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Banking on Productivity

Chu Yeong LIM

Singapore Management University, cylim@smu.edu.sg

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Accounting & Productivity

Answering the big questions



Edited by
Themis Suwardy & Gary Pan

Accounting & Productivity

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Themis Suwardy and Gary Pan

Editors

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a robust business case that clearly documents the vision for the finance function, the rationale for change, the road map for getting there and the financial implications for the business for approval by management.

With the ever challenging business landscape, the most nimble organisations with the best vision and leadership are the most well positioned to excel. Singaporean companies have an advantage because of the active support of the government in driving increased productivity, and the relative stability of our economy. It is important that our local enterprises recognise the sign of changing times and embrace productivity with gusto.

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Chapter 7 Banking on Productivity

Lim Chu Yeong, Singapore Management University

Introduction

Streamlining processes and improving productivity in the accounting function has been identified as the single most important challenge in a survey of the Institute of Management Accountants (IMA) members conducted in 2011. This is despite the majority of members indicating that they have achieved significant long term productivity improvements. Some of the other challenges identified by the interviewees include managing change in a global environment, implementing an enterprise resource planning system and connecting finance to front office. Automation and investing in data analysis/business intelligence tools are some of the tools used by the interviewees to improve productivity (IMA, 2011).

In this article, the same theme of productivity improvement will be followed. Although this article is primarily set in the context of banks, the same principles may be applicable to non-banks. This article is organised as follows: The first section covers the interaction between accounting and other functions. This is followed by discussions on the measurement of productivity and the possible obstacles to higher productivity in banks respectively. Finally, it concludes by suggesting possibilities to enhance productivity.

Interaction between Accounting and Other Functions

Within the accounting function, myriad systems and inconsistent data sources for multiple financial reports are some of the causes of low productivity. The systems and data problems are exacerbated when banks start to merge and become larger. As banks become more complex with multiple entities and special purpose vehicles, all accounting activities become significantly more difficult. In particular, financial consolidation and reporting becomes an increasing challenge.

In addition, rapid changes in businesses, regulations and accounting standards demand a resilient accounting system and process to cope with these changes. There is also a demand for varied data analysis from front office and management. From front office and management, there is an increasing expectation for accountants to play a larger role in supporting businesses and to take the lead in influencing change within the banks.

In order to better support businesses, in many banks, new accounting functions are set up to report to the heads of major business units. For example, the treasury division employs accountants specialised in treasury products and treasury systems. These accountants, alternatively called product controllers serve the dual roles of providing information to the treasury traders for making business decisions and ensuring the proper accounting of treasury activities for financial reporting and regulatory reporting. The product controllers need to analyse the risks together with the profitability of each business and thus interact with the risk management unit on the risk analysis. The product controllers need to interact with their regional/global counterparts and the accountants responsible for financial and regulatory reporting.

As the roles of accountants evolve and they become more involved in business activities, their interactions with other departments increase and these interactions pose new productivity issues. The functions which accountants interact include settlement/operations, IT, legal and compliance, risk management, front office and internal audit. Exhibit 7.1 shows an example of such interactions.

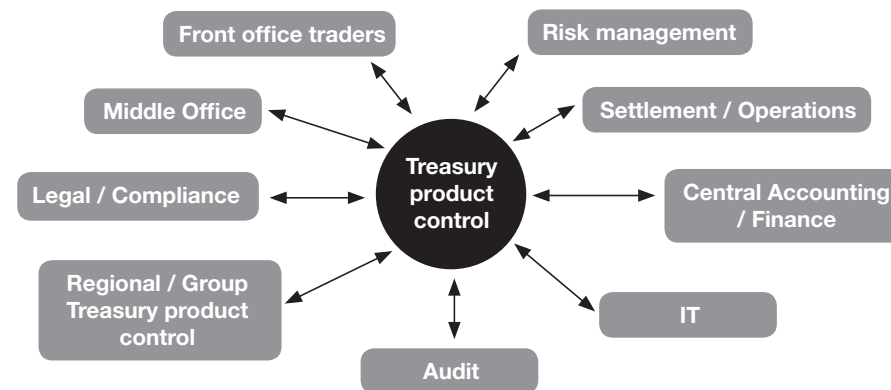


Exhibit 7.1 – Accounting Functions Interfaces

Accounting interfaces with the settlement/operations department. The settlement/operations department is the first “line of defence” to ensure controls over the transactions are in place and positions are reconciled between the front and the back office systems. It also posts any manual accounting entries to the general ledger when systems are not able to generate these entries. A weak settlement/operations department with inexperienced staff is a bane to the accounting function as the latter will be busy cleaning up transaction data errors and trouble-shooting. Conversely, a strong settlement/operations department is half the battle won to a resilient, efficient and most importantly high quality accounting and control process. In many banks, the accounting function also works with the middle office, which carries out reconciliations between front office and back office systems.

