PwC

edge

Special Edition 2005

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PricewaterhouseCoopers Thought Leadership Series

*connectedthinking

Editor’s Note

Children of today are unlikely to have a Thomas the Tank Engine in their collection of toys. For those who grew up when steam trains were still running steam locomotives have an enduring appeal. I remember my first visit to a train museum in England where I spent hours going over the controls of the Flying Scotsman and the Mallard. Each gauge and lever held me in fascination and years later I often associate driving a train with running a business with input from a myriad of gauges and finely balancing the performance with deft handling of the levers and controlling the throttle and brakes. Speeding through the night towards the destination, confident that you have everything under control.

The CEO of today would have even more gauges to read and levers to operate. What if the competitor is driving an electric train while yours is a coal burner because of a paradigm shift? What if your gauges and controls are for steam but the traction is provided by an electric motor? CEOs of today often find themselves in these nightmarish scenarios and realise that the controls that they have might not be right for their business. The gauges on the dashboard are not telling them what they need to know, the fuel on board is insufficient to make it to the destination and worse of all the track that the train is on is leading to Mandalay when Shanghai is the ultimate destination.

In this special issue we carry 12 pieces of thought leadership first published in the Business Times earlier in the year. I like to think of them as classical pieces for managerial success and the main benefit being in ensuring that managers are paying attention to the levers and gauges that are relevant to the business’s performance and it’s on the right track. I wish you happy reading.

Kyle Lee
Managing Editor

Managing Editor
Kyle Lee

Editor
Lee Wan Ming

Contributors
Keith Stephenson
R Raghunathan
Paul Cornelius
Karen Loon
Tan Shong Ye
Amitava Guharoy
Greg Unsworth
Koh Soo How
Ong Chao Choon
Benjamin Kan
Subra Iyer
Goh Thien Phong
Chan Kheng Tek
Yeoh Oon Jin
Richard Schulte
Kok Ee Lan

Design & Layout
Yvonne Yan

Circulation
Maimunah Asmawi
at (65) 6236 3953
maimunah.asmawi@sg.pwc.com

Printer
Image Office Systems
& Supplies Pte Ltd
Mita(P)069/10/2004

Address
8 Cross Street #17-00
PWC Building Singapore 048424

Comments and suggestions
should be addressed to
Lee Wan Ming at (65) 6236 3973
wan.ming.lee@sg.pwc.com

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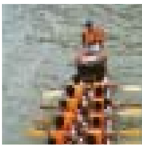

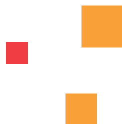

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With the recent slew of accounting scandals, the confidence of shareholders has been shaken. Governance and transparency matters aside, corporate Boards also have to drive business strategy and manage earnings expectation. Keith Stephenson and R Raghunathan share how achieving Finance Function effectiveness will help the Board steer company performance to greater heights.

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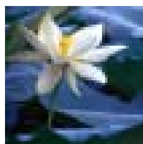
Managing risk, managing people and creating value; these are the elements of an effective and efficient tax department. A world-class tax department can help you create value for an organisation while balancing tax risk. Paul Cornelius reveals how you can maximise stakeholder value and what tools can assist you in the process.



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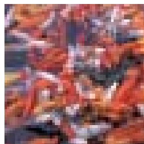

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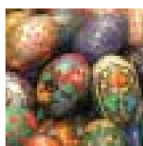

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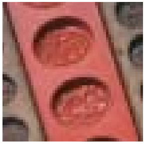

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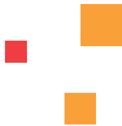

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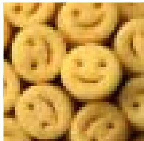

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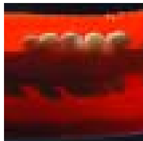

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BY KEITH STEPHENSON (ABOVE) AND R RAGHUNATHAN Performance Improvement

Be the Finance department of tomorrow*

Moving Finance Function from being a scorekeeper to being a business partner

Unless you have been living in Outer Mongolia for the last year, you cannot fail to have read about a whole stream of accounting scandals that have hit the media. It is alarming to see the number of companies which are being investigated for improper governance, lack of transparency and reporting failures. Not surprisingly, the confidence of shareholders in the market has taken a beating, and as a result the Boards of these companies, and in particular their independent directors, have been placed in the unenviable position of having to explain events to their shareholders, that they were not even remotely aware had taken place.

But being on top of governance and transparency matters is not all there is to it. Today's corporate Boards face other challenges as well. Boards have to formulate and drive business strategy in a global marketplace and in an environment of fast-changing technologies, oversee risk management and compliance with regulations, and manage earnings expectations.

The day is not far away when the Boards of companies will have to explain positively to their shareholders just how they have acted to optimise the overall corporate performance of the company. It is clear that Boards will need a lot of support and assistance in meeting these requirements and in dealing with the challenge of being on top of all things at all times.

So, what is the solution? If we look at any company, we will find that there is one function which is uniquely positioned to help the Board meet its challenges; and that is the Finance Function. Finance is the corporate glue which brings together all departments through a common language, the language of numbers! If the Finance Function works well, it can relieve the Board of a large portion of its worries. However, if the Finance Function does not do what it is supposed to, more often than not, you will find the company stumbling around aimlessly.

So it is clear that the Board has to rely upon its Finance Function to deliver the goods. The question then is: Does the Finance Function know enough about itself to enable it to assert positively to the value it provides to the Board?

For the Finance Function to provide this positive assertion, it needs to take action to address the key challenges faced by the Board. Figure 1 illustrates some of the key challenges faced by a typical Board and how the Finance Function can assist in addressing them.

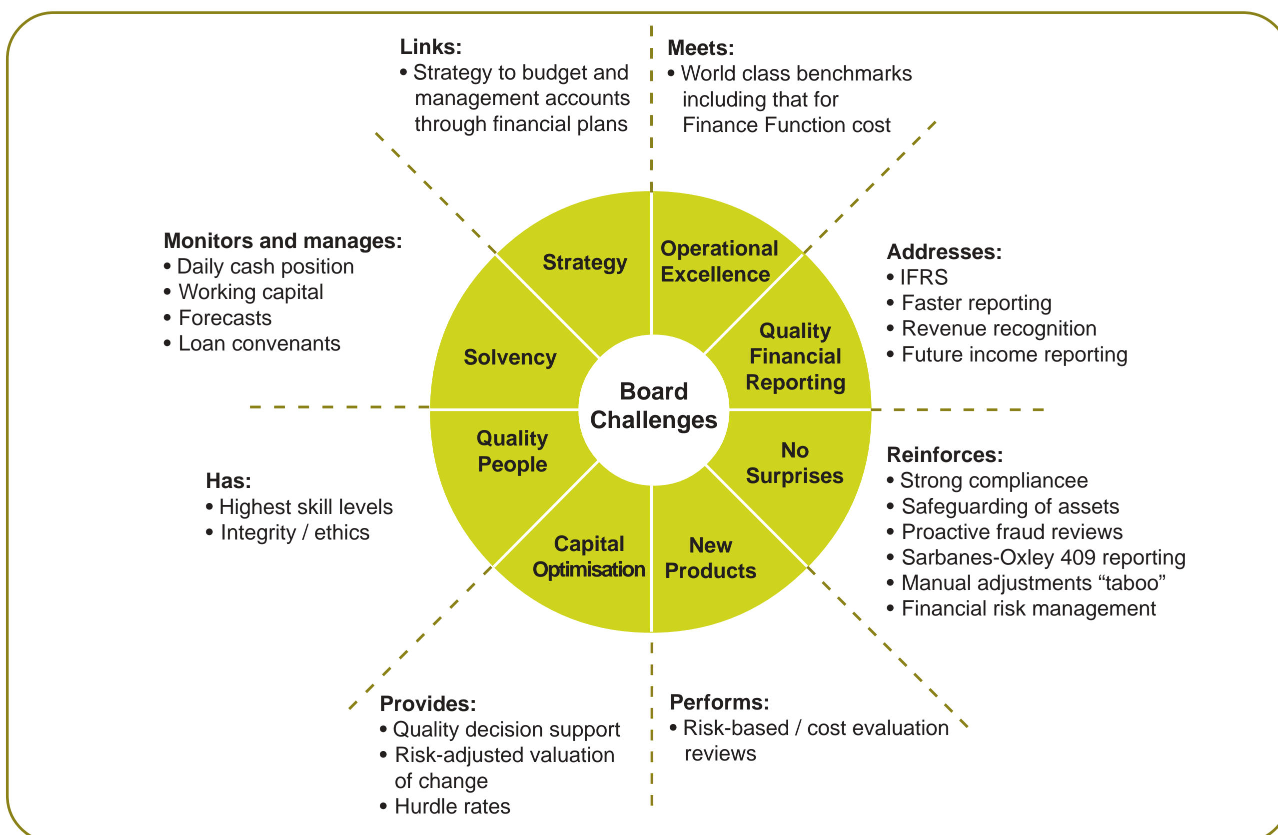


Figure 1: How the Finance Function can address key challenges faced by the Boards of companies

Clarifying Board expectations

However, providing an assertion to the Board is not easy and there are several difficulties in doing so. Firstly, most Finance Functions are not clear as to what their Boards expect from them in the first place, and similarly many Boards may not be clear as to what they want – or indeed should expect - from their Finance Function. We all know very well how difficult it is to work for someone who does not clearly set out their expectations. The same logic applies to Finance Functions and their working relationships with the Board. We often see a company's Finance Function busy responding to ad-hoc Board requests, primarily because the Board is working on a different wavelength.

This matter needs to be addressed – and urgently. One of the ways to bridge this expectation gap is to formalise the Board's expectations of the Finance Function in a Finance Governance Statement. This statement is designed to spell out in a clear and concise manner, the Board's expectations in different areas. These would include areas such as strategy support, reporting, decision support, performance management, governance, compliance, controls risk management, etc. The Finance Function can then sign-off and implement the necessary measures that would enable them to meet the Board's expectations. At the end of every quarter, they can report back to the Board on the progress made to meet the Board's expectations. The advantage of having a Finance Governance Statement is that it removes uncertainty, clarifies expectations, and enables the Board to spot issues early on. It thereby gives it a greater level of comfort, and provides a basis for the Board to make a continual assessment of the Finance Function's performance.

Need for transforming the Finance Function

Having drawn up and signed a Finance Governance Statement with its Board, many Finance Functions will realise that there is a big gap between what they currently do and what the Board actually expects from them.

To get behind these differences, let's take a look at the way in which a typical Finance Function works.

The working life of finance staff can be roughly described as:

- gathering/receiving data;
- inputting into the system;

The advantage of having a Finance Governance Statement is that it removes uncertainty, clarifies expectations, and enables the Board to spot issues early on.

- waiting for more data (that usually comes in late);
- inputting that into the system;
- working hard under tight deadlines to reconcile the numbers at month-end;
- making period end adjustments and estimates (most likely with little time to check their validity);
- taking a short break for a day or two;
- and then starting the whole process all over again.

Quarter-end activity is more of the same, but usually with a closer look at the numbers and additional reporting. Year-end has all the added pressure of ensuring the numbers are right, and meeting significant reporting obligations.

Not surprisingly, these activities are labour-intensive and expensive. A typical Finance Function costs 1.4% or more of a company's revenues, with transaction processing and control activities consuming more than 80% of these costs (source: Hackett Group).

Additionally, management information systems can be disparate and inconsistent in items reported, making the consolidation process a nightmare. Often, the monthly financial reports are finally presented to the executive committee, "just-in-time" – a virtue in other parts of the organisation, but not here! The committee may only see the reporting pack for the first time during the meeting and even then, excessive manual adjustments may be highlighted and circulated afterwards.

Does this sound familiar? If so, take comfort. You are not alone.

With a Finance Governance Statement in place, it is clear that the Finance Function has to transform itself. The CFO is the person who will need to drive

this transformation to ensure that the Finance Function becomes the flag bearer that champions good governance, financial discipline and best practices within the company.

The changing role of the CFOs

To begin with, CFOs must realise that the role of Finance needs to evolve from being transaction-oriented and scorekeeping in nature to being more analytical and strategic, thereby adding value to the business and providing support to the Board.

