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PROFESSIONAL ACCOUNTANT

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DUE DILIGENCE FOR SMALL BUSINESS

THE CHALLENGES OF A FAMILY BUSINESS

THE VITAL ROLE OF THE PUBLIC OFFICER

THE BUSINESS MODEL AND DUE DILIGENCE

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CONTENTS

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A WORD FROM SAIPA

CHANGE YOUR FOCUS, SECURE YOUR FUTURE

Many career paths have changed due to major shifts in macroeconomic, social and technological forces influencing customer expectations over the last decade. The result is a blurring of boundaries between professions, an overlap in areas of service delivery and clients that expect a one-stop-shop rather than a specialised niche offering.

While the natural initial reaction is to conserve what is and protect what was, South African Institute of Professional Accountants (SAIPA) members will do well to view these changes in demand not as threats, but as opportunities to be embraced and explored.

People tend to buy products and services that offer a combination of value and exclusivity; the time of procuring services based purely on technical prowess is long gone.

The more advice you can provide on areas that traditionally fall outside of the accounting scope, the more valuable you will become to your clients. Once you are seen as an integral part of their strategic decision-making processes, replacing your services with a simple piece of technology won't even cross your clients' minds.

In this edition we touch on a few topics with which every SAIPA member should become familiar, to the point of the issues becoming part of regular conversations with clients and employers:

- SME owners are usually not experts in practising due diligence. This is, however, one area that is extremely important to get right as it poses significant risks to the sustainability of a business when not thoroughly completed.
- Do you know how to advise your clients on dealing with organic growth? Many business owners are completely unaware of the risks involved with growing either too slowly or too fast. Your clients will appreciate you being able to advise them on the correct pace of business growth

Mulligay Pillay – Marketing | Managing Editor

- While being creative and innovative with tax laws and accounting standards is not something we advise SAIPA members to ever undertake, we strongly advise making significant efforts in being innovative in the way you provide client service. Technology makes it possible to provide real-time status updates and become a go-to resource for business advice needs. There are many opportunities to create more value for clients.

The end of the year is a good time to reflect on the total experience you are offering your clients or employer. Do they see and use you as a business advisor yet, and if not, what will you do in the new year to make yourself an indispensable, valuable and wanted part of their business?

Mulligay Pillay - Managing Editor

Publisher
Richard Lendrum

Editorial Board
Debbie Bassa - *Editorial Coordinator*
(debbie@thefuture.co.za)
Mulligay Pillay - *Managing Editor*
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Education, Training and Membership Executive
Rashied Small

Design & Layout
Prosperity Refiloe Dlamini
Production
Mabel Ramofoko

Advertising Sales
Debbie Bassa
(debbie@thefuture.co.za)

Reproduction and Printing
Typo Colour Printing Specialists

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PO Box 3355, Rivonia,
2128, South Africa

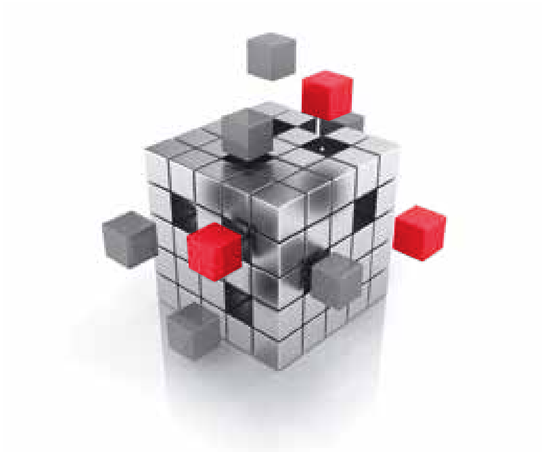
Delivery & Courier
4 Biermann Avenue Rosebank, 2196
Tel: +27 11 280 3000
Fax: +27 (86) 509-2666

SAIPA YOUR WEALTH™ Media

SAIPA National Office
SAIPA House, Howick Close,
Waterfall Park,
Vorna Valley, Midrand
PO Box 2407,
Halfway House, 1685
Tel: 08611 (SAIPA) 72472
www.saipa.co.za

SAIPA'S PROJECT ACHIEVER

Rashied Small and Faith Ngwenya



The South African Institute of Professional Accountants (SAIPA) has been awarded funding of R5.7 million to develop the capacity of the potential and aspiring professional accountant (SA), with the primary objective of making a positive impact on transformation in the accountancy profession.

The project targets black African candidates who are preparing to write the Professional Evaluation (PE) examination, which is the final competency evaluations hurdle on the pathway to becoming a professional in the accountancy industry. The objective of the project is to assist 480 candidates to successfully complete the PE examination and take up full membership as a professional accountant (SA) over a period of 20 months (from September 2015 to May 2017).

Although the project is driven to assist candidates to complete the PE examination successfully, it also aims to enhance the development of the capacity and competence of the professional accountant (SA). This is to meet the increasing standards and demands on their services in the accountancy profession and the economy of the country. To do this, the delivery of the programme is embedded in two fundamental principles, viz (i) student-centred learning, where the focus is on the development of the candidates rather than the transference of technical knowledge, and (ii) competency-based education, where the focus is on developing technical knowledge competence, practical and skills competence, attributes (professional conduct and ethics) and soft skills (communication, critical reading, report-writing and group work).

The project is executed using the 'workshop methodology' based on themes rather than subjects and topics, which integrates the three competencies (knowledge, skills and attributes) throughout the teaching and learning process, building on the principle of 'think-write-pair-share'. The project implementation plan involves:

- **Preparatory work:** The candidates are provided with material that they should use as a basis for preparing for the sessions and provide a basis for the technical knowledge component.
- **Session presentation:** The trained facilitators present the body of knowledge (BOK), which is limited to 15% (maximum of an hour) of the daily sessions (08:30 – 16:00). This is a high level overview of the content matter.
- **Group activities:** Candidates are divided into groups consisting of six to eight members, who actively engage in discussions, developing solutions to activities that are designed to integrate the application of technical knowledge to business scenarios within a defined business context. The focus is on the process of developing a solution rather than the solution itself. The facilitators monitor and assist groups during the discussions by prompting and guiding the discussions.
- **Feedback:** Each group provides feedback or their solution to the workshop members on (i) an interpretation of the business situation – key issues, (ii) the process of developing a solution – strategy, and (iii) the proposed solution. The group also responds to questions raised on their presentation.
- **Summary:** On completion of each activity, the facilitators provide a summary of the objectives of each activity.
- **Mentoring:** Candidates are allocated to facilitators to be mentored throughout the program to ensure engagement and participation in the sessions and to monitor the development and progress of the candidates.

Conclusion

The award of this tender was welcomed by SAIPA. The organisation is positive that the value added by the project will result in practitioners who are independent thinkers and have good business acumen.

DUE DILIGENCE FOR SMALL BUSINESSES

Donovan Jackson

For many small to medium-sized enterprise (SME) owners, the term 'due diligence' means very little until the company is readied for sale. However, when it is approached as an ongoing exercise in terms of which of the organisation's directors maintain the organisation, its records and stance with the tax authorities in a disciplined manner, it can contribute to a better run business which is also more attractive for merger or acquisition.

Due diligence is defined as an investigation of a business or person prior to signing a contract, or an act, with a certain standard of care. More generally, it refers to the care a reasonable person should take before entering into an agreement or a transaction with another party.

Haydn von Maltitz, associate director at BDO South Africa, says that the average SME owner tends to believe that due diligence is something to be performed only when they plan to sell their business to a larger trade player or private equity investor. "This type of due diligence is performed by the investor on a business that they intend to acquire - but there many other types."

Professional Accountants can be called upon by their clients to either perform or assist in the performance of due diligence exercises, he says. "Professional Accountants can assist SMEs to understand the role and importance of due diligence in their businesses and specifically on the owner's planned exit of the business. The Professional Accountant can also assist SMEs to put in place robust internal financial reporting systems and policies to ensure that (when necessary) due diligence procedures are not a major drain on management's time."

Von Maltitz points out that Professional Accountants need to assist clients to adhere to all regulatory, legislative and taxation requirements for their particular industry - ongoing work that supports due diligence exercises as and when those may be necessary. "In addition, they can assist SMEs with setting up a risk register in order to identify and manage on an ongoing basis the risks facing the business."

When is due diligence necessary?

Shashi Hansjee, chief executive officer at software development firm Entelect, says that as a "fairly risk averse organisation", the company invokes a due diligence process of understanding possible risks and scenario planning or forecasting only in two cases. "The first is if there are company-wide changes such as purchasing of new office space, or changes to pay structures across the staff base. The second is if there are decisions to be made which fall outside of our risk appetite, but are still to be considered due to strategic reasons – such as selling off divisions, or if investment is required for starting new divisions."

While due diligence processes form part of the company's risk management approach, he notes that it is performed on an ad hoc basis as part of the risk management approach.

