

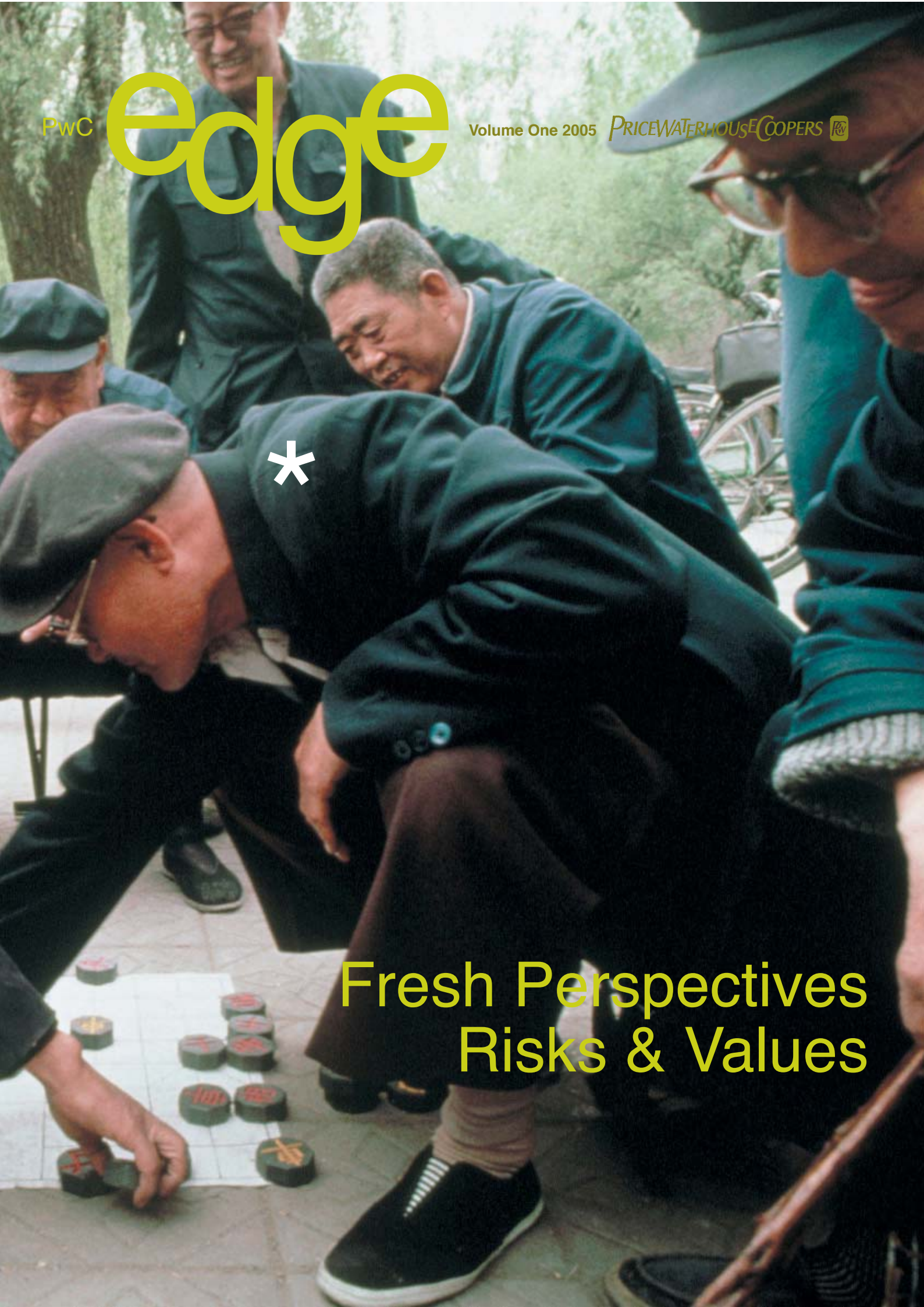
PwC

edge

Volume One 2005 PRICEWATERHOUSECOOPERS 

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Fresh Perspectives Risks & Values



Editor's Note

Ideas for Today and Tomorrow

The alarming increase in the number of companies being investigated for improper governance, non-compliance with laws and regulations, misreporting and outright distortion of financial numbers have made Governance, Risk Management and Compliance (GRC) a priority item on the Board agenda. Now more than ever, Board members, especially the independent directors, have been placed in an unenviable position whenever there is a failure in GRC, having to explain matters to the shareholders, which in the first place, were not known to them.

In this issue of PwC Edge, we strive to unravel the complexities of GRC. Some of the articles are descriptive and others prescriptive, carrying ideas that are relevant today and tomorrow. In "Finance Department of Tomorrow, Today" Keith Stephenson and R Ragnathan delve into the transformation of the finance function and the role tomorrow's finance function plays in helping the Board to deal with challenges of governance, transparency and value creation.

In the financial services industry, Karen Loon argues that remaining compliant is *conditio sine qua non* for industry players. Her ideas in "Grasping the value in Governance, Risk Management and Compliance" are relevant tomorrow as they are today. Capital adequacy is another *sine qua non* – Chris Matten's "Pillar 2 and you – Is economic capital back on the supervisor agenda?" is a technical tour de force to be appreciated by specialists in the industry.

Tax payers in general would argue that taxation is a value destroying activity and at best a necessary evil in an orderly society which should be mitigated. Practitioners like Paul Cornelius have different ideas. Today's tax department can create value and manage risk. How so? – Paul opens his tool kit to us in – "The Tax Challenge – Managing Risks and Creating Value".

There are more ideas to be shared on transfer pricing, goods and services tax, custom and excise, and last but not least international assignments. The thread that runs through all these articles carry ideas on risk management and value creation, ideas which are relevant today as they are tomorrow. If ever there is a time to talk about improving the practice of governance, risk management, compliance and value creation it is now – more than ever.

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Pillar 2 and you – Is economic capital back on the supervisory agenda?

The revised capital framework for banks, most commonly referred to as Basel II, has put the issue of economic capital firmly on the agenda of many banks. Some commentators have assumed that, to comply with Pillar 2 of Basel II, banks must adopt an economic capital model. In this article, we will analyse how much truth there is in that assertion and try to place economic capital in the proper context in relation to Basel II.



Anti-money laundering: The key issues

The revision of the FATF 40 recommendations in 2003 and the release of further recommendations on terrorist financing last year have pushed anti-money laundering up the risk management agenda. Rohan Bedi of PricewaterhouseCoopers identifies the top seven anti-money laundering issues faced by Asian banks.





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The Tax Challenge – Managing Risks and Creating Value

The tax affairs of local and multinational corporations are rarely seen as the glamorous side of the business. Filing tax returns and complying with other regulatory taxation obligations are necessary but mundane activities. So if the tax affairs of a company are not exciting, why are they important?



Transfer Pricing – Opportunities and Risks in Asia

Transfer pricing issues are of paramount importance in an increasingly global economy. It has been estimated that as much as 60% of international trade takes place within multinational groups. This will increase further as multinationals continue to centralise their logistics hubs, streamline their supply chain and create centres of excellence for manufacturing and services.



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Trade and customs management has been a part of commercial practice since modern trading between countries began in the early 20th century. As mercantile trade flows increased, the need for controls increased proportionally. Today, many customs territories imposed customs duties using sophisticated customs management techniques operated by highly professional customs administrations.



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Do companies understand the consequences of a situation where an employee is restricted from leaving a foreign country due to non-compliance with local regulations? Apart from the monetary consequences that can be addressed, the non-monetary repercussions in the form of adverse publicity are difficult to address and measure.







BY KEITH STEPHENSON (above) & R RAGHUNATHAN Performance Improvement

Be The Finance Department of Tomorrow, Today – Achieving Financial Effectiveness

As you will be well aware, this reporting season, the newspapers have been flooded with numerous articles highlighting scandals in Singapore listed companies. It is alarming to see the number of companies which are being investigated for improper governance, insufficient transparency and reporting of inaccurate results. The confidence of shareholders in the market has been dented to some extent. Not surprisingly, the Board, and especially the independent directors, have been placed in an unenviable position of having to explain matters to the shareholders, which in the first place, were never known to them.

Being on top of governance and transparency matters is not all. 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 where the Boards of companies will have to positively assert to their shareholders on how they have acted to optimise overall corporate performance. It is clear that the Boards need a lot of support and help.

So, what is the solution then? 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 most 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 in trouble.

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 such that it can positively assert to the value it provides to the Board?

For the Finance Function to provide a positive assertion to its Board on the value that it provides to the company, it needs to take action to address the key challenges faced by the Board. Figure 1 illustrates some of the key challenges faced by the Board and how the Finance Function can assist the Board to address them.

Clarifying Board expectations

However, providing an assertion to the Board is not easy as there are several difficulties in doing so. Firstly, most Finance Functions are not clear of their Board's expectations and similarly many Boards may not be clear as to what to expect from their Finance Function. We all know very well as to 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 urgently addressed. 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 Finance Governance Statement can clearly spell out the Board's expectations



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

in different areas including 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 the progress made to meet the Board’s expectations. The advantage of having a Finance Governance Statement is that it removes uncertainty, clarifies expectations, enables the Board to spot issues early on thereby giving it greater comfort, and provides a basis for the Board to continually assess the Finance Function’s performance.

Need for transforming the Finance Function

After having 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 they are required to do.

Let us look at the way in which a typical Finance Function works. The working life of finance staff can be roughly described as:

- gather/receive data;
- input to the system;
- wait for more data (that usually comes in late);
- input that into the system;
- work hard under tight deadlines to reconcile the numbers at month-end;
- make period end adjustments and estimates (most likely with little time to check their validity);
- take a short break for a day or two;
- and then start 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 company 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 consolidation process a nightmare. Often, the monthly financial reports are finally presented to the executive committee, “just-in-time”. 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 that you are probably 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 analytic and strategic, thereby adding value to the business and providing support to the Board.

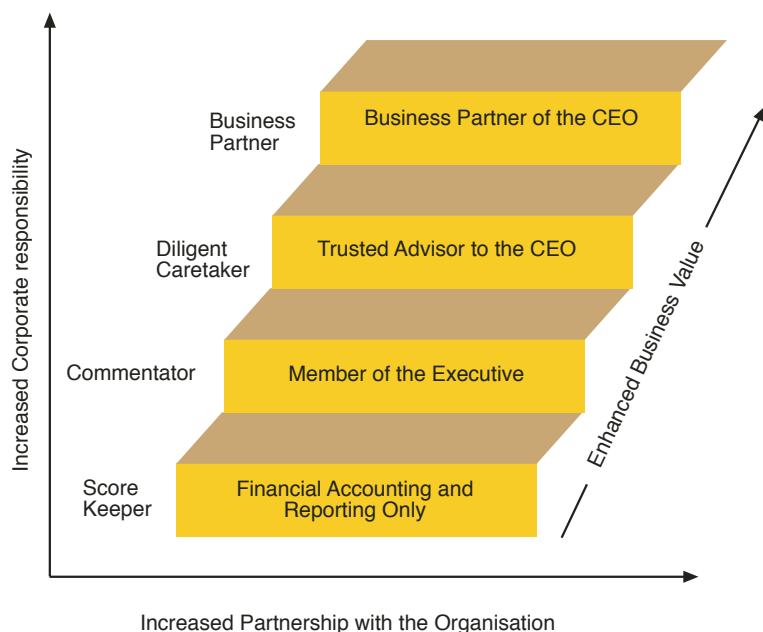


Figure 2: Changing role of CFOs

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 transaction,

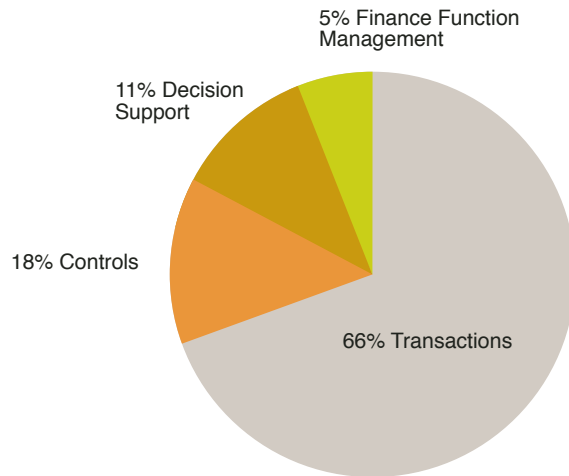


Figure 3: Time allocation of Traditional Finance Function

budgeting, taxation and reporting tasks. A traditional allocation of Finance Function time is depicted in Figure 3. 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, as depicted below:

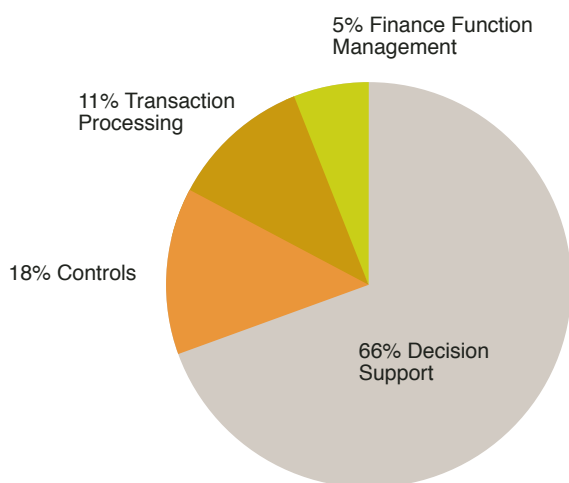


Figure 4: Time allocation of Tomorrow's Finance Function

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. PwC 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.

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BY KAREN LOON Banking and Capital Markets Industry Group

Grasping the value in Governance, Risk Management, and Compliance

At a time when society expects integrity as well as competence from their financial services providers, and as financial institutions seek to find an appropriate balance between economic returns and risk, and manage changing stakeholder expectations, governance, risk management, and compliance (GRC) has increasingly become an area that institutions globally are focusing on.

