CIMA Sri Lanka Division takes pleasure in introducing The CIMA Edge, a technical and business e-magazine for members, passed finalists, corporate partners and training partners of the South Asian and Middle Eastern region.

Achieving a competitive edge in today’s intense markets, leading an organisation through rapid change and economic volatility, and creating sustainable value to the stakeholders are very demanding.

We intend to journey on a process of adding great value to our members and partners by:

- providing updates on contemporary local and global economic and business issues,
- introducing developments in science of accounting, and
- promoting CIMA UK initiatives.

My sincere appreciation to all our contributors for sharing their invaluable knowledge and insight.

Regards,
Nilushika Gunasekera
Technical Manager
CIMA Sri Lanka Division

Contents: feature articles

Global recession and the impact on Sri Lanka by Dr Arul Sivagananathan
Debt was seen as one of the causes of the great depression of 1930s that lasted over ten years. It has once again played a leading role in bringing about the world’s current economic woes.

Basic introduction to trading volatility by Suminda Dharmasena
Trading strategies are numerous, but can be broadly classified as strategies to identify mispriced instruments, pure bets on market direction, and strategies that benefit from volatility created by the factoring-in of new information, referred to as ‘volatility trading.’

Sri Lanka Accounting Standard 21: The effects of changes in foreign exchange rates
This standard prescribes how to include foreign currency transactions and foreign operations in financial statements by choosing the appropriate exchange rate.

‘Quote: Unquote’ compiled by Imal Pereis
‘It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change.’ Charles Darwin.

The Ten Commandments of Business Failure
Donald R. Keough, the former President of the Coca-Cola lists ten reasons for business failures.

News and events

CIMA invites proposals on risk and performance research initiative
CIMA announces alliances with international accountancy bodies, CMA Canada and CPA Australia
CIMA contributes to global sustainability framework, a web based tool of issues and examples of good practice

Sri Lanka
The technical paper competition 2009 is open from 11 February to 8 May 2009. For more details visit www.cimaglobal.com/srilanka

Technical session on research techniques and analytical writing skills 9.00am, 28 February 2009
Speakers: Dr Travis Perera and Ms Anju Moses

Evening discussion on tough times smart investments 6.15pm, 4 March 2009
Speakers: Jayantha de Silva, Jay J Keller and Tariq Marikar

CIMA Sri Lanka launched its Corporate Partner Program 2009 on 5 February at Cinnamon Grand Hotel

India
CIMA signs mutual agreement with Indian accountancy body, ICWAI
Global recession and the impact on Sri Lanka
by Dr Arul Sivagananathan

How did it happen?
Debt was seen as one of the causes of the great depression of 1930s that lasted over ten years. It has once again played a leading role in bringing about the world’s current economic woes. Safe to say it started in the USA with the sub-prime crisis. Sub-prime lending refers to lending at higher interest rates to people who may not qualify to borrow under usual criteria for lending. Maybe they have a bad credit history or don’t have a regular job or income. In the past, due to high risk of default, banks did not lend to people who didn’t meet strict lending criteria.

However, since 2001 property prices in the USA have been rising continuously and bankers felt safe lending to sub-prime borrowers as the borrowings were secured by mortgages against the property. The idea was that if customers defaulted, the bank could sell the mortgaged property to recover the capital. The end began when the Federal Bank (US equivalent of Central Bank) started increasing interest rates. Sub-prime borrowers who could not keep up payments started defaulting and banks started selling the mortgaged properties. As properties flooded the market for sales, the property prices fell. The surviving banks became even more conservative in their lending, which intensified deflationary pressures on economies and brought businesses around the world to the point where, they didn’t have access to credit to run their daily operations. This lead to even more job losses and the vicious cycle continued downwards.

It is to try and arrest this downward slide that governments around the world have stepped in to infuse funds to the financial systems. USA announced a US$ 700 billion bail out of the US economy. The UK government announced a GBP 37 billion bail out of the banking sector as well as a holiday period for mortgage borrowers. Mortgages are to be recalculated after two years. In addition to the bailouts, UK has also tightened the regulatory framework. Many countries such as Japan, Canada and other EU countries have also lowered interest rates to encourage public spending to increase the production and bring a recovery as soon as possible.

