Messenger by believing in Him and Day of Judgment. Accordingly, He promises the achievement of the best results. In this respect, relevant Quranic verse is quoted below:

“O you who have believed, obey Allah and obey the Messenger and those in authority among you. And if you disagree over anything, refer it to Allah and the Messenger, of you should believe in Allah and the Last Day. That is the best [way] and best in result.” (17)

In another Quranic verse, He has directed leaders that, for achieving success in life, the prerequisite is that one should believe in Allah and fear Him and always seek the mean of requesting His favours and blessings. In this respect, relevant verse from Al-Quran is quoted below:

“O you who have believed, fear Allah and seek the means [of nearness] to Him and strive in His cause that you may succeed.”(18)

13: Leaders for Anti-Hoarding Practices

Malpractices in business generally occur from hoarding of goods. Free interplay of demand and supply is not allowed to function properly. Consequently, there is social destabilization. Inflation is caused and social evils continue to grow. Allah has warned painful punishment for those who resort to hoarding of goods. In this respect, relevant verse from Al-Quran is quoted below:

“… And those who hoard gold and silver and spend it not in the way of Allah – give them tidings of a painful punishment.”(19)

14: Austerity for Guidance of Leaders

Austerity management has been advocated by Allah. Conspicuous consumption is totally discouraged and leaders are directed to follow guidance on spending as per following Quranic verse:

“… And they ask you what they should spend. Say, “The excess [beyond needs].” (20)

15: Leader as a Trustee

A leader is expected to behave like a trustee on behalf of beneficiaries and also inculcate this spirit amongst his followers. The malpractices of grabbing, plundering, looting others wealth / property, specially that of orphans, is a misdirected action and is forbidden by Divine advice contained in the following verse of Al-Quran:

“And do not approach the orphan’s property except in a way that is best [i.e. intending improvement] until he reaches maturity. And give full measure and weight in justice. We do not charge any soul except [with that within] its capacity. And when you speak [i.e. testify], be just, even if [if concerns] a near relative. And the covenant of Allah fulfill. This has He instructed you that you may remember.” (21)

16: Verification of Information by Leader

A leader is expected to verify the information before sharing it with his followers. This can lend credibility to his stature and pave the way for compliance. In this respect, verse from Al-Quran is quoted below:

“And do not pursue that of which you have no knowledge. Indeed, the hearing, the sight and the heart – about all those [one] will be questioned.” (22)

17: Honesty as a Trait for Leader

Several traits have been stressed as an integral part for a leader. Amongst them, Allah has identified honesty as a singular trait to be possessed by leaders. In this respect, relevant verse from Al-Quran is quoted below:

“And weigh with an even [i.e. honest] balance.” (23)

18: Leader – Born out of Command of Allah

A leader is required to follow Command of Allah and be inspired by His guidance. In this respect, relevant verse from Al-Quran for compliance is quoted below:

“And We made them leaders guiding by Our Command. And We inspired to them the doing of good deeds, establishment of prayer, and giving of Zakah; and they were worshippers of Us.” (24)
Part-V: Way Forward

While lot of literature exists on Western Theories of leadership, a humble effort has been made in this paper to present Divine guidance given before 1432 years governing the behaviour, traits, approach, dimensions, roles etc. from God contained in the last Book Al-Quran revealed by Him. This paper can serve the spirit of Interfaith Dialogue so that the Western Scholars may get enlightened regarding the message of God and try to reflect on various ideas shared in this paper straight from the Holy Book, Al-Quran.

Accordingly, dialogue and debate can continue for improving the overall role of leaders in their decision-making styles for the betterment of followers to achieve high performance and help accomplish vision and mission of an enterprise.

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Doing job in today’s corporate world is very challenging. You face new tasks each day and you strive for the best to achieve those in the stipulated time. But those incoming and outgoing tasks often keep you so busy that you focus confines to your achievements, your career and your wishes. Resultantly you achieve your tasks and get promoted or get to a new role or even some new organization but unfortunately those fellows are neglected from whom you took most of your work, ignoring that you had to payback something too.

Like any other environmental factor that needs to be managed in a way that we achieve our maximum potential, we should also pay attention to the development of our subordinates. This management factor is often ignored by many and as a result we excel in our career, get rewarded whereas our subordinates remain on the downside and we never feel any responsibility towards them. This is, in my opinion, not the right way to manage it. There does stand a sense of responsibility on the manager’s part towards the workers and it needs to be honoured.

Assistants make a substantial part of your day. You face them in the morning, where you greet each other, you start your day by transferring work to them, you review their progress as the day progresses, you grant them leave and you see them off in the evening. Each step during the day needs to be managed in the best possible way considering humanity, values of our religion, our professional ethics and the very position we hold for managing them.

The three factors that determine the effectiveness of an employee are their Skills + Hard Work + Attitude.

It is said that if skills are missing, develop them, if hard work is missing, motivate the person but if attitude is missing, fire him. You really don’t take any chances.
when facing a stubborn attitude. But what needs to be analyzed is whether that attitude is an action or reaction and most importantly, if you are the one to whose action this is a reaction. If that is the case, it really is an area that deserves your attention.

Firstly, behavioral aspects need to be considered, since they matter the most. Being nice to our subordinates in the morning with a smiling face, going to their desks for just a shake hand will not undermine your respect and status at all and for sure, in my opinion, it will increase your respect in their books. Remembering their birthdays, taking them to some lunch outside, caring for events happening in their life will all have a very positive effect on them. Your appreciation when they do something well and your support when they fall somewhere will really matter to them a lot. The reason these small acts have major impacts on the motivational level of employees is that they fulfill their social needs and supervisory attention and feedback keeps them engaged in their work.

Secondly, to be a good assistant, skills are vital. A subordinate who comes up with an idea for a problem in which you are stuck in some thought when you are making some important communication, one who develops a good presentation for you, one who formats the document for you, will save a lot of your precious time. But to make your life easy, you have to train your subordinate so that he learns the necessary skills and picks up the mantle for you. One can himself take the lead and train the subordinates on a set agenda on a fixed time either weekly or on monthly basis. One should give his subordinate some time daily in which he should have some professional value addition. For making life of boss easier in a work environment, professional resources downstream are essential. Ideally, a boss should hire his second in command expert in a skill which the boss is not very good at himself. Thus he should learn from the front without waiting for the Human Resource department to act for him as it is he who would suffer the most, otherwise.

Hard work is fueled by motivation. Motivation these days is widely regarded to achieve through the salary and other monetary or non monetary benefits on which bosses have influence ranging between minimum to maximum. The first and foremost responsibility of a good boss is to motivate the subordinates to encourage them to deliver their best. Appreciation is widely regarded to be a highly effective tool for accomplishing this. Appreciating at the right time when the subordinate does a good job and supporting the subordinate when he makes mistakes are of equal importance. As a first step after an employee commits a mistake, a good boss should think of the solution towards that mistake. Solution includes correction of the problem and to try his best to protect the employee from the music from upstream. A wise approach in my opinion is to look for the solution of the problem first, avoid humiliating the culprit and advise him on the right solution later on in a mild tone. However, the manager often needs to change hats and be strict to the employee as well, if the same mistake is repeated frequently.