...the insights to the potential benefits of GRC are amplified when the concepts are viewed as an integrated whole.

As global financial institutions increasingly look to Asia as their next source of growth, Asian institutions too are looking to funding from markets outside Asia. With regulations and market practices continuing to converge globally, integrated GRC is likely to become increasingly more important and common in the region.

What is governance, risk management and compliance (GRC)?

Taken separately, governance, risk management and compliance are not new concepts. In one form or another, dealing with transparency and accountability, mitigating risk, and complying with regulations have always been issues that financial institutions had to deal with.

In a narrow sense, governance, risk management, and compliance often connote burdensome legal mandates that are viewed as necessary tasks... tasks which seem to require resources and entail costs far in excess of any perceived benefits.

However, the insights to the potential benefits of GRC are amplified when the concepts are viewed as an integrated whole. This means expanding the scope of GRC to include compliance with all requirements that help an organisation meet its strategic objectives, which takes into account the values of a wider group of stakeholders. From this vantage point, GRC has the potential to become a value-adding principle that is integral to an institution's competitiveness, and ultimately, its success.

GRC is defined as 'the organisation's practices and the various roles that the Board and senior management, line management, and the rest of the organisation play in relation to oversight, strategy, risk management, and strategy execution regarding compliance with laws and regulations and internal policies and procedures'.

Eight elements of effective GRC

While GRC is still an emerging field, the following provides a useful starting point:

- Corporate/organisational codes of conduct
- Policies and procedures
- Compliance and ethics training
- Demonstrating expected behaviour
- Ongoing process improvement
- Real-time reporting
- Monitoring/measuring GRC performance
- Accurate, timely, complete, and consistent information

So much effort, but is it enough?

GRC, and in particular corporate governance, continues to dominate boardroom and senior management discussions as a key risk which needs to be managed.

While some believe that changes to corporate governance processes and practices did not have a substantive impact on the way they run their businesses over the past two years, most would agree that they are growing in influence at the board level. Board members of financial institutions are now progressively fixing their gaze on this area, with the top two priorities of Boards being to ensure the adequacy of internal controls and ensure compliance with regulations². Interestingly, ensuring compliance with regulations has risen in importance in boardrooms over the past 12 months³.

As a result, for many financial institutions, there is heightened involvement at the board level, with board members having more robust discussions with executive teams, and requesting for access to more data on a timely basis, including forward looking information. Corporate

¹ In the 2004 Centre for the Study of Financial Institutions (CSFI)/PricewaterhouseCoopers Banana Skins annual survey of the risks facing banks, the top banana skin for emerging markets was Corporate Governance. Globally, corporate governance has increasingly become a concern of the survey's respondents, moving from 8th place in 2003 to 3rd place in 2004.

² PricewaterhouseCoopers 8th Annual CEO Survey – Financial Services specific questions

³ See the results of our PricewaterhouseCoopers/Economic Intelligence Unit (EIU) survey "Governance – From compliance to strategic advantage" issued in April 2004 which can be found at <http://www.pwc.com.financialservices>

governance now has a higher impact at the top of organisations, which ultimately filters down and influences the internal culture of organisations. With that, we are seeing more systematic processes over identification and management of risk, and improvements in management data and metrics⁴.

However, despite these efforts, financial institutions (including some operating in Asia-Pacific) have not been spared from governance issues in recent times, which have impacted the reputation of their organisations. Some particular aspects of corporate governance where people see risks are⁵:

- **The larger they grow, the bigger the risks** – As firms increasingly seek to generate value for shareholders, they may expand into new products and markets to exploit short-term opportunities. Controlling these new opportunities requires appropriate and timely revamps to an organisation's governance framework.
- **Ethics** – Business ethics and culture play an important role in an organisation's governance framework. New opportunities through products and markets can create ethical concerns.

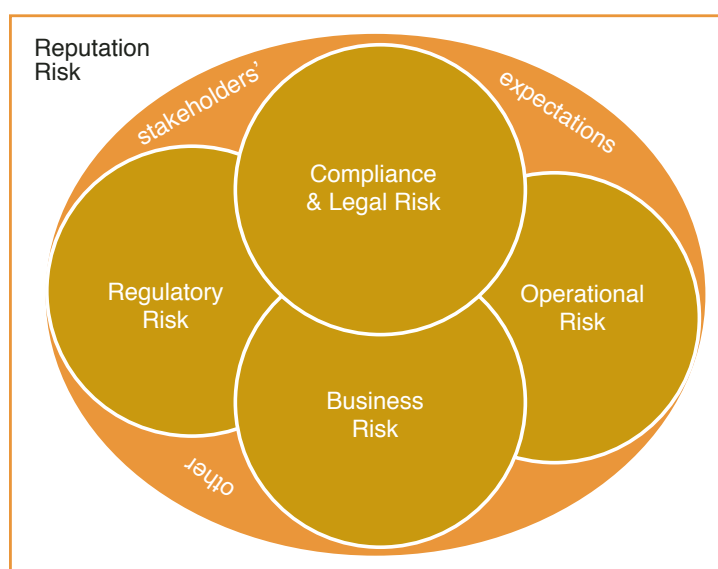
These concerns were also echoed by CEOs in our 8th Global CEO Survey². While most global CEOs have a good understanding of the breadth

of GRC and its interrelationships, many acknowledge that this is not easily achieved. 68% and 57% of global CEOs are confident that their organisations can respond to GRC matters related to domestic laws and regulations and internal policies and procedures in domestic units respectively. Yet, when it came to the same matters for foreign business units, we see a significant drop in their level of confidence.

Minimising reputational risk continues to be a concern of CEOs of financial institutions; most acknowledge that a reputation for integrity can be a competitive advantage for financial institutions⁶. At this point in time, as many Asian financial institutions continue to make cross-border acquisitions and investments, we also see convergence of regulations in a number of areas. Ensuring that an appropriate GRC framework is in place will make transcending the country/ jurisdiction divide a less painful experience for an organisation as it expands.

Embedding a compliance culture?

For many years, financial institutions have been making continuous improvements in their risk management frameworks, and good progress has been made in the last two years on improving corporate governance frameworks. These advances in the financial industry were in line with increasing regulatory expectations and imperative as institutions seek to further link (operational) risk,



⁴ PricewaterhouseCoopers 8th Annual CEO Survey – Financial Services specific questions

⁵ 2004 CSFI/PricewaterhouseCoopers Banana Skins report

⁶ 96% of financial services CEOs responded that a reputation for integrity can prove to be a source of great or some competitive advantage for financial institutions in our 8th Global CEO Survey.

capital and shareholder value. The evolution in GRC has led to one of the challenges for senior management and compliance officers today: to actively encourage recognition of compliance as a proactive management discipline. Being compliant is a fundamental goal for financial institutions – failure to comply with regulations, with the associated reputational damage when breaches are publicly penalised, could threaten survival, not just profits.

Our 2005 Global Compliance Survey⁷ confirmed that the concept of ‘embedding a compliance culture’ is clearly widespread in financial institutions in many countries. Boards and senior management are beginning to value the support of an efficient and effective compliance function⁸. Significant challenges remain, however, if organisations hope to reap the full benefits. Many organisations still believe that a large part of the challenge stems from the weight of new regulations and uncertainty over their practical application, and that conformance might undermine performance if regulatory requirements constrain the flexibility and innovation of business models, and impose apparently unnecessary costs. Given stakeholders’ expectations of integrity, compliance – like performance – becomes a prerequisite for staying in business. The compliance function provides one, albeit essential, tool to enable management to fulfil these expectations and protect the brand. Most compliance costs would certainly appear modest when compared to the billions that can be wiped off share values if lapses in probity, governance or codes of conduct come to light.

Analysis of the results of our survey⁷ surfaced a number of important related issues that require deeper management consideration.

Compliance officer: police officer or counsellor?

The traditional role of the compliance function – in Anglo-Saxon countries – is shifting from ‘police officer’ to ‘counsellor’. There is increasingly recognition that compliance, as a trusted advisor to the business, creates value and protects the brand. In some European countries where compliance functions are more recent,

Recommendations – Role of Compliance Officer

- Compliance officers, with management support, need to focus more on developing their business vision – the ability to advise management on compliant, but profitable, business solutions.
- Compliance must have input into all new business ventures and transactions, including new products, entry into new markets and mergers or acquisitions, as well as outsourcing or offshoring initiatives. It should also have the necessary authority to inhibit or flag any activities which may raise longer-term compliance issues.
- Compliance, supported by management, needs to strive to enhance dialogue with regulators – and other industry participants – to improve the depth of general understanding of the challenges faced by compliance functions, across organisations and across borders.
- There should be an overall continuous focus on the blend of skills and competences within the compliance function, ensuring suitable broad-based training for compliance officers and staff.
- Compliance officers should help themselves, and their firms, by further developing their “profession” through industry forums groups and associations.
- Compliance should develop more in-depth awareness of the technologies used by the organisation, including legacy systems, and be consulted with regards to new systems developments. At the same time, the IT department should develop greater awareness of the needs of the compliance function.

⁷ Our 2005 Global Compliance Survey was issued in April 2005. A copy is available at <http://www.pwc.com/financialservices>

⁸ When questioned how satisfied respondents to our PricewaterhouseCoopers/EIU survey, “From aspiration to achievement: Improving performance in the financial services industry” were with the performance of compliance, where 1 indicated extremely satisfied, and 5 extremely dissatisfied, compliance ranked on average 2.33, which was above many other areas.

emphasis has been on advising business, while compliance's 'police officer' role – its crucial compliance monitoring and oversight role – is often underdeveloped. However, the right balance needs to be struck between the two roles (within the organisational, business and cultural context) as the compliance culture is embedded in the organisation – care is essential to ensure the potential conflicts of interest between the two roles are managed effectively.

Segregating compliance responsibilities between compliance and the business is often difficult to accomplish in day-to-day operations. Today, compliance is often involved in executing compliance controls over daily business transactions (operational compliance), as well as providing ongoing compliance oversight. This causes another potential conflict of interests that can be mitigated through the 'tone from the top' (instilling a compliance culture throughout the organisation); consistent, on-going performance measures to ensure that the business is fully cognisant of its compliance responsibilities; and separating reporting lines.

Evidently, to be able to advise management and the business proficiently, compliance officers need a deep understanding of the business, a detailed knowledge of relevant regulations, and insights into regulators' expectations, as well as pragmatism. Many respondents stressed compliance officers' communication and influencing skills as key to engendering trust. How well their advice is trusted, however, should not rely solely on their influencing skills: management should always be prepared to listen and act.

Management talks the talk... but is it just lip service?

The study⁷ showed that boards' and senior managements' primary fear relates to reputation or brand damage, as well as personal liability – understandable given recent high-profile incidents. In many countries covered by the study⁷, organisations made minimal efforts in the compliance arena – particularly in terms of compliance functions – prior to explicit regulatory requirements. Ongoing pressure from regulators, or from other stakeholders, such as institutional investors and possibly rating agencies, should continue to underline the intrinsic value of compliance and of the compliance function.

Remaining compliant is a *conditio sine qua non* from a business perspective, but the general lack of progress in demonstrating the value of the compliance function suggests that should such pressure decline, the needs and the role of the compliance function could be subjugated to other regulatory and business priorities. In effect, management needs to place less emphasis on the short-term costs of compliance and more on its quintessential ability to enhance the overall return of investment for the organisation.

Although a great deal of progress has been made in terms of articulating a sound compliance vision and establishing and/or reinforcing compliance functions in recent years, the study⁷ showed limited evidence of coherent, sustainable strategies aimed at achieving compliant business practices and processes in the longer-term. When addressing regulatory requirements, compliance functions are often designed to essentially paste over the perceived gaps in an organisation's existing control framework. This may not be the optimal approach, particularly as organisations have not yet recognised, let alone realised, the overall benefits of being compliant.

Attempting to tackle all the issues with one major project, however, is unlikely to be effective. Instead, continuous initiatives in a number of inter-related areas (with iterative reassessments as the situation evolves), together with a clearer vision of the long-term end game, are essential. Based on an analysis of the survey⁷ results, common initial challenges for management include:

- 1 Assessing risk holistically, probing further the correlation between different types of business and market risk in terms of compliance, regulatory and reputation risk
- 2 Given a definition of "compliance risk" for all business activities, clearly determining the compliance function's associated roles and responsibilities, in the context of other control and support functions, such as internal audit, legal, risk management, human resources, etc
- 3 Establishing the right balance, mentioned above, between the 'counsellor' and 'police officer' roles, and providing organisational flexibility for these roles to evolve
- 4 Providing adequate resources to compliance, targeting efficiency through appropriate human and financial resources supported by a robust technological infrastructure

Recommendations – Role of Management

- Management should assess the current role and future evolution of the compliance function, as part of longer-term strategies aimed at instilling a compliance culture into business practices and processes.
- Management should strive for a coherent response overall to managing risk, developing holistic strategic risk assessments which explicitly encompass compliance risk within the overall risk profile of the organisation. Particular attention should be paid to the interaction between compliance and other risk management functions, while recognising the difference in emphasis when managing compliance risk.
- Management should develop a better understanding of what regulators require and recognise that limiting their aspirations to meeting minimum expectations will not lead to best practice, to the enhancement of the compliance function's standing within the organisation nor to the development of a robust compliance culture within the organisation
- Boards and senior management should ask themselves probing questions about the current and future configuration of the compliance function, the overall control framework of the organisation and the optimal level of resources – human, financial and technological. Senior management should continue to ensure that organisational design does not impede the independence and effectiveness of the compliance function. Inter alia:
 - Senior management needs to reconcile the different approaches necessitated by divergent societal and business cultures within its operations overall, with its associated strategies in terms of configuration, modus operandi and resources of the compliance function.
 - Management should pay careful attention to the interaction with other control and support functions, and ensure that the respective roles and responsibilities are clearly defined, and documented.
 - Recognising the dual role of the compliance function ('counsellor' and 'police officer'), it should make sure that the overall configuration is thoroughly assessed, both top-down and bottom-up, to permit appropriate access and interaction with front-line businesses.
- Boards and senior management should focus more on measuring the real cost of compliance and non-compliance, as a means to ensuring appropriate cost management strategies, ameliorating their understanding of compliance's value, and finally permitting an effective balance between compliance costs and value generated.
- Equivalent, if not higher, priority should be placed in the short-term on the development of compliance technology – recognising the fact that a robust technological infrastructure for compliance entails both sophisticated tools for monitoring compliance in business activities, together with appropriate tools for streamlining compliance function activities, and facilitating knowledge-sharing.
- Boards and senior management should focus more on frequency, timeliness and consistency of reporting as a means to deriving additional comfort that current business transactions and practices are much less likely to generate future compliance problems.
- Rating agencies should take more account of the role and potential contribution of the compliance function to the overall strength and quality of the organisation.