Knock-on effect on Sri Lanka
Sri Lanka does not have the conditions to start its own full blown recession for the simple reason that Sri Lanka does not have the type of sub-prime lending market that burst the bubble in the USA. However, Sri Lankan economy is so dependent on international markets that Sri Lanka cannot hope to escape the ripple effects of a world recession. Unlike India and China, Sri Lanka does not have a huge local market that can sustain the growth rates. However, Sri Lanka is yet to feel the full force of the economic down turns, but it is surely on its way. Already there are daily reports of the tourist industry affected greatly by the drop in the inbound tourists. The government has already recognized the plight of the tea, rubber and other agricultural producers and offered relief measures through the mini budget. Several companies in the apparel industry have already started to layoff staff. Orders for the upcoming quarters have reduced drastically and some face closure of the factories. Some factories have reduced the number of days that they operate to curtail operational costs. Lot of the employment in the Middle Eastern region has also dried up as a result of the reduction in foreign investment into the Middle East. This in turn means potentially less new jobs or worse, reduction in existing jobs for Sri Lankans.

As the donor countries face recession, aid services to Sri Lanka and other developing nations will be curtailed. This will directly impact on the development activities and employment opportunities in the NGO sector. Foreign investments in Sri Lanka are reducing both due to the recession faced by foreign investors in their own countries as well as the ongoing war in Sri Lanka. However, should the war in Sri Lanka end soon, there is potential for return of foreign investment as cost of doing business in Sri Lanka can be lesser than in their own countries.

Weathering the financial storm
• Keep your job. Not the best times to make risky career moves. If you are running a business, save the core business – even if you have to give up the ancillary businesses.
• If you are unable to even save the core business, get out early before the word spreads that you are in financial quicksand. As we have seen, once the world knows of your financial troubles, you have no bargaining power.
• Look for economies of scale – may be it is time to merge with another business.
• Get rid of your ‘White elephants’ – trim the frills.
• Cut costs - streamline your business. This starts from the top.
• Use car pools rather than driving alone.
• Don’t cash in your long-term investments if you don’t need the cash desperately.
• Renegotiate your credit terms.
• Don’t sacrifice the capital for the income. Invest in proven reliable investments.
• If you are lucky enough to have the cash to spare, this is the best time to grab a bargain. House prices and shares are at low prices.

World economy has risen before and this time will be no different. The only unknowns being when and what changes it will bring along. Be ready to adapt, change and go with the flow. Re-think your strategy, be innovative and use technology. Old ways of doing things may not work in the future. Finance professionals need to put their training to good use to steer their organisations through the storm.

Bibliography
http://en.wikipedia.org
http://www.sfgate.com
http://www.guardian.co.uk/business/2009/jan/04/credit-crunch-developing-countries

Arul Sivagananathan is currently the Senior Vice President of a leading BPO company heading the F&A operations handling over 400 accountants specialized in insurance F&A processes based in Sri Lanka and India. He is also the head of Business consulting division and is a regular contributor of business articles and has been a key note speaker at several CIMA technical forums. He is a qualified Civil Engineer with an MBA from Cranfield University (UK), ACMA (UK) and PhD (Washington).

CIMA Initiatives and CPD Support
Management Accounting Guides support CIMA Professional Development (CPD) which facilitates the continuous learning of members to be competitive in their careers and add value to their organisations.
These provide practical guidance on strategic management practices and concepts that can be deployed to aid improvement in organisational performance.
CIMA collaborates with AICPA and CMA Canada on these guides and associated infocasts.
Management Accounting Guides are issued encompassing four broad categories:
  • Governance
  • Managerial and financial accounting
  • Organisation management
  • Strategic management.
Read more about management accounting guides at www.cimaglobal.com/cpdcentre
(member login required)
Basic introduction to trading volatility

by Suminda Dharmasena

Introduction and background
Market participants consist of:
• Arbitrageurs
• Speculators
• Speculators
• Value traders

Volatility traders
Arbitrageurs attempt to identify securities trading at
two different prices on two separate markets, and trade
between the two, to make a riskless profit. Currently, this
traditional definition has been expanded to include math-
ematical or statistical models that identify mispricing.
Speculators make directional bets on tradable instru-
ments to make a profit, if they prove to be correct.
Value traders hope to secure long-term appreciation in
asset value by buying instruments that are undervalued
by the market. This is carried out by analysing stocks to
identify any mispricing.

Volatility traders are gaining recognition as distinct
market participants, largely due to the advent of
derivatives.

Volatility trading
Volatility results from new information being factored
into an asset price. When new information arrives, the
perceived, realisable value of an asset changes. This
results in the price adjusting to incorporate the new
information. During the information factoring-in process,
three things can happen:
• the market overreacts to the information
• the information is priced accurately
• the market under-reacts to the information.
The possibility of the market reacting to new
information gives rise to the opportunity for volatility
trading. When considering the process of how new
information is factored into a price, the accuracy of
the new information cannot be determined easily.
The market may initially overreact, and subsequently correct
itself, leading to the price moving change direction.
The reverse would also hold true; the market may
initially under-react to the new information, and
subsequently continue in the same direction.