Another skills improvement can be achieved through delivering presentations on some knowledge which is of equal benefit and importance for all. Example of which include delivery of presentations on different International Accounting Standards by accounts department personnel, presentation on income tax updates and budget highlights etc. These sorts of presentations have multiple benefits as they, on one hand benefit the whole department by increasing their knowledge base and on the other hand they fortify team spirit, smoothen mutual communication and play an important role in easing out the boss’s work, while simultaneously adding to the knowledge base of everyone present.

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Chartered accountants and CPAs are some of the brightest professionals in the world. Accountants regularly rank in the top 10 percent on college entrance exams, and most people would argue that their intelligence quotients rank at the very top, as well.

A book, Leading an Accounting Firm is about leading a small (or large) group of very bright, somewhat introverted, and skeptical accountants toward a common goal. It’s about leading a small team of auditors, tax accountants, or consultants. It’s about the new manager leading a group of accountants on an engagement, leading niches, divisions, and service lines or leading large organizations with many offices and hundreds of partners, owners, or shareholders.

When I became an audit senior and later a manager at Price Waterhouse, I mistakenly thought that the title on my business card gave me the right to tell people what to do. Looking back in horror, I know now that people didn’t want to follow my leadership because they felt dominated and manipulated. It was a painful lesson for me to learn that I could manage projects and processes but not people. It took me many years and experiences to grasp the lesson embodied in Drucker’s opening quote, and I am still working hard on it today. To be effective, you can’t manage people; you must lead them.

This makes the case for leadership. I have found that if people first understand the way of something, then the how, what, when, and where come easier. In upcoming blogs, I will describe why leadership matters in Accounting firms and what aspects of leadership matter most to those who are running those firms—often in their own words. The payoff (benefits) of great leadership will be discussed, along with some of the challenges of leading a highly skilled and intelligent workforce. We will also cover the leader’s role in growing the firm and leadership compared with management. An interesting topic that we’ll cover is how leading an accounting firm has some similarities and differences to other business types. My hope is that you grasp the why of leadership and that it will encourage you to devour other material on leadership that will take you through the how, what, when, and where of leadership.

To bring these leadership lessons to you, I’ve interviewed nearly 100 leaders from accounting firms all over North America, like Tony Argiz in the following section. Many of the interviewees’ firms have been named best-of-the-best or all-star firms by various publications. A large number of my interviewees are leaders of firms that have progressed from start-up to becoming a member of the top 100 accounting firms in the United States. At the end of 2010, there were approximately 25 accounting firms in the top 100 that are still in the first generation of their leadership. A few, like Reznick Group, are in transition from the first generation of leadership to the second generation. That is an amazing statistic when we realize that the United States has nearly 50,000 firms. So, I wanted to know what it was about the leadership of these firms that powered them into the best-of-the-best category or the top 100 in the first generation. What did their partners say about them? And what can we all learn from their insights, wisdom, and experiences?

Here is a Profile of one of our great leaders: Tony Argiz, founder, CEO, and managing partner of mega-regional firm Morrison, Brown, Argiz & Farra, LLP based in Miami, Florida.

The leadership development story of Tony Argiz is one of the most fascinating in the accounting industry today. Born in Cuba, Tony was sent to the United States by his parents, who desperately wanted to keep him safe from the burgeoning Communist regime. Only 8 years old when he left, he became part of Operation Pedro Pan. He sadly remembers his mom working for days to make him a suit and an overcoat for the journey to the United States, but the regime’s militiamen wouldn’t allow him to take anything but the clothes he was wearing.

Raised in a Catholic boarding school funded by the Archdiocese of Miami, FL, Tony cried himself to sleep many nights because of loneliness and feelings of abandonment. Although he somewhat understood the dangerous political climate in Cuba at the time (the Cuban government had nationalized all businesses,
including his father’s wholesale meat business), he nonetheless spent many days sad and bewildered.

Today, Tony has become a recognized business and civic leader in south Florida. As the CEO and managing partner of Morrison, Brown, Argiz & Farra, LLP (MBAF) since 1997, he has led the growth of the firm to become one of the top 40 accounting firms in the nation. MBAF is also a 15-time honoree on the INSIDE Public Accounting (IPA) annual list of the nation’s 25 best-managed accounting firms. Tony was also selected as one of the “Top Five Most Admired Peers” by the IPA 100.

Adam Spiegel, MBAF partner, says, “The best thing Tony has created within our firm is a culture of people who always seek to grow and improve. He is constantly encouraging each and every person to think, “What can we do next for our client, our firm, and our community?”

The culture we have at MBAF requires us to work smarter and improve efficiency and effectiveness in the work we do on a daily basis. Many people who are no longer with the firm now miss this special culture.

Tony is a strong believer that if you do not write down your goals, your chances of achieving them will be much diminished. Tony creates an environment of opportunity and sets the framework for unlimited growth and satisfaction in all our people. I truly believe that “the sky is the limit” is each person’s opportunity at MBAF. It does not matter if you start in our file room or as the receptionist; what matters is your initiative, effort, and desire to improve, grow, and utilize the firm’s resources to achieve collective and individual goals.

Tony has led our organization through this economic crisis by teaching each of us to provide exceptional value-added service, to be consistent and diligent about the communications with our clients, and to use our skills of professional skepticism to protect our number one asset: the firm. I believe that this brand of leadership is the reason that we have continued to grow as an organization through the economic crisis. Tony’s ability to anticipate problems and, most of all, to provide solutions ahead of time has helped us and our clients survive and thrive. Tony has an impressive ability to get people to focus on the “solutions” and not the problems. This ability is imperative to the optimistic culture within our firm.

Tony encouraged me to get involved in Leadership Miami, where I met future leaders of our community and built relationships that have lasted 14 years. This program led to several important developments within our firm, such as our mentoring program. Tony then encouraged as a result of this experience, I have implemented several new principles into my day-to-day activities and into the culture of our firm. We have just announced a combination with the firm ERE in NYC, and Tony’s leadership through the year-long process has been unwavering. He has always been positive and optimistic that this combination will provide additional opportunities for each individual within the firm. Tony has been very concerned that both firms have a synergistic culture and that each member of the combined firm feels that this is a once-in-a-lifetime opportunity to be a part of a firm that is going to grow beyond its wildest dreams.”

Well-known for his community and industry leadership, Tony has served on many boards and as chairman of many, including the Orange Bowl Committee and the United Way of Miami-Dade. Tony has actively served on leading industry associations, chairing key committees in furtherance of the accounting industry. He has served on the AICPA’s Nominations Committee, the governing body of the AICPA’s Council and the Private Companies Practice Section Executive Committee and its Technical Issues Committee. In 1986, Tony was appointed to Florida’s Board of Accountancy and was then elected to chair the board. He chaired its Probable Cause Panel, as well.