- 5 Adopting a bottom-up as well as a top-down approach to achieving compliance, whereby business processes and practices are thoroughly reassessed to ensure current and future compliance, taking particular account of the technological needs.

Challenges for Asian financial institutions

Many financial institutions globally, not just in Asia, believe that the sheer and increasing complexity – both in terms of volume and frequency of changes – of the regulatory environment is the principal challenge to enhancing their GRC frameworks. Together with balancing the different and changing expectations of other stakeholders (including shareholders, rating agencies, customers and employees), institutions must continually review their strategies, processes and capabilities to match these stakeholder needs. Over and above looking at processes that have a positive impact on stakeholder satisfaction/contribution, firms need to housekeep and make a conscious effort to ‘embed’ processes and capabilities which have been taken for granted into their control frameworks.

Firms face two interconnected challenges towards enhancing their GRC frameworks on a sustainable basis:

- Embedding a compliance culture within the organisation, particularly across borders and across sectors.
- Remaining compliant on a cross-border, cross-sector basis in the context of a dynamic business environment and rapidly changing regulations.

Dynamic business environment changes include the desire to expand into new markets, commence new businesses and launch new products (in order to sustain growth), together with regulatory complexity and the need to manage global and national cross-border regulatory requirements.

Many believe that making improvements to an institution’s GRC framework comes with significant costs, the benefits of which are difficult to measure. Where strategic objectives, values and goals of an institution are in line with its GRC framework, GRC does have the potential to become a value-adding principle that is integral to an institution’s competitiveness, branding and, ultimately, its success.

Essentially, meeting these challenges requires a more holistic and proactive approach to compliance which moves beyond statutory expectations to embrace broader ethical and strategic considerations. This approach should focus squarely on the achievement of compliant business practices and processes (i.e. compliant outcomes), rather than placing the onus solely on the compliance function. Certain common elements underpin such an approach:

- Closer integration of governance, risk management and compliance structures, forming a practical continuum underpinning the overall integrity of the organisation and aligned to the achievement of strategic objectives
- A culture which instils compliance into the DNA of the organisation, fostering awareness and ownership of compliance at all levels of the organisation, and supported by appropriate rewards, processes and procedures
- An extension of the role of compliance to tactical and strategic decision-making in areas ranging from acquisition to product development
- A clear definition of the relationship between the business as the first line of defence; the compliance function as the second; and independent assurance and non-executive directors as the third
- Coherent approaches to ensuring that processes and procedures generally facilitate, rather than frustrate, compliant business and that robust technology infrastructures foster both conformance- and performance-focused decision-making.

The shift towards a principles or risk-based regulatory or supervisory approach in many countries would call for more emphasis on the compliance function’s advisory role: but it is a question of balance. Primarily, the organisation needs to anticipate and quickly respond to the most serious threats to the brand, rather than seeking to ‘comply’ with everything all of the time. Management’s success in configuring the business for conformance, as much as performance, will predetermine the evolving role and ongoing efficacy of the compliance function.

Areas which financial institutions may wish to focus on when improving their compliance frameworks are in the areas of technological infrastructure, the roles and responsibilities of compliance, and embedding compliance into strategic decision-making.

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BY CHRIS MATTEN Banking and Capital Markets Industry Group

Pillar 2 and you – Is economic capital back on the supervisory agenda?

The revised capital framework for banks, most commonly referred to as Basel II, has put the issue of economic capital firmly on the agenda of many banks. Some commentators have assumed that, to comply with Pillar 2 of Basel II, banks must adopt an economic capital model. In this article, we will analyse how much truth there is in that assertion and try to place economic capital in the proper context in relation to Basel II.

Economic capital and the Basel II framework

In the first drafts of Basel II, there was a strong theme of reliance on banks' own internal economic capital models – be these credit risk modelling capabilities under Pillar 1 or broader economic capital models under Pillar 2. This emphasis was significantly diluted, however, in the later drafts.

For example, the second draft consultative paper (CP2, issued in January 2001) refers under Pillar 2, principle 1 (sound internal capital assessment) to the need to assess 'the economic capital levels' of a bank relative to its risk profile and the adequacy of its risk management process and internal controls (§618). By the time CP3 was issued in April 2003, however, the equivalent paragraph (§710) refers only to the 'capital level', a phrase which survives into the final framework of June 2004 (§752). Indeed, the term 'economic capital' appears only four times in CP3.

It would seem that, during the consultation process, the Basel Committee became less confident about relying on banks to assess their own capital requirements using internal models and hence both internal credit models and full economic capital models were omitted from successive drafts of the framework.

Interestingly, however, economic capital makes a minor comeback in the revised framework of June 2004, although only as a member of the supporting cast and not in a starring role. There are eight paragraphs which reference the term. For example, in §18 in the introduction, the Committee refers to engaging the industry in a discussion of prevailing risk management practices, including those aiming to produce 'quantified measures of risk and *economic capital*'. This is the same paragraph which talks about potentially allowing full internal credit models in the future and thus the reference to economic capital is to future developments, not the framework as it currently stands.

The other references are largely in 'peripheral' parts of the framework, such as in the Pillar 2 section on securitisation, where the Committee suggests that supervisors may wish to review a bank's 'economic capital' assessment of maturity mismatches and asset correlations in a pool of securitised assets. In no case, however, does economic capital play a formal part in the Basel II framework.

However, a reading of Pillar 2, principle 1 ('Banks should have a process for assessing their overall capital adequacy in relation to their risk profile...') would indicate, at least at first sight, that some sort of economic capital is required, even if this is not explicitly mentioned. Under 'sound capital assessment', the fundamental elements would include (§731):

- Policies and procedures designed to ensure that the bank identifies, measures and reports all material risks; and
- A process that relates capital to the level of risk.

Note that the requirement is to measure all material risks, not just to manage them.

A process which measures risk and then relates this to capital would seem *prima facie* to be the definition of an economic capital model but no such model is referred to in the text. So does Basel II require an economic capital model or not? Comments by leading supervisors over the past few years would seem to indicate a strong desire to see such a link between risk and capital but stop short of a direct requirement to do so.

Two views on Pillar 2

Before we attempt to answer this question, we need to take a step back and look at the intent behind Pillar 2. Principle 1 clearly puts the emphasis on assessing capital needs on the bank itself. This is a departure from the Basel Accord of 1988, which merely established a set of rules and required banks to hold a minimum level of capital relative to those rules (this function is replaced by Pillar 1 in the revised framework). While it might have been the practice of individual supervisors to require some sort of self-assessment, this was not a requirement of the 1988 Accord. Basel II changes this, by formalising the responsibility of overall capital adequacy assessment under Pillar 2. Thus, it is no longer enough for banks to demonstrate that they have adequate capital in relation to their risk-weighted assets; they must go beyond this and demonstrate that they have enough capital to cover all of their risks, and must do so in a structured manner.

There are two views on Pillar 2 which seem to be under consideration by banks and their supervisors. Figure 1 illustrates the 'accepted' view, under which Pillar 2 represents an add-on to Pillar 1, to account for the risks not specifically covered by that pillar.

Under this approach, the capital required for credit (counterparty) risk, market risk and

operational risk is set by Pillar 1 and the balance under Pillar 2 is to adjust for the other risks (interest rate risk on the banking book, country risk, credit concentration risk, etc).

The spirit of Pillar 2, however, would appear to go beyond this. Under Pillar 2, banks must assess all of their material risks and relate this to their assessment of their overall capital needs. This is illustrated in Figure 2.

Under this view, the capital required for the Pillar 1 modelled risks need not be the same under Pillar 2 – credit risk, for example, could be greater or less than the Pillar 1 amount. As long as the total capital assessed under Pillar 2 is greater than the Pillar 1 amount, a bank would meet the requirements.



Figure 1: Pillar 2 as an add-on to Pillar 1

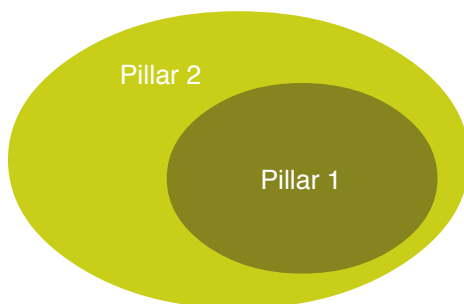


Figure 2: Pillar 2 as a holistic assessment of risk capital

This approach would seem more consistent with the intention behind Pillar 2. This is borne out by the introductory paragraphs of Pillar 2, which state for example ‘bank management continues to bear responsibility for ensuring that the bank has adequate capital to support its risks...’ (§721),

or that ‘...banks must be able to demonstrate that chosen internal targets are.....consistent with their overall risk profile’ (§726).

Indeed, it could be argued that if Pillar 2 worked properly and supervisors could rely entirely on banks’ ability to assess their risks and relate capital to these appropriately, there would be no need for Pillar 1 at all. This is where the discussion around replacing the 1988 Accord was centred in the late 1990s but the Basel Committee has clearly decided that it would be premature to allow this at this stage.

Is economic capital required by Basel II?

So does Basel II require an economic capital model or not? Arguments in support of such a model would be based on the Pillar 2 requirement to ‘measure all material risks’ and ‘relate capital to the level of risk’. A major argument against this model would rest on the fact that the Basel Committee, having started off with references to reliance on economic capital, has virtually removed all such references from the final framework.

To get an indication, we must look at how banking supervisors are starting to interpret Pillar 2. The Committee of European Banking Supervisors (CEBS), for example, distinguishes between sophisticated, complex institutions and other less-complex ones. Their third consultative paper, ‘The application of the supervisory review process under Pillar 2’ (May 2004), states that some institutions might indeed take the Pillar 1 capital and then determine an add-on for other risks, as in Figure 1. While ‘institutions will not be required to use formal economic capital models’, however, the paper notes that ‘it is expected that more sophisticated institutions will elect to do so’.

In other words, while supervisors do not require an economic capital model, adopting such a model would be consistent with meeting the requirements of Pillar 2 and may well be expected of many larger, more sophisticated institutions.

If an organisation does not choose to adopt economic capital, what other options does it have? These would appear to range from basic Pillar 1 capital plus a subjective assessment of other risks, through to add-on type modelling (with different approaches for different risks) as described above, to stress testing and simulation modeling.

¹ Under this approach, companies model individual assets and liabilities, cashflows etc (using product projections and other business/marketing forecasts) to build a 1–5 year picture of the financials and from this the overall levels of equity can be observed. These models are stochastic and generally do not break down into individual risk types. From this, one can place stresses and scenarios into the tool to get a picture for the various levels of capital. The tool can be designed to produce a capital number at a given confidence level, but this is not its only aim.

The key issue is that economic capital should be driven by business considerations, and not simply comply with supervisory requirements.

Some institutions might choose to adopt the 'dynamic financial analysis' used largely in the insurance industry¹. For example, one leading European bank is using a similar approach to assess its overall risk appetite, by modelling the volatility of different factors and their impact on the bank's balance sheet and P&L, and this sort of approach may be accepted by supervisors as an alternative to full economic capital.

So if economic capital is not specifically required by the supervisors, should organisations adopt it at all? In another article in the latest edition of *The Journal*², Miles Kennedy and Mark Johnston look at the application of an economic capital model and examine some of the potential shortcomings. Adoption of a full economic capital is not an automatic choice, and will be driven by a number of largely internal factors. Certainly, economic capital can bring a significant improvement over more traditional performance measurement and financial decision-making processes. In particular, the ability to convert risk into a quantum which can be compared with returns is extremely useful, and in general the move to more quantitative approaches to risk management is to be welcomed. Some organisations, however, have decided that they would prefer to approach the risk/return equation which underlies banking from a different perspective, and we do not consider that there is any single, 'right' answer. Thus, while we believe that there are considerable business benefits which can be gained from adoption of economic capital, this approach may not suit every organisation. Many attempts to implement an economic capital regime have run into the sand, usually because they are not properly integrated into the management philosophy and practices of the organisation.

