Middle East

Point *of* View

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2014 is the year of the horse in the Chinese calendar and, according to predictions in the press, it is a year of upheavals: good for some, bad for others. But whether one believes in astrology and predictions or not, one cannot argue that it will be a good year for Dubai. Awakening from a harsh hit as a result of the 2008 financial crisis that has left much bigger economies in a slumber, Dubai has risen from the ashes to become the first country in the Middle East to host the World Expo in 2020, fighting off contenders such as Izmir and Sao Paolo.

Despite the pomp and circumstance that accompanied the results of the bid, Dubai seems to be approaching the whole event with caution and stands to benefit greatly from hosting the Expo, according to our experts in the fields of finance, leisure and construction. Mutasem Dajani, United Arab Emirates regional managing partner at Deloitte, says: "By staying true to this goal and the themes of the Expo, ("Connecting Minds, Creating the Future") Dubai 2020 will impart an energy and relevance that may be unmatched by any recent exposition the world has seen…Today's university graduates will be managers in industry and the public sector and will be more mobile, globally connected, and technologically adept and determined in addressing the challenges of the next decade," he continues. For more of our experts' opinion on the subject, make sure to read our article Expo 2020, a game changer for Dubai, on page 6.

But the countdown to 2020 is not the only thing on our minds here in the Middle East. Ready or not, FATCA is here. By April 25, 2014, Financial Institutions across the Middle East will need to have entered into an agreement with the U.S. authorities to comply with specific requirements set forth in the FATCA (Foreign Account Tax Compliance Act) regulations so as to avoid being subject to the penal 30 percent withholding on certain U.S.-sourced payments. "Non-compliance with FATCA could leave organizations and senior personnel open to significant financial and personal penalties," says Ali Kazimi, managing director, international tax services, at Deloitte Middle East. "Appropriate action should be taken now," he says.

Appropriate action is what governments in the Gulf Cooperation Council countries should be taking now to fill the skills gap, says Richard Barrett, leader of Education and Skills consulting services at Deloitte Middle East. "GCC governments are committed to policies of nationalization," he says, "but young people still seem focused on public sector jobs and those with the required technical qualifications are in short supply." Barrett further notes that while enrolment in primary and secondary education across the Gulf region rates at a very high 90 percent, it is the 23 percent enrolment in tertiary education that compares less favorably with data from many developed countries.

Catching up to the West is not only relegated to the domain of education. Women in the workforce, it is often thought, tend to be more prevalent in the western world than in developing countries. Or are they? Vanessa Borchers and Linda Human, global diversity leaders at Deloitte Touche Tohmatsu Limited, set out to challenge some common misconceptions about female leadership in emerging and growth markets. "Emerging and growth markets are facing significant challenges in terms of attracting and retaining talent," they say in their article on page 20, Catching up to the West? but some of these challenges are different from those experienced by traditional markets, and they are not necessarily getting in the way of resilient women rising to the top."

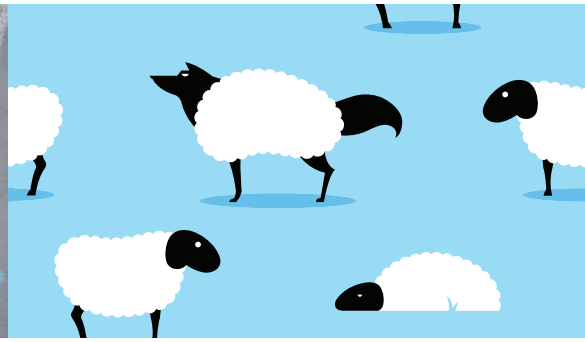
Other topics covered in this, our first issue of 2014, include procurement fraud, discount rates and technology in M&A transactions. So regardless of your stars, or whether you believe in them, or not, we at the Middle East Point of View, wish you a prosperous year.

