Page 9 13/07/09 01 01lr1307LAW straussv 08:00:47 AM 13/07/09

Procuring a method to erase fraud

Employers less likely to blow the whistle and lose their jobs in the face of recession

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THERE is no doubt that as economic conditions worsen and we enter a recession, fraud, theft and corruption will increase. Many people used to a certain lifestyle have had to compromise and it's been a bitter pill to swallow.

We are also aware of the positive business opportunities the 2010 World Cup represents. Our major centres are undergoing extensive facelifts to accommodate thousands of soccer fans.

Procurement fraud is defined as the intentional misrepresentation of facts in the procurement process designed to deceive, allowing an individual or entity to gain an unfair advantage over other potential vendors. The playing fields are disturbed and any sense of equal and open opportunity is lost.

Unfortunately, this procurement function is far more exposed to the risks of fraud when compared to other core business activities. Procurement is a way in which business and government allocate spend and in many large projects this expenditure is governed by a fixed, non-negotiable timeline. The pressures to evaluate, adjudicate and recommend appropriate vendors increases as the time drawing nearer to an expected event decreases.

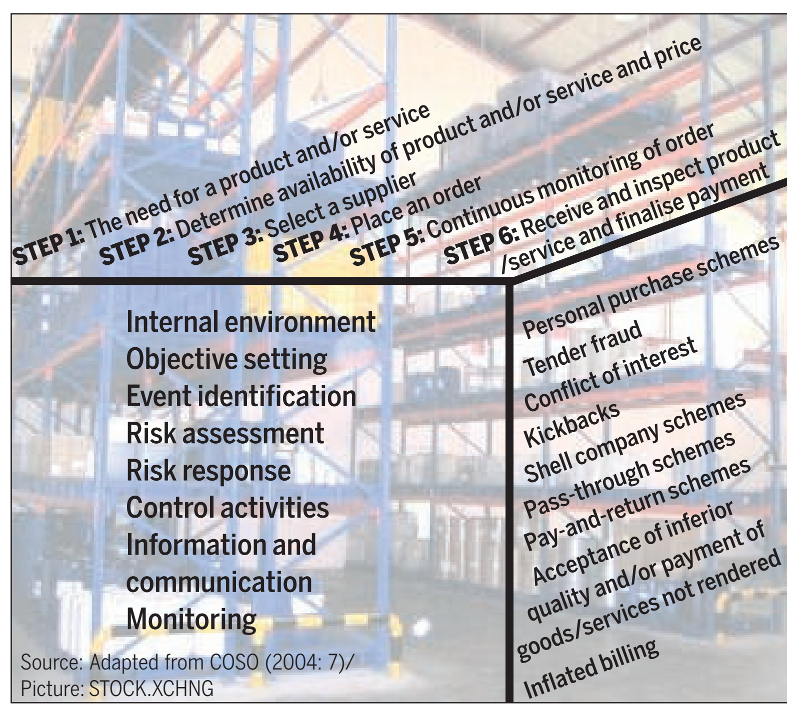
Added to this are unexpected delays which place greater strain on line functions to deliver and increased pressure on procurement departments to make decisions. Wage negotiations, union disruptions and site health and safety issues are examples of events that would dramatically decrease the ability of any project team to deliver within fixed time constraints. It is under such conditions controls and governance functions implemented risk being circumvented and overridden.

An additional driver to this is the remuneration structure contractors and project team members operate under. Incentives geared solely on the timely completion of a project can result in a certain management style that contradicts the role of effective procurement risk management.

Management can exert unnecessary pressure to deliver a product often at the ultimate expense of the project. Intimidation and kickbacks can easily become the modus operandi in the face of such pressure. Such tactics unfortunately have a greater chance of succeeding when employed by those in positions of power and influence.

The risk for employees challenging such decisions is they potentially jeopardise their career prospects. These dangers make whistleblowing less appealing. Any ethical concerns an employee has against such behaviour will come under severe scrutiny in the light of a global economic crisis that has resulted in huge corporate restructures and ongoing retrenchments.

As a result, we return to our procurement fraud risk model and how it can assist us in the detection and prevention of such behaviour. The simplified fraud risk matrix at left provides some practical components that can help successfully identify procurement fraud risk before it's too late.



Source: Adapted from COSO (2004: 7)/
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> Procurement function is far more exposed to the risks of fraud when compared to other core business activities

The matrix differentiates between the eight components of enterprise risk management, six steps proposed as part of a procurement process and nine types of resulting procurement fraud that could be identified.