Rosamari Bravo, MBAF partner, says, “Tony has a keen sense in identifying an individual’s strengths. By doing this, he creates an environment in which everyone can succeed. I started to work at MBAF right out of college with no professional experience. After a couple of years, Tony would invite me to attend client meetings with him. At first I spent most of the time listening. Little by little he would give me more responsibility until it got to the point that he expected me to run the meetings. This experience allowed me to learn from Tony and gave me the confidence to believe in my abilities.

Tony is the epitome of a person that leads by example. Everything he expects us to do, he is always doing himself first. He is the first one working in the morning and the last one to leave the office. He tackles every challenge that comes his way and is always thinking about how we can improve and serve our clients better. Seeing his dedication and attention to detail inspires me to work harder to become a good leader of my team.”

In high school, he found that sports provided him with many opportunities to learn to lead a team. Later, he pitched for Florida International University, which brought him back to Miami. Tony Argiz found that his high-school sports experience gave him some of his first leadership training because in a sports team and an accounting firm, there’s really no difference in leading. If you’re on a baseball, football, or basketball team, you can’t win by yourself. It’s a team effort, and it’s a team sport. My role is not only the management and making sure that we make the money, but it is to continually bring in business, whether it’s litigation, for me to testify, or audit work or tax work.

Based on a new book by Troy Waugh – Leading an Accounting Firm, the pyramid of success available at www.therainmakercompanies.com or www.cpa2biz.com:
Private Equity
An Emerging Asset Class

Hassan Kamal Farooqui, ACA

Just a few years back, the financial markets were evidencing a new sector within the financial markets named as ‘Asset Management’ and by now most of the world’s developed financial markets have now deeply dived into this sector which is evidenced by development of numerous sub asset classes and investment strategies. Funds/Asset Managers are specialising and investors appear to be much converged towards specialised markets.

Investment managers kept their pace delve into investment opportunities with higher yields and ‘Alternative Investments’ turned out to be one of the highly considered areas. An ‘Alternative Investment’ is an investment other than the conventional investments of shares, securities, bonds, property or cash deposits. The term has broad meaning when used but, in terms of financial assets, includes Private Equity, Hedge Funds, Venture Capitals, commodities and financial derivatives.

This article is purely focused on Private Equity, an asset class, which is now widely recognised in European and American financial markets, with Middle Eastern countries’ hastily entering to place themselves.

What is private equity?

By definition, Private equity is an asset class comprising equity securities or debts in operating companies that are not publicly traded on a stock exchange. Some of the most common Private Equity investment strategies are: leveraged buyouts, venture capital, growth capital, distressed investments and mezzanine capital. In a typical leveraged buyout transaction, the private equity fund acquires majority stake of an existing or mature entity. This is distinct from a venture capital or growth capital investment, in which the private equity firm actually invests in immature or emerging companies, and hardly obtains majority control.

Some of the main investment strategies are briefly explained below:

Venture Capital - investing in an immature or developing company.

Venture capitalists are the professional investors who put their finances alongside the management of an emerging and rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital also assists start-up companies in initiating their operations and in actively marketing their products and services.

Buyout - acquiring a complete or controlling position of another firm

A buyout Private Equity fund, also known as a leveraged buyout or “LBO,” seeks the takeover, controlling interest, or complete ownership of a company. A buyout fund employs leveraged capital – a mixture of debt usually secured by the assets of the business, and equity provided
either by the fund’s capital or newly raised funds. Buyout funds may take an active or passive role in managing the acquired company.

**Mezzanine** – Investment in the expansion of an existing company

In a typical scenario, a Mezzanine capital is a late-stage investment which is employed just prior to an initial public offering (IPO).

Private Equity funds provide Mezzanine financing through a variety of different structures depending on the specific objectives of the transaction and the existing capital structure in place at the investee company. The basic forms used in most mezzanine financings are subordinated notes and preferred stock.

The investors target a certain rate of return which can come from in combination of their investment in debts and securities. Investors entering a private equity fund at this stage typically take on less risk than at earlier stages due to anticipated capital appreciation or liquidity events resulting from the upcoming IPO.

Mezzanine financing is a hybrid of lending and equity investing, and broadly refers to unsecured, high-yield, subordinated debt or preferred stock. With higher repayment priority than equity, it can facilitate payment of new management ahead of existing management in the event of bankruptcy, and is often used in acquisitions and buyouts.

**The term ‘Private Equity’ has increasingly been in the discussion over the past many years - but how do these PE firms operate?**

Some frequently used *terms* need to be defined first in order to describe the operational structure of the Private Equity Firms:

**Committed Capital** – is that amount of capital which an investor has actually legally committed to provide to private equity fund by signing Limited Partnership Agreement or side letter.

**Drawdown Capital** – is that amount of investor’s committed capital which has actually been drawn down (i.e. called by a private equity fund and paid to them by the investor).

**Invested Capital** – as the name suggests, is that part of drawn-down capital which has actually been invested in assets.

**Capital Call** - When a private equity fund needs cash for investment/expense, the General Partner ‘GP’ (explained below) will issue a ‘Capital Call Notice’ (usually known as ‘Drawdown Notice’) i.e. will request for a certain amount of money from investors to be paid into a specified bank account by a certain date and will give brief details of why money is required for.

The investors (LPs) will check that the purpose for which the money is required is valid according to the terms of the LPA (i.e. the investment within the stated scope of the fund), and that the amount is correctly calculated.

**Distribution** - Distributions are the other side of the Cash flow. Whenever a fund exits an investment by sale or if there is any excess money called from the investors then they will have cash available to return to the investors. This is usually achieved by a ‘Distribution Notice’ which is just reverse of the ‘Capital Call Notice’, and will notify each individual investor of how much money they should expect to have transferred into their bank account, and the value date.

**How the private equity funds are structured**

Private equity funds are invariably structured as Limited Partnerships, thus leading to the steady adoption of the American terminology “LP” (Limited Partner) for an investor in such funds and “GP” (General Partner) for a manager. This limited partnership is closed end fund with a finite life time (typically 5 to 10 years), depending its investment strategy i.e. buy out or venture capital fund. (See diagram - Fund Structure)

Private equity funds are distinct from other forms of investments in a way that that they represent a stream of unpredictable (in terms of both timing and amount) cash flows over the life of the fund, both inward and outward.

The way in which a private equity fund invests is that investment power is confined to the General Partner (GP) or fund manager. The investors have no right to be heard at all in the investment process and indeed, should not prefer to have any right since there is significant risk of them losing their limited liability if they can be shown to have played an active part in the management of the fund.

**How the Fund Managers get remunerated**

The fee structure for private equity firms varies, but it typically consists of a management fee and a performance fee (in some cases, a yearly management fee of 2% of total commitment and 20% of net realised investment gains). That said, how firms are incentivized can vary considerably. Given that a private equity firm with $1 billion of assets under management might have no more than two dozen investment professionals, and that 20% of net realised gains can generate tens of millions of dollars in fees for the fund manager, it is fairly easy to establish why the private equity industry has attracted top talent and equally why investors are enticed of private equity investments.

