Sri Lanka recently saw an end to the brutal war which marred the country for three long decades crippling the economy and costing thousands of human lives. It is ‘Now’ time for new beginnings and time for harvesting those opportunities or new business prospects which were long curtailed due to the political unrest. Developing the nation from the remnants of war and destruction is not an easy task and can only be achieved by united efforts of public sector, private sector and the NGO’s. Attracting FDI to the capital markets, repositioning Sri Lanka on the world map for tourism and other industries, developing livelihood to support the village economy in North and East and nurturing human talent and skills set to relate to the job opportunities should be high in the agenda for many organisations and the country itself. However along with the economic and business development it is important to pay substantial attention to the emotional healing of the people who were affected by the negatives of this war for 30 years. From another perspective it is time to bring back the knowledge workers we have lost over the period of time due to economic and political uncertainty. Bringing practical solutions to attract these workers back to the economy with diversity of experience gained by working overseas will undoubtedly fasten the development process. My sincere appreciation to all contributors for sharing their invaluable thoughts and insight.

Nilushika Gunasekera, Technical Manager, CIMA Sri Lanka Division
Fair value accounting – is it truly fair or fairly true by Methmal Senaviratne

The IMF released its global financial stability report on 21 April 2009 and according to the report, financial institutions and investors worldwide lost US$4 trillion from bad debt and toxic assets as a result of the current financial crisis. The banking sector is estimated to absorb about two-thirds of this loss.

While fingers are being pointed in different directions, what caused the financial crisis has led to interesting debates. Some blame irresponsible lenders while financial regulators, rating agencies, mortgage brokers, and sub-prime borrowers are also criticised for their irresponsible and ignorant behavior. Though these contributed to the crisis, there is an underlying factor triggered by the evolution of financial markets, which is not an unfamiliar concept to accountants. It is none other than the fair value or mark-to-market accounting.

Under fair value accounting, financial assets are recorded at their current market values rather than historic or future values. When there is an illiquid market and the transaction is distressed, the fair value of the asset tends to be much lower than the present value of expected cash flows or the perceived value of the asset under ordinary circumstances. This prompted financial institutions around the world to take large asset write-downs, especially on mortgage-backed securities and auction rate securities. This also contributed to a shortage of credit for businesses as well as individuals due to fear of lending among financial institutions. Critics pointed out that the lack of credit triggered the current economic crisis and questioned the applicability of fair value accounting, especially when there is an economic downturn.

In the US, fair value accounting is governed by ‘SFAS 157 – Fair Value Measurements’ and according to SFAS 157, it permits a reporting entity to use a price rather than the most recent trading price if the transaction is a distressed sale. But it has not been clear as to how broadly the ‘distressed sale’ exception could be interpreted. As a result, users increasingly relied on applying recent trading prices to determine the fair value. This led financial institutions to take substantial asset write-downs in their portfolios. The simple question accountants failed to ask, ‘Where is the true value of the asset under ordinary circumstances?’

Moving across the Atlantic, the International Accounting Standards Board (IASB) has set out a detailed six-month plan to publish a proposal to replace IAS 39 – Financial Instruments: Recognition and Measurement, which addresses fair value accounting in the European region.

After studying FASB guidelines on fair value measurement, the IAS issued its stance on this matter in a press release on 24 April 2009, which can be summarised as follows:

Fair value measurement: The guidance on fair value measurement issued by the FASB is consistent with existing guidance on IFRS contained in the IASB’s Expert Advisory Panel report ‘Measuring and disclosing the fair value of financial instruments: Recognition and Measurement’, which addresses fair value accounting in the European region.

One thing that is clear from the IAS stance is its keenness to ensure consistency among the two standard-setting bodies. IASB expects to include guidance issued by FASB in the Exposure Draft on Fair Value Measurement, which it plans to issue later this month and expressed the desire to even use the same words that FASB had used in order to avoid any confusion. In addition, when it revises the standard, IAS plans to address other fundamental differences that exist between IFRS and US GAAP on impairment.

On the other hand, there is a political dimension to the application of the fair value accounting as well. The EU’s finance ministers and the European Commission have openly criticised what they think is IASB’s insufficient response to the current financial crisis. Their biggest concern so far is ‘the risk of a divergence between how banks are treated in the EU and in the United States.’ The greater flexibility available in valuing assets would allow US-based entities to make their balance sheets appear healthier than those of their European counterparts. On the contrary, there are opposing views as to how the reforms should take place. According to Nigel Slegh Johnson, Head of financial reporting at the ICAEW, rushing in new IASB standards without due process could not only risk confusing investors, but also erode the capital markets. He added that the IASB had responded to the US changes in a ‘fairly appropriate way’.