The accounting function also interacts with the legal and compliance departments because in many banks, the CFOs are responsible for control and compliance matters which span regulatory issues. Usually, the business unit controllers and compliance department work together to ensure controls over business processes are in place. The accounting function naturally interacts with the internal auditors who audit the accounting and control processes.

The interfaces between the accounting function and other departments demonstrate that productivity of accounting function is affected by the activities in other departments. In particular, accounting is a downstream function. From a supply chain perspective, accounting relies heavily on all other departments for their inputs in order to generate the outputs, such as financial reports to investors and management. The importance of linkages among the parties in the business reporting supply chain has been emphasised in a report based on interviews of key business leaders globally. The report quotes a business leader as saying that the reporting supply chain is only as strong as its weakest link (IFAC, 2011).

The quality of the accounting information and the costs required to generate this information are driven substantially by the quality and the productivity of the IT systems, the settlement/operations functions and crucially the front office functions. If the IT system is poorly-designed and generates a lot of accounting errors, significant resources in the accounting function have to be utilised to 'clean up' the accounting errors.

Measurement of Productivity

The measures of productivity in the accounting function may differ depending on the output of the accounting activity. There are four broad roles of the accounting function. The first role is to meet legal, regulatory and accounting rules. The complexity of financial reports differs across different legal, regulatory and accounting regimes. The productivity of the financial reporting and regulatory reporting functions can be benchmarked against the legal, regulatory and accounting rules that the firm has to meet. A possible reference point may be the costs of the same functions of other banks with similar activities operating in similar countries, which can be obtained by carrying out some market research. The productivity of the financial reporting function can be measured by the costs used to generate the reports benchmarked against the costs of the same functions in other banks. The costs should be weighed against the quality of the financial reports in terms of the accuracy, clarity and amount of information in the reports.

The second role is to ensure that internal controls over all accounting activities are in place. To the extent that many operational, legal and compliance issues have financial impacts, the accounting function is inevitably involved in instituting controls over business operations. The productivity measure could be based on the financial impact of the control issues in terms of additional costs and lost revenues, which should be allocated to the departments which cause the financial losses. The accounting productivity may be measured in terms of the financial losses arising from control issues compared against the costs of the financial control function.

Third, some accounting functions are operational in nature. Examples are payment activities. One productivity measure for the payment function is the dollar cost per payment processed. Improvements in accounting productivity can be measured in terms of cost savings given the same volume of payments.

Fourth, reconciliation activities are typically treated as operational activities. However, the nature of reconciliation is that it is unstructured and entails investigation work. Thus, the productivity measure cannot be based on a standard measure such as the number of reconciliation items per dollar. Rather, it should be treated as a joint fixed cost to be eliminated. Accounting reconciliation is a non-productive activity and reflects inefficiencies in the bank's business processes, operational processes and information systems. The responsibility and cost of reconciliation should be shared among the departments which generate the reconciliation items. The reconciliation function should estimate the time spent attributable to each department and allocate its cost to the respective department. This will incentivise all departments of the bank to work together jointly to eliminate reconciliations.

Fifth, the accounting function such as the management reporting team and the business unit controllers provide management information for business decision making. Productivity can be measured in terms of the cost that it takes to produce a specific piece of information. The cost of such information should be analysed against the benefit of the business decisions to be made. This approach is similar to the model of the IT functions, in which business specifications have to be raised for changes to be made to IT systems

and the costs of changes are estimated based on the specifications. The revenues generated or costs saved attributable to a piece of management accounting information may be quantified and compared against the costs of that accounting information. This measure prevents management accounting information from being treated as a free good.