At Coolcumba Communications, director Debbie Whittaker advises building due diligence into the company DNA as a matter of operational practice. "When starting up an SME there are a number of areas where due diligence is advantageous. Start off with your staff; a lot of SMEs take CVs or the recruitment agency's word for things. Rather do the checks yourself, meet the potential candidates face to face, and get a 'feel' for them. "Look at your suppliers. Meet them face to face, if you can, and work to build a trusted network of reliable people who will deliver on time and in budget. And do due diligence on your clients, too. There is a tendency of SMEs to be enthusiastic and hungry for business, which can mean getting taken advantage of. Unless you have long-standing relationships with clients, do your due diligence and be very wary."

However, von Maltitz says most SMEs don't take a comprehensive approach to due diligence and, even worse, despite often only thinking of due diligence in the context of an exit, many SMEs are ill prepared for it. That is owing, at least in part, to the owners very seldom performing ongoing due diligence procedures on their own businesses or on clients.

It is in these companies that the Professional Accountant can play a crucial role, bringing due diligence to the attention of business owners and providing supporting services as appropriate and as required.

"That being said, there are many very well run SMEs in South Africa that regularly and effectively monitor and manage risk," von Maltitz adds.

Due diligence as risk management

Whittaker and Hansjee agree that due diligence can be implemented in its wider sense as a component of effective risk management strategies. However, for many SMEs, risk management isn't a formal discipline, but tends to be exercised on the basis of nothing more than gut feel.

He notes that risk management, which should be a component of management's obligations, doesn't have to be onerous – but that depends on how well it is understood within the business. "Our board has a stable understanding of where our risk appetite is at this point, and it hasn't really changed over the past five years. However, we review it on an annual basis, looking at things like the spread of revenue and market, potential loss of certain clients and key-man dependencies. When larger decisions are taken, if they fall outside of our general risk appetite and tolerance levels, we perform a more in-depth review of the effects such a decision will cause."

Hansjee points to the invaluable role played by the Professional Accountant in risk management. "In our case, higher-level strategic decisions are made by the board with input from, in our case, our general manager: finance. We run scenarios by her, and she performs due diligence from the perspective of financial and legislative factors, which can include potential loss of revenue, tax implications and implications from a labour law perspective."

Certainly, Hansjee stresses, due diligence and risk management is an important component of the finance office's function and responsibilities.

The views of the business owners are backed by von Maltitz. "Due diligence investigations are very important for managing risk," he agrees. He reinforces Whittaker's and Hansjee's positions. "These investigations may be appropriate when a business takes on a new major supplier (supplier due diligence), when it obtains a major contract with a new client (client due diligence), applies for finance (financial due diligence), or seeks to grow operations through merger and acquisitions (financial, tax, legal and commercial due diligence)."

Don't fear due diligence

Whittaker puts her finger on the crux of due diligence for the SME (it is also where the Professional Accountant plays, arguably, the most valuable role in supporting the practice). "Financials are key. [As an SME owner] you need to ensure you have done your due diligence on your accountant and financial advisors, who should assist you when it comes to staying in SARS' good books."

She therefore stresses that Professional Accountants themselves should be the subject of a due diligence exercise. "Especially do due diligence on your accountant. Too many businesses assume the accountant is paying their tax, but he has not and they go under when SARS comes looking for several years' worth of payment."

Hansjee says the major advantage of ongoing due diligence is risk mitigation, but points to a potential downside, too. "It can often impact the agility of decision-making that SMEs often enjoy. That is why setting and communicating the company's risk appetite and tolerance levels to the management team is key to ensuring full due diligence is only performed when outside those boundaries."

Von Maltitiz says that many SME owners can find the process of a due diligence exercise stressful for a number of reasons, which can include the absence of appropriate internal financial reporting, approaches to taxation which may not be in line with the practices of the larger company looking for an acquisition and lack of support from high level management "who may view the process as a witch hunt of sorts".

However, he adds that the fruit of due diligence as an ongoing practice is that it can be a useful management tool to monitor and manage risk on an ongoing basis. "It also delivers increased business confidence in respect of the action to be taken and, potentially, a higher sales price in the case of an exit."

Due diligence checklist

While the risks faced by one business may differ from another, there are common areas against which most companies should be vigilant (or be provided with by their Professional Accountant). They include:

- Reputational risks.
- Key-man dependency.
- Human risks (errors, labour disputes, sabotage by rogue employees).
- Technology risks (disruption as well as dependency on unreliable technology or hackers).
- Physical risks (fire, theft, natural disaster).
- Financial risks (credit, taxation, foreign exchange, commodity).
- Regulatory and legal risk.

THE BUSINESS MODEL AND DUE DILIGENCE

Rashied Small, Lucinda Smidt and Achmat Joseph

A business model outlines all the core inter-related architectural, co-operational and financial arrangements designed and developed to pursue the strategic goals and objectives of the organisation. A business model indicates the value proposition for its customers, products and/or services, value architecture and activities to deliver the value proposition, value finance required to sustain the value creation activities and value network within and outside of the organisation. The business model therefore describes the rationale of how an organisation creates, delivers and captures value in economic, social, cultural or other contexts within its corporate governance and risk management framework.

A business model is encapsulated in four main dimensions:

Value proposition: The business model should include a description of the products/services the organisation offers or will offer to the defined target market, along with the value elements incorporated within the offering.
Value architecture: Portrays the concept as a holistic structural design of an organisation, including its technological architecture, operational processes and organisational infrastructure.
Value network: Depicts the cross-company or inter-organisation perspective towards the concept of value creation and risk management.
Value finance: Depicts information related to costing, pricing methods and revenue structure of the organisation.

Value creation for customers and investors/shareholders is the primary aim of any business entity. The traditional financial perspective views value creations as a situation when a business earns revenue (or a return on capital) that exceeds expenses (or the cost of capital). Value creation in a broader context in modern business environments is increasingly represented by the intangible drivers like innovation, people, ideas and brand. When broadly defined, value creation is increasingly being recognised as a better management goal than strict financial measures of performance, many of which tend to place cost-cutting, which produces short-term results, ahead of investments, which enhance long-term competitiveness and growth.

"If you put value creation first in the right way, your managers will know where and how to grow, they will deploy capital better than your competitors and they will develop more talent than your competition," Ken Favaro explained in Marakon Commentary. "This will give you an enormous advantage in building your company's ability to achieve profitable and long-lasting growth."

The first step in achieving an organisation-wide focus on value creation is to understand the sources and drivers of value creation within the industry, company and marketplace. Understanding what creates value will help managers focus capital and talent on the most profitable opportunities for growth.

"If customers value innovation and high performance, then the skills, systems and processes that create new products and services with superior functionality take on high value."

According to Robert S Kaplan and David P Norton, authors of Strategy Maps: *Converting Intangible Assets into Tangible Outcomes*, the following are considered to be the intangible factors that drive value creation: technology, innovation, intellectual property, alliances, management capabilities, employee relations, customer relations, community relations and brand value.

Due diligence may be defined as a legal or voluntary investigation or process through which a potential acquirer evaluates a target business prior to signing an acquisition contract. Due diligence is important because it provides a company with insight into what it is purchasing. The primary purposes of conduct a due diligence holds is that it contributes significantly to informed decision-making by enhancing the amount and quality of information available to decision-makers and by ensuring that this information is systematically used to deliberate in a reflexive manner on the decision at hand and all its costs, benefits and risks.

The objectives of merger and acquisition (M&A) due diligence vary depending upon (i) whether a party is the buyer or the seller; (ii) the buyer's business purpose for the transaction (i.e., does the buyer plan to integrate operations following the closing, or will it strip down the seller's operations to assets); and (iii) the proposed deal terms, including the type of consideration that the seller would receive. For the buyer or seller, if the transaction contemplates a stock-for-stock exchange, the objectives of due diligence may include the following:

- Accumulating sufficient information to validate the proposed valuation and to justify the business reasons for consummating the deal;
- Learning more about the seller's business and operations and collecting information that may be critical to operating the seller's business post-transaction or extracting institutional knowledge seeded in the seller's personnel that may not continue on with the surviving entity;
- Uncovering and identifying the current and potential issues, problems, risks and liabilities posed by the transaction;
- Determining whether the seller's business can effectively be integrated into that of the buyer;
- Identifying unused capacity and determining how such capacity can be effectively utilised to produce synergies.

For a seller receiving cash consideration in the transaction, its focus during due diligence will be on:

- What shareholder or third-party consents are required to consummate the transaction;
- Corporate, business records or contract clean-up issues;
- Compensation, severance or personnel matters;
- Arrangements where the consummation of the transaction would cause an undesirable effect on the seller, such as an event of default, a right of a third party to terminate a material obligation of the seller or a trigger of a source code escrow obligation.