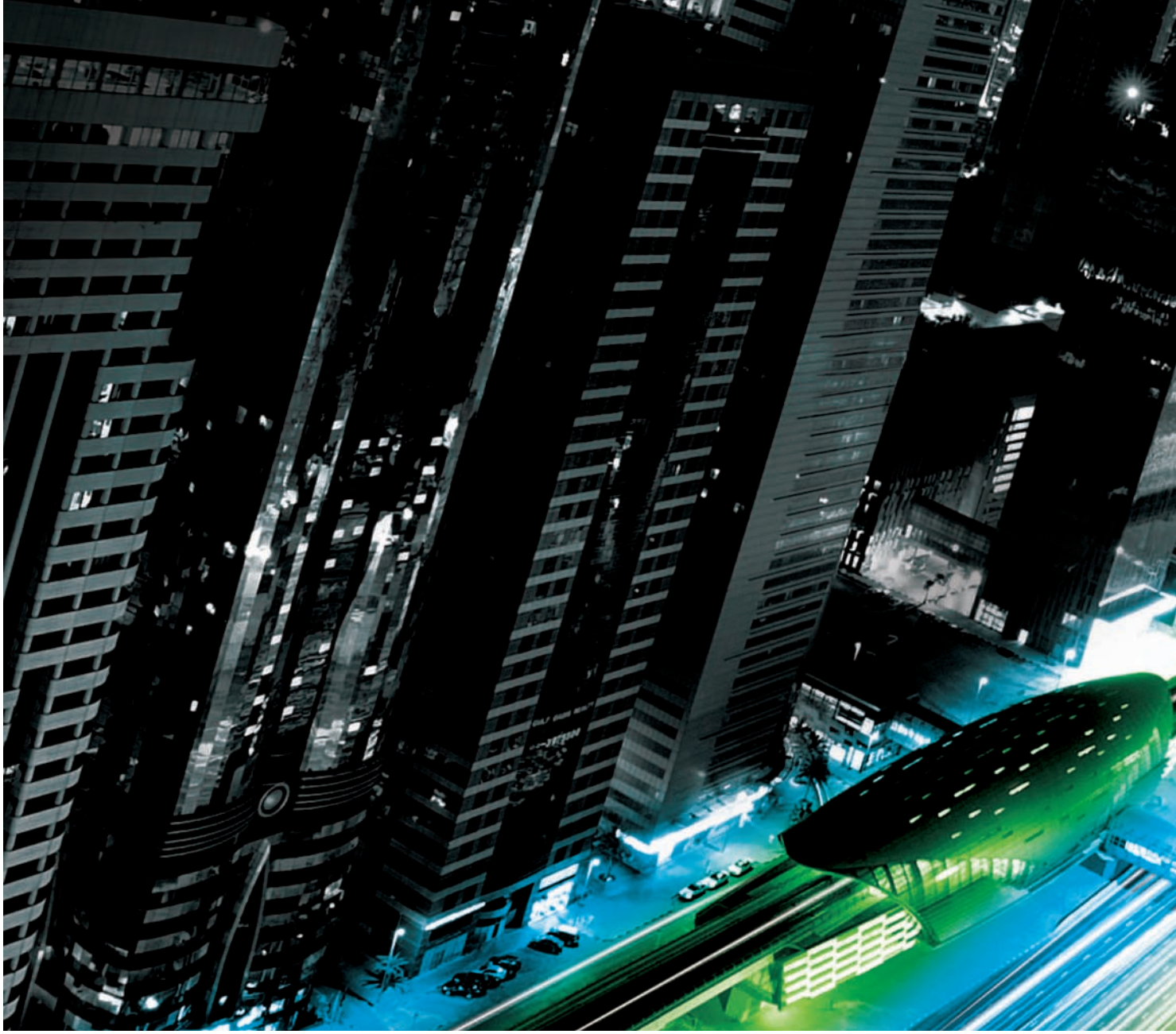
ME PoV editorial team

Contents

In this issue







Expo 2020

A game changer for Dubai

Following the United Arab Emirate's bid to host the World Expo 2020 in Dubai under the theme "Connecting Minds, Creating the Future," all eyes were focused on the Emirate awaiting the news of whether it would, in fact, be holding the hugely popular event. With the announcement of Dubai winning the bid, the entire GCC and Middle East markets gathered to celebrate the historic win, as the event had previously never been held in the Middle East. Boon or bane? We asked our experts to weigh in.

Bound to attract millions of visitors, Expo 2020 will no doubt change the way we do business, and will create significant changes be they opportunities or challenges – in most industries and market sectors. Here our Deloitte leaders and experts discuss how they think the Expo 2020 win for Dubai will reshape and alter the way business is being done and the impact it will have on their industries. One thing is certain: "business as usual" is no longer applicable.

Mutasem Dajani, United Arab Emirates regional managing partner, Deloitte

Q. How do you think Dubai's Expo 2020 win will affect the region in general, and Dubai in particular?

A. As the first-ever World Expo to be held in the MENASA (Middle East, North Africa and South Asia) region, Dubai Expo 2020 will undoubtedly have an impact that ranges beyond Dubai and even the UAE itself. If we take a moment to consider the meaning and the possibilities behind the theme "Connecting Minds, Creating the Future" it is clear that Expo 2020 will go beyond a local showcase of commerce, technology and infrastructure, however impressive these things may be. The stated subthemes of the Expo are Sustainability, Mobility and Opportunity. By focusing on identified key drivers of global development, Dubai will itself become an agent for future global progress as securing sustainable energy and resources, connecting and moving people, goods and services across markets and exploring the intrinsic spirit of entrepreneurship come together in a location that is uniquely synonymous with achievement in each of these areas.