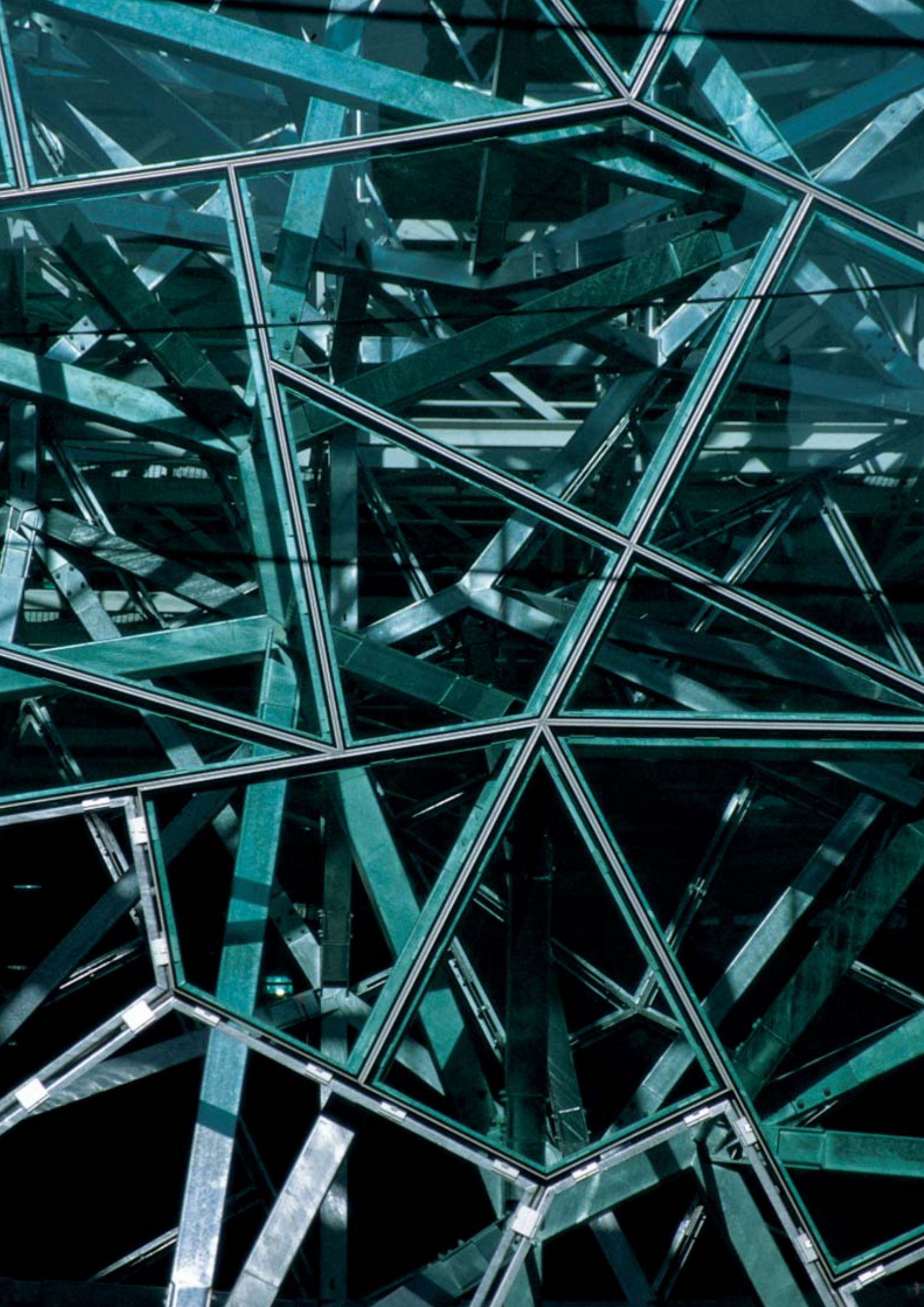
An organisation which, therefore, adopts economic capital primarily to meet regulatory requirements is likely to run into problems. Not only will the model fail to take hold internally and result in confused metrics but, worse, the initial purpose will not be fulfilled, as the underlying theme of Basel II is that such techniques must be fully embedded in management decision processes or else fail the 'use' test. The key issue is that economic capital should be driven by business considerations, and not simply comply with supervisory requirements.

The sort of questions that organisations need to ask before embarking on an economic capital project are:

- What is the strategy of the organisation in terms of balancing risk and rewards? (For example, how capital efficient do we want to be? Is shareholder value generation a key part of our financial goals? Does this conflict with other goals, such as market share or eps growth?)
- Will economic capital be an integral part of the financial decision-making processes of the organisation?
- How will economic capital be embedded in performance metrics?
- How actively will capital allocation be embedded in the strategic planning and resource allocation/budgeting processes?
- How will economic capital be factored into performance compensation policies?

The above article was first published in *The Journal* Special risk management edition (January 2005).

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BY ROHAN BEDI Banking and Capital Markets Industry Group

Anti-money laundering: The key issues

The revision of the FATF 40 recommendations in 2003 and the release of further recommendations on terrorist financing last year have pushed anti-money laundering up the risk management agenda. Rohan Bedi of PricewaterhouseCoopers identifies the top seven anti-money laundering issues faced by Asian banks.

The revision of the Financial Action Task Force (FATF) 40 recommendations on anti-money laundering in 2003, along with the publication of special recommendation nine last year, which targets the cross-border movement of terrorist funds, have pushed anti-money laundering (AML) up the list of priorities for Asian banks. A number of enhancements have been made to anti-money laundering regulations in several Asian jurisdictions, and others are expected to follow suit in 2005.

These revisions have had significant implications for financial institutions operating in Asia by introducing new requirements for information collection on fund transfers, trusts and private limited companies. There's more emphasis on risk-based monitoring, while banks must implement effective due diligence of correspondent accounts and politically exposed persons (PEPs). The onus is very much on financial institutions to identify the controllers and beneficial ownership of accounts, transfers and transactions.

However, there's still a lot of work to be done. This article identifies the top seven anti-money laundering issues for Asian financial institutions, and highlights common weaknesses in AML compliance programmes.

1. Good theory, bad practice!

There are some key broad factors that supervisors will look at while reviewing a financial institution's suspicious transaction reporting (STR) file:

- How does the STR filing pattern compare with the best among the financial institution's peers?
- Is all 'know your customer' (KYC) data on file considered, and is new due diligence/ enhanced due diligence (EDD) conducted where required?
- Is the STR reviewed by the Money Laundering Reporting Officer (MLRO), management and the relationship manager? Did senior management play their role where required?
- Are STRs suppressed for business reasons? Does the correspondence indicate that the MLRO is not sufficiently empowered?
- Are the reasons for filing STRs clearly documented and similarly, the reasons for not doing so?

Of course, each business has its own peculiar money laundering risks. But a peer comparison is a good starting point for a more detailed review.

- Is the STR filed in a timely manner and does it have sufficient details to assist the financial intelligence units (FIU) – which are government units created explicitly to look into money laundering and terrorist financing – to investigate the STR further?

The STR file is ultimately the litmus test of the effectiveness of all AML efforts. It cannot be looked at in isolation. If one financial institution files 30 STRs annually and its peer files only two, there could be something amiss. Of course, each business has its own peculiar money laundering risks. But a peer comparison is a good starting point for a more detailed review.

2. Usage of good-quality KYC databases

The potential for using information already in the public domain for due diligence/ EDD is tremendous. The key value of commercial KYC databases lies in the links they throw up, which a line manager would find difficult – if not impossible – to identify. For instance, the definition of a politically exposed person is very wide, going beyond a head of state to senior politicians, judges, military, religious figureheads, their relatives and friends, their advisers and consultants, their business associates, and most importantly, their companies, trusts and foundations.

Given the enormity of the task, any financial institution that feels it is safe simply by reviewing the Central Intelligence Agency's list of 'Chiefs of State and Cabinet Members of Foreign Governments' is deluding itself. After all, a financial institution is unlikely to be hit by a corrupt head of state or his/her subordinates directly, but through another person linked to the PEP.

Banks also need to implement a good names analysis programme to analyse transactions. More than 1000 financial institutions globally have already subscribed to key databases, such as

World-Check, Factiva, IntegraScreen Online and Regulatory DataCorp International. They screen customer transactions and even use these databases in pre-hiring employee and vendor checks. Every financial institution should ask itself what it has done on this issue.

3. Basic AML Monitoring Reports

Many financial institutions in Asia use outmoded AML reports that monitor only basic events, such as cash placements, large transactions or investments foreclosed prematurely. Many banks still do not have systems that flag the high-risk categories (such as cash-intensive businesses, jewellers, import/export businesses), and have yet to identify peer groups for system monitoring of their transactions by cutting-edge AML trend monitoring systems. These institutions are unable to analyse a transaction in an effective manner; for example, comparing the history of the account with the account holder's peers, or comparing the average balance in the account versus the average balance one year ago. Statistical data on an account is critical to help the bank in its due diligence/ EDD processes. There are also linked data quality and data consolidation issues that need to be addressed. For instance, customer data on the system may be inadequate vis-à-vis the current KYC regulatory requirements, requiring a remediation exercise; while legacy systems may not be connected (e.g. banking and credit cards), making it difficult to get a consolidated picture of a customer relationship with the bank.

Most financial institutions acknowledge that AML Software would help, but consider them simply too expensive to buy or implement. There is an element of truth in this argument. These technologies are expensive, but collaboration between regional governments and vendors could help to push prices down.

Of course, it is not a 'one size fits all' prescription and the smaller banks may find that ordinary rules-based systems suffice for their purposes (these will also be less expensive). On the other hand, online brokers will find that AML trend monitoring software is absolutely essential for their AML requirements given the lack of customer interface in their transactions.

4. Risk-based due diligence

Financial institutions should refer to three risk models when conducting due diligence –

geography and country risk; business and entity risk; and product and transaction risk. Banks need to take a systematic approach to risk that covers all three bases, rather than just one or the other.

These models are ultimately just common sense, built on an appreciation of the money laundering risks unique to the business and the data sources that could help a financial institution to manage these risks. If a financial institution does not have FIU-type data interrogation and forensic capabilities for EDD, either for reasons of size of operation or budgetary constraints, it should support the process using the services of a good third-party service provider.

Risk-based due diligence leads to the better allocation of compliance resources and more effective cost management (especially in retrospective KYC data remediation exercises). It also has a critical impact on the quality of customer service (it means the bank will not harass a client when there is enough information to indicate that the risks are low), and needs to be enshrined into AML training of frontline staff and line management. Without a risk-based approach, AML efforts can become counter-productive, with staff simply taking a 'tick-box' approach to compliance.

Without a risk-based approach, AML efforts can become counter-productive, with staff simply taking a 'tick-box' approach to compliance.

5. Compliance and internal audit not empowered

This is a serious problem that smaller organisations face rather than bigger institutions (although the bigger firms are certainly not immune). Business units may bully compliance officers not to file STRs based on business considerations. Compliance officers may also double up in other functions, diluting the AML focus or even creating conflicts of interest. The MLRO should be the ultimate judge of whether an external filing of the STR is needed or not.

A key tool to empower MLROs is to require the submission of an annual report – along the lines of the UK Joint Money Laundering Steering Group Notes (under the British Bankers’ Association), which assesses risk annually, evaluates trends and events and analyses new regulations and their potential impact. It can also highlight issues such as undue pressure not to file STRs. Such a report should be reviewed by senior management and/or the board of directors. A system must be in place to act on the recommendations of the report, to allocate responsibility and to track and verify completion. Such a system opens up the financial institution’s AML systems to supervisor scrutiny, which is a very useful self-discipline.

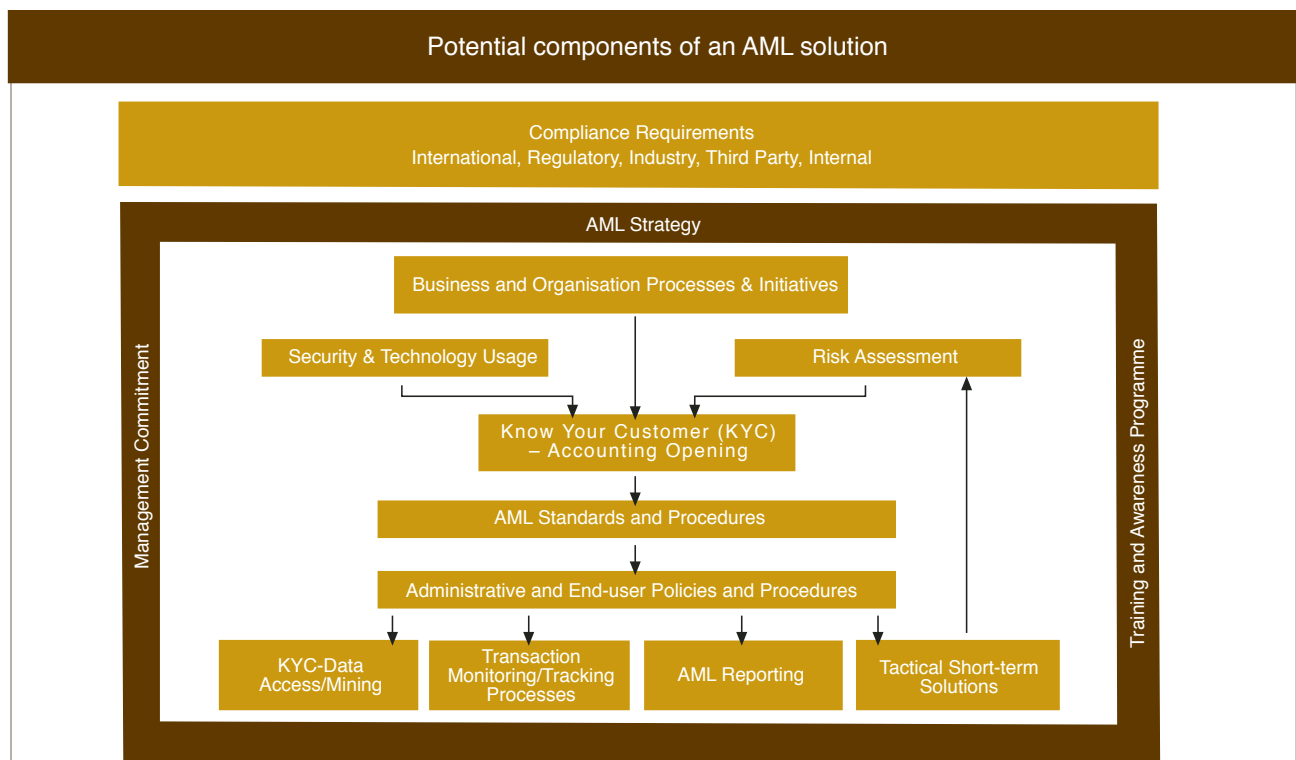
Feedback from the UK regulator, the Financial Services Authority (FSA), indicates that the second round of annual reports filed with the FSA were not up to the mark. In a letter written in March 2004 to chief executives of all groups supervised by the FSA’s major financial groups division, the FSA criticised the quality of many reports, stating that they did not assess the risk of money laundering properly and did not adequately account for the risks of their business. It also criticised the quality of information that

went into the report. A review of the data sources of the report is an important best practice.