The following is an abridged checklist for buyers in a due diligence investigation:

- **Financial results:** Analysis of the accounting, tax and financial information and operating information for a minimum of five years, as well as the budgets, variance analysis and performance reports.
- **Customers:** Analysis of target market, customer growth and market share, credit terms and conditions, cash flow from customers, litigations and customer relationship management reports.
- **Products and service:** Analysis of the product life cycles, value propositions, market position and competition and product development.
- **Suppliers and vendors:** Analysis of the status and relationships with major suppliers and vendors, credit terms and conditions, contracts and penalty clauses and description of any supplier quality issues.
- **Human resources and labour relations:** Analysis of human resources policies, key staff and their contracts, staff turnover (especially resignations of key staff), remuneration compensation, labour disputes and litigations.
- **Financial structure:** Analysis of the financial structure and policies, financial obligations, terms and conditions of debts, contingent liabilities, compliance to debt commitments and obligations.
- **Risk management and governance:** Analysis of risk management and governance policies, risk management strategies, risk recovery strategies and risk assessment reports for the past three years.
- **Information technology (IT):** Analysis of IT policies and procedures, technological infrastructure, including servers, network and data centres, support structures or internal departments and privacy policies.
- **Operations:** Analysis of the nature of the operations and process flow, infrastructure and resources supporting the value creation activities, core competencies and competitive advantages, condition of resources and the continued use to sustain operations and core competencies.

In conclusion, a business model is the blueprint for the efficiency with which the strategic objective of the organisation will be pursued and achieved, with the primary focus on sustainability and value creation for the business and its stakeholders. An effective due diligence involves the critical analysis of the business model and its implementation in achieving the strategic objective and the performance on the strategic path.

THE CHALLENGES FACING A FAMILY BUSINESS

Lynette Dicey

All businesses have unique challenges and a family-owned business is no different. In fact, these same challenges can be exaggerated within a family business as personal relationships and family dynamics come into play.

The aphorisms vary from culture to culture but they all say basically the same thing: something along the lines of 'shirtsleeves to shirtsleeves in three generations', which essentially describes the propensity of family-owned businesses to fail by the time the founder's grandchildren have taken charge. However, that need not necessarily be the case. South Africa has numerous family-owned businesses that have been extremely successful – consider the tobacco, diamond and retail sectors, for example, and it soon becomes clear that some of South Africa's wealthiest families have family businesses to thank for their fortune.

One of the best known local family businesses is Pick 'n Pay, which looks set to outlast and outlive even founder Raymond Ackerman's grandchildren. "The reason some family-owned businesses - like Pick 'n Pay - are so successful is that they have avoided the common pitfalls that beset so many family-owned businesses," says SAIPA's Ettiene Retief, a professional accountant and chairperson of the National Tax (Policy) and SARS/National Treasury Stakeholders Committees.

According to Retief, there are two types of family-owned business: the one stays small, relying largely on the founder/owner and flounders once the founder/owner is no longer part of the business; the other grows and develops to the extent that it becomes an independent entity, capable of existing even without the owner/founder. In the latter version, as the business becomes less reliant on the owner/founder, it becomes a saleable entity and has the ability to attract investors or partners. "If the business is hugely reliant on one individual, come retirement time, you have nothing to sell," he cautions. "One of the challenges of establishing a new business is ensuring that it can survive without the founding member within due course. A sustainable business is one that is not reliant on any one individual forever. To achieve this, the owner/founder can't be ego-driven," he says.

The common challenges facing a family business are a lack of business strategy and little long-term planning. "Most family-owned businesses rely on organic growth, with the result that they never put proper systems and procedures in place. There is no clear plan on how to sell, close or walk away from the business," says Retief. "In that same vein, there is also no knowledge of the worth of the business and what makes it valuable – or valueless."

His advice? Family-owned businesses need proper planning, processes and systems just as much as any other business. "Put the correct infrastructure in place from the outset and outsource certain competencies rather than trying to be a jack of all trades. Family-owned businesses need to align themselves with people who can support them in order to free themselves up to grow and develop their businesses," he urges.

Managing cash flow is another critical element to the success of any business and family-owned businesses are not immune to this challenge. "It is important to know when money is coming in and, even more critical, when it is going out," says Retief. "I've seen loss-making businesses successfully continue operating because they manage their cash flow carefully. The trick here is to surround yourself with people who can advise you properly, experts in their particular fields and proper controls. Family-owned businesses need to be aware of not falling into the trap of excluding outside expertise, controls and policies."

Another challenge that afflicts many family-owned businesses is that control is usually centralised – often paternalistic – and is influenced by tradition rather than good management practices. Coupled with this, many business owners battle to separate themselves from the business. "Because they own the business they believe that any profits are theirs," explains Retief. "What they are forgetting is that once they have registered a company, they've created a separate, legal person. It is the company that is entitled to the profit and not the owner of the business. Any transactions need to be on behalf of the business in their role as member/director/shareholder or employee."

This pitfall, says Retief, is exacerbated in a family-owned business, where many founding owners are in the habit of setting up loan accounts. "The businesses that have loan accounts in place need to realise that it is harder down the line should they wish to get an investor or partner involved in the business, or should they wish to sell the business. In addition, the loan account is often used to postpone or avoid employees' tax, but at some point you will need to clear out the loan account - and that's the point when all those tax skeletons come out."

Similarly, the existence of loan accounts leads to a number of other risks around creditors, fiduciary duties and so on. "It is important for a family-owned business to start with the right mindset and separate the individual from the business," he insists.

If family members make up the majority of the employees, there is the risk of tunnel vision, a lack of outside opinion and diversity on how to run the business. A propensity to primarily employ family members could also lead to a lack of suitable talent and expertise to take the business forward. Training and development is also usually absent from family-owned businesses. According to Retief, there needs to be some kind of training programme in place that clearly outlines the goals, expectations and obligations of each position, allowing for proper development.

Succession planning is also usually noticeably absent, he notes. Because most family businesses don't have a clear plan for handing power to the next generation, conflict and division can result. One of the biggest challenges facing a family-owned business, however, centres on personal relationships. "It is important to separate family and business; at the office you are not relatives but business partners or employees and at home you need to avoid business discussions," advises Retief. "Leave what happens at home there, and leave what happens at work at work. If you allow work affairs to cross over, your relationship with family will become strained."

On the up side, there is anecdotal evidence that suggests family businesses weather storms more effectively; when times are tough they tend to pull together more effectively. However, urges Retief, this should not be at the cost of the businesses talent pool. "In today's highly competitive business environment, it is a case of adapt or die. Your talent pool cannot be allowed to stagnate and you need to continually add new thinking and innovation. Children should not be made to feel obligated to join the family business, neither should it be a fall-back option after they've failed to make their mark with other companies."

Emerging best practice in this regard, according to a *Harvard Business Review* article by George Stalk and Henry Foley, is that any child who wishes to join the family business must have earned a university degree, have several years of relevant professional experience outside the family business and apply for the position in competition with non-family applicants.

"Family run businesses can survive over the long haul and even survive the transition from one generation to the next if they adopt formal policies and procedures from the outset, don't treat the business bank account like their personal loan account, have a policy in place in terms of who they employ, balance family and business interests and have sufficient systems in place to allow for continuity and consistency," concludes Retief.

A GROWING CONCERN

Ettiene Retief, SAIPA

The organic growth and development of a business is something that every decision-maker has to deal with, and deal with well. How can the business grow organically without compromising the bottom line or customer deliverables? What are the challenges that face the business owner or CEO in a mercurial market with ever-changing goalposts? The modern enterprise has to find the answers to these questions to ensure it is capable of sustainable growth over the long term.

Every business is different and faces different challenges. One business may be greatly impacted by load-shedding while another thrives on it – such as selling generators or inverters. However, the one challenge that every business faces is that of cash flow.

Happiness is a positive cash flow

This cold, hard cash plays a pivotal role in the organic growth of an organisation. It is needed to ensure the business remains afloat as it grows and it is not the same as profit or loss. A very profitable company can be brought down by poor cash flow and the best budget is useless without having an available pool of money at the correct point in time. This can severely cripple the growth of the company and should be one of the primary considerations when looking to expanding a business. If cash flow is limited or poor, work within these constraints and don't rely on promises and maybes from clients before spending money that doesn't exist.

Additional capital necessary to grow

For many organisations additional capital is required in order for them to grow. This capital may be needed for expansion, generators, greater stock and other such considerations. For others, the ongoing weakening of the rand has made growth almost impossible. As for the question of whether or not the business owner should be chasing growth, there is a saying: 'If you're not moving forward, you're standing still and standing still is the equivalent of moving backwards'. However, growing too fast can also be a problem.

Whether the business is a one-man band or a conglomerate, the biggest threat to growth is cash flow. When the business is paid late or sales are slow or there are unplanned expenses, these have the ability to destroy a business, much less hamper its growth.

Finding a balance

This balance between growing steadily and growing too fast is one of the biggest challenges facing an organisation. Finding the right pace can be something of a minefield. While the first step is ensuring there is adequate cash flow, the second is sustainability.