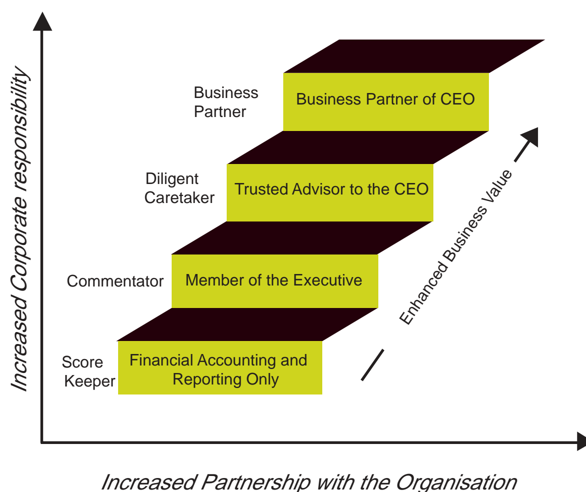


Figure 2: Changing role of CFOs

For example, senior management may like to know the answers to questions such as:

- Which parts of the business are producing and consuming financial resources?
- How do different businesses within the organisation compare with one another in the production and consumption of financial resources?
- How does our actual spend measure up against budgets and forecasts and do we really understand what caused any differences?
- What investment opportunities should we take?
- Which products or services are actually generating a profit?
- Which customers are more profitable?

These are the kind of inputs which the CFO would increasingly be expected to provide to influence strategic decisions within a business.

Tomorrow's Finance Functions

Leading-edge Finance Functions embed themselves within the organisation rather than being a "support" operation. This "partnering" can be enabled by reducing transaction processing effort, reducing budget preparation effort, improving all aspects of tax recording and accounting and focusing on value-added decision support.

To be successful in this transformation and to respond to key challenges, the Finance Function has to move from being a scorekeeper to being a business partner. This involves a significant shift in role and the Finance Function needs to first assess whether or not it currently has the relevant skill-sets to fulfil this role. It also needs to gain the confidence of the CEO and secure a mandate - this can happen only if it demonstrates that it is willing and able to meet the new requirements.

The key to this transformation is to optimise all aspects of the Finance Function's present and future activities. This is enabled by progressively reducing the amount of effort and time that the Finance Function spends in completing all of the different transactional, budgeting, taxation and reporting tasks.

The Finance Function should aim to move the "traditional" time allocation for Transaction Processing from 66% of total time to approximately 11% of total time and effectively reverse the decision support and transaction processing time and effort:

To be successful in this transformation and to respond to key challenges, the Finance Function has to move from being a scorekeeper to being a business partner.

Transforming the Finance Function

Achieving Finance Function effectiveness requires a combination of drive, enthusiasm, vision, strategy, processes, resources and support from the CEO and the Board.

This journey of transformation is not easy, but big gains await those organisations who succeed. PricewaterhouseCoopers recently launched a 360-degree holistic diagnostic assessment that looks at making the journey more systematic and structured. Success will not only enable a business to lower its cost of capital and provide better returns to shareholders, it will also be instrumental in helping the Board understand, manage and steer company performance to greater heights.

We will next delve a bit further into the effectiveness of the Finance Function by taking a closer look at the tax function and how neglect of this area can cost your company dearly.

Achieving Financial Effectiveness

- The Finance Function must move from being a scorekeeper to being a business partner.
- The Finance Function should use a Finance Governance Statement to formalise the Board's expectations of it.
- The Finance Function should move towards spending more time on decision support than on transaction processing.

About PricewaterhouseCoopers Performance Improvement

PricewaterhouseCoopers Performance Improvement helps clients attain increased performance by improving the efficiency and effectiveness of key business processes. Our in-depth industry expertise and understanding ensures tailored solutions for our clients. We focus on Financial Effectiveness, IT Effectiveness and Governance, Risk and Compliance business processes and deliver this through key enablers such as Change and Programme Management, Data Services and Technology.

Keith Stephenson, Advisory Partner and Asia Pacific Leader for Performance Improvement can be contacted at
tel • (65) 6236 3358
e-mail • keith.stephenson@sg.pwc.com

R Raghunathan, Advisory Partner can be contacted at
tel • (65) 6236 3258
e-mail • r.raghunathan@sg.pwc.com

BY PAUL CORNELIUS Tax

Towards a world-class tax function*

In today's world, the impact on the bottom line is only one of the areas where inappropriate or ineffective tax management can rear its ugly head. Corporate reputation can be damaged, directors can face personal liabilities, and there can be a catastrophic loss of shareholder value, as yesterday's forgotten transactions suddenly come back to bite you.

Some companies have large tax teams to deal with this area, some have tax work embedded in the Finance Department; and some outsource the lot. But the actual model chosen will have little impact on the risks and obligations that senior management are required to handle.

An efficient and effective tax department

Whilst value creation is seen as important for the tax function, compliance and risk management are becoming increasingly important, in the light of increased regulation globally. However, value creation and risk management are not competing objectives. They are significant motivational forces that can be harnessed to form a potent business ally.

The elements of a world-class tax department are illustrated in Figure 1 below. You will see there are three requirements to maximise stakeholder value, and four tools which can be used to meet these objectives:

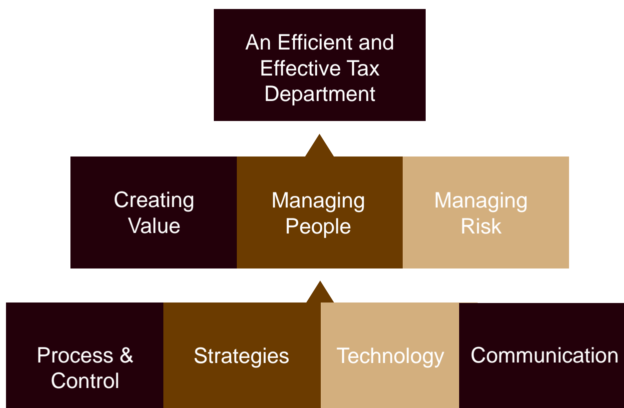


Figure 1: Elements of a successful tax department

Three keys to maximising shareholder value

1. Managing risk

To manage tax risk, you have to know what the risks are. The risk assessment process must be comprehensive. Risks of non-compliance with indirect tax laws (GST, customs) can be as severe as those associated with income tax. The $247 million in tax and penalties collected last year from GST audits tells its own story. Figure 2 shows the type of risks an organisation needs to get a handle on.

Types	Risks associated with
Compliance Risks	• meeting a company's tax compliance obligations
Transactional Risks	• application of tax laws, regulations and decisions to specific transactions
Operational Risks	• application of tax laws, regulations and decisions to everyday business operations
Financial Accounting Risks	• disclosure in financila statements and reports

Figure 2: Risk classification

Managing the first three requires a thorough understanding of an organisation's business operations and transactions, and how these should be reflected in tax returns. Management of financial accounting risk requires extensive knowledge of accounting standards to ensure appropriate disclosure.

But that is not where it stops. Organisations then need to determine their risk appetite, in a financial, regulatory and reputational context. A probability assessment should be made of each risk.

2. Managing people

It is of course vital to have quality tax staff with the appropriate skills and training. However, the management of people extends beyond the tax department door.

Relationships with personnel in government can be critical to the outcome of incentive applications, ruling requests, audits or lobbying efforts. Such relationships need to be cultivated and maintained to ensure quick resolution. Effective communication with external service providers can improve efficiency in this area. Open communication lines with staff in the business units can mean the difference between an informed and an uninformed tax decision. For example, GST is a transaction-based tax. This demands close communication between those responsible for accounting for the tax and the frontline staff who negotiate and close business deals for the supply of goods and services.

3. Creating value

A tax function creates value by providing informed advice and planning initiatives to both reduce an organisation's tax burden and avoid unnecessary tax exposures. Some degree of risk is usually associated with tax planning initiatives. Effective tax planning takes into account the individual organisation's tolerance for risk.

Four tools to achieve key objectives

So how do organisations meet the three objectives of creating value, managing people and managing risk? How can organisations tap on the expertise of tax professionals to achieve these goals?

Tool 1: Implement a tax strategy

It will never be possible to cover all eventualities. But to create a "no surprises" environment, the tax department must have a strategy in place to cover all aspects of risk management, in particular, they should have:

- A benchmark for measuring the value created by the tax function (eg. dollar value-added each year and/or effective tax rate targets)
- Identification of potential tax risks and documented procedures for dealing with them
- Tax compliance benchmarks (eg. target lodgement dates, absence of penalties)
- A set of roles and responsibilities, clearly stating the experience and ongoing technical support required for each
- Communication benchmarks (eg. tax update as part of quarterly board meetings)
- Tax department costs and budget
- Benchmarks for lobbying and government liaison (eg. target dollar value of incentives obtained)

Tax professionals can assist in assessing tax risks and opportunities, and help develop appropriate strategies.

> ...companies may decide to outsource some of their tax compliance functions to professional service providers who have the infrastructure to support the tax compliance process.

Tool 2: Develop and document your tax policies and procedures

A tax map can be developed to determine the key tax decision points in an organisation. Tax policies and procedures should cover all areas of tax management such as:

- Tax function approval for acquisitions, divestments, changes in corporate structure, changes in business operations and changes to accounting disclosure of taxes
- Early involvement of the tax function in tax sensitive transactions
- Fully documented tax accounting, reporting and payment processes
- Involvement of external advisors to support in-house decisions

Tool 3: Leverage off technology

Technology can generally be used to support three of the key tax areas (see Figure 3).

Technology	Support tax in
Research tools, often Internet-based	• tax planning and advisory work
Tax software	• tax reporting and compliance
Tax Management software	• tax management

Figure 3: Using technology to support the tax function

If companies must rely on manual controls over tax compliance, reporting and payment functions, care must be taken to ensure these controls are robust. Alternatively, given the complexity, companies may decide to outsource some of their tax compliance functions to professional service providers who have the infrastructure to support the tax compliance process. In a nutshell, the greater the degree of automation, the stronger the controls and the less room for human error.

Software exists which can simplify the management of tax, especially for multinationals. One such product is the PwC Global Compliance Solutions. This software allows clients to access a database via the Internet which contains details of all aspects of a group's tax compliance position, including a company-by-company status, and tax planning opportunities.

Tool 4: Communications

Communication is the gel that holds the other tools together and gets the tax management wheel turning. The tax function must be in regular communication with the business units and the other departments of the finance function.

Some form of communication can be mandated to cover aspects such as reporting the impact of changes in tax laws and practice on the organisation. However, there will always be a need for networking and informal communication within the organisation in order for the tax function to be effective. It is equally important for the tax function to keep its staff members up-to-date, particularly where it is regional or global business. Other key communication channels include government tax authorities and external tax service providers.

Summary

It is no mean task to create value for an organisation while balancing tax risk. To tackle this difficult task, PwC has developed a diagnostic process to assist organisations in systematically reviewing the functions of the tax department.

But here are some simple questions to help you work out if your organisation enjoys a world-class tax function.

1. Does your organisation have a tax department? Name them.
2. When was the last time you saw them?
3. What is the company's effective rate of tax?
4. How does that compare with your competitors?
5. What taxes (income tax, GST, withholding taxes, foreign taxes, customs duties, property tax, stamp duty etc) does your company pay each year and who is responsible for each (i) locally, (ii) globally?

If you struggle with these (and there are many, many others), then you can be sure there is something down there waiting, watching...just ask what's left of the taxpayers who had to fork out a total of $396 million in tax and penalties from income tax and GST audits last year... (Source: IRAS Annual Report 2003/2004). But it doesn't stop there. In March 2005, it was reported that over 22% of disclosures under section 404 of the Sarbanes-Oxley Act mentioned problems with tax accounting. And if you don't know what section "Sox section 404" is, it's time to worry even more.

Achieving a World-Class Tax Function

- Implement a tax strategy to cover all aspects of risk management
- Develop and document your tax policies and procedures
- Leverage off technology to support the tax function
- Ensure regular communications with business units and the finance function

About PricewaterhouseCoopers Tax

PricewaterhouseCoopers Tax practice is among the largest in Singapore. With more than 250 tax professionals and directors, we help individuals, businesses, both public and private organisations, with tax strategy, planning and compliance. From financial services, treasury, fund management, mergers and acquisitions, intellectual property, international tax planning (inbound and outbound) and Goods and Services Tax (GST) to transfer pricing, our tax professionals will provide you with the ideal tax solution.