Internal audit (where it exists) may not fully appreciate the risk-based monitoring paradigm or its own role in enforcing this. For example, high-risk accounts should be system flagged and subject to EDD, periodic reviews by business units, and independent reviews by internal audit. Judging from the lack of such system flagging (which only seems to be done in some American banks and key local financial institutions), internal audit may not be carrying out this independent review function. What’s more, judging from the lack of comments in internal audit reports, overall independent review of the health of the risk-based process may be suspect in many cases.

Internal audit should also provide an independent review of the compliance officer’s function and the health of the ‘know your employee’ (KYE) controls. Beware of ‘the enemy within’; many private banks/ broker-dealers have fallen prey to employees who join their organisations, moving their money laundering accounts with them.

Financial institutions must remember that, in a situation where they do not know the employee or the client fully, they face double trouble.



A change in mindset is needed – it's not about the law, it's about implementing the law.

6. Training techniques need to evolve

Training has a real role to play and is not a 'tick-box' exercise.

- While financial institutions are happy to use role play in customer service training, they shy away from using it as an AML training tool. Role play should be actively used to underscore key points and create qualitative detection abilities in staff.
- Similarly, e-learning, videos and audio tapes should be used in a blended approach with regular in-house training to cut training costs and to make training more interesting.
- Focus is needed on the risk-based approach to AML.
- MLROs would do well to have special AML training focusing on the needs of senior management and boards in order to highlight their own personal accountabilities, and what has actually gone wrong for chief executives around the world who have found themselves trapped in the vortex of a money laundering scam. This may be the only way to get budgets for AML.
- Participants on training courses need to be assessed formally, following the principle that 'what is taught must be evaluated'. This also helps to increase the effectiveness of training in generating awareness.

7. Tone at the top is deficient

AML regulations will not make a difference if they are not implemented properly. The tone of senior management and the board of directors should be 'do or die'. Without a clear AML corporate statement repeated frequently, awareness of AML will be a result of annual training only and will simply not be sustainable. Any line manager who is subject to yet another round of boring annual AML training will not take proper action on this issue, especially if the only thing his/her boss talks about is targets. 'Top of mind' recall of the money laundering and terrorist financing

issue is critical to ensuring an enterprise-wide AML system.

Supervisors are also keen to specifically examine whether boards and senior management have reviewed the strategic money laundering risks of their businesses on an annual cycle (does the financial institution understand what risks it carries, are these acceptable to the board/senior management?), and whether these decisions reflect in the bank's account opening, monitoring and review requirements. Also, do boards and senior management keep informed of potential money laundering incidents? Boards (and/or the designated oversight committee) should ideally be informed on all significant STRs once a month.

Conclusion

A change in mindset is needed – it's not about the law, it's about implementing the law. AML is today a mix between an art and a science, backed by technology. Financial institutions have to run to keep up with money launderers.

The above article was first published in the February 2005 issue of AsiaRisk.

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BY PAUL CORNELIUS Corporate Tax Services

The Tax Challenge – Managing Risks and Creating Value

The tax affairs of local and multinational corporations are rarely seen as the glamorous side of the business. Filing tax returns and complying with other regulatory taxation obligations are necessary but mundane activities. So if the tax affairs of a company are not exciting, why are they important? Read on as Paul Cornelius shares on the role tax plays in an effective organisation.

Value creation and risk management are not competing objectives, they are twin benefits which today's tax department can contribute towards the business.

One answer is that effective tax management can have a material impact on a company's bottom line. A PricewaterhouseCoopers (PwC) global tax benchmarking survey¹ modelled the impact of a 1% reduction in cash tax rate for three European companies. The result was an increase in shareholder value of between 1.4% and 2.3%. In comparison, an increase of between 12% and 15% in turnover was required to generate the same increase in shareholder value.

However, in today's world the impact on the bottomline is only one of the areas where ineffective tax management rears its ugly head. Corporate reputation can be damaged, directors can face personal liabilities and there can be a loss of future shareholder value as today's hidden problems come to light in future.

We recognise that today's tax department can take on myriad forms in a bid to meet the needs of companies in the region. Some companies have large tax teams with global reporting lines, some have tax work embedded in the Finance Department and some outsource the majority of their tax affairs. It is horses for courses but in reality, the actual model employed has little impact on the tax issues, risks and obligations that an organisation's senior management are required to handle. What's important is to address the key risk areas, and manage taxes to generate optimal value and benefits.

Efficient and effective tax department

So what are the key components of an efficient and effective tax department? A recent PwC regional survey² indicated that value creation ranked as the number one challenge for the tax function. But this is only one piece of the pie. The emphasis on compliance and risk management is growing, given the increased

government regulation, including the Sarbanes-Oxley legislation, in the US. Value creation and risk management are not competing objectives, they are twin benefits which today's tax department can contribute towards the business.

The elements of a successful tax department are illustrated in Figure 1. These address the three requirements to maximise stakeholder value and four tools which can be employed to meet these objectives:

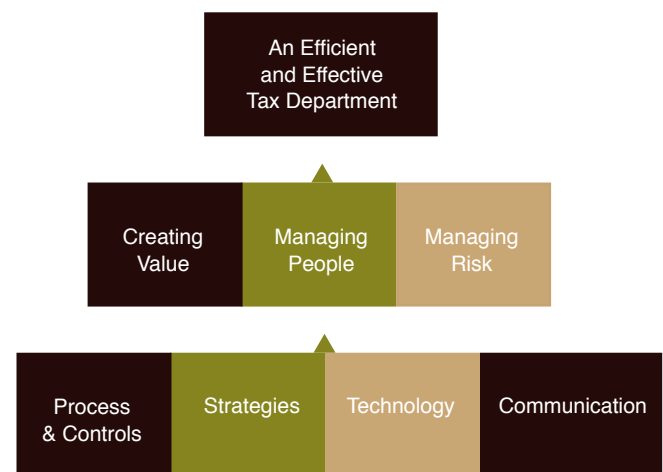


Figure 1: Elements of a successful tax department

What do these mean and how do they fit together in the context of tax management?

3 keys to Maximising Shareholder Value

1. Managing Risk

To manage tax risk, companies must first identify and understand their sources of tax risk. This process must comprehensively cover all types of tax incurred by a company. Risks of non-compliance with indirect tax laws can be as severe as those associated with income tax.

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 financial statements and reports

Figure 2: What types of tax risks do organisations encounter?

¹ PricewaterhouseCoopers Global Retail & Consumer Sector Tax Benchmarking Survey – 2004

² PricewaterhouseCoopers Asia – 2005 Survey Report on Challenges Faced in Managing Tax Functions in the Region.

Managing compliance risks, transactional risks and operational risks requires a thorough understanding of an organisation's business operations and transactions, and how these should be reflected in tax returns and reports. In addition, management of financial accounting risks requires extensive knowledge of accounting standards to ensure appropriate disclosure.

Risk is a double-edged sword – actions carry inherent risks but inaction can result in a loss of value. Tax risk management requires more than just identifying risks. Organisations must determine their risk appetite, while keeping in mind (potential) financial, regulatory and reputation issues. Risks should be quantified as and when they are identified. An assessment of the probability of occurrence should be made and tagged to that risk.

Ideally these will be determined prior to the actual event so that taxes are managed in a 'no surprises' environment. However, it is acknowledged that to some extent, most organisations are likely to uncover some risks in retrospect. This may be discovered during the preparation of the tax return or on an audit or investigation. To reduce the impact of such shocks, the tax department must have a strategy in place to cover all aspects of risk management.

2. Managing People

As with other disciplines it is necessary to have quality tax staff with the appropriate skills and training to effectively perform their duties. However, for the tax function the management of people extends beyond the tax staff.

Relationships with personnel in government can be critical to the outcomes of incentive applications, ruling requests, audits or lobbying efforts. Such relationships need to be cultivated and maintained for expedite resolution and processing of tax issues, as well as tax filing and compliance. Effective communication with external service providers can improve efficiency and derive value from expert advice. Open communication lines with staff in the business units can mean the difference between an informed and uninformed tax decision in the overall scheme of business decisions.

To function well, the tax department must proactively develop relationships with all of its stakeholders and advisers.

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, as demonstrated in Figure 3. Effective tax planning takes into account the individual organisation's tolerance for risk.

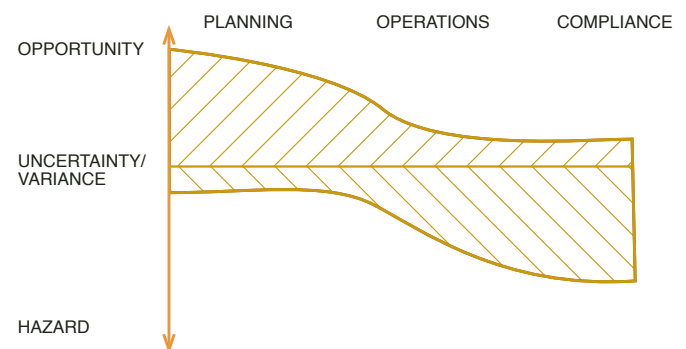


Figure 3: Opportunity/Hazard relationship with the different roles of the tax function

4 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 such as PwC to achieve these goals?

Tool 1: Implement a Tax Strategy

In a recent PwC survey² only 26% of respondents had fully implemented a tax strategy that was documented and agreed this with senior management in their organisation. It is advisable for all companies with material tax liabilities or risks to study and put in place appropriate tax strategies. The components of the tax strategy should cover all of the activities of the tax function, in particular:

- A benchmark for measuring the value created by the tax function (e.g. dollar value-added each year and/or effective tax rate targets)
- Identification of potential tax risks and documented procedures for dealing with them (including disclosure of information and resolution of disputes and audit findings/recommendations)
- Tax compliance benchmarks (e.g. target lodgement dates, absence of penalties or interest)

Tax law and practice tends to involve finding a footing within the shades of grey rather than the luxury of obviously marked walkways of black and white.

- Clear roles and responsibilities for all areas of tax, clearly stating the experience and ongoing technical support required for the respective roles to be undertaken effectively
- Communication benchmarks (e.g. tax update as part of quarterly board meetings)
- Tax department costs and budget
- Benchmarks for lobbying and government liaison (e.g. target dollar value of incentives obtained)

Tax law and practice tends to involve finding a footing within the shades of grey rather than the luxury of obviously marked walkways of black and white. This poses obvious challenges in accurately measuring value or determining the level of risk. These are areas where organisations must determine their own tolerance for risk before further progress can be made. Organisations can seek assistance from tax experts to assess their tax risks and opportunities and to help develop appropriate tax strategies.

Tool 2: Develop and Document your Tax Policies and Procedures

Tax policies and procedures should cover all taxes incurred by the company and touch on all four types of tax risks (i.e. transactional, operational, compliance and financial reporting risks). 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 Technology

Technology can generally be used to support three of the key tax areas (see Figure 4).

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 4: Using technology to support the tax function

The weakest controls are manual controls, particularly in the transfer of data from one accounting system to another and where spread sheets are used. In some countries, tax reporting systems are linked directly to the general ledger and tax asset register. These systems can also link tax reporting for return, management accounting and financial reporting purposes. However, such systems can be expensive and may not be suitable for all companies. 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 tax service providers, who have the sophisticated infrastructure to support the tax compliance process. Even then, the tax return data is only as good as the information provided by the company to the outsource-tax professional. In a nutshell, the greater the degree of automation for both in-house and outsourced tax compliance, the stronger the controls.

There also exist tax softwares which can simplify the management of tax affairs for organisations, especially those whose businesses span multiple operating locations. One such tax product is the PwC Global Compliance Solutions. This software allows clients to access a database via the internet. It contains details of all aspects of a group's tax compliance position, including the company-by-company status of queries from the tax authorities

and tax planning opportunities across a local, regional or global group. PwC and the organisation will jointly manage the database which acts as a single source access to the organisation’s current tax management data.

Tool 4: Communications

Communication is often the gel that holds the other key 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 a regional or global business. Other key communication channels include government tax authorities and external tax service providers.

Effective communication with the various business units may prove to be a potential area of concern when part or all of the tax function is outsourced to an external service provider. Such cost concerns, whether real or perceived, may hinder communications. In this case, it may be preferable to have clearly mandated communication policies, for example stipulating required periodic updates, a retainer to cover day-to-day operational queries and early involvement in tax sensitive transactions.