While it draws a great deal of interest observing the corrective actions taken, it’s important to realise the fact that we should not let such confusion recur. Since organisations are closely linked with the environment in which they operate, processes of setting and revising standards should allow due consideration to the developments in business context and wider environment. Though it should not be a continuous reaction, prompt attention should be given to ensure that the standards remain relevant and applicable to different economic and business conditions. As Management Accountants play an instrumental role in creating, sustaining and driving the value system in an organisation, it is the equal responsibility of Management Accountants(6) to ensure that the financial and regulatory framework supports a long term sustainable business model.

References
Global Financial Stability Report, April 2009
http://www.imf.org
Financial Accounting Standards Board official website
http://www.fasb.org
International Accounting Standards Board official website
http://www.iasb.org
The European Voice official website
http://www.europeanvoice.com

‘Quote: Unquote’
‘Making your mark on the world is hard. If it were easy, everybody would do it. But it’s not. It takes patience, it takes commitment, and it comes with plenty of failure along the way. The real test is not whether you avoid this failure, because you won’t. It’s whether you let it harden or shame you into inaction, or whether you learn from it, whether you choose to persevere.’
Barack Obama

‘Life is a train of moods like a string of beads; and as we pass through them they prove to be many coloured lenses, which paint the world their own hue, and each shows us only what lies in its own focus.’
Ralph Waldo Emerson

‘You gain strength, courage, and confidence by every experience in which you really stop to look fear in the face. You must do the thing which you think you cannot do.’
Eleanor Roosevelt

‘If you are distressed by anything external, the pain is not due to the thing itself, but to your estimate of it; and this you have the power to revoke at any moment.’
Marcus Aurelius

‘Character is like a tree and reputation like a shadow. The shadow is what we think of it; the tree is the real thing.’
Abraham Lincoln
Corporate social responsibility: myth or reality?
by Michael Kekulthotuwa

Interpretation
The opening line of the speech made by Otto Reich, Assistant Secretary for the Bureau of Western Hemisphere affairs said that some people think that corporate social responsibility is an oxymoron, a contradiction in terms. This clearly summarises the general perception among the public, NGOs and activists on the corporate role towards corporate social responsibility. However, most corporate organisations do genuinely want to make a difference to the community.

CSR (corporate social responsibility) if we adopt the judgmental approach, the case for more responsible behaviour by organisations can only be stronger. We need not go further than to cite the reasons as to why CSR has gathered momentum. The outcry against Asian sweatshops in the 90s clearly was pivotal and justifiable for the development of the CSR movement. Therefore, it cannot be contested that CSR has developed largely in response to the real or perceived failure of legislation, regulation and enforcement to control and regulate the impact of company activities (Green, 2003, p75).

If we take a more realistic view of how multinationals have embraced CSR, their efforts to be change agents can be credited - in certain areas.

Let us broadly categorise what we term ‘CSR’ into three parts:

1. The first covers what organisations do under philanthropy or voluntary contributions to society; this is now more popularly re-branded as ‘community engagement for wealth creation’. This is the most prolific form of CSR, and the companies’ response to the recent tsunami disaster is a clear reflection that multinationals do own a ‘CSR conscience’.

2. The second refers to the direct impact of an organisation’s business operations on society. Respect for employee rights and work conditions, operating within the legal framework of the country, adopting international standards, selling safe products and services broadly encompass these requirements.

3. The third refers to a more abstract form of CSR relating to improvements that organisations can make in the value chain from suppliers through to trade customers to consumers – these are not within their immediate control.

Wilhelm and Plowman (1999) categorise CSR into three parts:
1. The first covers what organisations do under philanthropy or voluntary contributions to society; this is now more popularly re-branded as ‘community engagement for wealth creation’. This is the most prolific form of CSR, and the companies’ response to the recent tsunami disaster is a clear reflection that multinationals do own a ‘CSR conscience’.

2. The second refers to the direct impact of an organisation’s business operations on society. Respect for employee rights and work conditions, operating within the legal framework of the country, adopting international standards, selling safe products and services broadly encompass these requirements.

3. The third refers to a more abstract form of CSR relating to improvements that organisations can make in the value chain from suppliers through to trade customers to consumers – these are not within their immediate control.

Whilst the first two clearly are where organisations have excelled in CSR, the last is where organisations continue to perform poorly.