While growth is good, the focus must be on the sustainability of that growth. I've seen new businesses pushing every extra cent into capital to fund their rapid growth, but they failed to consider what would happen if the market changed or a client didn't pay on time or, even worse, a client went into liquidation or business rescue.

A successful business has a good balance of the essentials and a large proportion of this success is built around planning. Budgets, cash flow forecasts, debtor management and creditor management all need to be carefully handled and controlled to ensure that the risks are always prepared for and the business is capable of evolving alongside the market.

IMAGINATION
INSPIRATION
VISION
KNOWLEDGE
CREATIVITY
TECHNOLOGY

Planning is critical to understanding the sustainability of your business and what is needed to support its growth. There must be a clear understanding of capacity and the extent to which you can meet your clients' demands. Taking a big order and not being able to deliver on that order does substantial harm to your business reputation.

Planning for growth demands a checklist that covers all of the basics and beyond. Does the business have high quality accounting policies and records? Is inventory managed properly? Are there enough trained staff members on hand to fulfil orders or deal with clients? These are questions that should be asked across all levels of business, from the microenterprise to the conglomerate.

The planning should include a capital budget so that the costs of expanding are clearly known and funding can be sought. If the assets required for the expansion have a useful life of 20 years, then don't use current cash to fund this, you should use asset financing to match the asset, thereby leaving your cash available for current operations. This includes raw materials, inventory and staff training.

Big and small

It is not just cash flow and planning that must be considered as the organisation spreads its wings. Red tape is definitely one of the issues that impact the growth of the business, but it is not the most significant. Compliance takes time and resources and has a definite cost, but there are many other factors – such as changes in accessibility, technology and pricing – that will play a role.

The easy access and immediate gratification provided by technology such as iTunes has seen many of these stores unable to keep their doors open. In some cases you can remedy the problem, adding in new items that cannot be downloaded.

Other concerns that could play a role in hampering growth is having badly trained staff, poor systems, a lack of services, lack of quality, poor back office management and pricing. The business owner has to identify all the risks that they face within their specific market and use this understanding to uncover what could be causing poor performance. Successful organisations are usually those that have dedicated time to establishing future risks and changes in the markets and have adapted and innovated to match, sometimes even before the market itself has changed.

It is important to critically review the business and the changing market. Many successful businesses today had to evolve and would not be here if they had not. Apple Inc today is the second largest information technology company in the world, and listed as the most valuable brand in the world. This was a company that was on the brink of closure. Its ability to innovate is the key! Just consider all of the iPhones, iPads and iPods that have been distributed. Software platform iTunes has irrevocably altered the way we purchase and consume media.

When it comes to growth, the organisation – regardless of size – needs to avoid making the most common mistakes. It needs to ensure it balances this expansion with careful cash flow management and sustainable development. Lack of planning, resistance to change, insufficient control over cash flow and insufficient understanding of organisational and market risks will impact negatively on growth. That said, inventiveness and innovation alongside planning and awareness will see a business well into a successful future.

REVENUE RECOGNITION IN BUSINESS – FOCUS ON SALE OF GOODS

Mahomed Kamdar, Rashied Small

The IT14SD is a supplementary declaration in which a company must reconcile income tax, value-added tax (VAT), pay-as-you-earn (PAYE) and customs declarations after the initial submission of the company income tax return (IT14/ITR14) for the applicable year of assessment as specified in the verification letter. The challenge for practitioners is how to recognise and when to report revenue for financial reporting, income tax and VAT.

Revenue recognition for financial reporting is governed by International Accounting Standards (IAS 18 and IFRIC 15), while for income tax it is governed by the Income Tax Act (ITA) and, more specifically, by the definition of gross income. Revenue recognition for VAT, however, is governed by the Value-Added Tax Act (VAT Act) and, specifically, the value and time of supply rules.

Financial reporting purposes (accounting)

The IAS defines 'revenue' as: the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

When we consider revenue from sale of goods, revenue is only recognised once all the following requirements have been met:

- When it is probable that the economic benefits will flow to the entity and these benefits can be measured reliably, viz. the value of the sale must be measurable at the transaction date.
- The entity has transferred to the buyer the significant risks and rewards of ownership of the goods, viz. the buyer takes full control over the goods sold.
- The entity retains neither continuing managerial involvement to the degree usually associated with ownership, nor effective control over the goods sold.

When a company sells goods, revenue should be recognised when it is probable that the economic benefits associated with the transaction will flow to the purchaser of the goods and the cash inflow from the transaction occurs for the seller.

Income tax

For income tax purposes, an amount will be recognised as income as per the definition of 'gross income' as defined in the ITA.

'Gross income, in relation to any year or period of assessment, means:

(i) In the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

(ii) In the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature, but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely:

(a) any amount received or accrued by way of annuity, including any amount contemplated in the definition of 'living annuity' or the definition of 'annuity amount' in section 10A(1), other than an amount contemplated in paragraph (d)(ii).

Therefore, an amount will be recognised for income tax purposes, in relation to any year or period of assessment, if the total amount, in cash or otherwise, received by or accrued to, or in favour of a person, from anywhere, in the case of a person who is a resident of South Africa, is not be of a capital nature.

In the case of a non-resident, revenue will be recognised for income tax purposes only from a South African source, other than receipts of a capital nature.

Valued-added tax

With reference to VAT, the registration basis of the vendor is relevant. If a vendor is registered on an invoice basis, a taxable supply event arises (the time of supply) at the earliest of the invoice date or the date any payment of consideration is received, but the taxable liability arises when the invoice is issued.

If a vendor is registered for VAT on the payment basis, the payment for the supplies by the customer triggers both the timing of the taxable event and liability for VAT and the rule of the earliest of invoice or payment does not apply.

Comparative analysis

Financial reporting	Income tax	VAT
General sales transaction		
Revenue is recognised with effect from the date the risks and rewards associated with ownership are transferred to the buyer.	Revenue is included in the year of assessment in which the cash or consideration is received by or accrued to the seller, but for non-residence, revenue is only recognised if the source is from a South African source.	Revenue will be recognised based on the basis of registration, if registered on the invoice basis, then it is recognised from the earliest of the invoice date or the date cash is received. However, if registered on the cash basis, then the date from which cash is received.
Connected persons		
Same as for general sales, but additional disclosure requirements need to be included in the financial statements.	Same as for general sales.	The recognition of revenue depends on the nature of the goods sold, (i) for moveable goods, with effect from the date the goods are removed, and (ii) for immoveable goods, from the date the goods are available to the recipient.
Instalment credit agreements		
Revenue is recognised in two parts: the sale value is recognised as revenue when the goods are delivered, while the interest element is recognised periodically over the period of the agreement.	Revenue is included in the year of assessment in which the seller received the instalment or is entitled to receive the cash (if it accrues).	Revenue is recognised at the earliest of the date when the payment is due or the date goods are delivered.

Fixed property		
Revenue (nature of business is real estate) is recognised as a sale when the property is transferred and registered in the name of the buyer. If the business does not sell properties as part of its core business, the profit/loss is recognised on transfer.	Revenue is included in the year of assessment in which property is transferred (delivery of goods) or the date the cash is received. If the selling of properties is not the core business, the gain/loss is subjected to capital gains tax with effect from the transfer date.	Goods consisting of fixed property are deemed to be supplied upon the earlier of the registration of transfer of the property in a deeds registry, or the date upon which any payment is made in respect of the consideration.
Lay-by sale agreements		
Revenue is recognised based on the policy of the seller or an estimate when there is evidence that the sale will not be cancelled – goods must be available for delivery.	Revenue is recognised in the year of assessment when the payments are received.	Revenue is R10,000 or less, it is recognised when the goods are delivered. The cash received represents a deposit that is not subjected to VAT – money or cash is exempt.
Successive and progressive sale agreements		
Revenue is recognised for successive and progressive sale agreements (construction) based on the work performed – degree of completion method.	Revenue is recognised in the year of assessment based on the earlier of the issuing of the invoice (work performed) or the cash received.	If the time of supply rule for successive and progressive supplies is applicable and the services are supplied to the vendor in the construction, repair, improvement, assembly or alteration of goods, then the payment becomes due and payable in relation to the progress made. As a result the time of supply is the earliest of the date when payment is due or is received, or any invoice relating to the payment is issued. So, if the invoice is issued in the following year, then output tax is declared in the tax period when the invoice was issued and assuming that no payment was made in the interim period.

If the lay-by sale is cancelled or terminated for any reason, any deposit payment retained by the vendor or any amount of the consideration paid (or which is recoverable) is regarded as consideration for a taxable supply of services by the vendor. In such cases, the vendor must account for output tax on the total amount retained in the tax period during which the sale was cancelled or terminated.