Summary

Over the recent years, the scope and function of the tax department has evolved rapidly to become the complex giant it is today. With a highly complex tax system and fast-paced

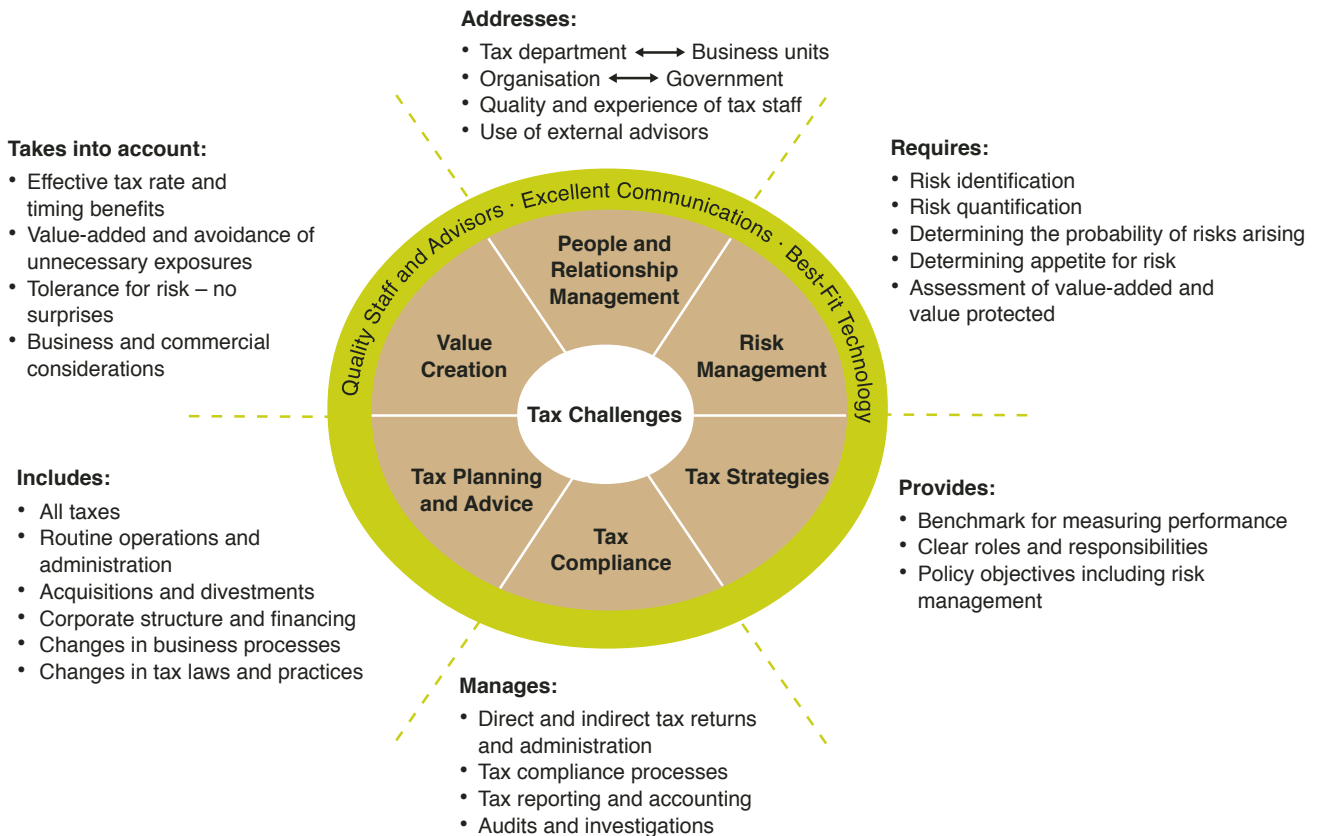


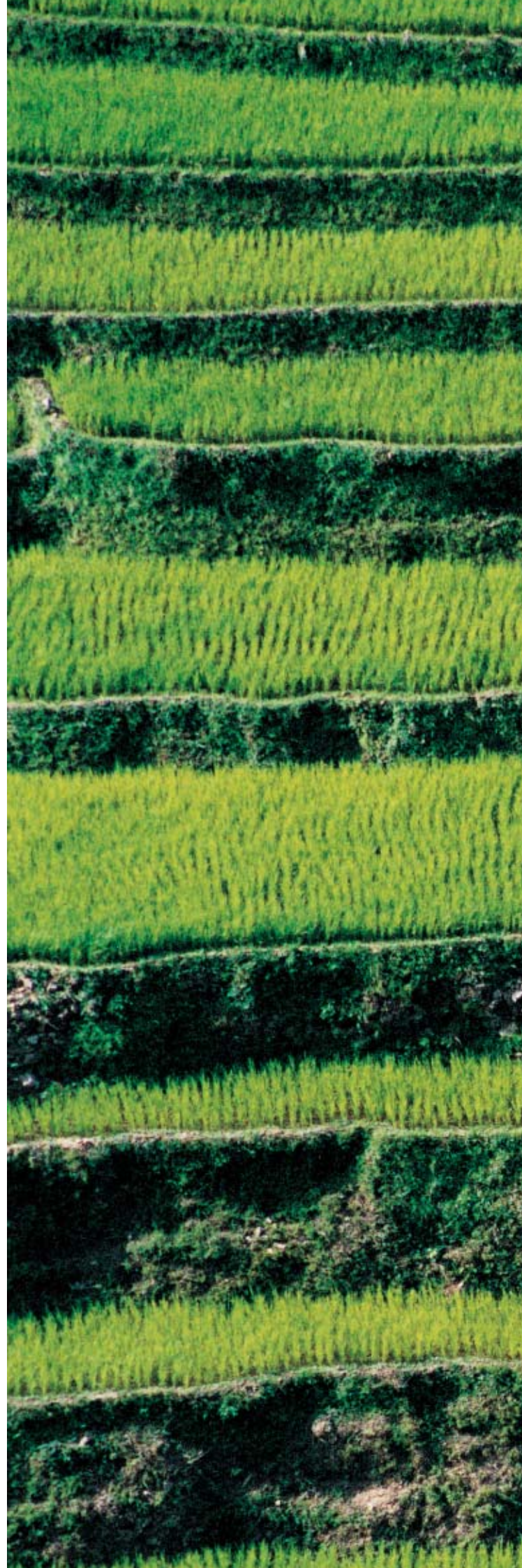
Figure 5: Tax challenges

environment, today's tax departments face many new challenges. Figure 5 summarises the challenges that must be addressed by today's tax department:

It is no meagre task to successfully create value for an organisation while balancing tax risk. To tackle this difficult task, PwC developed a diagnostic assessment to assist organisations in systematically reviewing the functions of the tax department. It is certainly worthwhile for an organisation to undertake a comprehensive review of its tax department to kick-start its journey to becoming an efficient and effective unit which is able to contribute significantly towards stakeholder value.

Change your perspective.
See the value tax management brings to the business.

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BY NICOLE FUNG (above) & STEVEN CAREY Regional Transfer Pricing

Transfer Pricing – Opportunities and Risks in Asia

Transfer pricing issues are of paramount importance in an increasingly global economy. Multinationals have universal brands, regional and global management centres and regional profit centres. They are often structured for reporting and measurement purposes on the same regional or global basis. It has been estimated that as much as 60% of international trade takes place within multinational groups. This will increase further as multinationals continue to centralise their logistics hubs, streamline their supply chain and create centres of excellence for manufacturing and services.

The response of governments to this worldwide phenomenon has been both pragmatic and defensive. Corporate tax rates are on a global downtrend as governments compete for the investment dollar. On the other hand, governments also recognise that they need to protect their tax base. To this end, their response has been to build more complex rules to retain what they view as their fair share of profits.

It is no wonder that transfer pricing is one of the key tax issues faced by multinationals today. In this article, we will look at how the Asia Pacific region has responded and in particular, the challenges ahead for Singapore in its aspiration to be a global/regional hub for intellectual property, distribution, logistics services and manufacturing.

Transfer Pricing Trends in the Asia Pacific Region

A snapshot of the region reveals an upward trend in the focus on transfer pricing. Figure 1 shows the countries which introduced transfer pricing rules or documentation requirements into their tax regimes over the last five years.

The trend indicates a clear signal that almost all Asia Pacific tax authorities now feel that intercompany pricing merits close scrutiny and that companies need to clearly document the basis for their pricing.

Companies with a presence in any of these countries need to be aware of their compliance obligations and act on them. Transfer pricing frameworks typically 'recommend' that companies should prepare appropriate documentation and benchmarking to show the tax authority that profits are at 'arm's length'. Failure to do this invites intrusive transfer pricing audits and

typically harsh penalties. One such example is Toyota Australia, which is currently defending a proposed transfer pricing adjustment estimated at over AUD 1 billion.

Companies need to make a risk assessment of where their key exposures lie in the region and act now to address them, and should seize this opportunity to use transfer pricing frameworks to achieve their tax planning goals in a transparent and defensible way.

Trends in Singapore

Notable exceptions to the above trend of introducing transfer pricing requirements are Hong Kong and Singapore, where corporate tax rates are lower than the rest of the region. On the basis that multinationals would be more likely to locate their profits in lower tax jurisdictions, does this mean that the tax authorities of countries like Hong Kong and Singapore need not be concerned about transfer pricing?

The answer to that is a resounding 'no'. Singapore has many attractions as a key global/regional hub for manufacturing and services – infrastructure, location, highly skilled workforce, intellectual property protection and, on top of all that, a favourable tax rate. The Singapore government is understandably keen to attract and retain investment spending. Thus, when multinationals increase their assets, functions and risks in Singapore, it is incumbent on the Singapore tax authorities to defend the resultant profit shift.

Even in situations where there is no substantive shift of assets, functions and risks to Singapore, the tax authorities will need to focus on transfer prices in view of the increased scrutiny in the region. Failure to do so may result in the shift of profits away from Singapore to other jurisdictions

2000	2001	2002	2003	2004
China*	China	China	China	China
Australia*	Australia	Australia	Australia	Australia
New Zealand*	New Zealand	New Zealand	New Zealand	New Zealand
	Japan*	Japan	Japan	Japan
	India*	India	India	India
		Thailand*	Thailand	Thailand
			Malaysia*	Malaysia
				Taiwan*
				Philippines (draft)*

Figure 1: Adoption of Transfer Pricing across Asia Pacific Countries (*Introduced transfer pricing in the year indicated)

which are more aggressive in this area, as taxpayers attempt to manage regional tax risks.

It is likely that Singapore tax authorities will increase their focus on transfer pricing, although not necessarily via specific documentation requirements. The Singapore tax authorities believe that with the burden of proof on the taxpayer, there is already an unspoken requirement for taxpayers to defend their related party pricing with appropriate documentation. The focus will be on more detailed questioning of corporate transfer pricing policies and scrutiny of significant shifts in profit levels from year to year.

Another way which the Singapore tax authorities may focus on transfer pricing is through the use of Advance Pricing Agreements (APA) and/or Mutual Agreement Procedures (MAP).

One advantage of Singapore over Hong Kong is that the former has a large network of double tax agreements (DTA) under which taxpayers are protected from being taxed on the same income twice. Thus, if the Japanese tax authorities contend that the price of products sold from Singapore to Japan is too high and adjust the profit level in Japan from 4% to 10% for a company with a turnover of \$100m, this will result in additional tax payable of \$2.5m. Such an adjustment will result in double taxation as the income would already have been taxed once in Singapore. Taxpayers should be aware that under the MAP procedures in the DTA between Singapore and Japan, they may request that the two tax authorities negotiate and agree on a pricing policy and appropriate adjustments such that double taxation is avoided.

In an environment where corporations can be severely penalised for unknown risks, APAs may be used as a tool for corporations to manage one of the most significant of these risks: transfer pricing.

An APA is an agreement between one or more related taxpayers and tax authorities to achieve an agreed profit level over a 3-5 year period. They are becoming commonplace among tax authorities in the region, including Australia, Japan and China. A taxpayer who locks into an APA has certainty that there will be no transfer pricing scrutiny of the transaction – and the tax authority has a guaranteed revenue stream – for the period of the APA.

For Singapore, a robust APA or MAP regime will send a strong and positive message to investors

...a robust APA or MAP regime will send a strong and positive message to investors that the Singapore tax authorities are willing to engage with them and other tax authorities to ensure that the appropriate profit level can be sustained in Singapore.

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Conclusion

In an increasingly global economy it can often be difficult to determine exactly where profits are generated – is it through research and development, marketing, an efficient supply chain, valuable manufacturing process or something else? In recognition of this, tax authorities in the region will continue to have a strong focus on transfer pricing and will form their own opinions on the appropriate profit returns in their market. Corporations will need to be proactive in managing their transfer pricing risks and formulate practical and clear strategies in their business models, pricing policies and documentation in order to capture the full potential of the value created through effective management of transfer pricing.

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BY KOH SOO HOW Goods and Services Tax

GST and SOS (Saving Our Services)

Governments need to provide a consumption tax environment that facilitates a well functioning services economy and would, at the same time, protect the tax base. The current international consumption tax environment runs an increasing risk of failing to meet both criteria.

OECD Report "The Application of Consumption Taxes to the Trade in International Services and Intangibles"
(Released June 2004)

Is the above statement true for Singapore? Koh Soo How examines whether the Goods and Services Tax (GST) system is impeding Singapore's efforts to promote its international services sector.

2005 is not just turning out to be the Year of the Rooster but also the Year of Global Services for Singapore. Recent initiatives have shown that promoting the export of services is a key thrust in the government's efforts to grow Singapore in the international services arena. This is further confirmed in the 2005 Singapore Budget on 18 February 2005, which announced a number of tax measures to foster the growth of the services sector.

A report in the Business Times earlier this year hailed Singapore as the world's top location for outsourcing on a project per million people. Besides political and security risk, regulatory environment, labour laws, and infrastructure, the tax regime was cited as one of the categories on which the 60 countries were ranked in the study by the Economist Intelligence Unit that looked at data gathered by the United Nations Conference on Trade and Development (UNCTAD).

Looking at Singapore's tax regime, it is true that it does have an income tax regime which promotes the services sector as the financial services industry and multi-national companies (MNCs) are encouraged to set up regional headquarters in Singapore to conduct regional and global activities, shared service facilities, info-communication activities, etc.

What Singapore can perhaps do better is in the way the GST applies to such regional and global services.

Zero-rating of international services

Like most jurisdictions with a value-added tax or GST system, the GST applies to the domestic consumption of goods and services in Singapore. To maintain international competitiveness, the export of goods and the export of services are treated as zero-rated supplies, which means that such exports can be effectively made free of GST.

So long as the relevant export documentation is maintained as proof of the physical export of the goods, the export of goods can be zero-rated.

On the other hand, the export of services is much more complex as the zero-rating treatment is dependent on the nature of the services and the interpretation of the legislative provisions (the zero-rating provisions) which deal with exported services.

Amending legislation in November 2004 stipulated that in order to qualify as zero-rated international services, the services have to be supplied 'under a contract with' a person who belongs outside Singapore and 'directly benefit' that person (or persons) outside Singapore and who is outside Singapore at the time when the services are performed. (There is also the condition that the services must not be directly in connection with land or goods in Singapore).