**What is being criticised in Private equity Funds?**

Amongst other areas, private equity funds are being
mainly criticised in terms of transparency and their tax implications.

**Transparency** - The transparency of private equity firms is somehow a concern, with critics saying a lack of accountability means that decisions are made behind closed doors. This is however slightly mitigated via third party independent administrators, external audits and periodical reporting to the investors.

**Tax** - One of the big objections to private equity is the tax breaks given to the industry, more particularly the tax on the carried interest.

Private equity executives pay taxes on their basic pay and bonuses, but a large part of their income comes from carried interest which is the 20% slice of profits left after paying back to the investors.

For investors, this money is classified as a capital gain and ultimately is subject to a much reduced tax charge, typically 10%. It has been criticised that this should be charged at normal income tax rate too.

**Scope of Private Equity Funds in Pakistan**

Based on industry news, JSPE Fund I was Pakistan’s first private equity fund sponsored by JS Group with institutional limited partners including International Finance Corporation (IFC), Saudi American Bank (SAMBA), DCD Group and Global Investment House, Kuwait (GIH). JSPE Fund I was launched in 2006 and targeted private equity buyouts, minority block positions in public/private enterprises and expansion capital in Pakistan. The fund was headquartered in Karachi with representation in Dubai and London. The fund was closed just after two years of operation due to economic turmoil.

In terms of Private equity investments in Pakistan, the market heard some more names like TMT Ventures, CapAsia etc; though Pakistan is still a virgin private equity market. Despite its political turmoil and instability, Pakistan is still one of the hottest emerging markets for the investors and on and off there are always positive activities. One of them being a newly Pakistani private equity fund ‘Indus Basin Holdings’ has managed to get Britain’s former secretary ‘David Miliband’ on board as a senior advisor.

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We look forward to your cooperation in this regard.
The U.S. Foreign Account Tax Compliance Act (FATCA) is the latest talk of the town in financial sectors around the globe – thanks to Extra-territorial jurisdiction (ETJ) i.e. the legal ability of a government to exercise authority beyond its normal boundaries. FATCA is designed to stop the flow of money from the US into untaxed accounts and raise revenue by collecting unreported earnings. According to estimates, this tax evasion by US persons costs the US government $100 billion annually. But, while FATCA takes a giant step in closing the loophole, the feasibility of implementing and enforcing it on foreign financial institutions (FFI) around the globe is a troublesome equation.

The goal of FATCA is simple: Combat tax evasion. However, its implementation is extremely complicated as the onus of compliance will now be on FFIs. Foreign governments, banking associations, both in the U.S. and abroad, and various corporate entities have criticized the Act as being cost prohibitive. Financial industry professionals also question the real return on investment for the U.S. once the cost of enforcement is calculated along with tax dollars gained. One thing is certain though, like it or not, FATCA has arrived and is here to stay!

Key Facts about FATCA
The regulation sets out new reporting rules for U.S. taxpayers both at home and abroad. Though it is a U.S. law, FATCA also imposes compliance regulations on foreign financial intuitions (FFIs), which have stirred up global denunciations. FATCA, signed into law in March 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, is being implemented in stages. The first phase, which covers filing requirements for U.S. taxpayers, is effective with 2011 tax returns. The second phase detailing obligations for foreign financial institutions becomes effective in January 2013.

Requirements for U.S. Taxpayers
Under FATCA, a U.S. taxpayer must file new tax form if his foreign financial assets have an aggregate value exceeding $50,000. Failure to report these foreign assets carries penal implications.

Some Common Myths about FATCA
✦ If we have no US persons and/or assets, we don’t have to do anything
✦ It is a just a Tax problem
✦ FATCA only affects Private Banking
✦ FATCA is going to go away

Well none of the above is true!
Requirements for Foreign Financial Institutions

FATCA is technically voluntary however those FFIs that do not participate in FATCA will suffer 30% withholding on all income and sales proceeds from the US. FATCA sets strict compliance and reporting requirements for the FFIs. Under the law, FFIs must perform due diligence on customers and report information directly to the IRS. FFIs must:

- Identify US taxpayers having accounts with them
- Report these US taxpayers annually to US Treasury

Furthermore, FFIs that decide not to participate in FATCA may be:

- Exposed to a series of financial, commercial and reputational risks
- Force to comply even where no US source payments exist as many third parties are likely to require you to be FATCA compliant for practical business reasons

International Concern

FATCA has raised concerns among FFIs across the globe regarding the cost and compliance burden of identifying U.S. accountholders, performing specific due diligence and reporting on them annually. Some argue the law violates their national borders and sovereign laws.

What needs to be done by Banks?

Take Strategic decisions

- Comply? To what extent? If not, repercussions?
- What entities to include in FFI agreement?
- Strategic business decisions i.e. divestment, clients

Client Relationships and Client Service

- Communicate new changes to existing clients
- Consider closing accounts held by U.S. Persons
- Handling of clients that will not provide information
- On-going monitoring of changes to client status

KYC/AML

- Expand on-boarding procedures/documentation
- Classification of account holders as US persons
- Remediation of existing accounts

Information Technology/Systems

- Data validation/remediation of accounts
- Communication of new and existing systems
- Additional data/information storage requirements

Legal and Compliance

- Monitor organization’s compliance with FATCA
- Tolerance level of non-compliance
- Potential conflicts with local secrecy laws

Tax Reporting

- Track and withhold for FATCA
- New annual IRS filing requirements

The Bottom Line

Most of those who have commented on the new law agree that plugging holes in tax legislation is a laudable goal. But the debate whether FATCA is the right plug continues to rage. FATCA is here, but how successful it will be, remains to be seen.

About the Author:

Nadeem Iqbal, ACA is a member of the Institute of Chartered Accountants of Pakistan since 2004. He currently Heads the Compliance and AML function of a leading Bank in Oman. He has previously worked in senior positions within compliance / assurance functions for various Financial Institutions in UAE and Pakistan. He is also a Certified Anti Money Laundering Specialist from ACAMS USA.

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Introduction

The Institute of Chartered Accountants of India organized an International Conference for CA students at Nagpur, India on 13 & 14 July 2012. The theme of the conference was "Interact to innovate" where around 1200 students from all India and 29 International students from SAFA member countries were present. 5 students including myself from the Institute of Chartered Accountants of Pakistan (ICAP) visited India and became part of this international conference. I would like to share some insights of this conference to my friends who missed this mega event and take the maximum benefit of the same.

Highlights of the Technical Sessions

The first technical session started on the topic "International Financial Reporting and Taxation". The topic was of utmost importance in the sense that India, Sri Lanka and Nepal, all are in the initial phases of adopting IFRS, especially as to how Indians are trying to make "IND-AS" (Indian Accounting Standards) to converge with IFRS which was their main emphasis for a step towards global compatibility.

The second technical session was about accountability in Public Domain and Corporate Governance. Papers were presented on "Sarbanes-Oxley Act" that has created new standards for corporate accountability as well as new penalties for wrong doing.