Conclusion

Generally, if the sale of goods was invoiced before year-end, such a sale will be recognised as gross income for income tax, and a supply for VAT purposes. However, the risk and reward of ownership of the goods have not yet transferred at year-end; such will not be revenue for accounting purposes. The taxpayer does not have a choice as to whether an amount must be taxed at the time of receipt or at the time of accrual. If the amount is accrued to a taxpayer, it must be included in the gross income at the date accrued corresponding to the appropriate tax year. Essentially, gross income is triggered at the earlier of the date:

- an amount is received, or
- accrued.

If the taxpayer is a vendor, the amount to be disclosed for financial reporting and income tax purposes should not include the amount for VAT.

RECOGNITION AND TREATMENT OF SETTLEMENT DISCOUNT FOR SALE OF GOODS TRANSACTIONS

Rashied Small, Jade Jansen & Lucinda Smidt

Revenue is an important figure to the users of financial statements, especially when analysing the performance of the business for decision-making. The question relating to settlement discount is whether the amount should be written off against the revenue amount to reflect the gross revenue or whether it should be treated as operating expenses. The difference in the treatment may significantly affect the analysis of the performance of the business.

To answer the above question, one needs to consider whether the settlement discount is a sales strategy, in which case the discount may be written off against the revenue amount, or whether it is an operating strategy, viz. a collection of cash from customers, in which case it should be recognised as operating expenses. However, the manner in which the settlement discount is recognised in the accounting records may not necessarily be the same as that reported in the financial statements, which report the net revenue figure rather than the recorded revenue figure (net revenue = revenue less returns less all discounts).

Recognition of settlement discount – Accounting purposes

Settlement discount results from future transactions, viz. when payment is received from the customer. If the settlement discount is to be recognised at the revenue transaction date, then it must be recognised as a provision for a future obligation that will arise if the conditions are met (IAS 37). The settlement discount can only be recognised at the transaction if there is certainty that it will be granted to the customer, viz. satisfying the conditions and criteria for the recognition of provisions – (i) present obligations have arisen from a past event (sales transactions with a settlement discount clause), (ii) transactions probable or a level certainty of occurrence (more likely than not), and (iii) the amount can be estimated reliably (IAS 37.14).

Basic recognition of settlement discount

The only criterion questionable for recognising the settlement discount at the transaction date is the probable occurrence of the event. This means that judgement should be made at the revenue transaction date whether there is certainty that the settlement discount will be granted to the customer. If there is certainty, then a provision should be recognised at the transaction date, and the amount can be written off against the revenue invoice amount. However, if there is uncertainty about whether the settlement discount will be granted, then the settlement discount should be recorded at the date the payment is received and the revenue should be recognised at the invoice amount at the transaction date.

Example:

	Certainty	Uncertainty
Sales invoice amount	100,000	100,000
Settlement discount (transaction date)	(10,000)	0
Revenue recognised	90,000	100,000
Settlement discount (payment date)	0	(10,000)
Cash payment	90,000	90,000

	Certainty		Uncertainty	
Transaction date:	**Debit**	**Credit**	**Debit**	**Credit**
Accounts receivable	100,000		100,000	
Provision for settlement discount		10,000		
Revenue		90,000		100,000
Payment date:				
Cash/Bank	90,000		90,000	
Settlement discount	0		10,000	
Provision for settlement discount	10,000		0	
Accounts receivable		100,000		100,000

The question that arises is whether the settlement discount recognised at the payment date can be written off against the revenue recognised for the transaction. Revenue should be measured at the fair value of the amount received or receivable at the date the revenue transaction is recognised (IAS 18.9). This means that revenue should be recognised at the amount which can be measured with certainty at the transactions date. Furthermore, any changes to the amount recognised is only permitted if it results from a change in estimate (IAS 8), therefore the amount recognised initially should remain unchanged and any change should be recognised as a separate transaction similar to sales returns.

Default on settlement discount recognised

If the customer defaults on the settlement discount condition and the settlement discount was recognised at the transaction date, the provision for settlement discount should be reversed as a change in estimate, viz. the provision recognised should be cancelled against the revenue to re-instate the revenue at the invoice amount – in the above example, the revenue will be re-instated at R 100,000. The reversal of the provision should be recognised on the expiry of the settlement condition rather than when payment is actually received.

Implications of VAT

Output VAT should be recognised on the invoice amount, but as the net revenue was recognised in the accounting records, the VAT amount should be matched with the revenue recognised. However, the VAT payable should be based on the output VAT recognised in terms of the VAT Act, therefore the VAT applicable to the settlement discount should be recognised accordingly (see below). If a provision for the settlement discount was recognised at the transaction date, then a provision for VAT reversal should also be recognised. Similarly, when the payment is received and the settlement discount is granted, both provisions for settlement discount and VAT should be reversed.

Example:

	Certainty	VAT
Sales invoice amount	100,000	14,000
Settlement discount (transaction date)	(10,000)	(1,400)
Revenue recognised	90,000	
Settlement discount (payment date)	0	
Cash payment	90,000	
Net output VAT		12,600

		Certainty		Uncertainty
Transaction date:	**Debit**	**Credit**	**Debit**	**Credit**
Accounts receivable	114,000		114,000	
Provision for settlement discount		10,000		0
Revenue		90,000		100,000
VAT (output)		12,600		14,000
Provision for VAT		1,400		
Payment date:				
Cash/Bank	102,600		102,600	
Settlement discount	0		10,000	
Provision for settlement discount	10,000		0	
VAT (output)			1,400	
Provision for VAT	1,400			
Account receivable		114,000		114,000

VAT implications – Tax purposes

It is important to note that the calculation of the VAT liability is based on the requirements of the VAT Act (viz. output VAT is based on tax invoices) rather than the application of the accounting standards and principles. In terms of section 20 of the VAT Act, No 89 1991 (VAT Act), a VAT vendor who makes a taxable supply has to issue a tax invoice to the recipient within 21 days of making the supply. This creates an accounting dilemma as revenue transactions should be recognised when all the risks and rewards associated with ownership are transferred from the seller to the buyer (IAS 18.14). The issue is how the VAT component linked to the settlement discount should be recognised in the accounting records due to the difference in the requirements of the VAT Act and IAS 18.

The VAT vendor has to account for output VAT in respect of that supply with reference to its applicable tax period. Certain practical problems may arise. For instance, there may be uncertainty as to what the value of the supply is, what amount should be reflected on the tax invoice and whether any credit or debit notes need to be issued.

In terms of a credit sale transaction, the supplier and the customer may agree prior to the sale or as part of the terms and conditions that the customer will receive a discount if the account is settled on or before a certain date. Such sales transaction can be interpreted for VAT purposes in various ways:

(a) Invoiced at the amount before the settlement discount

In such a case, it is clear that a tax invoice was issued to the customer at amount before deducting the settlement discount and the output VAT will be calculated based on the invoiced amount. If the customer settles the invoice and receives the settlement discount, then a credit note must be issued in terms of s21(1)(c) of the VAT Act to account for the reduction in the output VAT amount for the sales transaction. For example, if the tax invoice amounted to R114,000 (inclusive of VAT), then the output VAT amounts to R14,000. When the customer settles the invoice and receives an early settlement discount of 10%, amounting to R11,400 (inclusive of VAT), then a credit note should be issued to allow for the deduction in the output VAT of R 1,400 (11,400 X 14/114).

(b) Invoiced at the amount after accounting for the settlement discount

In such a case, the tax invoice is deemed to be issued to the customer at the amount after deducting the settlement discount. However, if the customer does not fulfil the conditions to claim the settlement discount, then a debit note must be issued to the customer in terms of s21(1)(c) of the VAT Act to cancel the discount transaction and increase the sales amount. For example, if the tax invoice amounts to R 102,600 (inclusive of VAT), then the output VAT amounts to R 12,600. When the customer defaults on the conditions to claim the settlement discount, then a debit note of R 11,400 (inclusive of VAT) must be issued to increase the output VAT by R 1,400 (11,400 X 14/114).

However, it is important to analyse the agreement to determine whether it constitutes a settlement discount or a penalty for late payment (GUD Holdings *(Pty) Ltd v Commissioner for SARS 69 SATC 115).* The reversal of the settlement discount will affect output VAT, whereas a penalty for late payment may not be subject to VAT.

(c) Invoice is not clear as to which amount is applicable

At the time such a transaction is concluded, there is uncertainty about the consideration, viz. the amount can either be the amount after deducting the settlement discount if payment is made on or before a certain date, or the amount before deducting the settlement discount if payment is made after that date. The consideration will only be determinable on the date of payment or the cut-off date that qualifies the customer to receive the settlement discount. However, this practice is not necessarily helpful as the vendor would still have to account for output VAT in respect of the applicable tax period, and if the consideration does not become certain by that time, the vendor may not know which amount to account for.