The Inland Revenue Authority of Singapore (IRAS) on 12 January 2005 sought to clarify the interpretation and application of the expression 'directly benefit' used in the zero-rating provisions. Essentially, the IRAS expressed the view that where the services supplied 'directly benefit' a local person(s), the services would be subject to GST at 5%. What this means in practice is that GST can apply to services that are received by a local person even if the services are invoiced to the overseas client who contracted for the services.

An example in the financial services industry is 'give-up' futures transactions whereby trades are executed for a Singapore customer. Based on the current rules, the commission charged to the overseas clearing broker who contracted for the services, will be liable to 5% GST. In the case of a regional headquarters set up, the 5% GST would also apply to any services that are performed for an entity in Singapore even if the services are billed to an overseas parent company under a cost-plus arrangement.

The interpretation has given rise to certain practical difficulties as it puts the burden on the Singapore service provider to prove that there is no one in Singapore who can be said to 'directly benefit' from the services before he can apply the zero-rating treatment. This requires looking beyond the overseas client who contracts for the services to see if there is someone in Singapore who can be said to directly benefit from the services at the time of entering into the contract and at the time of performing the services. Obtaining information on the end-persons, if any, receiving the services, may not be possible due to commercial sensitivities.

Where the services benefit both an overseas person (zero-rated) and a local person (standard-rated), the IRAS has also stated that the value of services provided to the overseas and local person must be apportioned between services subject to the 5% GST and those services that can be zero-rated.

The competitiveness of Singapore services would inadvertently be affected if GST were charged to the overseas client who has to bear the additional 5% GST charge. Alternatively, the service provider's bottom line would be affected if he has to absorb the tax to stay competitive. Given the highly competitive nature of the services sector, the additional GST cost would disadvantage Singapore's position in the global services economy.

It should be argued that the person who can be said to 'directly benefit' from the services, is the (overseas) client who contracts for such services as he needs the services to satisfy his contractual commitment to service his own customers in Singapore.

So is there a solution to the problem?

A proposed solution

Perhaps, the solution can be found within the GST legislation itself. To explain, one must understand why the legislation has been interpreted and amended in the current manner. A popular belief is that it is to prevent 'round-tripping' whereby services are performed for a person in Singapore under a contract with the overseas client. If zero-rating were allowed to apply to the invoice to the overseas client who subsequently charges it back to the Singapore-based recipient of the services without GST, the tax would be avoided.

If round-tripping is the problem, it may be time to consider activating the 'reverse charge' that is currently provided for in the GST legislation and at the same time, allow the zero-rating of all contractual services that are billed to the overseas client.

Under the 'reverse charge' provision (which long existed in the GST Act when it was introduced), the Minister for Finance may prescribe services that are received in Singapore from overseas to be subject to GST. As there are currently no such services prescribed for the purposes of applying the reverse charge, it also means that services that are received from abroad are not subject to GST unlike imported goods, which are subject to the tax.

One concern with the reverse charge is that it could increase the cost of situating a financial services operation in Singapore if it has to pay GST on management or head office support services from overseas without full input tax

recovery due to exempt supplies that it may be making. To overcome this, the reverse charge could be restricted to those services that are on-billed by the overseas person to the Singapore party who receives the services. This would also address the issue of 'round-tripping'.

Further, the reverse charge corrects the anomaly that imported services are not subject to GST while locally provided services are subject to GST. Having a reverse charge is also in line with the fundamental principle of tax neutrality in a taxation system. In other words, the recipient of services in Singapore would pay GST at the standard rate regardless of whether or not the services are invoiced by a Singapore service provider or invoiced by a person who belongs outside Singapore. If the recipient of services is registered for GST, it will recover the GST charge as an input tax credit in the normal manner.

Conclusion

Services are highly mobile and will continue to be so with advances in information technology and telecommunications. If taxation is a key consideration in the consideration of setting up a centre to provide regional and global services, the imposition of a 5% GST to such services in a highly competitive industry such as financial services would impede Singapore's efforts to be a global services hub.

While there may be issues that need to be considered with a reverse charge, it may be time to consider having such a tax on imported services in order to make all Singapore's international services free of GST and facilitate Singapore's long-term competitiveness in its global services.

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BY FRANK DEBETS (above) & LOK HWEE CHONG Worldtrade Management Services

What's the Value in Customs Valuation? Where's the Risk in Post-Clearance Audit?

Trade and customs management has been a part of commercial practice since modern trading between countries began in the early 20th century. Merchants plying the high seas between Europe and America or between America and Asia have always been drawn by the immense value that trading brings about through the simple act of buying and selling. As mercantile trade flows increased, the need for controls increased proportionally. Border taxes on the flow of mercantile trade was imposed and this became the most early and primitive form of customs duties. Today, many customs territories imposed customs duties using sophisticated customs management techniques operated by highly professional customs administrations.

The WTO agreement on customs valuation aims for a fair, uniform and neutral system for the valuation of goods for customs purposes – a system that conforms to commercial realities, and which outlaws the use of arbitrary or fictitious customs values.

An important area of value and risk within financial management lies in managing direct taxes, the large chunk of which materialises in the form of customs duties. To understand the issue better, firstly, we can view the issue of customs valuation as the portion providing value to the company. The risk in customs duties lies in the post-clearance audit where posthumously, there is a risk of failing to comply with the rules and regulations on customs valuation portion properly, and the company finds itself facing stiff penalties.

Customs Valuation

The issue of customs valuation is an important area of customs practice which is often in the centre of disputes between private sector and customs administration. For importers, the process of estimating the value of a product at customs presents problems that can be just as critical as the actual duty rate charged. This process called Customs Valuation is a customs procedure applied to determine the customs value of imported goods. If the rate of duty is ad valorem, the customs value is essential to determine the duty to be paid on an imported good.

Brussels Definition of Value

From the 1950s to the 1970s, customs duties were assessed by many countries according to the Brussels Definition of Value (BVD). Under this method, a normal market price, defined as 'the price that a good would fetch

in an open market between a buyer and seller independent of each other'. This method caused widespread dissatisfaction among traders, as price changes and competitive advantages of firms were not reflected until the notional price was adjusted by the customs office after often lengthy periods of time.

Tokyo Round Valuation Code

The Tokyo Round Valuation Code, or the Agreement on Implementation of Article VII of the GATT, concluded in 1979, established a positive system of Customs Valuation based on the price actually paid or payable for the imported goods. Based on the 'transaction value', it was intended to provide a fair, uniform and neutral system for the valuation of goods for customs purposes which conforms to commercial realities. This differs from the 'notional' value used in the Brussels Definition of Value (BVD). As a stand-alone agreement, the Tokyo Round Valuation Code was advocated by more than 40 contracting parties.

The governing principle today – WTO Agreement

Today, Customs Valuation is governed by the WTO Agreement on Implementation of Article VII of the GATT 1994 following the conclusion of the Uruguay Round of discussions. The WTO agreement on customs valuation aims for a fair, uniform and neutral system for the valuation of goods for customs purposes – a system that conforms to commercial realities, and which outlaws the use of arbitrary or fictitious customs values. The agreement provides a set of valuation rules, expanding and giving greater precision to the provisions on customs valuation in the original GATT.

The WTO agreement on customs valuation is essentially the same as the Tokyo Round Valuation Code and applies only to the valuation of imported goods for the purpose of levying ad valorem duties on such goods. It does not contain obligations concerning valuation for purposes of determining export duties or quota administration based on the value of goods, nor does it lay down conditions for the valuation of goods for internal taxation or foreign exchange control.

In addition, the WTO Ministerial Decision on Customs Valuation gives customs administrations the right to request for further information from importers where they have reason to doubt the accuracy of the declared value of imported.

goods. If the customs administration maintains a reasonable doubt, despite any additional information obtained, it may be deemed that the customs value of the imported goods cannot be determined on the basis of the declared value. Customs would then need to re-establish its value by taking into account the provisions of the Agreement. In addition, two accompanying texts further clarify some of the Agreement's provisions relevant to developing countries and relating to minimum values and importations by sole agents, sole distributors and sole concessionaires.

Basic Rules for Customs Valuation: The 6 Methods

The WTO Agreement on Customs Valuation stipulates that customs valuation shall, except in specified circumstances, be based on the actual price of the goods to be valued, which is generally shown on the invoice. Thus, the first and most important method of valuation referred to in the Agreement is:

$$\text{Transaction value} = \text{Actual Price} + \text{adjustments (based on Article 8)}$$

For cases in where there is no transaction value, or where the transaction value is not acceptable as the customs value because the price has been distorted as a result of certain conditions, the Agreement lays down five other alternative methods of customs valuation. Note that these are to be applied in the prescribed hierarchical order, as follows:

- Method 1 Transaction Value
- Method 2 Transaction Value of Identical Goods
- Method 3 Transaction Value of Similar Goods
- Method 4 Deductive Method
- Method 5 Computed Method
- Method 6 Fall-Back Method

The above valuation methods must be used in hierarchical order with the exception that the sequence of methods 4 and 5 can be switched at the request of the importer (not, however, at the discretion of the customs officer). With more than 90% of world trade valued on the basis of the transaction value method and price adjustments based on objective and quantifiable data, the WTO Agreement provides more predictability, stability and transparency for trade. This serves to facilitate international trade while at the same time ensures compliance with national laws and regulations.

Other Provisions and Exemptions

Since this Agreement is an integral part of the single WTO undertaking, all WTO Members are Members of the Customs Valuation Agreement. By 1 June 2000, there were 78 WTO Members already applying the Agreement.

However, to accord an orderly accession and application by the WTO members, the WTO Agreement on Customs Valuation contains provisions for special and differential treatment of developing countries and for technical assistance. All ASEAN-6 member countries, with the exception of Singapore, has filed to delay the implementation of the application of the computed value method for a period not exceeding three years following their application of all other provisions of the Agreement. In addition, these ASEAN member countries have opted for the flexibility to reverse the order of the deductive and computed value methods, and reserved the right to value the goods under the deductive method even if the goods have undergone further processing in the country of importation, whether or not the importer so requests. This also commonly referred to as the 'super-deductive method'.

Developments in ASEAN

In recent years, ASEAN has embarked on a Strategic Plan of Customs Development (SPCD) on Customs Valuation to undertake the full technical implementation of the WTO Agreement and the ASEAN Customs Valuation Guide (ACVG) by 2006.

The practical intent is for ASEAN customs administrations to harmonise their valuation systems and practices to be in accordance with the WTO Agreement on Customs Valuation. In particular, it would prove to be extremely helpful in facilitating the establishment of the ASEAN Economic Community by 2020 to have in place not only an ASEAN Harmonised Tariff Nomenclature (AHTN) but also an ASEAN Customs Valuation System based on the WTO Agreement on Customs Valuation.

Trading parties will benefit from the ASEAN Customs Valuation System as it effectively abolishes arbitrary uplifts of value for duty to increase the collection of import duties. Similarly, it was deemed that the price agreed between seller and buyer should not be rejected simply because it is considered to be 'too low' or not market price.

To reach SPCD's ultimate goal for customs valuation, it is necessary for ASEAN member countries to faithfully undertake the full implementation of the recommendations and Action Plan of the ASEAN Customs Valuation Guide.

As a first step, all ASEAN member countries would need to engage national legislation to implement the WTO Agreement and to remove any reservations with respect to the Agreement on intra-ASEAN trade between each other. In particular, ASEAN customs administrations would need to work together to ensure that there is a harmonised interpretation and definition of certain terms of the WTO Agreement.

Communication and consensus are critical to ensure that there will be a consistent application of the WTO Agreement.

An extension of the objective is to ensure that eventually, all ASEAN member countries should apply or take into consideration the 'best practises' fostered by the World Customs Organisation as they introduce and apply the WTO valuation standard in their home jurisdictions.

The recommendations of the ASEAN Customs Valuation Guide seek to harmonise and standardise the key areas of valuation laws, regulations and administrative practices that are beneficial to both the customs administrations and commercial trading community. Some of these recommendations are listed below:

What you need to know:

New recommended features of Customs Valuation

1. Adoption of the Generally Accepted Accounting Principles (GAAP) as a national requirement for customs valuation purposes.
 - condition or consideration
 - related parties
 - partners in business
 - closely approximates
 - at or about the same time
2. The calculations of customs value shall be based on objective and quantifiable data. The customs law should require that proper books and records (as well as in the electronic format) to be maintained by declarants and the relevant parties to enable later verification under post-clearance system.
3. Issue clear policies and interpretation of certain terms of the WTO Valuation Agreement which could promote better understanding between customs and traders in the application of the provisions of the Agreement. Some of these terms include:
 - customs value of imported goods
 - sale
 - sold for export to the country of importation
 - activities undertaken by the buyer on his own account
4. Use the Valuation Declaration Form for import declarations.
5. Implement a Valuation Ruling System as a customs valuation procedure.
6. Develop a fully transparent administrative procedure to deal with appeals.
7. Establish a system of release of import goods on guarantee.
8. Adopt risk management principles in national administration of Customs Valuation programs.
9. Develop a price database to be utilised as a risk indicator.
10. Review the penalty provisions in national customs laws to ensure that sanctions

It is evident that the ACVG recommendations are very comprehensive in nature and would provide greater transparency and clarity to the trading community and customs administrations once it is implemented. It would be further enhanced if clear rules and mechanism are made available to importers at an early stage, to enable them to seek and adopt valuation rulings prior to the importation of the goods. This would allow subsequent imports of identical goods made by the importer from the same supplier to be valued in an identical and consistent manner.

While the need of an appeal mechanism has been highlighted in the ACVG, provision should be made for the dispute settlement mechanism to engage the full participation of both the private sector and public sector. The panel or appellate body established to preside over valuation ruling disputes should include representatives from both the private and public sector to ensure that the views and concerns of both the trading community and customs administration are given equal share of voice.

To lift the positive pay-offs to the next level, the individual ASEAN customs administrations could explore the possibility and feasibility of exchanging and recognising rulings between different administrations. The ideal scenario would be to see the creation of an ASEAN customs valuation ruling by the ten different ASEAN customs administration. This idea could possibly be explored and examined through the establishment of an ASEAN Committee on Customs Valuation which could act as a forum for the ASEAN Customs Directors of Valuation.