Paul Cornelius, Tax Partner can be contacted at
tel • (65) 6236 3718
e-mail • paul.cornelius@sg.pwc.com

BY KAREN LOON Banking and Capital Markets Industry Group

Going for growth*

Striking the right balance for Financial Services in Asia

Financial institutions around the world are shifting up a gear after a period of conserving and building their resources and boosting returns to shareholders. According to the results of a PricewaterhouseCoopers/Economic Intelligence Unit Global Financial Services briefing, managing for value is still a priority for 97% of financial services executives, but 65% agreed that growth is higher on their agenda than it was 12 months ago.

Drivers of growth

In recent years, institutions in Asia have concentrated on conserving and building resources as well as creating value for shareholders. As we look forward, it is economic and demographic factors that will be the key drivers of growth in the region as shown in Figure 1.

Recent economic growth has been driven by interest rates, which are still low by historical

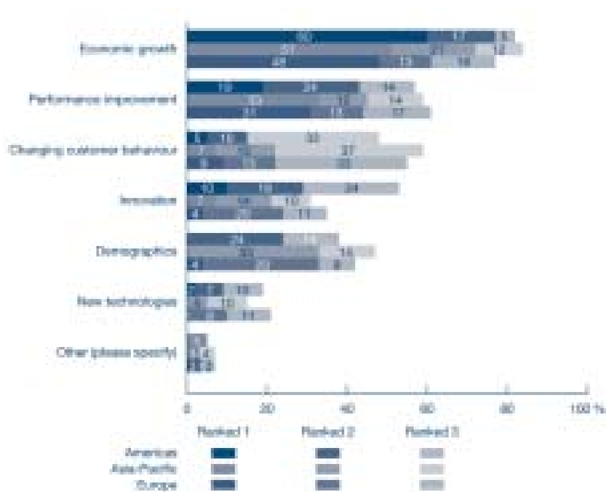


Figure 1: Key drivers for growth

standards. This has allowed the world economy to grow at a reasonable clip. Bad debts in the region have also reduced, and an increasing use of derivatives is helping to spread risk and make capital more mobile.

Rising standards of living in Asia, and the propensity of governments to push responsibility for pensions back to the individual, is leading to faster rates of growth in both savings and consumer lending, as well as increased demand for investment advice.

How will financial institutions achieve growth?

Financial institutions in Asia are positive about opportunities for organic growth, alliances and joint ventures. They are upbeat about outsourcing and Mergers and Acquisitions (M&A) activity in Figure 2 below.

Figure 2: Strategies for Growth

Eighty-two percent of Asian respondents to the survey expect the key source of growth to be organic, with a focus on new channels to market (63%), and new products and services (67%). Penetration of new customer segments and new geographies will also be important sources of growth for Asian financial institutions – private banking and wealth management will be a key growth area in many Asian countries, and one which many Singapore financial institutions are expanding into.

Others have been focusing on M&A activity, as well as establishing alliances and joint ventures, and entering into outsourcing arrangements. Forty-seven percent of Asian respondents expect growth to arise from entering into alliances and joint ventures. M&A as well as outsourcing will also be important sources of growth for Asian financial institutions. Much of the M&A growth in Asia in the next few years is expected to centre on India, China and South Korea – all countries with an expanding middle class in the wealth management sector. In 2004, Singapore banks made some cross border acquisitions in South East Asia, including Thailand and Indonesia.

Whether developing new products or building on existing ones, whether seeking out new customers or selling more to existing ones, an organisation's growth will largely depend on its people; training is an area which many Singapore financial institutions are investing in currently. From improving the skills of customer-facing staff to nurturing risk appetite, the quality of management and of employees will be critical in creating success.

Challenges to growth

Competition is the key challenge which will face Asian financial institutions as they grow. Whilst organic growth will be the primary driver of expansion for many organisations, new business models and products may be required to break the mould in more saturated, mature markets. In some Asian markets, although growth is relatively easy, the smartest organisations will work firstly to carve out a place in the market and then afterwards erect barriers to entry around it so that, as competition intensifies, the benefits of fast-growing economies continue to flow.

Risk, both economic and political, will also cast a shadow over growth prospects in several markets. The sliding US dollar, rising interest rates and the possibility of a sharp reduction in growth rates all have the capacity to undermine the macroeconomic balance.

Finally, changes in regulations and the need to comply with them will require senior management focus. For institutions operating in multiple territories, putting in place local and regional governance structures which are satisfactory to various regulators need to be considered. Increased focus on compliance, governance and risk management will be important for management as they grow organically and make acquisitions. Creating an entrepreneurial culture will be one of the key challenges of moving from a focus on value to one on growth.

A tight focus on cost control, efficiencies and performance improvement will also be essential. Performance improvement was given a high rating in the hierarchy of drivers for growth identified in the survey. Two-thirds of respondents also view cost efficiencies as either critical or very important in driving growth over the next 12 months.

What does this mean for Asian financial institutions?

For strategies to succeed, financial services firms cannot sit back and wait for the pie to grow. Leading financial institutions can improve their chances of sustainable growth through the following courses of action:

- Plan and communicate strategies. Proper quantification of risks and financial outcomes, and the use of a range of analytical techniques, is essential in formulating strategy. This may mean selecting the right geography or segment to achieve and sustain profitable growth. Successful institutions are capable of testing new ideas and adjusting to market feedback at speed.

- Set realistic targets. Growth can be defined in a number of ways: respondents to our survey mainly target revenue, followed by operating income and assets under management. Managers must consider the impact that rapid growth can have on the quality of customer service, on performance levels, and on profits, bearing in mind possible reputational issues.

- Get close to the customer. High satisfaction levels among existing customers can provide a source of referrals and of opportunities to extend sales. Closeness to the customer also implies the flexibility to change offerings to suit local market conditions: what works in the US may or may not work in India.

- Use technology appropriately. If people are critical to growth, technology is close behind. Electronic distribution channels can be a significant enabler of cost-effective growth. Technology is also critical to the effective management of customer relationships and to the measurement of company performance. Controlling the cost of IT can also make a material contribution to the bottom line. But the value of technology will vary between markets and customer segments: CRM in some emerging markets is likelier to depend more on personal relationships than data analysis, for example.

- Innovate in areas of strength. Whether they are dealing with new products or old, virgin markets or existing ones, institutions must be prepared to innovate, not just to grow but also to create and raise barriers to entry. Many global companies have achieved growth in markets such as China,

> Increased focus on compliance, governance and risk management will be important for management as they grow organically and make acquisitions.

but have neither innovated nor distinguished themselves significantly from their local competitors. The key is leveraging those skills and technologies in which the organisation is best in class in order to build a differentiated platform for growth.

- Invest in, develop and reward the right talent. One of the biggest challenges associated with growth are, firstly finding the right people and, secondly, creating a more entrepreneurial culture. Growth strategies will require greater numbers of talented people with a global mindset, a relentless focus on the customer and innovative skills, as well as flat decision-making structures that are capable of incentivising staff and enabling innovation.

The future therefore is bright for the financial services sector in Asia and growth opportunities are significant. But there are challenges too that need to be faced and complacency is not an option. As Confucius once said (or was it his brother?) “Even thin turkey gets fat in run up to Christmas. Only clever turkey sees New Year”.

Achieving Sustainable Growth

- Plan and communicate strategies
- Set realistic targets
- Get close to the customer
- Use technology appropriately
- Innovate in areas of strength
- Invest in, develop and reward the right talent

About PricewaterhouseCoopers Banking and Capital Markets Industry Group

As a leading professional services firm in Singapore, PricewaterhouseCoopers Singapore’s dedicated Banking and Capital Markets Industry Group (www.pwc.com/sg/banking) has a team of multidisciplinary professionals with specialist knowledge, in-depth local market knowledge and proven expertise that enable us to address our clients’ specific needs, coupled with insights into market place developments and global opportunities.

Karen Loon, Banking and Capital Markets Industry Group Partner can be contacted at
tel • (65) 6236 3021
e-mail • karen.loon@sg.pwc.com

BY TAN SHONG YE Security and Technology Group

One size doesn't fit all*

When it comes to safe IT

Faced with an ever increasing number of threats from cyber-terrorism, corporate espionage, hijacks, logic bombs, trojans, worms, viruses, hoaxes and all sorts of other nasty diseases, it is little wonder that the poor souls charged with defending and maintaining the integrity of an organisation's electronic data are paranoid about security.

However, the question is, how much security is enough security? More precisely, what is the appropriate level of security that an organisation needs to spend its money on before it can safely assume it is sufficiently protected?

Some CIOs look for the “standardised approach”, which means they identify what seems to be best practice, adopt it wholesale, deploy and get certified. Job done. This approach is popular, as shown by the interest that security standards such as ISO17799 have gained over the past years. However in terms of efficiency, the “standardised approach” is seriously flawed. While standards are useful, over-reliance on standards can be dangerous because it gives a false sense of security.

Evidence has shown that there are companies who have gone through standards-certification, only to see their IT systems penetrated, because critical systems were not identified as such and given the level of attention they merited. Other less important areas were protected by defences that made Fort Knox look like an open sandpit.

The fact is that IT security management is a process of managing business risks. Since business risks vary from company to company, IT security can never be properly addressed with a standardised approach.

The Security Framework explained

PricewaterhouseCooper’s Enterprise Security Business Model (ESBM) strings the necessary processes together. It systematically describes the activities required to identify, create, capture and sustain value through security.

Having a proper IT security framework is vital because it links business risks with security practices, with the people, and finally with the nuts and bolts in the IT systems.

The IT Security journey

Starting with the *Envision* phase, companies first need to review their current security structure in the context of their business objectives. The IT security strategy can then be mapped out and resources allocated to areas most in need, according to business requirements.

Activities include aligning security initiatives with their associated costs, justifying the cost in terms of the business, increasing the efficiency of existing services and/or mitigating business risk.

The result? A security strategy that balances enablement and protection, blending the security of inclusion (allowing access to the right people) and exclusion (preventing unauthorised access to internal resources).

A telecommunications company who shall remain nameless started off its IT security journey with a technology risk management workshop involving the CEO, CFO, key business and IT heads. Between them, they identified key information assets and saved a few million dollars of potential IT security spend that would not have been put to good use. They also discovered that security could add the most value to their business if they could communicate their level of achievement in security to their customers and differentiate their products accordingly.

Next, the *Engineer* phase transforms the security

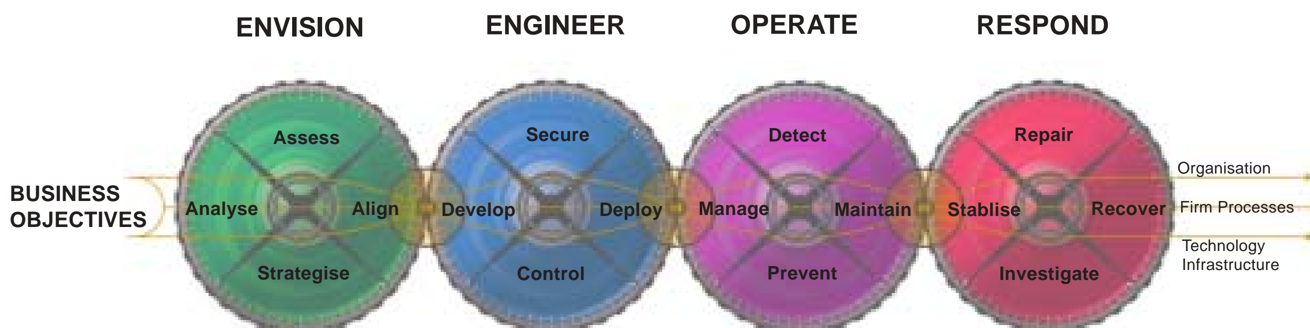


Diagram: PricewaterhouseCoopers’ Enterprise Security Business Model – describing security in business terms rather than from a pure technology perspective.

strategy into technologies and processes that help accomplish the business objectives of the company. These technologies and processes serve to protect information assets and enable access to them, according to the organisation's needs and goals.

Enablement may include enterprise identity management (authentication, access control and user management) as well as the enforcement of business rules. Protection may include secured technologies and the deployment of threat and vulnerability management systems.

But this stage can be the most challenging. The reason is that advances in security technology are happening at a hearty lick, and most companies may not have internal resources to design an appropriate architecture, build the right systems or choose the right technology providers. The risks for project management can also be very high because of the technical complexity involved. Nevertheless, organisations that are able to execute well can extract significant value as a result.

As an example, a large technology manufacturer recently saved $10 million through an identity management project which broke even in less than eighteen months.