SARS issued a Binding General Ruling 6, which states that a vendor must issue a credit note for a discount if the discount:

- alters the original price of a supply of goods or services in terms of an agreement with the customer; and
- results in the tax charged on the tax invoice in relation to that supply being incorrect (that is, the amount of tax charged shown on the tax invoice exceeds the actual tax charged).

Conclusion

Settlement discount can be recognised in the accounting records either:

(a) As a provision at the transaction, thereby reducing the revenue recognised, only if there is certainty [more likely than not] that the settlement conditions will met, or

(b) As a settlement discount expense when the payment is received, resulting in revenue being recognised at the invoiced amount, only if there is uncertainty that the settlement conditions will be met.

If the settlement discount is recognised as a provision at the transaction date, but the customer defaults on the settlement conditions, the provision should be reversed and the revenue re-instated to the invoiced amount in terms of the requirements for changes in estimates.

For accounting purposes, the VAT should be recognised based on the revenue amount recorded at the transactions date. If a provision for settlement discount is recognised at the transaction date, the output VAT is raised on the net revenue amount and a provision for VAT is recognised based on the discount amount. If the settlement discount was not recognised at the transaction date, the discount should be recognised together with the related VAT (reversal of output VAT) recognised at the settlement date.

However, for tax purposes (VAT returns), the manner in which output VAT is determined is based on the manner in which the tax invoice is presented, based on gross amount or net amount. If the tax invoice is based on the gross amount and the settlement discount is granted, a credit note should be issued to claim the VAT relating to the discount amount. Without the issuing of a credit note, the VAT relating to the settlement discount can be claimed for tax purposes.

TAX FRAUD

SAIPA Technical and Standards Department

Tax filing season is an opportunity for the criminally inclined to defraud taxpayers, and one way of doing this is posing as a tax practitioner. You should check that someone is a registered tax practitioner before you grant him or her access to your financial affairs – and the South African Institute of Tax Professionals (SAIT) has made it easier for you to do this.

The Tax Administration Act requires that anyone who submits tax returns on behalf of the public for a fee must be registered with the South African Revenue Service (SARS) and a recognised controlling body, such as SAIT, the South African Institute of Professional Accountants (SAIPA) and the South African Institute of Chartered Accountants (SAICA). Every registered practitioner has a tax practitioner number or a membership number.

There are 11 recognised controlling bodies, but you don't have to phone or email each one to check whether someone is a legitimate tax practitioner. Stiaan Klue, the chief executive of SAIT, says the organisation offers a free service that enables you to check whether someone is registered with any of the controlling bodies in South Africa.

Another red flag is if a person advertises their tax consultancy services on flyers stuck on lamp posts, Klue says.

Faith Ngwenya, the technical executive at SAIPA, says that the two signs that show you are dealing with an unethical and potentially fraudulent tax practitioner are if:

* A practitioner charges a contingency fee – in other words, the fee for his or her services is a percentage of the tax refund that you may receive from SARS. Ngwenya says that this practice is illegal, and taxpayers should never agree to it.
* A practitioner is prepared to claim expenses that you did not, in fact, incur (for example, inflated out-of-pocket medical expenses).

Ngwenya says that you must not accept assistance from people who say they are acting as an agent of a registered tax practitioner; all your engagements should be with the registered practitioner or their office.

Another type of fraudulent activity that peaks during tax filing season is emails purporting to come from SARS that ask people to disclose their banking details.

Klue says scammers prey on our vulnerabilities, including our need for money, and so fraudulent emails often have an address, such as refunds@sars.gov.za, that raises the expectation that you are eligible for a tax refund. These emails contain links to forms and websites that seem to be genuine, but the aim is to trick you into entering personal information, such as bank account details, which the criminals extract and use fraudulently.

You should disregard emails that ask for your tax, banking and eFiling details, because SARS will never ask taxpayers for such information in an email, Klue says. SARS will also not ask you to divulge your banking details over the phone, in an email or on its own or on another website, he says.

You can report online fraud to SARS by emailing phishing@sars.gov.za or by phoning the fraud and anti-corruption hotline on 0800 00 2870 or the SARS contact centre on 0800 00 7277.

EVOLUTION OF THE PROFESSIONAL ACCOUNTANT

Juanita Vorster, At That Point

The Professional Accountant role has evolved, becoming something far richer and more versatile than ever before. This shift is driven by a number of factors and challenges including technology, competition and increasingly demanding client expectations. Organisations are looking to the Professional Accountant to be a business advisor and to provide an array of services that are flexible, tailored, adaptable and at price points that they can afford. Through innovation, creativity and technology, the Professional Accountant now needs to adapt to ensure that they create more value for their clients and become more competitive in order to thrive.

The accountancy landscape is undergoing significant change and the professional needs to examine what solutions they are going to put into play to capture and retain their clients. Expectations are changing and the Professional Accountant is in an almost enviable space where their expertise and understanding of accountancy practices can be used to transform how their clients view their roles.

Embracing technology

Competition for business has never been so fierce or demanding and there are countless challenges that the Professional Accountant has to overcome. One of these is, of course, technology. The organisation now has access to an abundance of accounting solutions that are cost-effective and easy to use. Software that can be accessed from the cloud – anywhere on any device – has placed the accountancy role into the hands of anyone who is online and has some ability. While this is very much a threat to the Professional Accountant, it should, however, be seen as an opportunity.

The Professional Accountant can now step up and provide a multi-layered service that shows how their expertise is essential to the organisation when it comes to navigating the choppy seas of the future. They must empower their clients by guiding them along the best routes to saving and making money and offering insight into how processes can be streamlined for greater efficiency. In addition to this, the accountant should develop their so-called 'soft skills', which see them engaging with clients on a more personal level.

The evolution of social media and apps, such as Whatsapp, allow for the Professional Accountant to connect with their clients on a more intimate level. It is an opportunity for the external service provider to be in contact with the client on a regular basis, to update them and let them know about trends and market shifts and to provide a highly personalised service that will distinguish them from other service providers.

Technology may have ubiquity and capability, but it remains a solution that only works brilliantly in the hands of the expert. For the Professional Accountant, this shift towards a more technology controlled environment can be used to their advantage and to add value to their client. Understanding the solution, knowing how to maximise it for greater capability and inputting data accurately to ensure no costly errors – these are the vital parts the Professional Accountant has to play. It is their innate understanding of what their work entails and how it needs to be done that will see them overcome the threat of technology and transform it into a tool to ensure success.

Innovation is essential

Professional Accountants have a business advisory role to play in order to create more value for their clients. The ability to adapt to technology, the capability to try new solutions and systems and a commitment to being ahead of the market curve in developments are all part of being innovative. The million rand question is, of course, how can the Professional Accountant tap into trends, solutions and ideas in order to innovate effectively? One of the most important steps is to stay on top of technology and to know which solutions are the most popular, which are steadily gaining traction in the market and to ensure that they have the requisite skills to use the systems that their clients have adopted. This knowledge can also be used to advise clients when they are at the point of investing in new software, providing them with the insight they need to make the right choice for the business.

The digital disruption brought about by technology will impact the Professional Accountant, of this there is no doubt, but alongside becoming a valuable partner in using the technology more efficiently, they need to also deliver new ways of doing things and be open to change. Organisations want to know that they are being given the best service and have the best systems and the Professional Accountant needs to answer these questions. A look back as far as 2009 shows how PricewaterhouseCoopers launched a space called iPlace where employees could come up with innovative ideas to help the company's customers. The goal of iPlace was pure innovation and has already saved the company a lot of money on internal systems, and made plenty more on external client solutions.

Research undertaken by the Chartered Institute of Management Accountants (CIMA) and the American Institute of Certified Public Accountants (AICPA) found that management accountants actually play an essential role in driving advancements at some of the most innovative companies in the world. The interviews that formed the basis of this research were held at companies such as Coca-Cola and the BT Group and revealed the valuable role that the Professional Accountant plays in the success of the organisation. It is the innovation-centric mindset of both Professional Accountant and organisation that saw these enterprises create environments where ideas flourish and the bottom line prospers. While there are challenges with heavy market competition, the threat of technology and a mercurial legislative environment, the Professional Accountant is also at a point where they can transform their roles and use their expertise to deliver personalised, powerful and innovative solutions to their clients.

PIERCING THE CORPORATE VEIL – SEPARATION OF THE BUSINESS FROM THE BUSINESS OWNER

Rashied Small, Lucinda Smidt and Achmad Joseph

The financial distress of many small and medium-sized enterprises (SMEs) and start-up businesses, m any of which result in business failures, can be attributed to the intertwining of the business owners' personal lifestyles with the activities of the business. The question often encountered is "where does the owner's life end and the business start?" The perception of many owners is that they are the business and the business is his/hers.

Business owners are advised to formalise their businesses by registering a company, which will provide them with personal protection, especially with respect to their assets. The argument provided for such a decision is that the company has a legal persona, but, more importantly, that it provides the owners with a limited liability risk cover. Given this, when the owner treats his/her business as a personal resource and the line between the owner and the business becomes blurred, the professional accountant may have an ethical dilemma. For example, reporting on the owner's loan account and the classification/recording of expenses.