To provide greater transparency and minimise conflicts and disputes over customs valuation, the valuation rulings by ASEAN customs administrations should be made publicly and readily available to the private sector to facilitate business planning and precedence setting.



Having understood how the new customs valuation create value for both the trading parties, as well as the customs authorities, it is now appropriate to turn our focus to the practical aspects. We can now look at how customs administrations handle the risk of customs valuation while maintaining a pro-trade facilitation stance.

The answer lies in the post-clearance audit process. Let's take a closer look at how it works.

Post-Clearance Audit

Post-clearance audit is one of the important areas of customs development that is rapidly evolving over the last decade. As the role of customs becomes increasingly more focused on facilitating the movement of goods to support an ever-burgeoning volume of international trade, the task of customs control have made a marked shift away from physical clearance at entry points, and new control methods are targeted at the pre-clearance and post-clearance stages. Today, post-clearance audit represents one of the most effective measures for preventing and detecting commercial fraud, particularly valuation fraud. The use of post-clearance audit function will enabled customs administrations to ensure greater compliance with customs laws, regulations, and agreements; to obtain more latitude in the deployment of control resources; to provide greater control in areas such as licensing, quota, dumping, etc and most importantly, to protect revenues collection and minimise leakages.

With the introduction of the WTO/GATT Valuation Agreement, customs administrations will, in most cases, have to accept the value of goods as declared by importers. This necessitates the creation of an effective post-clearance audit system to verify the value and to detect and prevent fraud under the WTO/GATT Valuation Agreement. Once an effective post-clearance audit program is set-up, it can be successfully applied to any valuation system, even for those who have yet to adopt and implement the WTO Valuation Agreement.

Post-clearance audit is primarily carried out to determine whether the customs declarations by the importers were made in compliance with the requirements of customs laws and regulations, and other relevant legislations. It is retrospective in nature, which means the audit examination takes place after the release of the consignments from the entry points. An important element in this process

is the deployment of risk-management techniques to screen and identify companies for audit.

What exactly is Post-Clearance Audit?

Post-clearance audit (PCA) is a process which enables customs officers to verify the accuracy of declarations through the examination of the books, records, business systems and all relevant customs commercial data held by persons/companies directly or indirectly involved in international trade.

This process focuses on those persons who are active in moving merchandise/goods across international borders. Customs administrations which employ post-clearance audit as an extension of the control of the goods find that the process brings about many benefits. It is an effective tool which provides a clearer and more comprehensive picture of the import/export transactions as reflected in the books and records of international traders. When applied to companies who have made consistent customs declarations for a certain length of time, PCA demonstrates remarkable effectiveness as a tool for analysing their historical records.

Recent Developments in ASEAN

As with Customs Valuation, ASEAN has similarly undertaken an ASEAN Strategic Plan of Customs Development in Post-Clearance Audit which aims to harmonise post-clearance audit practices and procedures among the various ASEAN members countries. The objective is to better facilitate trading while maintaining a highly efficient and effective protection of customs revenues from leaking out of the system.

In the sphere of PCA, ASEAN's goal is to share best practises and procedures among the ASEAN customs administrations. The desired outcome would be to elevate the level of sophistication of the various risk management systems deployed. This will then heighten the efficiency and effectiveness of post-clearance audit in preventing and identifying any fraudulent activities.

To reach the ultimate goal of SPCD on post-clearance audit, it is important that the necessary legal and regulatory framework on the implementation and operation of post-clearance audit are effectively implemented. It is pertinent that both customs administrations and private sector stakeholders are aware of the mechanisms of the post-clearance audit

process. In particular, customs administrations need to determine and construct the organisational structure and composition of post-clearance audit teams. Customs administrations need to ascertain that appropriate risk management techniques are deployed to ensure the correct identification of potential auditees.

It is also imperative that the customs administrations have in place a system to facilitate the movement of the physical goods. One obvious area to achieve this would be working to reduce the bottlenecks at on-site physical clearance check-points. Customs administrations need to shift away from relying on physical clearance. Otherwise, that will prove to be a key stumbling block to the progress and development of the post-customs audit.

Greater transparency and cooperation between the customs administrations and private sector stakeholders on the requirements of the post-clearance audit process will pave the way for greater compliance and revenue protection.

It is true that post-clearance audit targets to identify fraudulent practices and violations and to a certain extent, criminal and deliberate negligence. Yet, we should bear in mind that there is no hidden agenda, and post-customs audit is not meant to be an avenue to impose draconian measures or penalise the private sector for unintentional or human mistakes. To emphasize this, customs administrations should make all effort to take a cooperative approach to persons/companies being audited. On the flipside, auditees should also endeavour to be cooperative and provide clear and written consent when required.

Open communication and co-ordination through continuous dialogue with the auditee and other Customs units is critical, from the from the pre-audit planning stage through to audit completion.

Going about It

According to the World Customs Organisation, post-clearance audit places special emphasis on the professional conduct of its review and examination of the importers/exporters books and records. Open communication and co-ordination through continuous dialogue with the auditee and other Customs units is critical, from the pre-audit planning stage through to audit completion. At the end of the audit, a report is produced to ensure that all findings and other issues pertinent to the audit are shared and open for discussion among the vested parties.

The phases of the post-clearance audit are :

Selection Phase

- Auditee profiling
- Risk assessment
- Auditee selection

Auditing Phase

- Pre-Audit Survey
- Initial contact
- Field Audit
- Review and assessment of the audit result
- Final Report

Assessment and Follow-up Phase

- Internal assessment of audit performance
- Follow-up action

New Activities of PCA

Customs administrations would need to put in place a comprehensive organisation structure and identify the operational teams to implement the post-clearance audit process. At the moment, ASEAN has already developed a post-customs audit manual (PCA Manual) to assist the implementation of the post-customs audit process by customs administrations. Currently, the administrations are exploring harmonising the implementation of the PCA Manual by the various customs administrations, by adopting similar interpretations of allowable or questionable documentation or trade flows.

Having a consistent documentation process would ease efforts on the part of the private sector stakeholders. These are especially helpful in instances of third party re-invoicing or off-shore banking and treasury activities. With the consistent set of rules, the private sector

stakeholders are assured that the documentation will be acceptable by all customs administrations, which removes the fear of reprise or running the risk of being penalised.

The credibility of the PCA system would be dependent on the clear and transparent implementation of customs administrations of the PCA system. As such, customs administrations should strive to enhance transparency to reduce friction and disputes over the PCA system.

It is critical for ASEAN customs administrations to manage and reaffirm the private sector that the main strategic objective is not to penalise the private sector for unintentional or human mistakes but to ensure that companies maintain a robust documentation process which is in compliance with customs requirements.

It is important that customs administrations recognise and allow the private sector to voluntarily amend its customs documentations without penalty when the importer found out errors in the declaration even after the submission of the declaration. As the post-clearance audit process has been stressed to be cooperative, companies should be allowed to voluntarily offer information on any errors to customs PCA officials before the commencement of the PCA and amend those errors without facing any penalty.

ASEAN plays a key role in facilitating the sharing of best practices in risk management techniques employed to enhance the efficiency and effectiveness of PCA in identifying fraudulent traders and violators. It is important that post-customs audit teams share and enhance their cooperation both internally among customs units and with other tax/revenue agencies. On a regional basis, customs administrations should enhance and deepen mutual assistance and cooperation in identifying systematic frauds and violations on cross-border trade.

Conclusion

Value is created through Customs Valuation. Post-Clearance Audit acts as a check to manage the risk, in order for Customs Valuation to spread its sails and pick up the winds of trade. Trade volumes have been on the rise. As a region, we should embark on capturing the value in this by working together to put the enhanced Customs Valuation in place. Communication and sharing best practices in the area of Post-Clearance Audit will

streamline and improve the efficiency of the region, bringing in greater revenue streams.

Care should be taken that vested parties take active participation and are given active voices in the discussion process. Ultimately, this journey through Customs Valuation represents a significant value and risk to companies' financial management process, given its direct impact on the bottom-line transaction costs and corporate profile.

Let's set our sights on elevating Customs Valuation to the next level over the next few years, to the benefit of all.

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Human Resource Services – International Assignment Solutions

International Assignments... Impact of non-compliance

Not a single day goes by in our business without companies querying, “What are the consequences of non-payment of taxes?” or “How will anyone know that our employees have come and gone from a particular country?”

Simple and direct questions. But the notion runs deep and the answer is far from simplistic. Do companies understand the consequences of a situation where an employee is restricted from leaving a foreign country due to non-compliance with local regulations? Apart from the monetary consequences that can be addressed, the non-monetary repercussions in the form of adverse publicity are difficult to address and measure.

In a world where employees are constantly moving across borders to solve complex business issues, compliance and risk management are of significant importance. Board members and audit committee members are increasingly focusing their attention towards ensuring full corporate compliance in the countries in which they have a presence. Of late, this also includes a focus on compliance issues with respect to employees. The question now being raised is, "Have we done everything that needs to be done?" However, there will always be companies that continue to question what are the real risks and what is the true value or benefits of full compliance with regulations impacting international assignments.

In the following paragraphs, we have penned some of our thoughts and reasons for why companies should go for full compliance and the value which can be derived from it.

See the benefits beyond the burden

In a world post-Enron, companies have significantly increased their focus on compliance related issues, whether it is employee related compliance issues, or employer related compliance obligations. With companies operating in global markets, employees are constantly 'on the move', giving rise to tax issues in multiple jurisdictions, i.e. taxation of employees in their host countries (the country in which the employee renders services) as well as taxation of employees in their home countries.

It is important that the employer satisfies all its obligations in the home as well as the host country. In respect of employee tax return filing, one can argue that it is the employees' liability to file their own returns and that the company has no obligation to do so. However, the company needs to ensure that the employees have actually filed their tax returns and to some extent, also provide them with support to ensure that the returns are correctly filed on a timely basis. This becomes a 'corporate liability' and playing this role well could minimise the risk exposure of back taxes, penalties and levies.

Additionally, when companies operate in different countries through its employees, the company itself could potentially be exposed to corporate taxes in those countries. It is likely that companies may have create a Permanent Establishment (PE) through their employees in the countries in which they operate. Consequently, these companies may be subject

to corporate taxes within those tax jurisdictions. In such a situation, these companies may be required to file corporate tax returns.

Appropriate tax planning may minimise taxes, but it is cannot be viewed as an escape route from compliance requirements.

Companies are under significant pressure from their Boards and Audit Committees to ensure that they are fully compliant with regulations. Although this may result in additional costs for the companies, the benefits from compliance could be equally significant.

Some key benefits:

- Minimal risk exposure to penalties, back taxes and additional levies which results in indirect savings.
- By ensuring that employees file their tax returns appropriately on a timely basis, and by adopting consistent positions, the organisation is less likely to be exposed to investigations by the Revenue authorities
- Appropriate accounting of employees costs, which are correctly reflected in the financial statements
- Reduced risk that disgruntled or dissatisfied employees go to the Revenue authorities to complain on employee and employer non-compliance
- If companies are 'black listed' by the Revenue authorities for failure to pay taxes, they are also often 'debarred' from bidding for any Government contracts

Employee tracking and Immigration issues

9/11 has brought immigration compliance under the spotlight. Constant security threats clearly point out the need to have a detailed mechanism for tracking employees who are constantly on the move. In the past, companies often used the lack of a robust employee tracking mechanism as a convenient excuse for non-compliance. However, 9/11 seemed to have created a change in people's attitudes. Companies now have strong tracking systems in place which gives them an overview of their employees' locations at any given point of time, so that they can be easily contacted or evacuated at short notice. Immigration authorities in countries have also developed sophisticated means of identifying individuals who move in and out of a country.

From an immigration perspective, it is also critical that employees carry correct travel documents when they are on business travel. Immigration laws in most countries are fairly stringent with detention or travel bans to that country as penalties on recalcitrant travellers. In view of such strict measures, it is critical that companies ensure that its employees are accompanied by appropriate travel documents, whether they are visas, work permits or employment passes. Yet, often companies only look at the tax compliance aspects while addressing international assignment related issues and still overlook the immigration related compliance since appropriate control mechanisms are lacking.

Though it is difficult to attribute a monetary value to compliance from an immigration perspective, the adverse publicity that comes with non-compliance and its related implications can be far reaching.

Human Resource Effectiveness

The value of being compliant can also be seen from a human resource perspective. Being compliant in all countries ensures that a company treats all its employees equally, and that the company does not discriminate between employees or nationalities. These companies are seen to have strong human resource policies and are often viewed as trendsetters. Notably, we see such companies approaching compliance issues in a more consistent manner, through well-defined policies, effective administration and implementation of these policies. This could result in companies capturing tax and cost savings which can be analysed and managed more effectively. In emergencies, companies who are aware of employee movements will be able to better manage and control risks surrounding data management on a real-time basis.

Impact on business

The most significant value of being compliant is clearly visible from a 'Corporate Governance' perspective. A significant lapse of non-compliance casts a shadow on the credibility of the Board of Directors and the Audit Committee. Business associates may question the wisdom of being associated with such companies and whether they are exposing themselves to indirect risks through their contact with such organisations. It is therefore important and beneficial for company boards to proactively ensure that

Though it is difficult to attribute a monetary value to compliance from an immigration perspective, the adverse publicity that comes with non-compliance and its related implications can be far reaching.

compliance issues have been addressed, and that appropriate checks and balances are introduced.

Preparing for tomorrow

A combination of the factors mentioned above and the fact that the immigration authorities, and perhaps the Revenue authorities as well, are aware of employee movements, has led to greater employer awareness of compliance and compliance related issues.

As the world gets smaller through enhanced connectivity and increased information sharing, compliance issues arising through international assignments will be under greater scrutiny. Global companies would have to ensure that they are fully compliant in jurisdictions in which they operate.

Undoubtedly, there is a cost to be incurred to be compliant, but that will be a small price to pay in the long run.

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