Admittedly, all productivity measures involve some elements of judgement and subjectivity. They may lead to additional time spent to collect data on the performance measures. However, if the performance measures lead to the right incentives and motivate the relevant departments to reduce accounting process inefficiencies, the improvements in productivity should outweigh the costs. In order to enhance productivity, the accounting function should strive to create sustainable value to businesses while making the present processes more efficient. In the long run, the CFOs should aim to improve efficiency while maintaining controls over the third and the fourth operational roles, invest in the first and the second financial control roles to protect value for the banks and build up its fifth role to create value by providing information for business decision making. This can be achieved by reinvesting efficiency gains from the third and fourth roles into the fifth role (KPMG, 2011).

Obstacles to Raising Productivity

Operational and System Problems

A lot of time is spent by bank accountants to reconcile data generated from different systems and to correct errors in the data. The accounting errors may be created because of operational errors, data input errors, systems not specified correctly for certain conditions and others.

A key cause of operational errors is the lack of experience in the operation staff. One common myth is that all operational work is routine and can be relegated to junior staff. When a bank embarks on cost cutting, operational costs are top of the list even while the bank increases costs by adding the levels of managerial hierarchy and the number of checkers to oversee the operational work. When it comes to outsourcing to low-cost locations, operational activities are the chief target while a ‘skeleton’ team remains in the original location to support the front office.

This mode of operation overlooks the following key points. Operational work requires skilled and experienced staff to execute efficiently and effectively. Operational work forms the engines of a bank that supports the revenue-generating activities. Skilled and experienced staff is especially crucial when the revenue-generating activities create products and transactions that are non-standard and complex, which incidentally yield higher profit margins. The experience and knowledge of the operation staff determines success or failure in the execution of major revenue-generating transactions and the degree of operational errors in downstream financial and regulatory reporting processes.

For example, in one bank, the treasury operations and finance teams that carry out reconciliations between front office treasury systems and back office systems as well as prepare treasury performance reports is originally located in country A with the treasury business. In order to reduce costs, the teams in country A are disbanded and new teams are set up in a low cost country B. A “skeleton” team remains in country A to meet the needs of the treasury traders but the outsourced teams do not report to the traders. The “skeleton” team lacks access to the data for reconciliations and preparation of the reports. The end result is that the teams in the outsourced low cost country B produce very low quality financial reports and reconciliation work. The “skeleton” team struggles to fix errors to the best of its ability but the real problems are never solved. The reconciliation difference increases significantly to millions of dollars and the bank suffers a loss due to the reconciliation difference.

The problem of this model is that the outsourced teams have no incentives to improve their productivity since they neither face the traders nor report to the “skeleton” team. If the “skeleton” team were to remain in country A, it should play the role of advisers but the primary responsibility on the financial reports and reconciliation output should be transferred to the outsourced teams. Instead of muddling through, the actual impact of outsourcing will be known by the front office, which will then push for improvements in the accounting productivity of the outsourced low cost country. If prior to outsourcing, the assessment is that the drop in output quality far outweighs the cost savings, outsourcing should not have been implemented.

Another issue is the creation of additional levels of managerial hierarchy and staff to check on operational work, which only impose additional burden on the few operational staff. There is anecdotal evidence that in some situations, one junior operation staff trouble-shooting has to answer the same queries from six or more different parties. The additional levels of checkers impose a drag on operational work and do not add value. In one example, a key system generates significant erroneous accounting entries. One operation employee works together with an accountant to fix the system issue. The supervisors of each employee and the heads of operations and accounting departments, the internal auditors, the front office department head, the compliance department officer, the external auditors ask the two employees repeatedly for status updates, hence hindering their attempts to solve the problem.

There are banking system issues to note. The banking systems can generally be classified into front end transaction processing systems (including trader systems), middle office and back office settlement systems, general ledger and other financial systems (such as financial data warehouse, regulatory reporting systems). A few examples of situations when the systems are not specified correctly for financial reporting are listed here:

- The accounting configuration of transaction processing systems is not set up to generate correct accounting entries.
- The accounting entries are not posted to the correct legal entities.
- Similar products and transactions are booked and accounted for differently in multiple systems, creating position and profit/loss reconciliation differences.
- The systems do not generate the correct interest accruals for month end, year end and public holidays, especially when the last day or the first day of the month/year falls on a public holiday.
- The functional currency equivalent of foreign currency transactions are not converted correctly by the systems.