Further, it should also be noted that buying an
undervalued asset does not always result in a profit, as
the price may not adjust in a timely manner. In order
to make a profit, you should enter the market before the
price adjusts, and exit the market after the price adjusts
to the proper valuation – which might not always
happen within the investment horizon. This may increase
the likelihood of a capital loss. Although not risk-free, the
better alternative is to try to profit from the
factoring-in of new information to the asset price. This
can be achieved by using derivatives that exhibit an
asymmetric payoff.

An asymmetric payoff is when the downside loss/upside
gain is disproportionate to the upside gain/downside loss.
At this point, we should introduce the concept of
‘convexity’. Convexity, for our purposes, is defined as
the incremental favourable movement in the underlier
resulting in continuously increasing incremental
movements in the derivative, and unfavourable
movements in the underlier resulting in continuously
decreasing decremental negative movements in the
derivative.’ In mathematical terms, this is when \( \frac{\partial^2 V}{\partial S^2} > 0 \), or when gamma is positive.
The asymmetry of the payoff could be an advantage or
a disadvantage.

When the asymmetry results in a convex payoff, the
outcome is positive. The favourable price movement in
the underlying asset would result in continuously
increasing incremental price movements. If the
asset price moves unfavourably, the disadvantage would
be continuously diminishing, i.e. the incremental price
reduction would reduce continuously.

The convexity of the payoff can be measured using
formula (\( = \frac{\partial^2 V}{\partial S^2} \)). If gamma is positive, the payoff is
convex, and if gamma is negative, the payoff is concave.
A convex payoff occurs when the gradient of the payoff
graph is continuously increasing as the price increases,
i.e. the incremental increase of the price in one direction
is continuously increasing as the price increases.

Due to convexity, an upward movement would result in
a continuously increasing positive gain on calls, and
a downward movement would result in a continuously
increasing positive gain on puts. This convexity
advantage could disappear in exotic derivatives with
complex payoff structures, which means that the payoff
switches between convex and concave states. If the
measure of convexity, which is gamma, is also convex,
it would result in the gamma advantage increasing in a
manner that the incremental increase in gamma would
continuously increase, and any decrease in gamma
would become incrementally smaller. The measure of
the curvature of gamma is called gamma of gamma.

The simplest option strategy to achieve long-gamma is a
‘straddle’ (go long on a call and a put at the same strike)
or a ‘strangle’ (go long on a call and a put at different
strikes, with the call strike greater than the put strike).
The return can be maximized when the strike’s strikes are
optimal to buy delta at the cheapest level. Delta is
defined as the amount of option price movement for a
unit change in the stock price.

In more complicated strategies, it makes sense to buy
the option Greeks (which are the derivatives of the
option price or possible variables in the option pricing
formula), as cheaply as possible, according to the need
for rebalancing.

Derivatives are sensitive to other parameters that also
include volatility, interest rates, and time lapes. These
sensitivities are measured using derivatives with respect
to volatility (Vega), which is the change in the option
price when volatility changes by 1% – an exposure that
you want to hedge away, interest rates (Rho), and time
lapses (Theta or bleed).

A derivative’s sensitivity to these factors also changes
with time. The sensitivity or elasticity to the underlying
price, which is delta, changes with respect to changes in
other variables. The change of delta over time (Charm or
Delta Decay = \( \frac{\partial^2 V}{\partial S \partial T} \) = \( \frac{\partial \Delta}{\partial T} \)) needs to be consid-
ered, especially when hedging your open position over
a weekend. Further, the delta would have sensitivity to
implied volatility (Vanna \( \frac{\partial^2 V}{\partial \sigma \partial S} \) – the change of
delta with respect to volatility) and interest rates (Vanna
\( \frac{\partial^2 V}{\partial \sigma \partial R} \) – the change of delta with respect to
interest rates), especially if there was a pending rate-
change announcement. In addition, the advantage of
having high gamma may diminish with time. This can be
found by looking at Color (\( \frac{\partial^2 V}{\partial S \partial T} \) – the change of
gamma over time).

Discussion
For a derivatives portfolio to have positive gamma, the
number of long positions should be greater than the
number of short positions that are closer to the at-
the-money (ATM) point. Since time-decay of option
value is always present, the advantage gained from the
gamma or convexities with respect to payoffs, should
outweigh the bleed or time-decay, and transaction cost.
The bleed can be reduced by writing options that would
reduce gamma. If gamma becomes negative, the payoff
becomes concave, and any departure from the per-
fecly-delta-neutral hedge would result in a continuously
increasing loss or an unfavourable hedging error.