The purpose of the *Operate* phase, is to manage a secure environment over a period of time, monitor for anomalous events, implement appropriate mitigating controls, integrate with the core IT environment and escalate appropriately if events turn into incidents or emergencies. It includes updating, enhancing and monitoring the technology environment, as well as staying current with known threats.

Most companies know how to operate security, that is, do things right. But what is needed here is to do the right things. This means not over-protecting information assets.

An insurance company that has succeeded in this area involved its auditors, top management and risk manager at the *Envision* and *Engineer* phases. The support of these stakeholders helped to improve operations and cut down inefficiencies. The auditors, for example, assisted in reviewing the IT operation periodically to ensure compliance with the security framework.

Last but not least, the *Respond* phase helps a company prepare, react, respond, investigate, recover and minimise loss in the event of an incident or crisis. It includes identifying the root cause of security vulnerabilities, stabilising the incident to minimise business damage and subsequent forensic investigation. Many organisations, in this aspect, have formalised incident handling procedures and call upon external help eg. computer forensics experts when needed.

Conclusion

The ideal level of IT security for an organisation is not about implementing best practices. It is a journey of self-inspection. If properly implemented, the ESBM framework will bring about a harmony between business risk management and IT security investment.

Of course, as in any major new project and changes to existing workflows, other implementation issues that should not be overlooked are management commitment, people, training and structure.

Nobody will tell you that it is an easy journey, but organisations that have been successful on it have managed to obtain great value. They have been able to leverage their IT infrastructure to reach out to more customers, suppliers, partners and to manage information flows and risks better than their peers through a strong capability in managing enterprise security business risks.

In short, an organisation needs to remember:

- Each company has to assess its own security risks in the context of its business risks and goals.
- A structured model is available for companies to adopt and use to determine their own ideal level of IT Security.
- Don't let anyone tell you any more that one size fits all.

About PricewaterhouseCoopers Security and Technology Group

PricewaterhouseCoopers is the global leader in information security and privacy solutions, with more highly trained professionals in the field than any other organisation. Our multi-disciplinary teams help clients effectively identify, assess, implement and manage security and privacy solutions.

Through proven methodologies, best-of-breed tools from our Alliance Vendors and best practice services, S&T helps organisations build and maintain a secure and high-performance business infrastructure.

Our service offerings include:

- Security Strategy Services
- Threat and Vulnerability Assessments
- Managed Security Solutions
- Enterprise Application and Control Services
- Security Integration Services
- Identity Management
- Data Management
- IT Assessment and Architecture Review
- IT Requirements Definition and Analysis
- Technology Selection and Implementation Support

Tan Shong Ye, Advisory Partner and Head of Security and Technology can be contacted at
tel • (65) 6236 3262
e-mail • shong.ye.tan@sg.pwc.com

BY AMITAVA GUHAROY India Desk

Out of India*

Taking advantage of investment opportunities

Perhaps no country other than China has attracted so much interest in recent times as India has. Much has been written and spoken about the opportunities that the rapidly growing economy with its vast domestic market presents. As advisors who have significant experience of on-the-ground realities, we examine the sectors of opportunity and how investors can optimise results in the Indian market.

The economy

The Indian economy has exhibited a consistent real growth rate of between 5% and 8% for over a decade. This is indeed a remarkable performance in view of the size of the economy which is approximately US$ 600 billon, and this is expected to nearly double in size by 2010. In Purchasing Power Parity (PPP) terms, it is already the 4th largest economy globally with an estimated size of US$ 2.7 trillion. Over the years, there has been a gradual opening up of the economy and greater encouragement of foreign investment.

The sectors of opportunity

With a population in excess of one billion, it is possible to argue that almost every sector presents significant opportunities. However, certain specific sectors are emerging as areas of rapid growth.

The auto components industry which is estimated to be worth around US$ 6-7 billion today is projected to grow to between US$ 30 billion and S$ 40 billion by 2015. Of this, exports, which today aggregate approximately US$ 1.5 billion, are expected to reach US$ 20-25 billion. A number of leading international auto makers are planning to use India as a major sourcing base. Indian auto component manufacturers have also been awarded the prestigious Deming award for quality.

The Indian organised retail market represents what is perhaps the largest single-country opportunity in the next decade. The organised retail market, which is worth about US$ 6 billon today, is expected to attain a size of around US$ 25 billon by 2010. Food and grocery, clothing, fashion accessories and consumer durables are expected to lead the retail growth.

With recent changes in regulations, the Indian textile industry is poised for massive growth and the larger manufacturers have made or are planning to make significant new investments. Textile exports are expected to grow by between 15%-18% annually between now and 2010.

The slow pace of infrastructure development has been a crucial impediment to India realising its maximum potential. Sectors such as power, roads, ports, etc. require a minimum investment of US$ 150 billon in the next five years.

The Indian pharmaceutical industry has made significant progress in recent times. Its share of the US generics market has increased from 0.4% in 1998 to 3.4% in 2004 and is expected to increase to around 7% in 2008.

The Information Technology and the Business Process Outsourcing opportunities in India have been too well publicised to merit further comment. However, other areas of outsourcing, including design and manufacturing, present new areas of potentially rapid growth. Knowledge Process Outsourcing (KPO) presents exciting growth potential for international companies to take advantage of.

Sectors such as banking, real estate, hospitality, logistics and healthcare are some other areas of considerable potential.

Recent policy changes

The current government in India has continued to liberalise the economy and encourage foreign investment. The recent change in foreign investment norms in the real estate sector emphasise the government's keenness to increase the level of foreign direct investment. Foreign shareholding limits have been enhanced in the telecom and airline industries and the much publicised Press Note 18 has been considerably diluted. Foreign investment in the retail sector is now being contemplated. Special Economic Zones (SEZs) are being created to encourage foreign investment. Corporate tax rates have been reduced and import tariffs lowered further. The investment norms relating to the banking sector are gradually being redefined.

Succeeding in India

India is perhaps no different from any other overseas investment destination in that it presents a unique set of challenges for any foreign investor. The nature, size and specific characteristics of the market are very different from other markets and it is important to be aware of these factors before

> The recent change in foreign investment norms in the real estate sector emphasise the government's keenness to increase the level of foreign direct investment.

embarking on a "Destination India" mission. A well defined strategy and a clearly articulated plan of action are important for eventual success. So is the identification and formalisation of relationships with a partner if that is the preferred approach for tackling the market. Clear alignment of goals and interests with the partner can contribute significantly to the ultimate success of the investment. While formalising partnership arrangements, attention needs to be given to the medium term business strategy and future requirements, and not just to immediate requirements. Most importantly, it is absolutely essential to be prepared to be patient and flexible in approach, to ensure optimum results from the numerous opportunities that the Indian market offers to potential international investors.

Sectors of opportunity in India:

- Auto components industry
- Organised retail market
- Textile industry
- Pharmaceutical industry
- Outsourcing in design & manufacturing and Knowledge Process Outsourcing
- Banking and real estate
- Hospitality, logistics and healthcare

About PricewaterhouseCoopers India Desk

PricewaterhouseCoopers' dedicated India-focused team provides business advisory to corporates, foreign and Indian entities seeking to derive value from trade and investment flows between India and Singapore/Asia Pacific. As a leading provider of best practices to the world's most successful corporations, we ensure our clients' needs will be delivered by our team of multi-disciplinary, multi-lingual and multi-ethnic experts with in-depth knowledge and understanding of India's business and regulatory landscape. We combined this with our industry sector and market knowledge across global markets to enhance our clients' value.

Amitava Guharoy, Advisory Partner and Head of India Desk can be contacted at
tel • (65) 6236 4118
e-mail • amitava.guharoy@sg.pwc.com

BY GREG UNSWORTH Technology Industry Practice

Sudden impact*

The effect of the new FRS on technology companies

If you think changes in Singapore Financial Reporting Standards (FRS) are just accounting issues, think again. Fundamental changes are afoot (some already in place) – changes that can affect businesses from investor relations to everyday procedures, changes that can affect the viability of products and even the reported profitability of the business itself.

All Singapore companies are required to make substantial changes to their existing accounting policies given the alignment of FRS to International Financial Reporting Standard (IFRS) developments. But for those in the technology sector, perhaps the most significant impact will be in the areas of business combinations, share-based payments, revenue recognition and research & development (R&D).

There is no time to sit back and muse about this. The new standards affecting business combinations, R&D costs and share-based payments already apply in Singapore for financial years beginning on or after 1 January 2005.

Ironically in the sometimes complex and volatile technology sector, it could be these financial reporting developments that have a greater impact on reported results than business performance itself. All stakeholders will be affected – shareholders, investors, lenders, analysts, directors, management and staff. It will be necessary to continually educate and manage their perceptions in respect of these changes.

Who will be affected?

It is clear that developments in FRS will have a significant impact on the technology sector, not only in terms of practical transitional issues, but also in respect of reportable earnings, net asset value, the level of gearing and returns on capital.

Let us take a closer look at the more significant developments for the technology sector.

Business combinations (including intangibles)

FRS 103 makes accounting for business combinations a boardroom issue for technology companies as the reporting of deal economics will change. There will be a need for more robust due diligence to make sure that what is being acquired is properly understood and increased transparency will provide the market with greater insight. These factors in turn may require companies to review their deal strategies.

Under FRS 103, many more intangible assets will be recognised as the allocation of purchase price has been made more rigorous. All identifiable intangible assets must be identified, valued and, unless they have an indefinite life, amortised. The valuation of such assets is a complex process and requires specialist skills, and should be considered early in the company's acquisition decision-making process. Early evidence from the US, where there are similar standards to FRS 103, shows that on technology sector deals, some 21% of the purchase price was allocated to specific intangible assets.

Examples of intangible assets for technology companies include trademarks, customer lists, customer contracts and order backlogs, licensing and royalty agreements, lease agreements, patented and unpatented technology, non-compete agreements and trade secrets.

Purchased goodwill is no longer amortised but subject to tough annual impairment testing. This will result in enhanced earnings for companies with significant goodwill balances if good acquisitions have been made, but will highlight poor acquisitions earlier and increase the potential for earnings surprises.

Share-based payments

Technology companies, in particular, have used stock options as a way of incentivising and rewarding performance; and the new standards will impact the technology sector significantly.

FRS 102, "Share-Based Payments" applies to almost all share-based payment transactions, not just those made to employees. In respect of employee share options, the key principle of FRS 102 is that the charge to the profit and loss account should be based on the fair value of the option at the date of grant. This will almost certainly result in higher charges in the profit and loss account for those companies with share compensation plans.

How is fair value established?

The fair value has to be calculated using an option pricing model and for most companies, this will require specialist input. Some valuation assumptions should be easily obtainable including, including share price at grant date, exercise price of the option and the risk-free rate of return. Other valuation assumptions are more difficult to obtain, including expected life of the option, turnover of staff, share price volatility and dividends expected on shares. Particular problems in calculating fair value may arise where a plan has market-based performance conditions that are linked to share price performance.

How will it affect technology companies?

The cost of share options is highly sensitive to the level of awards granted and day-to-day variability of the share price. Technology companies are generally known to have more volatile share prices.

This means that technology companies will need to spend more time than others in understanding the impact, looking at alternatives to mitigate cost and then reviewing how they should communicate to the investment community.

What should technology companies do?

Companies must consider whether they have the skills and resources available to make the appropriate benefit assessments and valuations for their financial statements. Significant disclosure demands are also made under FRS 102, and the impact of tax will need to be taken into consideration.

Revenue recognition

FRS 18, “Revenue” sets out the basis of accounting for revenue arising from certain types of transactions and events, including the provision of services, sale of goods, principal/agency arrangements and multiple element arrangements. However, this is a principles-based standard and provides only limited prescriptive guidance.

The technology sector is increasingly characterised by the offering of complex bundles as part of a single transaction or a series of linked transactions. While FRS 18 recognises the concept of multiple element arrangements, it provides very limited guidance on how to account for these complex arrangements. The overriding principle of the guidance is that the accounting should reflect the commercial substance of the arrangements.

The principles included in FRS 18 are that:

1. Revenue arrangements with multiple deliverables should be divided into separate elements;
2. Consideration should be allocated among the separate elements based on their relative fair values; and
3. Applicable revenue recognition criteria should be considered separately for each element.

Under FRS, revenue is likely to remain a critical area of focus for technology companies; and early consideration of the likely impact of new business models, significant deals and customer offerings are highly recommended.