Most companies express certainty that they and their employees live by their corporate values, but few can provide the same degree of confidence on their extended supply chain involving suppliers and customers. Increasingly companies are discovering that they are not only responsible for their own CSR performance but they are also responsible for their multi-tiered suppliers as well as customers. Implementing CSR where your sphere of influence is minimal is a challenging task that most corporate organisations would rather avoid by immersing themselves in philanthropic pursuits.

Following the public outcry for a more responsible approach to supplier management arising from the Asian sweatshop outcry, Multinationals like Nike and Reebok responded by developing and promoting Codes of Conduct with suppliers. They were required to ensure their suppliers complied with certain standards, such as no use of child or forced labour, no discrimination, no harassment of workers etc. This appears to be a universal approach to supplier management among companies such as John Deere, Proctor & Gamble, Hewlett Packard etc that are rated highly by various ethical indexes (Business Ethics Online, 2005 and Reich, 2002).

It must be recognised that the efforts of a number of multinationals have contributed to improving labour standards in China (Jiao, 2003). Also, many multinationals have developed their own supplier improvement programmes. For example, Caterpillar organises regular ‘Quality Forums’ and ‘Supplier Days’ to discuss best practices with its suppliers (Reich, 2002). Recently Toshiba announced a detailed sustainable procurement policy to encourage their suppliers to be proactive towards managing greenhouse emissions (Ethical Corporation, March 2005, p28). These are but a few valiant efforts by companies to be proactive towards CSR, and these individual efforts should be saluted.

However, there is much scepticism among the CSR community on the benefits of codes of conduct. This is not surprising, whilst work of this nature was the first step in embedding CSR principles in the supply chain, suppliers are often induced to breach these codes in the interest of meeting customer demands.

For example, in the apparel industry, where customers demand unreasonable production volumes from suppliers, without advanced notifications is a recurring theme. In the name of ‘flexibility’ or rather business continuity, they are forced to deliver, resulting in significant strain on their resources, often leading to breach of working hour standards of the country and the code. The supplier is then penalised by the customers’ auditing bodies for non-compliance against the business code which then deters future customer-supplier relationships. Hence, it can be argued that at times codes developed to promote CSR have only promoted a conflict in priorities for suppliers.

Activists often view codes as a means of companies shirking responsibility without providing support to embed these principles in suppliers’ operations. This resulted in many multinationals developing detailed audit methodologies to evaluate suppliers against these codes. In fact, auditing has become key to ‘compliance monitoring’ and companies such as Nike, Mattel pioneered the drafting of sophisticated methodologies for this purpose (Mattel Inc., 2005). Auditing however if not properly managed can be detrimental to the whole CSR process. Auditing in some cases have become synonymous with termination of contracts if compliance to the code is not satisfactory. Further compounded by the fact that auditors generally mandate investments that do not contribute to the bottom line, whilst on the other hand buyers squeeze suppliers for better prices, ‘CSR’ in these cases can certainly be perceived as a myth.

Is CSR a myth or reality?
Organisations thereby undo the positive efforts created by CSR. So, is CSR a myth or reality? Clearly the first two elements of CSR are in my opinion well embedded in the fabric of corporate governance. However, the current approach to CSR in the supply chain is neither effective nor sustainable. If CSR is to be a realistic and credible discipline, multinationals must endure the tough route of not walking away from non-conforming suppliers, but to remain with them and jointly build capacity in order to bring them up to credible standards. Auditing at the best of times can only be a snapshot in time. Moreover it is not only multinationals that should be trying to build CSR in the supply chain, but smaller local businesses should also be required to do their part. This can only be achieved through creating the infrastructure for companies to be able to adhere to and promote CSR. Real effort needs to be put in by NGOs, local governments and academia to collaborate with organisations more than ever before through informed debate and focussed attention to make CSR in the supply chain a reality.
Narrative reporting – better transparency or increased complexity?

Context of narrative reporting internationally

With increased corporate failures across the globe and periods of economic challenges, the need for better transparency, granularity of underlying financial performance, understanding of risks and uncertainties and indication of company's strategic direction becomes more and more important, for investors to make the correct economic decisions.

Thus nowadays narrative reporting has become an increasingly important aspect of corporate reporting along with financial reporting which forms the core of corporate reporting. This is quite apparent with the regulatory and voluntary requirements presented by various jurisdictions in different parts of the world.