System and Process Changes

In the present day, it is a myth to aim for a perfect system or a process that caters to every situation. There are occasions when a bank spends enormous resources and time to come up with a 'perfect' system, which is inflexible and difficult to make changes. As a result, when changes occur, the system cannot meet the new requirements and blame is typically placed on the users for not providing the 'perfect' requirements/specifications. The fact is no user can foretell all possible future changes. There can be unexpected changes in business, products, organisation structure, laws, regulations and accounting rules.

Any inflexibility of information systems, operational and accounting processes to meet the present pace of changes impacts adversely the productivity levels. It leads to temporary workarounds which become permanent processes. Once the temporary workarounds are in place, there are few incentives for front office business heads to push for the optimal institutional system changes. The temporary workaround is vulnerable because there is little institutional documentation and information is lost when individuals leave the bank. In one bank, the financial reporting processes relied heavily on ad-hoc complicated Excel spreadsheets with little documentation. During economic booms, there was a shortage of skilled experienced accountants in the job market and many of the bank's accountants left for better pay. The newly-joined accountants are unable to decode the existing spreadsheets and have to rebuild new processes and new systems from first principles.

Organisational, Power and Politics Dimensions

Productivity in the accounting function can be analysed from the organisational, power and politics perspectives. Firstly, there are always immense pressures from the front office on the accountants to launch products before the information systems, operational and accounting processes are fully in place. Despite the formal new product process in which the accounting and operation departments have to sign off before the launch of new products, in many cases they succumb to the immense pressure from the front office which wields significantly more power than the back office.

A second point is that different information systems may be developed for similar products due to organisational and power structure. Different business units may want to retain their own information systems to retain power and control over the information. This creates multiple system interfaces, which generate significant reconciliation work and errors that in turn lead to more accounting work and a reduction in productivity.

Third, it has become a cliché to claim that anyone who objects to system/process changes is being resistant to change. There are many cases when new-joiners institute system and process changes without understanding the legacy systems and the institutional background. These new-joiners want to prove themselves in a 'big-bang' approach and merely copy the systems/processes in the banks they come from without understanding the business and regulatory context, the existing systems and processes and the organisational structure of the bank they are joining. They adopt a 'quick-win' approach to gain recognition with little regard for the long term sustainability of the business processes. In one bank, the newly joined CFO implemented the same vendor system as the one used by her old company. Without understanding the local legacy systems of the bank and how the new vendor system would integrate with the legacy systems, the CFO simply asked the vendor to replicate the accounting configuration in her old company for implementation in the bank. This approach created significant system integration issues and costs later.

Finally, there should be a balance between retaining institutional knowledge and injecting fresh ideas. The right attitudes towards improving productivity must start from the top: business heads, settlement/operation heads, CFOs, IT department heads and so on. The senior managers need to set the right tone at the top, and genuinely set out to improve long term productivity while meeting business needs without settling into power and political games.

Approaches to Raising Productivity

Eliminate Redundant System Interfaces and Reconciliations

The basic principles to achieve higher productivity are to minimise the number of systems and the number of downstream checks. The ideal state is to move towards global systems and for most data integrity checks to be performed upstream. The objective is to reduce the number of system interfaces and hence the number of data reconciliations. One approach commonly employed is straight through processing (STP), in which the front end position monitoring, back end settlement/processing, risk management and accounting are contained in a single system for the same product and for the same transaction. In order to reduce the number of systems, similar products should be booked in the same system. This avoids the situation when different business units book the same product in different systems, which may revalue the product and generate accounting entries differently. When system interfaces are inevitable because individual systems have limitations in handling certain products or functions, the systems should carry out transaction reconciliations daily. For multiple currency ledgers, the local currency equivalents and foreign currency conversion rates should be reconciled between the general ledger and the front office transaction processing systems to ensure that the foreign exchange profits/losses are reconciled between systems.

Flexibility of Systems to Meet Changes

Another common information system issue to consider is whether to use end user computing tools such as Excel spreadsheets or institutional mainframe systems. Many controllers keep Excel spreadsheets for the flexibility to respond to business requirements. This only reflects the rigidity of the institutional mainframe system and its inability to cater to business requirements. Controllers are under pressure to meet the needs of businesses, yet the information systems cannot respond to the business needs. This is a responsibility and accountability issue as the onus should fall on the IT system heads to explain to business heads their inability to respond to business requirements. The number of temporary workarounds should be minimised because only a few people have detailed knowledge of these spreadsheets, making the systems and processes vulnerable to staff movements. Usually

such workarounds become permanent and there are few incentives for business heads and IT heads to work on the permanent system solutions since the 'temporary' workarounds serve the business needs. In the process of new product development, it is crucial that the systems, operational and accounting processes are fully in place before the launch of new products.