Research and development costs

Until now, virtually all technology companies have expensed development costs when incurred. Under FRS 38, development costs must now be capitalised if the appropriate criteria are met. Development costs are required to be capitalised if an enterprise can demonstrate all of the following:

- Technical feasibility of completion
- Intention to complete and abilities for use or sale
- How the project will generate probable economic benefits (typically as demonstrated cashflow projections)
- Adequate resources to complete and use or sell the output
- Ability to measure expenditure attributable to the project

This requires a demonstration of adequate project management, costing and appraisal processes; and systems capable of reviewing project performance or subsequent impairment.

Where to from here?

The impact of the new FRS on technology companies will be significant and inescapable. The rules are complex and subject to interpretation. These issues should be top priority for senior finance executives and the impact on reported results will need to be considered at Board level.

It is essential to have a full understanding of the implications, establish a plan to address the issues and take proactive steps to manage the expectations of all stakeholders. Of course, the right professional advice is critical...

Areas of most significant impact on technology companies

- Accounting for acquisitions
- Share-based payments
- Revenue recognition
- Research and development costs

About PricewaterhouseCoopers Technology Industry Practice

The technology industries – semiconductors, software, life sciences, computers and networking – profoundly influence our lives. Access to capital, faster time-to-market, and finding and keeping the right talent are more critical than ever. So are managing stakeholder and financial market expectations. Likewise, convergence – a common theme running through all technology industries – brings new and fundamental challenges to industry players.

How PricewaterhouseCoopers can help:

PricewaterhouseCoopers helps technology clients solve business issues and develop long-term strategic objectives. We help them achieve success by delivering industry-focused assurance, tax, and advisory services with a global perspective, local implementation, in-depth experience, and a forward-thinking approach. As technology companies grow, the issues they face may change – but our ability to add value is a constant they can rely upon.

Greg Unsworth, Assurance Partner and Technology Industry Leader can be contacted at
tel • (65) 6236 3738
e-mail • greg.unsworth@sg.pwc.com

BY KOH SOO HOW GST Practice

We know what you did last summer*

In that GST return

In tax management, surprises are always bad, which is why people want to avoid them. However, surprises, like accidents, happen when you least expect them. A clear plan for the management of all taxes – both direct and indirect – is therefore a crucial part of the corporate governance process for any organisation which is serious about identifying and managing its risks.

Even where a fully-fledged tax function is in place, indirect taxes rarely get the attention they deserve. Singapore is perceived to have one of the simplest Goods and Services Tax (GST) systems in the world with a high registration threshold of S$1 million and a low tax rate of 5%. This has led many businesses, including multinationals, to leave GST on the back burner. The trouble with back burners of course is that sometimes, they blow up and bring the whole house down with them.

The rather vague notion that GST has a tax neutral effect on businesses (which is what we have always been told) has led to a widespread failure to recognise the risks of getting GST reporting wrong. As can be seen from the Inland Revenue Authority of Singapore (IRAS) table below, tax and penalties from GST audits have been on the increase over recent years:

Financial year	Tax and penalties ($'000)
2001/02	206,192
2002/03	197,833
2003/04	247,107

Source: IRAS Annual Report 2003

With recent (and perhaps future) increases in GST rates and the ever increasing sophistication of audit techniques and intelligence gathering, it is clear that this number will keep on escalating, even dramatically. The trick is to make sure that your company does not contribute to these statistics.

Not so simple after all?

GST is a disarmingly simple tax. The problem however, is that it is a transaction-based tax which pervades every aspect of a company's business, and relies on the interpretation of legislative provisions that are anything but simple.

Basically GST applies, according to the law, when you do something for monetary consideration. Unfortunately, there are also provisions in the legislation that tax transactions for which no (obvious) consideration is received, for example, business promotion gifts and employee fringe benefits.

The problem with such transactions is that they will not be picked up by the accounting system and are often overlooked, unless someone makes a conscious effort to identify and include them in the GST returns.

But GST is only 5% and we only pay a few thousand dollars a quarter. It is therefore not worth bothering about at that level, is it ?

Well, the answer is, yes it is.

As there are GST considerations for every single transaction a company undertakes, the scope for error is almost limitless. Not only that, a single misconception about the rules can be replicated hundreds, perhaps thousands of times over a period (millions if the last time you checked was ten years ago). From this perspective, you are right. It is probably better not to think about it!

So how material can GST be?

For those who are still bold enough to read on, let us try to put the issue of materiality in perspective. A business has annual sales of, say, S$50 million and taxable inputs of S$45 million. GST is due on the net balance of S$5 million, resulting in a GST liability of $250,000. This may not be considered material to the financial statements. However, the correct output tax has to be accounted for on each and every sales invoice, and the input tax on each individual purchase or expense has to be supported by a valid tax invoice. It is therefore not sufficient to simply look at the net figure of $5 million.

The correct test for materiality is by reference to *throughput*, that is, the actual monetary flow through the business which gives S$2.5 million of GST on the sales, and S$2.25 million of GST on the taxable inputs, or a total GST figure of S$4.75 million for the year. The penalties for getting any of it wrong can therefore become a significant cost to the business.

How likely are errors?

GST is often seen as a by-product of the accounts payable and receivable system, which is often automated. Very little thought is given to control and ownership of the GST accounting process. As a result, responsibility for GST accounting generally falls on the shoulders of a junior accountant. This can prove disastrous if the person is not properly trained to understand the subtleties of the legislation, and how it applies to business transactions. Even if he has formal GST training, he may not have the necessary seniority or depth of experience to have intimate knowledge of the workings of the business.

The problem is compounded by the lack of communication between those with responsibility for accounting for GST, and the frontline staff who are doing deals and raising invoices.

What lies beneath?

As with any self-assessment system, the IRAS relies on a system of tax audits and penalties to ensure compliance with the law. As noted above, the IRAS has become more sophisticated with the use of computer-assisted auditing techniques (Caat) to spot irregularities in GST returns.

In one case mentioned in the newspapers a few years ago, the IRAS highlighted the use of Caat on a multinational corporation with roughly 3,000 records a month for sales and purchases. Not only did they find an under-reporting of GST of S$190,000 straightaway, but an extended check on the company's suppliers also revealed an incorrect reporting of $195 million, resulting in underpaid tax of $5.8 million.

Penalties for incorrect GST reporting can range from 100% of the amount of tax in error to 300% for wilful evasion. The penalty regime also provides for fines and imprisonment if the matter is taken to court. There is also provision in the legislation for the IRAS to charge a director, manager or employee of a company for a GST offence unless the individual can prove that the offence was committed without his consent, and that he had exercised all due diligence to prevent it. This particular provision was indeed applied in one case in which both the company and the managing director were prosecuted and charged S$240,00 in penalties for wrongful collection of GST.

In practice, and in the absence of any evidence of wilful evasion, the IRAS would normally offer to compound the error for S$5,000 for each corrected return. For quarterly returns, this amounts to a potential penalty of S$140,000 for a period of 7 years, plus possible additional late payment penalties of 5% of the tax underpaid or over claimed, compounding at 2%.

So what can be done?

While there can be no "one-size-fits-all" answer as to how to manage these risks, each business must have a function or process that enables GST returns to be signed off with a reasonable level of confidence. At the very least, businesses need to ensure that they have put in place the necessary accounting controls and checks to identify and correct errors early, and that the staff are well-equipped to account for the tax correctly. Common errors relating to the recharges of expenses, overseas billings, zero-rating of exports without valid shipping documents, disallowed input tax and business gifts for instance, are risk areas that require immediate attention.

Remember, someone knows your secret, someone knows you are scared, and they will find out (sooner or later) what you did last summer. It is better that you find out first.

Typical GST risks include common errors relating to:

- Recharges of expenses
- Overseas billings
- Zero-rating of exports without valid shipping documents
- Disallowed input tax
- Business gifts
- Employee fringe benefits

About PricewaterhouseCoopers GST Practice

Adopting a business-focused approach, PricewaterhouseCoopers GST team provides local and international consultancy services to SMEs and multi-national corporations. The team can help in:

- identifying areas to improve GST efficiency
- avoiding reporting pitfalls
- providing in-house training
- performing GST health-checks
- managing GST audits

Koh Soo How, Tax Partner can be contacted at
tel • (65) 6236 3600
e-mail • soo.how.koh@sg.pwc.com

BY ONG CHAO CHOON Transactions

How to avoid an M&A hangover*

And still go out on the binge

Singapore Inc and other corporations have been scouring the globe for investments to form Singapore's external economic wing for over a decade now. Many others have also set up offices here as a base for regional expansion. The art- and science- of deal-making and post-acquisition integration has grown in sophistication since. Corporations now, more than ever, realise that a successful deal involves more than a prime pick and a good price. To maximise an acquisition's value, significant effort in planning and preparation both during and after the deal is crucial.

Recent corporate scandals and financial debacles further emphasise the Financial Controller Office's (FCO) role in Mergers & Acquisitions (M&A). Corporations realise that nothing spooks investors, or destroys value faster than misleading financial reports and poor internal controls.

The morning after

Picture this. After months of due diligence, negotiation and awaiting regulatory and other approvals, the deal is finally completed. The FCO swings into action to prepare the consolidated results for the next few quarters, incorporating numbers from the new acquisition.

The financial year draws to a close. The auditors swarm in and identify significant audit adjustments for the new investment. Q4 results fall below market expectations. Prior quarters' results require restatement. Another headache is the auditors' management letter - detailing significant internal control failures in the investee and raising doubts about the integrity of the unaudited management accounts.

The board and management are surprised, likewise the investing public. The investment does not look so good in the cold light of day.

Enter the Financial Controller

In the heat of deal negotiation, internal control and financial reporting requirements often do not get tabled early enough. These matters are looked at after signing the Sale and Purchase Agreement (SPA) or even after completion. Yet they usually need time to resolve, often requiring negotiation of additional SPA clauses and, at the extreme, throwing up deal breakers.

With the ever increasing emphasis on the quality of corporate governance, corporations and deal advisors have quickly grasped the fact that a newly-acquired entity could become the Achilles' heel in the group's financial reporting and internal control processes. In addition, the Singapore Exchange's proposed listing requirements will put Directors and CEOs under increasing pressure to provide assurance on internal controls and interim results.

In order to meet control and reporting requirements effectively, the FCO must be actively involved:

At pre-signing due diligence: providing assessment to the deal team and inputs to the SPA; formulating post-signing and post-acquisition action plans.

After signing the SPA: quantifying accounting differences; engaging professionals to fair value investee's assets; working out group reporting requirements; monitoring the investee's finanicals.

After deal-completion: performing Completion Audit, detailed review of the investee's internal controls; executing accounting, reporting and internal control integration.

Set out below are some of the challenges faced by the FCO in these three stages:

Accounting for differences

With two thirds of Singapore M&As being cross-border, it is crucial to understand differences in Generally Accepted Accounting Principles (GAAP) between countries. These give rise to different accounting policies and treatments for the same items. Even in countries that follow International Financial Reporting Standards (IFRS) closely, inconsistent interpretation and application may still lead to vastly divergent treatment. Accounting Policy Differences may also arise from legitimate discretionary choice of treatment and estimates. Or they could simply be due to more aggressive (or erroneous!) interpretation of the same policies. Common examples include capitalisation of internal costs, revenue recognition, intangibles, pension accounting and financial instruments.

An in-depth analysis of these differences is required. The investee will need to adopt the acquirer's accounting policies, even if it continues to maintain local GAAP books for local reporting. Identifying, quantifying and adjusting to the acquirer's policies can be a mammoth task, especially in cross-border acquisitions.

Getting the Opening Balance Sheet right

One of the most critical tasks upon deal-completion is the Completion Audit. Getting the Opening Balance Sheet right ensures that the enlarged group starts with a clean slate – so that pre-acquisition liabilities and transactions do not impact the enlarged group's post-acquisition results. Examples of the key procedures are fixed asset/ inventory counts, search for omitted liabilities and contingencies, payroll audit, accounts receivable and payable confirmations.

Completion Audit can also be expanded to provide a sweep of the investee's financial records, allowing the acquirer to identify and request immediate remedies for breaches of warranty.

Purchase Price Allocation is performed in connection with the Completion Audit. FRS103 “Business Combinations” requires that the purchase price be allocated to the identifiable assets and liabilities at their fair values at the date of acquisition, with their remaining useful lives reassessed simultaneously.