"It takes two years to learn to talk but how, when, and where to talk, it takes the whole life". The third session delivered this message. "Legal, technical, and communication skills" was the topic of this session. Apart from how to communicate, prepare and present effective presentations, the paper presenters insisted on complementing the intelligence / cognitive capabilities (IQ) with a humane understanding of issues known as Emotional Intelligence (EQ) or soft skills.

"Cloud Computing" and "Green Audits", the two important terms, were discussed by the paper presenters in the forth technical session. Cloud computing actually suggests the use of Internet Network to share the IT infrastructure for business entities. Instead of building IT infrastructures consisting of servers, networks and applications, etc a third party hosts them in its large server farms and the user just pays a fee according to its usage. "Green audit" simply means "environmental audit". Green Audit has the aim of ensuring that the organizations take steps to combat pollution and other environmental issues not just legally but as their corporate social responsibility.

Indian Food and Culture

We went to New Delhi from Lahore by bus. Entering into the Indian territory did not make us feel any difference except for the Wine shops that were so common, Pigs and cows roaming on the roads, the Cycle rickshaws, a number of temples and especially, girls driving scooty. The people are same, the traditions are almost similar.

We then went to Nagpur by "Rajdhani Express" (considered to be one of the best trains in India). Nagpur is famous for its oranges and tigers. Nagpur has the zero point which is the exact center of India.

We often went to a restaurant for breakfast where we were served “Dosa” (delicious south Indian food). Apart from that, food was usually served in their traditional “Thali” with more than one food dishes to be eaten. The dinner on the second day of the conference was served at “Chokar Dhani” – a traditional Rajasthani cultural palace. It
made us feel that we are in Rajasthan. Mostly vegetarian food was served but cooked in an Indian style, it taste so good. The institute also organized a musical night which was just unbelievable where CA students performed at par with the professional dancers and singers.

Some Problems

Whenever one visits India, he must be aware of these issues. The visa issued to us was Delhi transit and Nagpur only and also required Police reporting. The transit visa caused us some problems. So get proper visa before visiting India on the safe side. All other SAFA students had all India non reporting visa and Nepalese had visa free entry. The internet and telephone facility was not provided, thus we were not able to communicate with anyone. All other students had mobile roaming facility available, but for Pakistanis, the roaming facility was not available. Halal non vegetarian food is not available easily. “Masajid” (mosque) were rare to find to offer prayers.

Interaction with SAFA Students and FAQs

All of us had a great interaction with the students of Nepal, India, Sri Lanka, and Bangladesh which was the most learning experience of our lives. All of us discussed issues related to our education, culture, language, food, traditions, and the political situation as well. One notable point is that everyone was aware of what is happening in Pakistan more than they had knowledge of any other country. A common question which was most often asked by every second person I met was about Pakistan’s internal conflicts and security concerns. People had unrealistic views about the affairs of our country and based their views on the views of the international media. Although it was nice to know that all of them understood and realized the strategic importance of Pakistan and the people of Pakistan in the world. Perhaps we learnt the most from this interaction than anything else.

In all, the trip was a memorable and learning experience where we developed our communication skills and opened new avenues of thoughts in our minds. The conference achieved its objectives as the interaction was really meant to innovate. I would like to appreciate the efforts of ICAP, Management and students of Institute of Chartered Accountants of India, who organized this mega event, invited us, made excellent arrangements for all the delegates and made this event a memorable event for all of us.

About the Author

Mr. Saqib Rafique is working as an Audit Associate, Rahman Sarfaraz Rahim Iqbal Rafiq, Chartered Accountants.

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Future of Cyber Security – Who Decides?

Afshan Aleem
Senior Officer - Publication Dept, ICAP

“If you know the enemy and know yourself, you need not fear the result of a hundred battles. If you know yourself but not the enemy, for every victory gained you will also suffer a defeat.”

– Sun Tzu, The Art of War

Our endpoints are under attack. With every passing day Governments, defense industries, and companies in finance, power, and telecommunications are targeted at a tremendous rate by overlapping surges of cyber attacks from criminals and nation-states seeking economic or military advantage. The invasion percentage are now so large and their sophistication so great, that agitated many organizations for determining which new threats and vulnerabilities pose the greatest risk and how should the resources be allocated to ensure that the most probable and damaging attacks are dealt with first. While exacerbating the problem is that most of the organizations do not have an Internet-wide view of the attacks.

- 27% rise in cyber security vulnerabilities identified by IBM (only) between 2010 & 2011.
- Global cyber security spending expected to reach $60 billion in 2011.

Compelled by a growing concern for the potential vulnerability of networked societies together with an increasing number of disruptions in the cyber-domain, many steps have taken by countries to better understand the vulnerabilities of and threats to their information infrastructure, and have planned measures for the protection of these assets. The common string is that these systems have become the ideal target for attackers whether they are the end goals or just the initial victim in a large attack. Antivirus and firewalls are some traditional defenses which are now no longer effective. Organizations should assess new approaches to battling malware.

Converging technologies and innovations will make communication possible between human brains with computers, cellular phones and the World Wide Web. But going around with these technologies we begin to feel sometimes, really paranoid on our own safety. May it be our tangible safety or the intangible security of the personal data it should represents about what is cyber security all about? Basically it is conserving the personal information or digital asset stored in a computer or in a digital storage device.

There are different kinds of threats that a person will have to encounter in cyber space and each one has its own degrees of seriousness which require specific levels of solutions. The more colossal the threat level is, the more advance or complicated the approach to implement safety measures to protect him from such harm. From simple malicious codes, which termed as malware and spywares to dangerous virus that can erase the whole contents of a computer, and hackers that can access and use the personal information for their own personal gain, these are the risks that a person will need to address. Oftentimes, those malicious codes or malware pass through the security system when people access a particular website or even when they open an email. These codes tap the loopholes in various applications and insert themselves within the computer systems which enable them to Xerox and infect other computers by attaching themselves to the emails that a person sent out or through his local network. These malicious codes are tricky. They claim to do something but instead they will go on a totally different path in infecting the system. They are not isolated to malware and spyware but also refer to virus and worms which are fatal and cause more damage. Even though malicious codes are quite harmful, another dangerous intruder would be hackers or attackers. Virus and worms can only do what the original programmer has intended it to do, but hackers can get the information they want and use it for their own interest. Occasionally hackers are just testing their skills
and deliberately invade systems not because they want information for their personal gain but because they are basically just curious or are just doing some mischief.

Everyone needs to avoid these kinds of things, and should know about cyber security and how to handle the various threats. To check the vulnerability a person has to look into his firewall and virus protection software to see if his current setup can prevent attacks from the outside. Due to this reason it's really important to continuously update the software since new threats are being created everyday and having an updated system can help protect anyone from being attacked. Another precautionary measure would be to create passwords, as passwords will serve as a deterrent and help to keep the whole system protected. With proper protection installed, a person can keep his files and information safe. It is imperative to keep in mind about cyber security. Cyber security is all about keeping your information safe from those who wish to access them. It is an important aspect of our lives and should never be disregarded most especially in today's computer age.