The responsibility rests with executive management to communicate this risk management philosophy throughout the company. A risk culture that is understood, well communicated and adopted by all those who form part of this process is critical. The procurement manager can then ensure this culture is aligned with that of the organisation.

Questionable business ethics and misguided decisions compromise our ability to deliver and damage our reputation on a global standing. With the spotlight on SA there has never been a greater need for corporate governance and personal integrity than now.

DUES DATE

Putting a price on derivatives and underlying income

Ferdie Schneider

The tax and VAT effects of income derived from derivatives mainly revolve around three issues

THE South African Value-Added Tax (VAT) system generally exempts financial services and disallows directly related input tax deductions.

The VAT treatment of derivatives usually follows the exemption route. Derivatives are often difficult to account for or understand which could potentially complicate their VAT treatment. The tax and VAT effects of income derived from derivatives broadly revolve around three issues, namely the nature and amount of the income (fee income, exempt income, or income not relating to a supply); the timing of the income; and the source of the income (domestic or foreign).

A derivative is a financial instrument created by a contract or agreement between two contracting parties which mandates that the risks and rewards of the contract depends on the fluctuations in the price of the underlying assets. Derivatives allows the investor more flexibility than the underlying asset since no principal amount is necessary and settlement entails settling the margin profit or loss on a notional principal amount.

Historically shares, bonds, commodities, currencies, interest rates, exchange rates and market indices have been the most used underlying assets from which derivates were derived. Markets have to such an extent diversified that underlying assets from which derivates now emanate include various new asset classes such as economic indicators and even weather conditions.

The new class derivatives also include credit derivatives — where the derivative contract price is determined with reference to the credit risk of an underlying asset. Credit risk is the risk of a counterparty being unable to meet its payment obligations. The credit derivative allows for the active trading of the credit risk. A credit derivative is distinguishable from a contract of insurance as the contract requires an insurable interest or asset; and a loss being suffered for the insurer to meet his obligations.

In SA the buying or selling of derivatives is deemed to be financial services and exempt for VAT purposes. The VAT Act peculiarly refrains from its usual reference to "...issue...or transfer of ownership" in relation to and exempting income derived from derivatives. The initial issue or creation of a derivative whereby ownership passes would presumably have to be read into the "selling of any derivative".

In contrast to many foreign VAT jurisdictions which do not specifically, and in law, deal with the underlying goods or services, SA deems the supply of the underlying goods or services to be a separate supply (from the supply of the derivative) at open market value.

This provision also deems the open market value of the underlying goods or services not to be consideration for the derivative. The implications of these deeming provisions are twofold, namely that the split of the derivative and the underlying could result in an exempt and taxable supply or two exempt supplies. The second implication is that the derivative has a value separate from the underlying.

The VAT treatment of derivatives largely follows the general accounting treatment. Derivatives, for VAT purposes, rely on the definition contained in International Accounting Standard (IAS) 39 or AC133 of generally accepted accounting practice. IAS 39 defines a derivative as a financial instrument or other contract with three characteristics:

(1) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract;
(2) It requires no or little initial net investment or an initial net investment smaller than would be required for other types of contracts that would be expected to respond similarly to market factor changes; and
(3) It is settled at a future date.

Single stock futures (ssfs) and contracts for differences (cfds) both fall within the definition of a derivative as their values change in response to an underlying instrument, they require little or no initial net investment and are settled at a future date.

Derivatives can have alternative VAT treatments: outside the scope of VAT; zero-rated; or standard rated.

The buying or selling of a derivative could potentially be outside the scope of VAT, for example, where it is done by a person who is not a resident of SA and does not have an enterprise for South African VAT purposes. Where a foreigner sells a derivative to a South African, the supply would comprise imported services for VAT purposes on which the South African would have to self-assess had it not been for a specific non-taxing provision.

The buying of a derivative by a South African-registered VAT vendor from a person who is not resident of SA and not a vendor may arguably constitute the supply of a financial service by the buyer to foreign seller which is subject to the zero rated.

Where a South African-registered VAT vendor sells a derivative to a person who is not resident in SA it would constitute a supply of financial services which could potentially be subject to VAT at the zero rate.

Where the buyer or seller of a derivative is not the same person as the issuer but acts as agent it is arguable the fee income derived by the agent for facilitating the deal with a third party does not constitute exempt income but is subject to VAT at the standard rate.

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