Common difficulties faced here are:

- the need to include assets (tangible and intangible) and liabilities not carried on the investee’s balance sheet. Examples: Brands, patents and contracts; fully depreciated assets still in use; contingent liabilities not provided for.
- that the recognition and measurement of intangible assets under FRS 38 “Intangible Assets” is fraught with complexities. Example: What qualifies? Customer lists may, but assembled work force will not, even though it is often the prized acquisition objective.
- that the value of intangibles may overlap, making fair valuation a nightmare. Example: Brand value and customer relationships.

Internal control robustness

The acquirer relies on the quality of the investee’s internal controls for reliable financial numbers. Significant deficiencies result in time-consuming and costly post-acquisition remediation, and worse, distract the acquirer from focusing on deriving value and achieving synergies.

A preliminary assessment of the internal controls environment should be performed during the pre-signing due diligence, with a detailed review conducted within three to six months of deal completion.

The pre-signing preliminary assessment poses the greatest challenge as it may uncover control issues that affect valuation, or even delay or break a deal. And yet, the acquirer has limited time and access to make this important assessment. He often only has interviews with key management, audit reports, and Audit Committee minutes to help him assess:

- quality of Internal Audit, their reviews and management’s response
- overview of key processes, reporting structure and corporate governance
- accounting errors and other findings during due diligence
- audit adjustments made by external auditors

The post-completion detailed review is critical to identify control deficiencies, set remediation in motion and harmonise controls with the acquirer’s.

Reporting integrity

Post-acquisition, the FCO needs to prepare both external financial reports and internal management reports on the enlarged group. A common problem, especially when acquiring an entity in a less developed country, is the quality and speed at which the investee is able to close its books. The FCO must communicate early the type of information required to meet the groupÕs management and statutory reporting needs; and also ensure that the investee is able to generate this information in a timely yet robust manner.

Finally, the acquirer needs to ensure that he has the right to access and demand all of the above where he controls less than 100% of the investee. Where such rights are not clearly spelt out in the SPA or Shareholder Agreement, post–acquisition difficulties may result, affecting relationships between partners.

Conclusion

The internal control and financial reporting matters discussed here do not, by themselves, make deals or create value in an acquisition. However, with quarterly reporting, complex accounting rules and market focus on controls and reporting integrity, there is little margin for error. The price of failure may be too high. So when you next hit the acquisition trail, make sure you ask the boring questions about controls and reporting early, so you do not end up with that morning after feeling.

Making the FCOs presence felt in 3 areas of an M&A:

- Accounting: Identify and adjust GAAP differences, perform Completion Audit and Purchase Price Allocation.
- Internal controls: Evaluate the quality of the investee’s internal controls pre- and post-acquisition.
- Reporting: Review the investee’s financial and management reporting process and capabilities.

About PricewaterhouseCoopers Transactions

PricewaterhouseCoopers Transactions practice provides Deal Support for both buyers and vendors to negotiate, evaluate and execute deals; conduct market studies, develop business plans; and value their business and assets. Our services include:

- Due Diligence (Market, Financial, Tax, Human Resources)
  Our diligence focus on deal breakers, comment on the quality of the target's earnings, cash flow and assets, identify potential tax and other contingencies, and highlight human resource issues and risks.

- Post-Deal Services
  Our end-to-end services include completion review to determine if there has been material deterioration of business and financial positions of target, and post-deal advice on purchase price allocation, GAAP reconciliation, internal controls and other processes to manage risks.

- Vendor assistance and Sell-side due diligence
  We help vendors to identify weaknesses and issues, assess the quality of earnings, determine the impact of transition/removal issues, structure the data room, and advise on the purchase agreement.

Ong Chao Choon, Advisory Partner and Head of Transactions can be contacted at
tel • (65) 6236 3018
e-mail • chao.choon.ong@sg.pwc.com

BY BENJAMIN KAN Corporate Finance

Message in a bottle*

Knowing when to stop in an M&A deal

In the last article ,we saw how the lack of attention to various aspects of a Merger & Acquisition transaction can leave you with a nasty hangover. We also read about preventive medicine you can use, which means there is no need to be afraid of going out and spending your money – on the right thing.

M&A activity has increased significantly over the last two years, from near meltdown caused by a run of bad news such as the Asian financial crisis, 9/11 and SARS. But the number of deals is now on the increase. Not only that. Deal value has also shot up. There are obviously some compelling factors driving companies to re-look at M&A as a growth strategy. However, there have also been some horror stories that are causing others to stand back. But it is only M&A deals that have gone horribly wrong that make the front page. The good deals seem to get little coverage and there are some good deals around, if you know how to find them.

Why deals fail

Many reasons are given for the deals that fail. Poor choice of target, lack of corporate governance or weak regulatory framework are the most common. However, if we look at the factors that are controllable, the main culprit usually turns out to be poor execution arising from lack of clarity of purpose and inadequate planning. More often than not, as the transaction process reaches its climax, the urge to close the transaction suddenly takes on a life of its own, superceding all other considerations (like why are we doing this deal?). There seems to be a point in each transaction process, beyond which the only acceptable option is to conjure up justification for completing the deal. This may be because the team was distracted and lost sight of its original intention, or because the deal rationale was never really made clear to begin with. Whatever the reason, it is understandable why private equity houses ask about the management team's track record in M&A deals before committing resources.

M&A is often perceived as nothing more than big deal broking. This cannot be further from the truth. It is, in fact, the use of a sophisticated and relatively high risk corporate strategy that can reap rich rewards for those who understand and are able to manage its complexity and risks. M&A can be a compelling and powerful strategy for companies wanting to achieve growth in today's ever-evolving global environment. It is also a high risk strategy that must be well managed if it is to succeed. But even then, a beautifully executed bad deal is still a bad deal.

Beware of the deal in your in-tray

To use M&A effectively as a growth strategy, management need to be proactive. When you set out to buy a house, you carry out detailed research on location, type of property, range of prices and funding. You engage an agent to show you the choices within your budget before you even think about putting your hand in your pocket. Many nights and weekends will be spent comparing options and consulting engineers and architects. Sometimes you will walk away from a seemingly good opportunity as it does not fit your long-term objectives. If you are willing to do all this for a simple residential property purchase, you should do much more when buying a business, which is a far more complex, time sensitive and multi-dimensional proposition altogether.

Management must therefore actively research the market to satisfy themselves that M&A is the best or only approach, and then decide on the parameters. They should then identify potential targets, sift through the choices and perform deeper research on the shortlist. The selection process must be based on reliable information.

Reacting to opportunities that land in your in-tray where someone else has seemingly done the leg-work is generally asking for trouble. These have probably been shopped around and are generally of lower quality. A good M&A operator will work exclusively with a select M&A house that has a wide network of contacts and relevant industry focus. Not only will these advisors have developed a good appreciation of the company's appetite for deals but they will also be sensitive to the all important "softer" side of a transaction, such as management style and risk appetite.

Get help with execution

As most organisations are not set up for regular M&A transactions, senior management time will be over-stretched if they have to manage the ongoing business and at the same time, be significantly involved in a transaction. Many potentially good transactions fail because of a lack of commitment in terms of time and senior resources. Senior management should consider engaging experienced external advisors to assist in managing the process and obtain specialist assistance, as and when required. M&A is a relatively high risk strategy and dedicated resources should be identified to ensure that the process is properly managed and senior staff commitment obtained at relevant times.

Mark out the pitch for pricing

The other major reason for deals being aborted is the inability to close the valuation gap between buyer and seller. There are many reasons for this. Some of them are manageable. Others are simply an unrealistic expectation by either or both parties.

One way of minimising the waste of time and resources is to obtain from both parties their price range upfront. This means that the buyer must be provided good information to enable a reasonable assessment of the target. As such, Information Memoranda should contain sufficient data and qualitative information.

Look at the structure

Deal structuring is an integral part of the transaction process. A well-planned structure should enhance returns to shareholders as well as limit risks and facilitate post-acquisition integration. The team involved should not only be financial and tax advisors, but also operational and human resource experts. Potential synergies could be lost if the deal is badly structured.

Hallmarks of a well-managed M&A transaction

- a well thought-out strategic planning process
- a commitment and direction by top management
- an experienced deal team supported by seasoned advisors
- a proactive approach and significant research, including research on alternatives not on the market
- detailed planning, a post-deal integration strategy and a systematic resolution of issues
- avoidance rather than accommodation of a bad deal
- emphasis on post-deal integration planning
- post-completion, a handing over of the reins to an experienced integration team

Message in a bottle

Growth in Asia is expected to be strong in the coming years, and with the focus on China and India, the rest of Asia will have to reposition itself to remain relevant in the new economic era. M&A is a strategy that could help you achieve a strong competitive position quickly. M&A activity is expected to remain strong over the next couple of years so if you have not already explored this compelling growth strategy, you should do so now.

But if there is one message to remember, it is this. Have the discipline to drop bad deals. You can take a systematic approach to this by following the example of a company we worked with recently, which has developed a two page checklist of critical factors. If there are more than 5 negative checks against some 20 red flag questions, the deal will likely be aborted.

We all know that avoiding a hangover does not simply mean not drinking. Avoiding the rough stuff and knowing when to stop is the key.

To adopt a proactive approach to M&A, you have:

- obtained top management commitment to the M&A process
- attained clarity of purpose, a sharper focus and thus, a more effective M&A process
- a better choice of target through focused research and rigorous evaluation
- achieved better use of management time and resources as the likelihood of chasing a bad deal is reduced
- made the best M&A decision possible

About PricewaterhouseCoopers Corporate Finance

PricewaterhouseCoppers Corporate Finance Pte Ltd's (PwCCF) team of dedicated corporate finance professionals with diverse expertise are well-qualified to provide strategic and financial advice to companies that look to Mergers & Acquisitions as progressive moves to the next stage of their growth. Our international network of Corporate Finance Services professionals well-positions us to serve our clients effectively in any part of the world. With access to market intelligence facilities, local and global resources, coupled with an international client and consultant base, we are able to efficiently identify targets, undertake fund-raising activities and capitalise on opportunities across the globe to help you maximise the value of your local/cross-border transactions.

Benjamin Kan, Managing Director of PricewaterhouseCoopers Corporate Finance Pte Ltd can be contacted at
tel • (65) 6236 3998
e-mail • benjamin.kan@sg.pwc.com

Key Transactions by PwCCF

TransLink Advised major shareholders on the disposal of their stake to PwC Logistics Financial Advisor	**United Group Ltd** Assisted in the acquisition of the entire share capital of PREMAS International Pte Ltd by United Group Ltd Financial Advisor	**Amtek Engineering Ltd** Advised Amtek on its disposal of stake in KLSE listed business, simltaneous acquisition of related business and injection of new business in listed entity Financial Advisor
Project Shining Mountain Advised a European MNC on a complex acquisition across Asia, Australia and South Africa Financial Advisor	**Fung Choi Printing and Packaging Group Ltd (“Fung Choi”)** Advised the major shareholders on the disposal of 33% stake in Fung Choi to Fraser and Neave, Ltd Financial Advisor	**Southern Bank Berhad** Advised Southern Bank Berhad on the acquisition of Asia General Insurance Financial Advisor
Tricon Restaurants International Acted as Financial Advisor in Tricon’s re-franchising of its corporate-owned restaurants in Singapore KFC, Pizza Hut, Taco Bell Financial Advisor	**Owl International Pte Ltd** Advised shareholders in the sale of Owl International Pte Ltd to Super Coffeemix Manufacturing Ltd Financial Advisor	**Meghmani Organics Ltd** Acted as issue manager (and provided pre and post IPO management services) for the first Indian IPO in Singapore Financial Advisor
Lindeteves-Jacoberg Ltd Acted as Financial Advisor in the acquisition of the Brook Crompton Motors business by Lindeteves-Jacoberg fromInvensys Plc of UK Financial Advisor	**Fung Choi Printing and Packaging Group Ltd (“Fung Choi”)** Acted as issue manager (& provided pre and post IPO management services) in Fung Choi’s IPO listing Financial Advisor	**China Paper Holdings Ltd** Acted as issue manager in China Paper’s IPO Financial Advisor
Meiban Group Ltd Advisor Meiban Group Ltd on the acquisition of Meiban Plastics Sdn Bhd, Meiban Tech Sdn Bhd and Meiban Industries Sdn Financial Advisor	**Ascendas Real Estate Investment Trust** Independent Financial Adviser to Independent Directors in relation to the proposed acquisition of Infineon Building and Techpoint Financial Advisor	**Ascendas Real Estate Investment Trust** Independent Financial Adviser to Independent Directors in relation to the proposed acquisition of Infineon Building and Techpoint Financial Advisor
Pentex-Schweizer Circuits Ltd Advised major shareholders Amvest Holdings and Schweizer Electronic AG on divestment to Sanmina SCI Corp. Financial Advisor		

BY SUBRA IYER (ABOVE), GOH THIEN PHONG (CENTRE) AND CHAN KHENG TEK

Crisis Management

Crime of the century*

Will your company be next?