The EU Accounts Modernisation Directive, former mandatory requirement of an OFR which was then repealed in November 2005 to be replaced by Enhanced Business Review within the Director's Report in the UK, Management Discussion Analysis of the US SEC and Management Reporting of Germany are examples of global direction towards adaptation of narrative reporting. However depth and breadth of information required to be disclosed either on mandatory or voluntary basis vary significantly between different parts of the world.

A survey conducted by Deloitte on annual reports of UK listed companies in 2008 titled ‘write from the start’ indicates that 54% of annuals reports were now taken by narrative reporting. Yet a recent global research study conducted by IFAC, in which 74 IFAC member bodies from 59 different countries and jurisdictions participated identifies and questions the true usefulness of financial reports due to insufficient reporting on non-financial indicators, risks, and sustainability performance, the unclear link between reporting and an organisation’s environment and strategy and its implementation. These areas were identified as some of the key issues that still require a solution among other factors. Even though there had been significant changes and improvement in the arena of annual reports in the recent years, it seems to be a known fact that the journey has not yet reached its end.

The main objective of a narrative report is to provide meaningful strategic and forward looking information and to provide better understanding of company’s business, market dynamics, key value drivers, underlying risks and future prospects. It is therefore, intended to complement and supplement the financial statements, providing insights to an organisation’s performance beyond the financial statements. It can be seen as an opportunity for an organisation to improve the quality of financial reporting by better telling the story of the organisation in the eyes of the management and an opportunity for investors to make well-informed investment decisions.

Narrative reporting in Sri Lanka

It won’t be long since this trend on corporate reporting will move in the same direction for the developing economies. The transparency and better access to future information may play a great role in developing the local capital markets and attracting FDI which are an essential part of sustainable economic growth.

In response to this growing need globally and the research finding from local annual reports indicating that most of the listed companies do not publish a structured narrative report of its nature (though some elements were addressed in different parts of the annual report), CIMA Sri Lanka submitted a proposal to the Colombo Stock Exchange and Securities and Exchange Commission to study the feasibility of introducing an OFR style narrative report to the listed companies in Sri Lanka.

Following approval of CSE board, in July 2007 CIMA Sri Lanka in consultation with CSE formed a committee to develop an OFR style narrative report titled ‘Management Review’ (MR) to be included in the annual reports. The committee, by discussion with preparers and users of annual reports, developed a discussion paper on introducing a MR in annual reports of listed companies in Sri Lanka. The MR guidelines have been developed by adapting/ customizing globally accepted best practices on narrative reporting content to suit the Sri Lankan context based on the overriding principle of whether it meets the information requirements of investors and whether benefits outweigh the costs. This discussion paper was open for public comment from February to April 2009 and a further discussion forum was conducted in early June 2009 to obtain further views and opinions of the initiative. Subsequent to analysing and reviewing the comments received, the way-forward for this initiative will be determined in due course.

Management Review (MR)

The MR is intended for listed companies, except ‘small companies’ (listed companies that fall below/outside the qualifying thresholds for Specified Business Enterprises referred to under ‘Other Companies’ as per the Sri Lankan Accounting and Auditing Standards Act No. 15 of 1995 and regulations made under the said Act), to be adopted on a voluntary basis.

Accordingly, the MR is to be regarded as recommended practice intended to have persuasive as opposed to mandatory force and planned for voluntary adoption.

According to the MR discussion paper the definition and key principles of MR are:

- A MR is a narrative report, provided in the annual report, analysing the main trends and factors underlying the performance, development and position of a company during the financial year covered by the financial statements, and which are likely to impact the company’s future development, performance and position. (Adapted from Reporting Statement–Operating & Financial Review).
- MR should provide a fair review on the business of the company through the eyes of the directors/management and focusing on matters that are relevant and material that is of interest to members. (Accounting Standards Board – January 2006).
- The MR should be comparable over time and should complement as well as supplement the financial statements in order to enhance the overall corporate disclosure and give a ‘balanced’ and ‘neutral’ view. (Accounting Standards Board – January 2006).

The discussion paper identifies that a principle based approach is more desirable than a rule based approach and that content/ disclosures and tone of presenting the MR is best determined by the board of directors/management of the company. Thus it sets-forth the below broad headings as areas for inclusion;

- The nature, objectives and strategic direction.
- Financial review.
- Principal risks and uncertainties.
- Current and future performance and trends.

More details about the content and disclosures in the MR and the MR reporting guidelines can be referred to reading the full discussion paper hosted on the CIMA website www.cimaglobal.com/srilanka > News and event > News.