While new signatures and heuristic techniques are developed each day, the malware problem remains significant with no sign of lessoning. It shows that the current protection technologies are struggling towards keeping up. Managing the whitelist can prove difficult in large, open environment. The challenges in dealing with memory based attacks such as buffer overflows are also clear.

Threats

Various threats to information and security impacted the world’s population. Currently businesses, consumers, and governments now maintain or transmit their information using information system that are directly or indirectly connected to the Internet through the use of a Local Area Network (LAN) or Wide Area Network (WAN). For those systems that are not connected to the Internet, may share information with remote computer systems utilizing a dedicated private data connection point (using frame relay, ISDN, ATM, or other intranet connection method) or in some cases a modem connection over the public phone system. Each of these scenarios depicts a method of sharing information electronically. The

Five Big Security Threats for 2011-12

Threat 1: Mobile Apps
What it is: when you run an application for the first time, the malware gains administrator access without your permission. Others are Repacked applications, data leakage from the lost phone.

Protect Yourself: Make sure to download apps from reputed sites, Also, read an app's permissions screen carefully.

Threat 2: Social Network Based Scams
What it is: Social networks such as Facebook and Twitter may be a breeding ground for malicious activities.

Protect Yourself: Revoke the app in your security permissions and changing your account password.

Threat 3: Fake Antivirus
What it is: Also known as “scareware,” these scams start by convincing to download a free antivirus program, appearing to be software from a reputable security company.

Protect Yourself: Make sure you are running a security program that’s current and effectively block brand new malwares.

Threat 4: PDFs
What it is: PDFs are potentially one of the most dangerous file formats available and should be treated with caution, it is significantly easier to generate legitimate and concealed malicious content with PDFs.

Protect Yourself: Make sure your antivirus is up-to-date, never open an e-mail attachment that you weren't expecting, keep Adobe Reader up-to-date.

Threat 5: War Games
What it is: State-sponsored malware attacks, industrial espionage, and hacktivism are on the rise. They may not be threats that affect everyone, but for a business, they are the sorts of issues which should be paying attention to.

Protect Yourself: Monitor your company’s network traffic for suspicious activity and conduct regular reviews of employee data access privileges.

Cyber Attacks

Hacking: Breaking into a computer or network to gain some form of control. Techniques include SQL injection, denial of service, access via default credentials, password or credential theft.

Malware: Software designed to infiltrate or damage a computer system without the owner’s knowledge or consent, e.g. key logging and spyware, malware to establish a botnet, trojan.

Misuse: Abuse of computer systems, abuse of personal privileges for malicious intent, abuse of system privileges, embezzlement.

Deception and Social: Manipulating an individual to gain unauthorised access to a computer system or network, eg phishing, pharming.

Physical: Trespass or threat to gain unauthorised access to a computer system or network, eg wire tapping, shoulder surfing, assault/threat of harm.
following is a list of common cyber security threats to most information systems:

1) Unauthorized access, alteration, or destruction of information.
2) Misuse of authorized access to information.
3) Accidental alteration or destruction of information.
4) Malicious software programs (viruses/worms/trojans).
5) Mis-configured or poorly designed information systems allowing too much access.
6) Improper handling of information. *
7) Physical theft of information or information systems. *

* Indicates a relation to physical security practices.

Vulnerabilities

Vulnerabilities are termed as weaknesses in policies, and procedures that can facilitate a successful exploitation of a threat. A threat cannot be carried out without a vulnerability that can be exploited. The fact that a threat and vulnerability exists in turn creates risk. The likelihood of the threat and vulnerability being exploited determines the overall risk probability or score. Not all vulnerabilities are relevant to every organization. Many of the vulnerabilities are directly related to the technological advancement. Most vulnerability tends to be found in the operating systems and applications on computer systems and devices that are used to maintain the information in the first place. With the low cost of technology and availability of the Internet, the possibility of exploiting vulnerabilities and turning threats into reality is a major concern.

Risks

1. Client-side software that remain unpatched

There are waves of spear-phishing attacks that exploit client-side vulnerabilities in some of the most commonly used programs (e.g. QuickTime, Adobe Flash, Adobe PDF Reader and Microsoft Office). These vulnerabilities are also used by attackers when users visit websites that are infected. The attackers’ objective is to steal data from the organizations and install back doors for further exploitation.

2. Internet-facing websites that are vulnerable

Over 60% of total attack attempts were planned against web applications. Attackers are exploiting such vulnerabilities in order to convert trusted websites into malicious ones. Examples of web application vulnerabilities include SQL injection and cross-site scripting flaws. These two vulnerabilities alone account for 80% of discovered vulnerabilities. The majority of website owners do not effectively identify these common flaws, enabling criminals to infect site visitors.

3. Don't Forget to Eye the URL

Visiting new websites is a risk. Always take a moment to scan the site's Uniform Resource Locator, or URL, which is displayed in a bar at the top of the Internet browser. That URL is the address of the website, to look out for typos or other irregularities to make sure they really are connecting to a legitimate website and not just a clever imposter. Most URLs will begin with the familiar 'http' before the site's address. News, entertainment and other general interest websites all use this format for their URLs. But to share sensitive information such as Social Security number, make sure that Web address starts with 'https' instead of 'http.' That little ‘s’ stands for secure, so the website has to have additional security precautions on the page keeping you safer and a whole lot less likely to have your information stolen.

4. Don’t Click on Shortened URLs

If using Twitter, shortened URLs are a method for streamlining a link so it can fit in Twitter’s 140-character limit. While shortened URLs are handy for sharing information via Twitter, they’re also dangerous. For posted links it’s good to proceed with caution. Whenever see a shortened link, you do not know what the actual Web address is until you click. Scammers often use shortened URLs to lead victims to a malicious software, or “malware” website. So it’s better to take the extra step of expanding the link to see the full address before clicking on it. But that’s not as simple as a mouse click. Many of the services that provide shortened URLs have stepped up their efforts to guard against scammers, but it’s also a good idea to have a tool that allows to safely open the shortened URL.

Conclusion

A Canadian once said about cyber security that it was “a Gordian knot around which many stakeholders circle, pulling on the strands that seem most promising and causing the entire thing to tighten even more snugly rather than loosen to reveal its internal structure”. Even though this quote dates back to 1999, it still rings true today. Cyber security is a great puzzle to people belonging from a variety of communities, and its intermediary secrets are far from being revealed. Drive
towards Cyber security might bring professionals closer to a global culture of cyber security. Many approaches at national level still remained unexplored with a great degree of diversity, and the most important initiatives are early-warning approaches, legal issues, public-private partnerships, and the need for more research.