We started this thought leadership series on the importance of an effective finance function in the context of recent accounting scandals. We continue on that note in this article. However, we are not just talking about Enron and WorldCom here, but also those closer to home which have been widely reported. However, they are just the cases that have hit the headlines. There are many more that do not get to see the light of day. Our work at PricewaterhouseCoopers rarely gets a full airing in the media for obvious reasons of confidentiality. But that does not mean we cannot share our experience, in general terms, on what can really go wrong when the finance function fails!

What is “fraud”?

Legally, fraud may not exist until someone puts his hand in the cookie jar (let us call that “traditional fraud”). From an accountant’s perspective however, inaccurate financial reporting is just as much a fraud, when there is a deliberate intention to mislead. Where traditional fraud is involved, the investigation principle is quite simple – follow the cash; the extent of work however may not be little.

Accounting fraud on the other hand can be simple or very complex, depending on the circumstances. In a few cases, for example, we have seen the creation of fictitious revenues and profits by mere paper generation exercises. Bogus invoices and delivery orders are created, but to give them legitimacy, payments are often actually received for the sales they represent. These payments are either funded by the company, or by an interested shareholder, who is often also involved in the company’s management. In the case of the latter, the shareholder will expect to recover, by some means, the amount he has paid to support the fictitious transactions. In one case we came across for example, a company that was perpetrating a fraud told its contractor (who was building its factory) to inflate the progress bills raised on the company and pay the difference directly to the shareholder. The money accumulated by the shareholder was then used to fund fictitious revenue.

Then there is the fraud where the accounting is simply wrong and deliberately kept secret from the shareholders as seen in some recent high profile cases. Yet another category of fraud involves corruption and bribery. Subsidiaries of companies registered with the Securities Exchange Commission in the United States are required to comply with the Foreign Corrupt Practices Act (FCPA), which prohibits recourse to the “greasy palm” approach to business dealings.

> From an accountant’s perspective, inaccurate financial reporting is just as much a fraud, when there is a deliberate intention to mislead.

Motivation

Three conditions are generally present in a fraud situation. They are:

1. Incentive / pressure
2. Opportunity
3. Rationalisation

Incentive/pressure

One of the reasons fraud is committed is because the perpetrators are in some form of financial difficulty or need. Some well chronicled examples are fraudsters who needed to feed their voracious gambling appetites. However, accounting fraud can also be sparked by the need to meet loan covenants, produce healthy financial forecasts or meet market expectations. Manipulation of information may also be necessary for successful insider trading.

Opportunity

The fraudster needs to be in the right place at the right time to seize his opportunity. In the case of the traditional fraud, he must generally have access to an account processing function (for example, cash, payables, receivables or payroll). Accounting fraud however, is usually committed at a much higher level as it is more complex. The accounting records generated to cover up a fraud need to look genuine enough to hoodwink the auditors. Hence, this often tends to involve the CEO and/or CFO. All fraudsters must have a good understanding of operations, policy and procedures; have access to the company’s books and records; and be in a position to exert requisite authority over relevant controls and procedures.

Rationalisation

The oft-quoted justification for fraud is “I did it for the company, not for myself.”. Other rationalisations have ranged from “I deserve the money for my sacrifice to the company” to “I was just testing internal control weaknesses, M’ Lord”.

Why is fraud so difficult to detect?

There are two sets of factors that prevent discovery of fraud – controllable factors and uncontrollable factors. The following factors are controllable factors, which, if fixed or effectively dealt with, can minimise fraud:

1. unclear reporting lines
2. unclear duties and power
3. inadequate segregation of duties
4. non-compliance with procedures
5. lack of a "whistle-blower" programme

The above could easily be described as factors contributing towards a sound risk management environment. It is quite amazing how such basic risk management structures do not exist even in listed companies, but complacency seems to be the main cause for this. If organisations were to take compliance with procedures a lot more seriously and were not to tolerate exceptions, they would be better equipped in the fight against fraud.

The last of the above five factors has recently gained much prominence following the passing of the Sarbanes-Oxley Act in the United States. Indeed, in many of the cases that we investigated, we found that people were often aware of the fraud; but for various reasons ranging from fear to loyalty to self-preservation, none of them raised the alarm with the independent directors or audit committee. If it was possible to institutionalise such a programme, we would all be one step ahead in the fight against fraud.

However, no matter how good the control environment and risk processes are, we will never be able to eliminate the risk of the crafty entrepreneur or fraudulent manager doing his work. There is thus a need to be cognisant of the uncontrollable factors. These are:

1. management fraud – controls are over-ridden
2. collusion between parties – within and without the organisation
3. forgery

The only real protection against these is vigilance. A good corporate governance environment will surely help in deterring potential fraudsters, but will never eliminate fraud entirely. For this, we need boards of directors who can set the tone at the top!

The dangers of being a director, independent director, audit committee member and audit committee chairman

If you are not already convinced of the dangers, just ask the independent directors of the companies recently caught in the spotlight for the wrong reasons. They have been severally criticised for a lack of vigilance in discharging their duties. Despite such episodes, it is quite alarming that there still are listed companies that do not have an internal audit function.

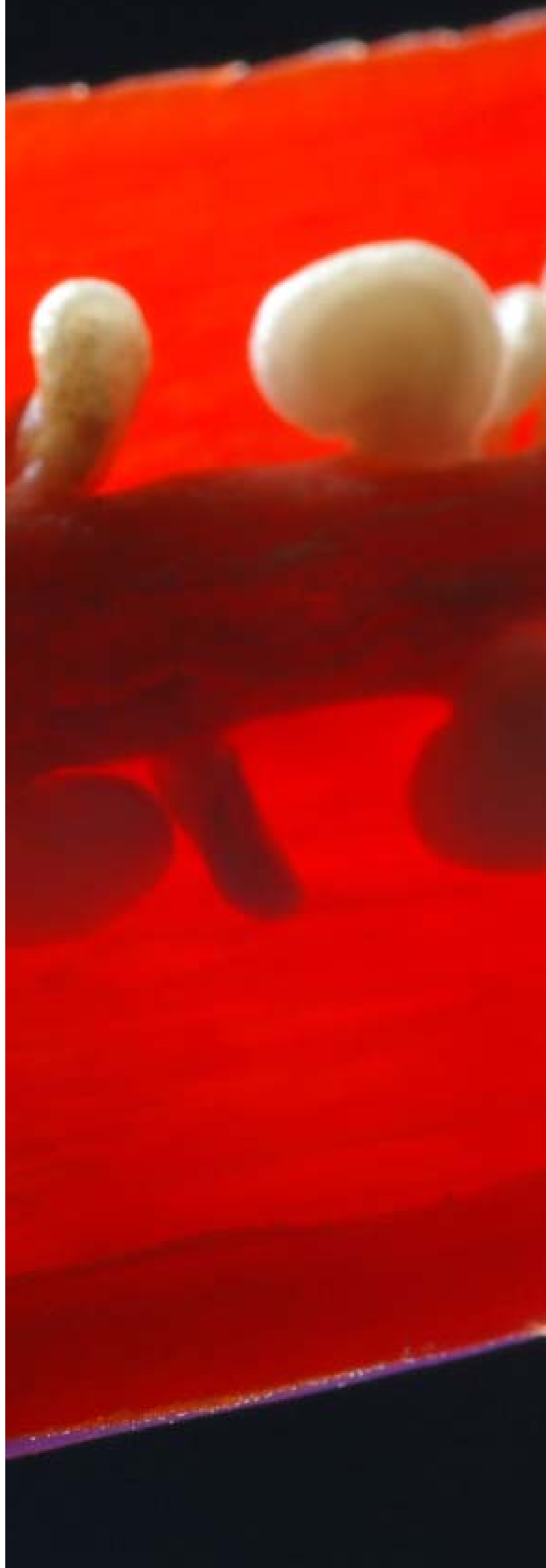
In the United States today, directors can be held financially liable for things that go wrong during their watch. Hence, the question uppermost in the minds of the directors of today must be – what is the risk of fraud in my company? The burden is even greater for independent directors and audit committee members of listed companies.

Everyone knows that compliance comes with a cost. But if audit committees are to discharge their duties effectively, they must have access to funds to spend on risk management. They will need the help of professionals to advise them on the effectiveness of the finance function in the organisation. If audit committees fail to do this, they surely do so at their own peril. They therefore need professional help to prevent these things happening in the first place, rather than to help them mop up the mess afterwards.

At the end of the day, nothing will eradicate fraud entirely. It is part of human nature and will be with us to the end of time. But more, much more can be done to make sure that it is only the most determined, clever – and lucky – fraudster who gets away; and to prevent your company from hosting the Crime of the century.

To minimise fraud in your organisation, you need to ensure:

- Clear reporting lines, duties and power; and adequate segregation of duties
- Compliance with procedures in practice, and not just on paper
- A well-designed whistle-blower programme
- A good corporate governance environment to deter potential fraudsters
- A vigilant team of independent directors, audit committee chairman and members to set the right tone at the top



About PricewaterhouseCoopers Crisis Management

PricewaterhouseCoopers Crisis Management assists organisations in responding to, mitigating and controlling a range of predicaments from simple problems to complex crises.

Our Business Recovery services involves a range of restructuring, rescue and turnaround assistance for companies or stakeholders concerned about the ability to meet changing market demands, and when all these effects have failed, we help liquidate these companies.

As for Dispute Analysis and Investigations services, we provide forensic expertise to organisations (and their lawyers) that are facing issues with financial and legal implications, to help them make intelligent, informed decisions whether in the boardroom or courtroom.

Subra Iyer, Advisory Partner and Head of Crisis Management can be contacted at
tel • (65) 6236 3058
e-mail • subramaniam.iyer@sg.pwc.com

Goh Thien Phong, Advisory Partner can be contacted at
tel • (65) 6236 4018
e-mail • thien.phong.goh@sg.pwc.com

Chan Kheng Tek, Advisory Partner can be contacted at
tel • (65) 6236 3628
e-mail • kheng.tek.chan@sg.pwc.com

BY YEOH OON JIN Assurance

The missing link*

How to sharpen up your corporate reporting

Over the last two years, the Singapore stock market has been rocked by news of unexpected corporate losses. To make matters worse, such corporate news and scandals do not seem to be losing their momentum. The questions are: Who's next? Can you tell the "good guys" from the "bad guys"? Are there any tell-tale signs of impending corporate failure? Is currently reported financial information adequate and indicative of potential trouble areas?

What is missing in current financial reports?

The business environment of today is much more complex than in yesteryears. A profitable company today may not always be as profitable in the future, and could even be loss-making tomorrow. In a bid to maintain or improve profitability, companies are required to be highly innovative in their business strategies, and develop new business models, products, markets and processes. They are required to look at business costs critically, and get the best value for money spent. They often have to operate across borders. Intermediaries in the financial markets are actively marketing complex structured products that promise to "enhance" corporate results.

All these, in a nut shell, expose companies to new or higher risks that need to be carefully understood and managed. Investors and stakeholders need to assess the quality and sustainability of the company's future profit streams. The dismal fact is that currently, information required that enables such assessments does not need to be reported, and is simply not provided by many listed companies.

A recent high-profile case of unexpected corporate losses is a clear example of inadequate disclosure of the extent of a company's activities, which limited the investor's ability to appreciate fully the risks which the company's performance, and the sustainability of that performance, were subject to. Take as a further example, a typical software company. Its key value drivers are brand, software under development, and human capital. How can it be possible to evaluate the sustainability of the company's performance if such information is not disclosed? When a company reports exceptional profits arising from its business model which are incongruous with the market or industry, investors should be alerted to a sustainability issue and should even question the reliability of the information they are being fed.

So, what should companies report?

The Council on Corporate Disclosure and Governance (CCDG) issued a Guide on Operating and Financial Review (OFR) in January 2004, which set out the principles that should govern the preparation and presentation of an OFR. Amongst other things, the OFR recommends that companies should provide investors with contextual information that would enable readers to develop an in-depth understanding of the company's performance, including the risk factors and measures taken to maintain/enhance the current and future profitability of the company, ie. the value drivers which sustain and enhance its corporate performance.