Conclusion

Structured narrative reporting helps reduce the complexity of today’s financial reporting. It helps the organisation to communicate its key value drivers, underlying risks and uncertainties and strategic direction to its stakeholders through a clear dialogue. After all strong capital markets and sustainable economic growth is facilitated and driven by high quality and reliable financial reports. This can be achieved by no other means than by taking an investor centric approach to determine what information is reported externally.

References
www.frc.org.uk
www.ifac.org


‘write from the start’, The Deloitte publication on a survey carried out in 2008 of narrative reporting.

A Review of narrative reporting by UK listed companies in 2006 conducted by ASB, January 2007

Information Paper on Developments in the Financial Reporting Supply Chain—Results from a Global Study among IFAC Member Bodies, February 2009
Islamic finance: a viable alternative?

Throughout the world, Islamic finance ('IF') has been charting remarkable growth over the past few years. According to Standard & Poor’s, the market for sukuk (or Islamic securities) more than doubled to USD60 billion in 2007, and is expected to hit USD100 billion in the next several years. Even though this prolific growth has been tempered by the current credit crunch and global liquidity crisis, Shariah-compliant instruments are expected to eventually resume their onward march - fuelled by massive investments and financing demand from the Gulf and Asian economies.

Nonetheless, one of the major this financial system operates. To address this, RAM Ratings has taken the initiative of publishing a series of articles on IF.

What is IF?

Contrary to popular belief, IF is not just about the avoidance of riba or usury in every transaction. According to Islamic law or Shariah principles, all business activities must be premised on moral and ethical values. Although trading in tangible assets or services is permitted, merely making money from money is considered riba or usury and is forbidden, as money today only serves as a medium of exchange and a unit of measurement. Therefore, any type of Shariah-compliant financial product or service cannot involve the element of interest, either explicitly or implicitly.

An inclusive alternative

Among the misconceptions about IF is that it is only for Muslims. In fact, even non-Muslim nations such as the United Kingdom and the United States are looking forward to developing Islamic financial products due to their immense potential as well as healthy demand from the public and other institutions.

Similarly in Sri Lanka, there is growing interest in IF. The vast majority of domestic conventional businesses should be able to tap this alternative source of funding - including those involved in garments, tea, coconut, rubber, porcelain - and can easily comply with Shariah principles. Foreign investors, including those involved in garments, tea, coconut, rubber, porcelain - and can easily comply with Shariah principles. Foreign investors, including those involved in garments, tea, coconut, rubber, porcelain - and can easily comply with Shariah principles.

What are the common Islamic instruments?

What are the common Islamic instruments?

The Accounting and Auditing Organization for Islamic Financial Institution has identified 14 structures, however the following six are more common.

- **Murabaha**: A sale and purchase of an asset where the cost and profit margin (mark-up) are made known and agreed to by all parties involved.
- **Ijarah**: Where the owner leases out an asset or equipment to a client at an agreed rental fee and pre-determine lease period. The ownership remains in the hands of the lessor.
- **Musharakah**: Partnership arrangement between two or more parties to finance a business venture. Profits are shared on a pre-agreed ratio, loss is shared on a basis of capital contribution.
- **Mudharaba**: Profits are determined by mutual agreement. However, losses - if any - will be borne solely by the owner of the capital.
- **Istisna**: A contract to manufacture goods, to assemble or process them, or to build a house or other structure according to exact specifications and fixed timeline.
- **Bai al Salam**: This term refers to advance payment for goods to be delivered later. Normally, no sale can be effected unless the goods are in existence at the time of the bargain.

Apart from the above there are Shariah compliant bonds or Sukuk (or Islamic securities): This refers to a financial document or certificate which represents the value of an asset, evidencing an undivided pro rata ownership of an underlying asset; in other words, a capital-market financial instrument that is tradable in the secondary market. The returns provided to sukuk holders therefore come in the form of profit from a sale, rental, or a combination of both. Sukuk structures lend themselves to a considerable range of innovations, as they may be based on Mudharaba, Musharaka, Murabaha, Salam, Istisna, or Ijara, or hybrid of these.

Domestic concerns

RAM Ratings Lanka notes that there is increasing interest in IF from various quarters, foremost among them Islamic institutions. Despite the keen interest, the IF industry faces a number of challenges these include, achieving consensus on Shariah laws, lack of regulations, accounting and tax issues.

Meanwhile, we observe that market players appear unfazed by the challenges ahead. This will fuel further interest in and the development of the Sri Lankan Islamic financial market. RAM Ratings Lanka will continue to assist in the development of this sector, by creating awareness and providing risk insights.