Further, being long on option positions would initially
result in an outflow of cash, while writing options would
result in an inflow of cash. For leverage considerations,
debit spread (a net outflow of cash) and credit spread (a
net inflow of cash) strategies should be used as desired,
while balancing the Greeks.

As a rule of thumb, horizontal and diagonal spreads can
be used to manage time-decay. Vertical and diagonal
spreads can be used to manage cashflows. A vertical
spread is when you buy and write options at different
strikes, but having the same expiration. A horizontal
spread is when you buy and write options at the same
strikes, but having different expirations. A diagonal
spread is where you buy and write options at different
strikes that have different expiration dates.

Conclusion
In the investment decision-making process, the only
guarantee is that asset values will fluctuate when new
information is factored into the asset price. Volatility
trading is, in its simplest form, a bet that capitalizes on
the volatility of asset prices, while benefiting from the
market’s expectation of volatility. Trading on volatility
has less downside than many of the strategies available,
provided that reasonable hedging is exercised, and that
transaction costs are managed reasonably well.

References
Turbulence – How to Make Money From Volatility Arbitrage, 2006,
Making Money on Both Sides of Volatility’s Golden Coin, 2006, Hedge
and Schmid, F. A., Asset Mispricing, Arbitrage, and Volatility, 2002,
Arbitrage from the Short Side, 2003, Hedge Funds World.
Sri Lanka Accounting Standard 21: The effects of changes in foreign exchange rates

The objective of this summary is to place before the Members in Business Management the most frequently encountered situations in the Standard on the Effects of Changes in Foreign Exchange Rates. If a detailed examination into all the facets of the Standard is required, as it would be by a Practitioner, reference should be made to the published documents on the Standard.

Objective
This standard will prescribe how to include foreign currency transactions and foreign operations in financial statements by choosing the appropriate exchange rate. Furthermore, it also explains how to deal with effects of changes in exchange rates in the financial statements. Hence the scope of the Standard would be:

1. Accounting for transactions or balances in foreign currency except financial instruments.
2. Translating the financial position of foreign operations.
3. Translating entity’s results and position into a presentation currency.
4. This standard does not apply to the presentation of cash flow.

Definitions
Closing rate: The spot exchange rate at the balance sheet date.
Spot rate: The exchange rate at the date of transaction.
Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.
Fair value: The amount for which an asset could be exchanged or a liability settled, between knowledgeable and willing parties in an arm’s length transaction.
Functional currency: The currency of the primary economic environment in which the entity operates. This is often the Presentation currency.
Presentation currency: The currency in which the financial statements are presented.
Foreign currency: Currency other than the functional currency of the entity.
Foreign operation: An entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.
Monetary items: Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.

Net investment in a foreign operation: The amount of the reporting entity’s interest in the net assets of that operation.
Initial recognition
A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency. This should be recorded, on initial recognition in the Reporting currency, by applying to the foreign currency amount the spot rate.
Reporting at subsequent balance sheet dates
At each balance sheet date, foreign currency monetary items should be reported using the closing rate.
Non-monetary items which are carried at terms of historical cost should be reported using the exchange rate at the date of the transaction.
Recognition of exchange differences
Exchange differences arise when the rate used in settlement or transacting of a monetary item is different from that used at initial recognition. This difference should be charged to the profit and loss account.
Exchange differences arising on a monetary item that forms part of an enterprise’s net investment in a foreign entity should be recognised as equity in the enterprise’s consolidated financial statements with the foreign entity, if it is a subsidiary. On disposal of the foreign operation, this exchange difference shall be recognised as a profit or loss when the gain or loss on disposal is recognised.
An exchange gain or loss on a non-monetary item may either be recognised as equity or in the profit and loss account depending on whether the overall gain or loss on the item was recognised as equity or in the profit and loss account.
Use of a presentation currency other than the functional currency
A company may present its financial statements in any currency if the presentation currency differs from the entity’s functional currency, it should translate its results and financial position into the presentation currency as per the following rules:

- Translate income and expenses at exchange rates at the date of transaction.
- Recognise all exchange differences as a separate component of equity.

If the functional currency happens to be a currency of hyper inflation, all assets, liabilities, income, expenses and equity items shall be translated at the closing rate at the date of the most recent balance sheet.

Financial statements of foreign operations
The results and financial position of a foreign operation are translated into the presentation currency as above so that the foreign operation can be included in the financial statements of the reporting entity by consolidation. Goodwill arising on the acquisition of foreign operation and any fair value adjustments to the carrying amounts of the assets and liabilities on acquisition shall be treated as assets and liabilities of the foreign operation and translated into the presentation currency as above.