Are listed companies preparing their OFR in accordance with the Guide? Possibly not, for compliance with the OFR is currently optional. Whilst some reputable companies do comply with the principles in the Guide, many listed companies do not. Something short of rocket science will tell you that companies which lack proper strategies and risk management procedures will have little reason to volunteer information about their inadequacies. However, it is these very companies that should sound alarm bells for their investors. It is interesting to note that in the UK, Reporting Standard, RS 1 *Operating and Financial Review*, which was issued in May 2005, is now mandatory for all quoted companies in the UK.

How reliable is the information reported?

Even when relevant information is reported, one needs to consider whether the information – which is compiled by the company itself - is reliable. Companies with a strong corporate governance structure and a sound system of internal controls would be better placed to report reliable information. Furthermore, strong internal controls would also make it more likely that the company will be able to deter and detect fraud or other irregularities, should they occur.

The Code

The Code of Corporate Governance (Code) sets out principles relating to board matters, remuneration, accountability and audit, as well as shareholder communication. Compliance with the Code is not mandatory but deviations would need to be explained. Do companies that report compliance with the Code produce more reliable information for stakeholders? It is interesting to note that those companies which failed recently did not highlight any significant deficiencies in their compliance with the Code. Therefore, by inference, these companies had the necessary internal controls and relevant infrastructures in place. So, what went wrong? Perhaps the problem lies in the implementation and execution of the principles in the Code. Codes and principles are meaningless in the face of high level management collusion and fraud, or the overriding of control procedures by senior key management personnel (sometimes allegedly by the CEO and/or CFO), or unclear reporting lines, or ineffective audit committees and/ or independent directors.

Sarbox gets into the act

The reliability of financial reports depends on the company's internal controls over financial reporting. Hence, for readers to derive some comfort over the reliability of the financial reports, it is important that an evaluation of the effectiveness of the company's internal controls be made and the results reported. In the US, the Sarbanes-Oxley (Sarbox) Act requires management and directors to make an assessment of the effectiveness of internal controls and report on any deficiencies. Auditors are required to make an independent attestation of the assertions made by the company. The SGX has recently proposed that directors provide a negative assurance on internal control matters in the listed companies' annual reports. We believe that this is a step in the right direction. However, one could question the reliability of the directors' negative assurance, as there is at present no common framework for the directors to refer to, when they make such assessments. Different boards may use different yardsticks as their basis for evaluation. Comparability and reliability are impaired. To address this issue, the requirement to assess the effectiveness of the internal controls should be benchmarked against an established internal control framework, such as the COSO framework. Obviously, the reliability of the attestation in the directors' statement would be further enhanced if independent reviews of these evaluations were made by external auditors. There is at present a reluctance to introduce this requirement, as it is expected to increase corporate compliance costs.

What next?

Compliance with the OFR Guide, and full disclosure of corporate governance practices and internal control matters should indicate or highlight symptoms of corporate problems, thus alerting stakeholders to any impending issues at an early stage. Should such compliance be left to market forces, or should the regulators take an active step and mandate compliance? Our regulators have an interest in upholding the integrity of the Singapore capital markets and our reputation of having the most robust corporate governance structure and the highest standard of corporate reporting in the region. Investors would welcome any move by regulators in this direction, as it should provide higher investor protection. Listed companies should similarly welcome this, for such compliance would translate into higher shareholder value, which would offset any increased compliance costs. At some point, the link between internal controls and external reporting needs to be made. Otherwise your company's disappearance may become another in a line of historical mysteries.

To achieve best practices in corporate reporting, companies should:

- have a strong corporate governance structure and sound internal controls system to report reliable information
- benchmark the effectiveness of its internal controls against an established internal control framework such as the COSO framework
- comply with the Code of Corporate Governance and implement and execute the principles in the Code
- provide investors with information which will help them develop an in-depth understanding of the company's performance such as risk factors and value drivers, in accordance with the Guide on OFR by CCDG

About PricewaterhouseCoopers Assurance

We work closely with our clients offering quality assurance services, supporting and keeping them abreast of developments in corporate reporting. We work hand-in-hand with boards of directors and management to respond to the increasing demands of higher-quality corporate reporting and governance, helping them ensure that appropriate systems and controls are in place to report accurate and timely information on the company's results and state of affairs. We take pride in providing sound advice that does not put our client's or our reputation at risk for short-term gain. We seek to bring a unique perspective to our client relationships with our objective, independent advice, based on our multiple competencies. These are the hallmarks of our assurance services and they cover:

- Audit - statutory and other non-statutory audit services for regulatory purposes
- Accounting and regulatory advice - technical accounting advice on transactions, corporate structures, corporate reporting disclosures and compliance with current and new regulations
- Attest and attest-related services - independent assessment of financial and non-financial data, review of financial statements, performance of agreed-upon procedures
- Public services assurance and advisory - audit, associated services for government, education and other non-profit organisations

Yeoh Oon Jin, Assurance Partner and Head of Assurance can be contacted at
tel • (65) 6236 3108
e-mail • oon.jin.yeoh@sg.pwc.com

BY RICHARD SCHULTE (ABOVE) AND KOK EE LAN Human Resource Services

The leadership challenge*

Maximising your human capital

Corporate leaders are expected to provide guidance in all areas of their businesses – from strategy to operational issues and everything else in between. Among the more important challenges leaders face is arguably that of maximising the value of their human capital.

"How can we attract and retain the right talent?"

"Are we getting the most out of our people in our business?"

"How do they measure and benchmark against the competition?"

"Are our people with us or against us?"

These are questions that keep leaders awake at night.

Human capital as a key asset

Exactly what is a company's human capital? The short answer is: the company's employees. But human capital is a lot more than just that. It is a company's most dynamic asset.

Your employee turnover can unexpectedly rise, motivation can vary, and individual performance can show changes on a daily basis and over time. Individuals can and do improve. By contrast, facilities and operational assets do not create new and innovative products, make sales or find new customers. Neither would you expect your current laptop to become next year's web server, and a couple of years later, the corporate system terminal. Only your people can contribute to your business in innovative and sustainable ways.

Besides, intangible assets are increasingly valued as an important component in a company's market value. Given the corporate misdemeanours uncovered in recent years, there is a gradual shift towards value reporting across global financial markets. Financial analysts and investors alike are starting to look more deeply into the intangible assets that contribute to a company's true value. Human capital is now a key component in the new value formula.

Effective leadership creates a conducive environment for top performance

Leadership in a corporate context is about influencing your people so that they come to share common goals, values and attitudes; and they will work more effectively towards the company's vision. In the same context, generating high employee engagement and commitment throughout all staff levels must be a constant mission. The important task of building employee engagement, a term that encapsulates the part-art, part-science discipline of creating loyalty and growing commitment, in the competitive talent market falls squarely upon the shoulders of corporate leaders.

There is an undeniable, symbiotic relationship between effective leadership and high employee engagement that spurs the achievement of top results. Effective leaders create an environment that is conducive to the attraction, development and retention of talent; and they promote employee engagement. This in turn powers talent to generate maximum output through innovation that both drives and preserves competitive shareholder and stakeholder values.

Measuring the effectiveness of your leadership

So how can a company measure the effectiveness of its leaders beyond the measurement of business results?

To date, the literature on leadership has focused on the behaviour, characteristics and traits of leaders. Over the past two years, Saratoga, a PricewaterhouseCoopers' human resource services offering, has developed a leadership index (see Figure 1) to measure the impact of leadership action in terms of business impact, follower behaviour, skills development and corporate social responsibility activity. The work undertaken by Saratoga, a global leader in human capital measurement and benchmarking, is one of the first serious attempts to look at the impact of effective leadership in an organisation.

Key Metrice of Great Leadership		
Business Impact	=	Wealth Created Ratio Added Value Ratio
Follower Behaviour	=	Remuneration/Revenue Ratio Resignation Levels
Skills Development	=	Training Hours Practiced Ratio Internal Promotion Ratio
Corporate Social Responsibility	=	Community Investment/ Profit Ratio

Figure 1: The Saratoga Leadership Index

Note: It is likely that all these metrics are present in your company if the leadership is competitively effective.

In the context of Asia, there is a growing emphasis on promoting work-life balance to enable employees to have a fulfilled life inside and outside paid work. This trend suggests that 'work-life balance investment' is another leadership metric companies can use that falls within the broader area of corporate social responsibility.

The metrics listed in the Saratoga Leadership Index can be used to jump start a company's measurement of the effectiveness of its corporate leadership. The results help audit the leadership gap in organisations and create an impetus for change.

Knowing the impact of your leadership, the next logical question is where your leadership taking your people? Is your leadership bringing you the best business and people impact? One way to tell is to look at your employee engagement.

Employee engagement and commitment: Measure it. Manage it.

Building employee engagement and commitment is an aspect of management that cannot be neglected. Unfortunately, it is an area that is often sidelined. Many companies underestimate the impact of measuring the level of engagement and commitment within their organisations - it is an area of management that is typically left to 'gut feel' and widely accepted as an intangible area that cannot be quantified.

But just as there are widely used benchmarks for issues ranging from corporate transparency to corporate social responsibility, companies can apply a rigorous, scientific and evidence-based benchmarking and decision making process to optimise its employees.

As illustrated in Figure 2, research demonstrates that employees who are highly engaged will typically offer unlimited time to the company, produce high output and demonstrate flexibility at work. They seek constant innovation and improvement in the business; as well as identify themselves by the work they do and the company they work for. Conversely, as the level of engagement falls, employees may simply 'co-operate' or 'comply'; and in the worst case, either 'withdraw' or demonstrate obvious 'hostility'.

Through careful observation of employee behaviours and reading of the right metrics, organisations can pinpoint existing performance strengths and weaknesses; as well as quantify and benchmark the impact and contribution of their employees.

Transform or else

It is interesting to note that while it is generally understood that leadership drives both business impact and employee engagement, Saratoga research also indicates that there is still a significant gap between the "should be" and "as is" in organisations today. When examining the effectiveness of leadership in terms of business impact and employee engagement, 66% of the clients tracked by Saratoga still fall within the "Need to Transform" category where top management has expressed that its human capital can have higher business impact and engaged capability.

Behaviour Type	Time	Work	Product/ Service	Identity
Commitment & Engagement ↓	Limitless	High Output & Flexibility	Innovation & Improvement	Goal Identity
Cooperation ↓	Contractual Attendence	Normal Output	Learning	Joking
Compliance ↓	Time Wasting	Effort Bargaining	Fidding	Change Resistant
Withdrawal ↓	Absence	Added Pay Creation	Pilferage	Negative Contention
Hostility	Resignations	Sabotage	Theft	Oppositional Solidarity

Figure 2: Saratoga Engagement and Commitment Matrix

So whilst there is increasing appreciation and recognition that human capital is one of the few investments that can actually drive results, corporate leaders are also recognising that they should leverage on the strong influence they have on their human capital.

By measuring leadership impact and employee engagement, organisations can take the first step towards maximising this human capital. Like it or not, human capital is likely to remain as one of the largest expense categories on any company's profit and loss statement. The challenge for corporate leaders today is to transform, or else.

To increase shareholder and stakeholder value through maximising human capital, organisations should:

- Cultivate effective leadership to create a conducive environment to attract, develop and retain the right talent
- Audit the leadership gap and measure the leadership impact
- Measure employee engagement as a first step to optimising employees' performance

About PricewaterhouseCoopers Human Resource Services

With more than 5,000 HR professionals, the Human Resource Services (HRS) arm of PwC is one of the largest human resource consulting practice globally. Through the use of selective human capital interventions and our wide array of solutions relating to people, process and culture, we collaborate with clients to develop holistic and practical solutions to address both tactical and strategic human resource challenges to achieve bottom-line results. Some of the key advisory services we offer include Human Resource M&A, strategies and processes alignment, job evaluation and job redesign, HR functional effectiveness review, human capital benchmarking, compensation and benefits review, change management and executive search.

Richard Schulte, Asia Leader for Human Resource Services can be contacted at
tel • (65) 6236 3768
e-mail • richard.schulte@sg.pwc.com

Kok Ee Lan, Associate Director, Human Resource Services can be contacted at
tel • (65) 6236 4091
e-mail • ee.lan.kok@sg.pwc.com

Your worlds
Our people*