In most countries, the law-enforcement cyber-crime perspective has emerged as the most prominent one, due to the nature of the threat, the resources that were available to the law enforcement community, and cultural and legal norms, they restrict the number of potential strategies available for selection. Thus, one key issue for all countries is the harmonization of the law to facilitate the prosecution of cyber-perpetrators. Global culture of cyber security has emerged from a bourgeois need on the part of the nation-states. The importance of world-wide scope of the Internet demands an international approach, even though any cyber-perpetrator is a physical entity in a physical location with an Internet connection. The dilemma here is that, as due to the nature of the technological environment, most of the military plans to engage in computer network operations and to attack and harm an adversary mean that the chances for a global culture of cyber security are considerably diminished. There is a need for a common understanding of threats and an understanding that can only be fostered if all experts address these issues on one ground. Equipped with a common idea, experts will no longer have to pull on the strands that seem most promising, but will be able to systematically untangle those strands that have hitherto kept the community from developing a global culture of cyber security.

Strengthening the trust framework, including information and network security, authentication, privacy and consumer protection, is a prerequisite for the development of the Information Society and for building confidence among users. A global culture of cyber security needs to be promoted, developed and implemented in cooperation with all stakeholders and international expert bodies.

1) In Internet terminology, a generic name for a list of e-mail addresses or IP addresses that are considered to be spam free.
Accountants frequently inherit spreadsheets created by others, and must quickly determine that such documents have proper integrity. Microsoft Excel offers a number of formula auditing techniques that spreadsheet users tend to overlook. In this article I’ll describe several techniques that I use to gain a comfort level with spreadsheets created by others. I’ll first focus on Excel’s formula auditing tools and then move on to uses of the Go To Special Command. I’ll then cover Background Error Checking as well as Excel’s Error Checking feature, and finally discuss the Show Formulas feature.

Formula Auditing Tools

To start, all versions of Excel include a suite of formula auditing tools. In Excel 2007 and later, these appear on the Formulas tab of Excel’s user interface known as the ribbon. In Excel 2003 and earlier, choose Tools, and then Formula Auditing.

You’ll notice that the Formula Auditing tools include commands for Trace Precedents and Trace Dependents. Use Trace Precedents to identify any cells that the formula in a selected cell is linked to. For instance, if cell B10 in a worksheet contains the formula =A1 then choosing the Trace Precedents command would add a blue arrow to indicate the relationship, as shown in Figure 1. Multiple arrows will appear if the cell in question refers to more than one other cell. In addition, you may sometimes see a black arrow that points to a worksheet icon. This icon signifies that the current cell is related to another worksheet. To determine the location of the cells on other worksheets, double-click on the black arrow to display the Go To dialog box, as shown in Figure 2. Double-clicking on the worksheet icon itself will simply select the underlying cell, so be sure to double-click the black arrow instead. The Go To dialog box will contain a list of cell references on other worksheets related to the current cell, as shown in Figure 2.
Another nuance with regard to Trace Precedents is that you can double-click the blue arrow to navigate between related cells. This is helpful when the precedent cell is located on the same worksheet, but beyond the area you can presently see onscreen. Double-clicking the blue arrows allow you to quickly move back and forth without physically scrolling the worksheet.

Keep in mind that the Trace Precedents command only identifies one precedent level at a time. Sometimes a series of cells are daisy-chained together, as shown in Figure 3. Be sure to click the Trace Precedents command multiple times to ensure that all precedent levels are identified. Unfortunately Excel does provide any visual indication that all of the precedent levels have been identified—you’ll simply stop seeing new blue arrows appear onscreen. In Excel 2003 and earlier, you’ll want to choose Tools, Formula Auditing, and then Show Formula Auditing Toolbar to make it easier to access the Trace Precedents feature in this fashion.

To clear the precedent arrows, choose the Remove Arrows command within the Formula Auditing commands section of your version of Excel, as shown in Figure 3. All of the aspects of the Trace Precedents feature work in a similar fashion for the Trace Dependents feature, which identifies cells that reference the active cell.

Go To Special

The aforementioned Go To dialog box provides access to an often overlooked feature known as Go To Special. In Excel 2007 and later you can choose Go To Special from the Find and Select menu on the right-hand side of the Home tab. In Excel 2003 and earlier choose Edit, Go To, and click the Special button. Or, in any version of Excel press F5 (or Ctrl+G) to display the Go To dialog box and then click Special. The dialog box in Figure 5 shows several auditing capabilities:

- **Precedents** – As shown in Figure 5, you can specify either Direct Only or All Levels. Choosing Direct Only is the same as choosing the Trace Precedents command once—only the immediate precedent cell will be selected. Rather than drawing arrows, Go To Special selects cells instead. Therefore, if you choose All Levels Excel will highlight all cells that are linked in any fashion to the present cell or block of cells. You can either change the color of the selected cells, as shown in Figure 6, to mark the cells for additional follow-up, or you can use the Tab key to navigate from cell to cell. Press Shift-Tab to move through the cells in reverse order.

- **Dependents** – This feature works in the same exact fashion as the Precedents option in the Go To Special dialog box. For both precedents and dependents Excel will notify you if no other cells are related to the current selection.

- **Constants** – The Constants feature allows you to identify cells that do not contain formulas. From an auditing standpoint, this allows you to quickly determine if anyone has overwritten a formula in a
large block of cells without having to review each cell individually. To do so, display the Go To Special dialog box, and then choose either Numbers or Text, depending upon the type of formula that you're auditing. Excel will either highlight cells that meet the criteria you specified, or else notify you that no cells were found.

 downhill • Formulas – The Formulas feature works similar to the Constants option, but allows you to search for various types of formulas:

- Numbers – This option identifies formulas that return numbers.
- Text – This option identifies formulas that return text.
- Logicals – This option identifies formulas that make logical decisions, such as IF statements.
- Errors – This option identifies formulas that presently return errors such as #DIV/0!, #NAME?, #REF!, and so on.

• Row Differences – This option allows you to determine if a range of cells within one or more rows contains an inconsistent formula. To use this feature, select two or more cells going across a row, and then choose the Row Differences option within the Go To Special Dialog box, as shown in Figure 7. As with the other Go To Special options, Excel will either select the cell or cells containing inconsistent formulas, as shown in Figure 8, or else notify you that no cells were found.

 Background Error Checking

All versions of Excel offer a built-in error checking feature that places a green triangle in the top left-hand corner of cells that may contain errors, as shown in Figure 9. This feature can be helpful, but is also distracting so users sometimes disable it. Follow these steps to confirm the status of automatic error checking in your version of Excel:

- Excel 2010 and 2013: Choose File, Options, Formulas, and then confirm that Enable Background Error Checking is enabled, as shown in Figure 10.
- Excel 2007: Click the Office button in the top left-hand corner of Excel, choose Excel Options, and then in the Formulas section confirm that Enable Background Error checking is enabled.
- Excel 2003 and earlier: Choose Tools, Options, and then on the Error Checking tab confirm Enable Background Error Checking is selected.