Legal protection – piercing the corporate veil

A key reason that business owners choose to formalise their businesses into companies is so that they will not be held personally liable for debts should the business be unable to pay its creditors.

In tough economic times, many small business owners scramble to keep their companies afloat or close down. If the business is closed down, the last thing the owner wants is to be held liable for the debts of the business. However, if the business is sued by its creditors because it is not meeting its obligations due to cash shortages and the owners were not careful, a court might lift the business' veil of limited liability ('piercing the corporate veil') and hold the owners personally liable for the company's business debts.

The risk of piercing the corporate veil is much higher for closely held businesses, that is, businesses that are owned by one or just a few members. When the corporate veil is pierced, the creditors can go after the assets of the owners and management to defray the debts – and the owner can lose his/her personal assets. However, the court will only impose a personal liability on the individuals who are responsible for the business or the wrongful or fraudulent acts and will not hold innocent parties personally liable for the debts of the business.

Conditions for piercing the corporate veil

The corporate veil will be pierced under the following conditions:

- **No separation between the business and its owners:** This occurs if the owner does not maintain a formal legal separation between the business and their personal financial affairs. If the owner personally operates the business as if the business does not exist (the line between business affairs and personal affairs are blurred or non-existent), then the owner will not be protected from the limited liability clause (corporate veil). For example, if the owner uses the business account as if it was his/her personal account by buying personal items, or makes significant business decisions without documenting them, then the court may decide that the owner is not entitled to the protection of the limited liability clause.
- **Business acted wrongly or fraudulently:** If management or the owner acted recklessly or fraudulently, which resulted in losses to third parties, then the protection of the limited liability clause will not apply. For example, if the owner concluded a business transaction knowing that the business would not be able to meet its financial obligations to its creditors, then the owner will not only be violating the regulations of the Companies Act (perform a

liquidity and solvency test before concluding the agreement) but will also not be protected from the limited liability clause.

- **Creditors suffer an unjust cost:** This occurs when the business cannot fulfil its financial obligations to creditors or an unpaid court judgement and the above factors are present; the owner will not be protected by the limited liability clause.

Factors contribution to the piercing of the corporate veil

The following are factors that may contribute to the lifting of the corporate veil for SMEs:

- **Large member/shareholder loans:** If the business is funded by loans from members and is in a position that gives the impression that the survival of the business is dependent on the continuous injection of capital from the owner – the business does not have sufficient capital to operate or stand on its own.
- **Failure to follow good business practice:** Due to the nature of their businesses, owners of SMEs are less likely to comply with good corporate governance procedures and formalities, such as holding annual meetings, documenting and maintaining minutes of important business decisions, etc. The assumption is that these matters will be taken care of by the professional accountant, whom the owner expects to be the business administrator as well.
- **Commingling assets:** This occurs when the owner uses the business account to pay for personal assets such as his/her bond or vehicle instalments, or transfers cash on a regular basis to his/her personal bank accounts. To gain the protection of the limited liability clause, it is important that the owner minimises the use of business funds for the payment of personal assets.

Advice

The following steps can be taken by a business owner to minimise the risk of the corporate veil from being pierced:

- Separate personal and business affairs by maintaining separate bank accounts;
- Avoid commingling assets – do not use business funds to pay for personal assets;
- Have an employment contract in place – take a fixed monthly salary and comply with the tax regulations;
- Avoid diverting business assets for personal use – this may be considered as asset stripping, which will be considered as mismanagement of business resources;
- Ensure that the business is adequately capitalised by making a reasonable initial capital investment – minimise the dependence of the business' operation on the owner's loan account;
- Do not provide personal guarantee payments for business debts as this exposes personal assets at risk;
- Do not act recklessly or fraudulently with business resources and in business transactions;
- Comply with business formalities by maintaining and documenting significant business decisions – conduct annual meetings; and
- Use the services of legal experts for any cases that may violate the corporate veil.

Although the formalisation of a business provides protection for personal assets under the limited liability clause, it is important that owners avoid circumstances and conditions that may result in the court piercing the corporate veil. When the court pierces the corporate veil, the assets of the owner are placed at risk, resulting in the loss of the livelihood of the individual.

PUBLIC OFFICER - A ROLE OF VITAL IMPORTANCE

Rodney Weidemann

Paying taxes, filing returns and keeping up to date with all tax-related matters is absolutely critical to the ongoing success of an organisation, but ensuring such vital tasks are completed on behalf of the business can be tricky. It is for this reason that the role of public officer has been created, with the person chosen to fulfil this role acting as the representative taxpayer for the company, meaning that they serve as the face of the company for tax purposes. In South Africa, a company is required to appoint a public officer within one month of the company either beginning business or acquiring an office in the country.

According to Ettiene Retief, chairman of the National Tax Committee for SAIPA, any enterprise has a number of different roles that need to be fulfilled, but the public officer is unique in that the candidate for this role is both a juristic person and a natural person.

"In terms of the legislation, the public officer is a juristic person, meaning that they are recognised by law as being the subject of rights and duties. At the same time, the nature of the role is such that, for example, documents may need to be signed or disclosures made. This requires a physical manifestation in the form of a natural person to do those things that a purely legal entity cannot," he says.

"The public officer's role, therefore, is to be the eyes and ears and essentially the physical manifestation of the organisation when it comes to all matters regarding tax. At the same time, it must be remembered that the company is regarded as having done everything the public officer does in their representative capacity – so it is vital that the board is not only always aware of what the public officer is doing, but that it also has faith in his or her abilities."

Retief adds that, by law, a public officer has to be a person who is resident in South Africa, and tax law further directs that it is mandatory that the public officer be a senior company official who is approved by the South African Revenue Service (SARS).

Personal liability

The South African Institute of Chartered Accountants points out that a public officer will be subject to penalties for 'the company's defaults' and, as a 'representative taxpayer' risks further liability in terms of the Tax Administration Act.

As an example, public officers risk liability for tax due to SARS to the extent that they concluded transactions or had control of income or received income from the company. They are also personally liable if tax is due to SARS and they divert or dispose of monies or assets that could have been used to settle the tax. There are differences of opinion in legal circles as to exactly how far these risks of personal liability go, but they are real risks.

Retief adds that if the public officer fails to offer full disclosure, it can become their personal problem. This is, he says, because a crime like tax evasion cannot occur on its own; it requires a person to undertake it, even if they are doing so on behalf of an organisation.

"This is where it becomes risky for public officers, since although they effectively hold the position as a way of representing the company, they cannot be wholly removed from any failure to do what is right. So, as another example, if employee tax is deducted, but is not paid to SARS, this is clearly wrong. Now if the business goes into liquidation, SARS cannot reclaim such money from the company, but it could conceivably seek redress from the organisation's public officer in their personal capacity."

"It is vital then that anyone who considers taking on the responsibilities of such a position also understands the attendant risks. Remember that there are multiple kinds of liability that come along with a role that essentially serves as the entry and exit point for all communications, returns and disputes between SARS and the company."

Necessary qualities

Since the public officer's role is critical and comes with great responsibility, it is generally recommended that the individual chosen is a director of the company. Since personal liability is part of the equation, a director will be familiar with this and will also be senior enough to deal with challenges that may arise.

Since the public officer's role is critical and comes with great responsibility, it is generally recommended that the individual chosen is a director of the company. Since personal liability is part of the equation, a director will be familiar with this and will also be senior enough to deal with challenges that may arise.

So what are the most important characteristics of a good public officer? "It is clear that only certain kinds of personalities will be successful in this role," states Retief. It requires someone who will not let themselves be bullied in any way, which is vital as it is a job where threats and intimidation regularly occur.

"Public officers need to be strong enough to stick to the duties they are appointed to perform and not allow themselves to get pushed around by others or strong-armed into doing anything they shouldn't."

He adds that the nature of the role is such that the person appointed also needs to be senior enough and distinguished enough within the organisation to effectively fulfil this role.

"And since a public officer cannot be expected to do it all themselves, they will need to delegate tasks to others. These others need to be people they can trust implicitly to do their jobs, whether it is registrations, the updating of details or the filing of returns, employees who are good at what they do and are capable individuals. The public officer essentially needs to be certain that these people are doing their jobs correctly, so oversight is critical, as it is ultimately their neck on the line."

Where the public officer's skills truly come to the fore, Retief explains, is in understanding the principles of risk. They need to be able to address the processes of the organisation with a view to minimising risk and understanding consequences.

"The final characteristic a public officer requires - and one of the reasons why the person filling this role should be a director - is foresight. When a business is debating new contracts or considering aligning with new trading partners, it is imperative to consider the tax risks and to be made aware of any potential challenges before anything is finalised. Since only directors have access to such high level discussions, it is important that the public officer be in a position to raise such concerns before any contracts are signed."