Disclosures required
- Amount of exchange difference recognised in the profit and loss account.
- Exchange difference classified as equity.
- The fact that the presentation currency is different from the foreign currency and the reason for using that currency.
- When there are changes in the functional currency of the reporting entity or a significant foreign operation.

Business impact
Due care should be exercised to ensure that the charge to the profit and loss account due to exchange difference arising out of the different rate used at the time of initial recognition and at the time of settlement is minimised. If for instance the rate used at the time of initial recognition is lower than the one at settlement, then in effect the business would be carrying its raw material stock at a lower value as the difference is being charged directly to the profit and loss. Hence the cost of the product items would reflect a lower variable cost resulting in a higher contribution ratio and a higher gross profit %.

Discussions on pricing and the focus of marketing thrust are largely based on these ratios. Hence every possible mean should be used to ensure that these differences are kept to a bare minimum. Not only using lower rates at the time of initial recognition but also using higher rates would lead to miscalculations in business decisions.

‘Quote: Unquote’
compiled by Imal Pereis

‘Commit to “CAN I!” – Constant And Never-ending Improvement’
Anthony Robbins

‘Champions aren’t made in gyms. Champions are made from something they have deep inside them: a desire, a dream, a vision. They have to have last-minute stamina, they have to be a little faster, they have to have the skill and the will. But the will must be stronger than the skill’.
Muhammad Ali

‘To exist is to change, to change is to mature, to mature is to go on creating oneself endlessly’.
Hemis Bergson

‘It is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change’.
Charles Darwin

‘Passion is the genesis of genius.’
Anthony Robbins

‘A man is not old until regrets take the place of dreams.’
John Barrymore

‘Bad times have a scientific value. These are occasions a good learner would not miss’.
Ralph Waldo Emerson
An initial keynote speech delivered on the theme 'Join the winners' at a large convention of customers has now evolved to a book written drawing on more than sixty years of Donald Keough's business experience. This book illustrates key reasons for corporate failures. In other words it presents what you should not do if you intend to be successful in business.

Listed below are these key reasons laid out by Donald Keough the former President of the Coca-Cola Company in his book The Ten Commandments for Business Failure, along with few quotes presented in the book.

Commandment one - quit taking risks
'He that is overcautious will accomplish little.' Friedrich von Schiller
'The world belongs to the discontented.' Oscar Wilde

Commandment two - be inflexible
'For this is the tragedy of man - circumstances change, but he doesn’t.' Machiavelli
'The man who never alters his opinion is like standing water, and it breeds reptiles of the mind.' William Blake

Commandment three - isolate yourself
'It’s a rare person who wants to hear what he doesn’t want to hear.' Dick Cavett
'Think not those faithful who praise thy words and actions but those who kindly reprove thy faults.' Socrates
'A desk is a dangerous place from which to view the world.' John le Carré

Commandment four - assume infallibility
'Certitude is not the test of certainty.' Justice Oliver Wendell Holmes

Commandment five - play the game close to the foul line
'Success is more permanent when you achieve it without destroying your principles.' Walter Cronkite
'Mangers are concerned with doing things right. Leaders are concerned with doing the right things.' Anonymous

Commandment six - don’t take time to think
'The real problem is not whether machines think but whether men do.' Burrhus Frederic Skinner

Commandment seven - put all your faith in experts and outside consultants
'It is better to know some of the questions than all of the answers.' James Thurber

Commandment eight - love your bureaucracy
'A committee is a group of men who individually can do nothing, but as a group decide that nothing can be done.' Fred Allen

Commandment nine - send mixed messages
'The problem with communication is the illusion that it has been accomplished.' George Bernard Shaw

Commandment ten - be afraid of the future
'Fear is that little darkroom where negatives are developed.' Michael Pritchard
'Worst case scenarios rarely happen.' Anonymous

Commandment eleven - lose your passion for work - for life
'Nothing great in the world has been accomplished without passion.' George Wilhelm Friedrich Hegel
'The reasonable man adapts himself to the world. The unreasonable man persists in trying to adapt the world to himself. All progress, therefore, depends upon the unreasonable man.' George Bernard Shaw

Chartered institute of Management Accountants
Sri Lanka Division
Colombo Office
356 Elvitigala Mawatha
Colombo 5
T. +94 (0)11 250 3880
F. +94 (0)11 250 3881
E. colombo@cimaglobal.com
www.cimaglobal.com/srilanka