 Periodically you may construct a formula that Excel incorrectly flags as an error. In such cases, select one or more cells in question, hover your mouse over the exclamation mark that appears, and then choose Ignore Error from the resulting drop-down list. To display any hidden error indicators, click the Reset Ignored Errors button shown in Figure 10.
Error Checking Feature

Excel’s Error Checking feature works in concert with Background Error checking to enable you to navigate to each cell within a worksheet that has been flagged as a possible error:

✦ **In Excel 2007 and later:** Click Error Checking on the Formulas tab.
✦ **In Excel 2003 and earlier:** Choose Tools, Error Checking.

When you invoke this command, Excel will either inform you that the error check is complete for the entire sheet, or will take you to each cell that possibly contains an error. As shown in Figure 11, the Error Checking feature contains buttons that will help you remedy the possible error:

Figure 11: Excel’s Error Checking feature helps you resolve common formula errors.

✦ Copy Formula from Left: This button will offer different solutions, such as copying a formula from an adjacent cell, or converting numbers stored as text to values. In other cases the dialog box will contain a Show Calculation Steps button that enables you to walk through the formula one step at a time.
✦ Help on This Error: This button launches Excel’s Help file, which depending upon the error, may present helpful information, or may just take you to a screen from which you can search the online help file.
✦ Ignore Error: This button allows you to signify that the formula is correct as written and that Excel should not consider it to be an error.
✦ Edit in Formula Bar: This allows you to manually revise the formula within Excel’s Formula Bar.

The Options button takes you to the aforementioned Error Checking settings section within Excel’s Options dialog box. The Previous and Next buttons allow you to navigate to other cells that Excel has marked as possible errors.

Show Formulas

Many users don’t realize that Excel worksheets can be displayed in two different modes: values mode and formula mode. By default you work in values mode, such that when you enter a formula in a worksheet cell you see the result, and not the underlying formula. However, you can toggle the worksheet do display all formulas instead:

✦ **Excel 2007 and later:** Click the Show Formulas command on the Formulas tab.
✦ **Excel 2003 and earlier:** Choose Tools, Formula Auditing, and then Formula Auditing Mode.

As shown in Figure 12, the worksheet will change to show all of the formulas. This provides an easy way to verify that no formulas have been overwritten, as every cell that should contain a formula will begin with an equal sign. Execute the aforementioned command again to return the spreadsheet to values mode. You can use the Ctrl+` keyboard shortcut to toggle this setting as well.

Figure 12: The Show Formulas command displays formulas on a worksheet instead of values.

Conclusion

The techniques in this article only present a subset of the techniques available to accountants seeking to establish a comfort level with unfamiliar spreadsheets. Excel’s Formula Auditing tools provide a visual aid in understanding how cells within a spreadsheet relate to other cells. Go To Special offers several ways to isolate formula differences or hard-coded values where formulas are expected. Background error checking can provide immediate feedback when cells may contain errors, but be aware that this feature often reports false positives, or can be disabled by users. Excel’s Error Checking feature scans the worksheet and offers to assist in resolving formula errors. The Show Formulas allows you to instantly determine all cells within a spreadsheet that contain formulas.

About the Author:

Mr. David H. Ringstrom is a Certified Public Accountant and president of Accounting Advisors, Inc., an Atlanta, Georgia-based software and database consulting firm that he started in 1991. Mr. Ringstrom’s articles on Microsoft Excel appear regularly on www.accountingweb.com and www.accountingweb.co.uk. Throughout his career he has spoken at conferences and written articles on Excel for various publications, and regularly presents continuing education webcasts for several United States-based providers.
Mr. Muhammad Yousuf
Roll No. 4062857
S/o Muhammad Farooq was awarded ICAP Gold Medal for outstanding performance in the subject of “Advanced Auditing” and ICAP Gold Medal (Adam Patel) for overall outstanding performance in “Module-F”.

Q.1) What was your source of inspiration to join CA?
My sole inspiration was my parents who always wanted their son to be a Chartered Accountant as it was and still a very challenging and prestigious qualification.

Q.2) What does it take to be a gold medalist?
To be a gold medalist one must carefully plan his studies and focus a lot on studies. It also takes solid hard work.

Q.3) What are your future plans after the completion of CA?
To serve my nation and make my country and Institute proud of myself.

Q.4) What message would you like to convey to the students who would like to, join the same qualification?
This qualification is very much achievable unlike what many people say but you need to be focused and determined come what may.

Q.5) What are your academic strengths?
My biggest academic strength is managing through ambiguity and to study when I feel like I should study. I believe in self improvement and I continuously evaluate myself to learn about the areas in which I need to improve.

Q.6) Generally what are your thoughts and impressions about CA qualification?
In my opinion Chartered Accountancy is one of the most prestigious and exalted qualification in Pakistan and ranked among the best in the world.

Q.7) During your study period was there something you struggled with, such as a specific technical issue or time management etc? If so, how did you manage to overcome this difficulty?
I lacked a bit in time management initially but then I start simulating the exam environment and it helped me a lot in refining my time management skills.

Mr. Sandeep Kumar Shamnani
Roll No. 4062955
S/o Vishin Das Shamnani was awarded Bhimji Gold Medal for outstanding performance in the subject of “Advanced Taxation” and Osman Ali Gold Medal for outstanding performance in the subject of “Business Finance Decisions” of Module-F.

Q.1) What was your source of inspiration to join CA?
CA is viewed as most challenging qualification throughout Pakistan. I, belong to a small town where there was no as such awareness about CA qualification. The perception there about CA is that it the most complicated qualification in Pakistan and only genius students can get
Q.1) What was your source of inspiration to join CA?
I always wanted to do something which can help me earn respect and prove the confidence that my parents had in me. Although my parents are from medical background, but I wanted to pursue a different qualification and accounting being my area of strength and interest, I took up CA knowing it is a challenging and rewarding field.

Q.2) What does it take to be a gold medalist?
In my view, it is your hard work, direction, knowledge and your skills, that makes you to achieve a Gold medal.

Q.3) What are your future plans after the completion of CA?
I would like to get practical exposure of diversified industries as much as I can. Further, I am also planning to excel in Financial Management by pursuing CFA qualification.

Q.4) What message would you like to convey to the students who would like to, join the same qualification?
The students willing to join CA should be goal oriented and pursue CA with full dedication. Further, I would also suggest them to plan their studies with a clear direction in their mind, should set realistic targets and stick to their planning.

Q.5) What are your academic strengths?
I believe in research work and used to do a lot of research which enabled me to enhance my knowledge from wide range of sources that has helped me throughout my academic career.

Q.6) Generally what are your thoughts and impressions about CA qualification?
Chartered Accountancy is the professional qualification that enables individuals to achieve their career goals and polish their raw skills. It strengthens your time and pressure management skills and makes you to sustain a challenging environment.

Q.7) During your study period was there something you struggled with, such as a specific technical issue or time management etc? If so, how did you manage to overcome this difficulty?
Being a trainee in a professional firm does have its toll on our studies. The two months study period was indeed hectic, with long hours of classes and sleepless nights. However, the key for me was to strategically manage my time and utilize it efficiently for all subjects. I also constantly sought guidance and advice from my teachers and seniors, which helped me to focus on the core areas.