The flexibility of systems to meet possible business and regulatory changes is the key to long term productivity. This system flexibility should not be in the form of end-user computing but should be built into mainframe IT systems to ensure continuity. Documentation of institutional systems is critical as there have been situations when accountants build their spreadsheets because there is a lack of knowledge on the institutional systems and these institutional systems cannot respond quickly enough to business and regulatory needs.

Flexible accounting systems and processes provide the foundation for the bank accounting functions to move up the value-chain. The accounting functions need to be able to meet the financial reporting and transactional processing needs arising from new products, new organisation structure, new accounting rules and regulations quickly before business managers would entrust them with the value-added business partnership roles.

Management Accounting Information

The management accountants and business unit controllers need to have deep understanding of the banks' business strategies in order to build the delivery of accounting information around the desired output (KPMG, 2011). For example, if a bank aims to build its fixed income business, the accountants need to understand the fixed income products and plan the potential changes to the accounting processes and systems. Some accounting information relevant to the business managers include the funding and transfer pricing policies, the accounting methodologies such as fair value hedging versus cash flow hedging and the valuation methodologies.

In terms of the information systems, the general ledger may produce management reports at a consolidated group level but a financial data warehouse may still be required for the flexibility to provide diverse analytical information to business managers. The financial data warehouse can contain

detailed data from transaction processing system such as yield rate, spread, transaction date, maturity date and internal transfer rate between fund collection and fund deployment units. The management accountants and business unit controllers may require data outside the data warehouse, in which case they should strive to obtain such data from the source system. This is because the data in the source systems are richer and more accurate, on the basis that any errors are corrected at source and no data 'cleaning' takes place downstream. The accountants also need tools to perform their control and analysis roles. For instance, the systems should provide reports for the accountants to perform checks on the rates and positions. The accountants can specify the conditions which they would like to check. Examples include trades which give exceptional profits and losses and trades which are inputted in systems with off-market rates.

Model of Accounting Function

The accounting function should aim to reduce the transactional processes and move towards more strategic business partnership roles. In order to achieve this, the accountants need to have a good understanding of the business, systems and processes of the bank. The leading-edge accounting functions effectively take charge of the financial control of the bank and lead the bank-wide system and operational process changes to meet the business requirements.

One way to achieve efficiency is to merge the management accounting and financial accounting functions. This is possible when management accounting earnings and balance sheet aggregate to the numbers in financial reports. The implication is that shadow accounting and multiple income accounting should be abolished. Revenues recorded in financial reports should be allocated between the departments which generate the revenues using a transfer pricing mechanism.

Next, the costs and benefits of accounting activities should be analysed. The accounting function can adopt the same approach as the IT departments in costing its activities. The accounting function may require that any request for an additional piece of accounting information be tracked. If a business head requests for a new accounting report, he or she should specify the

requirements, which will be logged. This will better track the accounting costs incurred to meet business needs. For the common accounting costs incurred in general ledger reporting and regulatory reporting, an estimate of the proportion of costs attributable to business lines can be made so that each business line and product bears the full accounting cost. A full allocation of accounting costs to business lines and products will lead to a more accurate profitability measurement of each business line and product.

Finally, the bank may reassess the performance evaluation process of business managers and CFOs. While CFOs take on greater business partnership responsibilities, business managers should be assessed by CFOs, risk management heads, heads of operations, compliance managers and internal auditors on the levels of business controls. Controls need to be present from the front office to the back office processes. Trader input errors in transaction processing systems create a lot of work downstream and are control issues. Operational costs attributable to trader errors should be charged to the traders' business units.

In many major banks, the pass/failure of an internal audit has an effect on the performance assessment and bonuses of the business heads. Still, an internal audit takes place once every few years, which reduces the motivation for business heads to consider controls seriously until an internal audit occurs. Many business heads and even senior product controllers continue to hold the attitude that the front office is only responsible for generating revenues and the responsibility for controls fall solely on accountants. Their argument is that without the front-line people generating revenues, the firm will not exist. However, a counter-argument is that a firm that is out of control will also not survive for long – look at the banks that suffer significant losses due to liquidity issue, counterparty/credit risk (failures of major borrowers), trader frauds, accounting irregularities and so on. Eventually firms need both short term earnings and long term business control to survive. Business managers need to partner CFOs and play a greater role in financial and business controls.