Finally, cautions Retief, the position of public officer is often viewed as a title without any real responsibility, but nothing could be further from the truth. "This is a role that needs to be filled properly and it has serious obligations which, if not fulfilled, can have huge impacts and liabilities on a corporate and personal level. Therefore, it is vital that the public officer takes these responsibilities seriously and remains fully focused on the job at hand, otherwise both the public officer and the company will suffer," he concludes.

HOW TO ENTER A JOINT VENTURE WISELY

Rodney Weidemann

Within those famous rules for life known as 'Murphy's Law', there is Bralek's Rule for Success, which states: "Trust only those who stand to lose as much as you do when things go wrong". When a business is considering entering into a joint venture (JV) with another organisation, this is one of the best rules of thumb to use.

According to Rashied Small, education, training and membership executive at SAIPA, a JV is a strategic alliance where two or more parties, usually businesses, form a partnership to share markets, intellectual property, assets, knowledge and profits. A JV differs from a merger in the sense that there is no transfer of ownership in the deal.

"In some cases, large businesses enter into JVs with smaller ones to quickly acquire critical intellectual property, technology or resources that may be difficult to acquire. A JV is similar to a partnership, although the latter usually involves a continuing, long-term business relationship, whereas a JV is based on a single business project," he says.

Ettiene Retief, chairman of the National Tax Committee for SAIPA, adds that when your look at a JV from a tax or accounting perspective, a JV is simply a contract. "What this means is that tax clearance will be required from the JV, as well as from each partner involved. It is a key issue as this ends up in two different organisations' books. This means that how such information is captured, who invoices for this and so on needs to be clearly defined and put into the initial JV contract. Also, businesses involved in a JV need to be aware that they cannot simply claim 50% of the JV's net profit; income and expenses also accrue to each business involved rather than simply to the JV."

Key legal considerations

Small explains further that a JV is not a separate legal entity and the revenues, expenses and asset ownership usually flow through the JV to the participants. Once the JV has met its goals, the entity ceases to exist.

"Whatever the rationale, a JV arrangement will most likely result in a loss of control and autonomy for the existing shareholders. This, then, underlines the importance of choosing the correct JV partner, identifying the most appropriate JV structure and giving full consideration to a number of related questions that may arise," he says.

"A confidentiality or non-disclosure agreement should be entered into between the parties during preliminary discussions. Public announcement requirements and share exchange obligations will need to be considered and satisfied if either of the parties is a listed company. Other material authorisations, consents, licences, terms of existing third party agreements and other conditions precedent may also have a bearing on the setting up of a JV."

Small points out that an appropriate legal structure - typically influenced by tax considerations, methods of funding, terms of commercial operations and an appropriate exit strategy will all need to be determined. It is also common practice, he suggests, for an agreement to expressly provide that it is the intention of the parties not to create a partnership and that each party to the agreement acts for his own account as principal and, except where otherwise specified in the agreement, has no authority to bind the other party.

"When embarking on a JV, it is imperative to have your understanding in writing. You should set out the terms and conditions agreed upon in a written contract; this will help prevent misunderstandings and provide both parties with strong legal recourse in the event the other party fails to fulfil its obligations while under contract. Dispute resolution should be highlighted, as well as an understanding of how, if necessary, the JV will be terminated," advises Small.

"The use of confidentiality or non-disclosure agreements is also recommended to protect the parties when disclosing sensitive commercial secrets or confidential information."

Additional complexity

Risk management is a critical aspect of international business activities, as different countries present varying degrees of political, economic and social risks. Political risks revolve around security and government stability, while economic risks include inflation and the competitiveness profile of foreign governments. Health and educational standards and cultural diversity present social risks.

"You can mitigate these risks by entering JV agreements in international markets," states Small. "Tariff barriers, unstable tax regimes, licence denials and unfavourable government policies remain some of the major political threats to international business. Some governments even pursue policies that require foreign companies to cede significant shareholding stakes to state agencies and local populations. JVs enable you to strike deals with local businesses in your host countries to avoid such state-sponsored shareholding and licensing restrictions."

JVs can also cushion your business from fluctuating rates of economic growth in host countries that otherwise might destabilise your sales volumes. Factors such as rising interest rates and inflation increase the cost of raw materials and reduce profits. Moreover, Small indicates, capital-intensive industries are characterised by significant barriers to entry, especially when they are launching operations in international markets.

"Culture shock among employees is another risk businesses experience when they establish new operations in foreign markets. Although it is possible to train employees to adjust to a new cultural environment, it is much more convenient to enter a JV with a company in the chosen country. Such a partner has a workforce that understands the cultural dynamics on the ground. Other challenges that can be minimised through a JV are differences of religion, national languages, health-care systems and education standards," continues Small.

Honeymoons and liabilities

Retief suggests that companies entering into a JV should treat such an agreement the way you would treat a marriage contract. "A JV is, after all, quite similar to a marriage in that there is a honeymoon phase during which everyone is happy and nobody is really concerned about scenarios and contracts. However, just like when a marriage breaks down, if things go awry with the JV, the need for a documented contract comes to the fore and is actually vital if you are to sort out any related problems," he says.

"In reality, a JV needs a proper contract because the happy beginnings will not last, and you need to thus be covered for any eventualities that may arise. These could be anything from one party running out of cash, to one of the companies going into liquidation, or even the simple matter of the two parties not getting along very well. It is thus important to map and plan all these various scenarios and ensure that solutions to these go into the contract."

He says that the agreement needs to specify a way to unwind or even exit the JV if deadlocks cannot be broken. Also, if the companies participating in the JV contribute assets or intellectual property, such contributions must be properly documented right out of the gate.

"Liability is another issue that needs to be covered by the JV agreement. For example, if two construction firms enter into a JV to construct a building and several years later one has gone out of business when the edifice collapses, who is liable? Often when entering into a JV, people don't think about such things because it is easier to simply accept the current circumstances. However, when it comes to something as complex as a JV, both parties need to think long and hard about every aspect thereof, so that they can plan for all possibilities," concludes Retief.

Key provisions in a JV agreement

- Clearly defined business objectives.
- The degree of participation and the management roles of each party in the business.
- Contribution of capital and ownership rights to property.
- Division of the profits and losses.
- A dispute mechanism to avoid management impasses that may produce deadlock or litigation.
- Termination/liquidation of the JV and the buyout provisions.
- Confidentiality.
- Indemnification.

RAGIEMA THOKAN-MAHOMED

Legal Manager, SAIPA

Q: Tell us about yourself?

A: I am a mother, wife and a person of strong conviction. I am a University of Johannesburg graduate in BCom Law and LLB. I am an admitted Attorney and I have had the privilege of running my own practice.

I have had the opportunity to work with people from many walks of life and this has given me a deeper appreciation for the human spirit.

Q: What do you do at SAIPA?

A: I manage the Legal, Ethics and Compliance department at SAIPA. I am responsible for:

- Ensuring that all complaints against our members are fairly dealt with by our internal structures;
- Overseeing and ensuring all institutional certifications and compliances are maintained;
- Managing member compliance to the Institute's constitution, by-laws and code of conduct;
- Providing advice to members regarding legal issues or ethical dilemmas;
- Vetting all contracts of the Institute, assisting with corporate governance functions and I am also a member of SAIPA's management committee.

Q: What is the best part of your job?

A: I love finding workable solutions to problems. I am required to analyse and interpret policies and I often have to make amendments to mitigate against possible future challenges. I provide legal counsel in respect of potential memoranda of understanding (MOUs) and service level agreements (SLAs). I work with an amazing team of people. Our cultural differences and diverse personalities make us a dynamic team, which I really enjoy.

Q: What are some of the more challenging aspects of your job?

A: Balancing the number of meetings with all of my other commitments can be tricky. Some challenges make us feel alive, engaged, connected and comfortable, whilst some simply overwhelm us. Identifying the variance is a challenge on its own. I love what I do and I know that if help is needed, my colleagues and team are there to support and assist. Nothing is impossible if you have the determination to succeed.

Q: What are your thoughts on the accounting industry as a whole and SAIPA's role in it?

A: I would personally like to see more regulation of the profession. Our members work so hard to obtain and maintain the Professional Accountant (SA) designation. It's disheartening to see people use the term 'accountant' with no formal qualification.

Q: What do you do for fun?

A: I spend as much time with my wonderful husband and two beautiful daughters. We build puzzles, do arts and crafts, watch movies, do karaoke and play video games – anything to entertain a three-year-old and five-year-old! All kids want is your time – they don't care what you're doing.

Q: Any personal goals or future plans you'd like to share with us?

A: My personal goal is to go for pilgrimage. I have been told that it is an invitation; so I have made my intention and now wait for God to answer my call.

I would personally like to see more regulation of the profession. Our members work so hard to obtain and maintain the Professional Accountant (SA) designation. It's disheartening to see people use the term 'accountant' with no formal qualification.

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