Conclusion

Although the approaches laid out appear to be common logic, yet in the midst of the fast-paced environment in which bank accountants work, many are barely staying on top of meeting the reporting and business needs, not to mention going through these changes. There are power and politics issues to contend with. It takes strong leadership not just in the accounting function but at the CEO and bank-wide level to set the right tone at the top and to see that controls are instituted from the front office to the back office, in the same way that risk management is part of banking business. Resources should be channelled to the right places instead of having additional layers of checks and systems, which create more reconciliation work. If the transaction processing system is not able to capture the right data or the traders input their trades incorrectly, this problem should be corrected at source. At present, resources are usually channelled to hire senior people at high cost to check the errors and to serve as reporters to report to senior management what has happened or to set up a separate process/system to 'clean' the data. They are not directly involved in problem solving and create more reconciliation work. Because of the additional costs incurred to hire the reporters or to set up new systems and processes, further cuts have to be made to the operation staff, leading to more errors and control problems. This article discussed only a few examples of the obstacles to raising productivity. It also discussed a few pathways to improve productivity. The applicability of the examples depends on the context of individual banks and departments. Nonetheless, this article would have achieved its objective if it led to heightened awareness and consideration of some of the productivity issues involved in the accounting function at banks and steps being taken to address these issues.

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About the Editors and Authors

Editors



Associate Professor **Themis Suwardy** (*F CPA Aust.*) is the Associate Dean (Curriculum and Teaching) and Master of Professional Accounting programme director at SMU School of Accountancy. He has been awarded numerous teaching awards, including the inaugural recipient of the international CEEMAN's Champion Award for Teaching in 2010. His textbook, *Financial Accounting: IFRS* (co-authored with Harrison, Horngren and Thomas, published by Pearson Education), is a global edition used in many institutions around the world. Themis is currently Deputy President – Singapore, CPA Australia and Vice-President (Membership) of the International Association for Accounting Education and Research.



Associate Professor **Gary Pan** (*F CPA Aust.*) is the Associate Dean (Student Matters) at School of Accountancy, Singapore Management University. Gary was awarded Most Outstanding Teacher, Master of Professional Accounting Teaching Award in 2010; School of Accountancy Most Promising Researcher Award in 2009 and Best Paper (*Honourable Mention*), *Journal of Strategic Information Systems* in 2009. His research and teaching focus on areas of accounting information systems, strategic implementation of IT systems and corporate governance. Gary is a member of CPA Australia, ICPAS and ICMA. He is also Associate Editor for *Journal of Information & Management*.

Contributing Authors

Elaine Chong, Co-Founder, Institute of Business Analytics

Andrew Lee, Associate Professor (Practice), SMU School of Accountancy

Lim Chu Yeong, Senior Lecturer, SMU School of Accountancy

Irving Low, Head of Risk Consulting, KPMG Singapore

Gary Pan, Associate Professor (Education), SMU School of Accountancy

R. Raghunathan, Partner, Business Consulting, PricewaterhouseCoopers LLP

Seow Poh Sun, Assistant Professor (Education), SMU School of Accountancy

Themis Suwardy, Associate Professor (Practice), SMU School of Accountancy

Richard Tan, Partner, Risk Consulting, KPMG Singapore

KK Tang, Co-Founder, Institute of Business Analytics

Melvin Yong, General Manager – Singapore, CPA Australia

Tracey Zhang, Assistant Professor (Education), SMU School of Accountancy

Interviewees

Chow Kam Wing, Executive Director and CFO, Micro-Mechanics Holdings

Kon Yin Tong, Managing Partner, Foo Kon Tan Grant Thornton

Sim S. Lim, Country Manager, DBS Singapore

Tham Sai Choy, Managing Partner, KPMG Singapore

Kenny Yap, Executive Chairman and Managing Director, Qian Hu Corporation

Philip Yuen, Chief Executive Officer, Deloitte Singapore

SMU School of Accountancy

60 Stamford Road
Singapore 178900

+65 6828 0632
accountancy@smu.edu.sg

CPA Australia

1 Raffles Place
#31-01 One Raffles Place
Singapore 048616

+65 6671 6500
sg@cpaustralia.com.au



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