Words like 'transformative' and 'economic catalyst' have been used to describe the potential impact of Expo 2020. When you consider that according to the Bureau International des Expositions (BIE), in 2010 more than 73 million visitors and 246 participating governments, international organizations, and Non-Governmental Organizations (NGO) attended the Shanghai Expo, the far-reaching scale of the Expo platform and its ability to create a lasting legacy becomes clear. While close to US$7 billion has reportedly been earmarked for development and infrastructure projects in Dubai so far, and tens of millions of visitors are expected in the first six months, the fact that Dubai is itself strategically located within four hours of a third of the world's population and is a bridge between developed and developing nations gives this Expo added potential for wider impact leading up to the event and afterwards for years to come.

The construction and tourism, hospitality and leisure sectors have obvious potential to benefit from development spending and job creation. Technological innovators in conventional and alternative energy as well as engineering, urban planning and logistics will also likely see a host of in-region opportunities. But beyond commerce there is also a real human development dimension to the Expo. With over one third of the population currently below the age of 15 across the developing world (and generally double the rate in most western developed nations), rapidly growing urban populations, scarce resources and an increasing need for investment in human capital, H.H. Sheikh Mohammad bin Rashid's statement last November after the awarding of the 2020 Expo to Dubai bears repeating: "Our goal is to build a better future for the region's youth. The UAE will achieve it through collaboration and inspiration at the event." By staying true to this goal and the themes of the Expo, Dubai 2020 will impart an energy and relevance that may

> It is clear that Expo 2020 will go beyond a local showcase of commerce, technology and infrastructure, however impressive these things may be
>
> Mutasem Dajani

be unmatched by any recent exposition the world has seen. Six years from now today's teenagers will be choosing their respective courses of study or entering the job market. Today's university graduates will be managers in industry and the public sector and will be more mobile, globally connected, and technologically adept and determined in addressing the challenges of the next decade. All indications are that 'Connecting Minds, Creating the Future' can go beyond a theme and become a catalyst for development of the UAE and the region.

Humphry Hatton, CEO, Deloitte Corporate Finance Limited

Q. How do you think Dubai's Expo 2020 win will affect Financial Advisory services?

A. There are likely to be a number of secondary and indirect effects to the financial advisory services landscape, in addition to the direct opportunities to advise on the capital project and real estate issues that will be directly generated as a result of the need to build new and innovative infrastructure: these would involve areas such as providing advice on project modelling and related financing needs, as well as providing project assurance once development is underway, where a genuinely independent professional view is required.

However, hosting Expo 2020 in Dubai seems likely to only further the attractiveness of Dubai as a base for overseas companies wishing to invest in the Middle East. It is easy to forget that there are still a great many companies around the world that do not have operations in the Middle East and have never invested here, and Expo 2020 should be yet another important component of any strategy to give Dubai a more prominent place in the business world, although there is clearly much work that will need to be done to be able to realize these benefits. In the next six years leading up to Expo 2020, I would expect to see even more impetus behind the important SME initiatives, where we are proud to be a partner of the Dubai SME, providing advice and support to that important band of entrepreneurs that are critical to a healthy and dynamic economy.

> Expo 2020 should be yet another important component of any strategy to give Dubai a more prominent place in the business world
>
> Humphry Hatton

In time, these activity levels are likely to flow through to an increase in mergers and acquisitions and other transactional opportunities, and perhaps to create pressure for greater economic liberalization and better regulation to ensure that the maximum possible opportunity is derived from this very significant event in the history of Dubai and indeed the whole of the UAE, as well as the wider region.

Finally, there is little doubt in my view that the high growth and high value economies of the future will be characterized by exceptional investment in infrastructure and education, and so clearly the opportunity exists to assist with related acquisition strategies, applying a range of diligence expertise and advisory skills as necessary to build lasting value from these transactions.

Anis Sadek, Dubai managing partner, Deloitte

Q. How do you think Dubai's Expo 2020 win will affect the tourism, hospitality and leisure/retail/consumer business industries?

A. There is no doubt that Expo 2020 will have a significant impact on Dubai and act as a catalyst, further energizing the hospitality, leisure, retail and consumer businesses here. It only takes a quick analysis of the impact of an expected additional 20 million international visitors over a six-month period to see that significant investment in hospitality and retail infrastructure will be required, expected to be particularly in the vicinities of Dubai World Central (Al Maktoum International Airport) and Muhammad Bin Rashid City, to cater for an estimated additional 70 million room-nights and a boost of over US$10 billion in retail/consumer spending. This is all in addition to the non-Expo predictions of 16 million arrivals in 2020.

In a city where hotel occupancies are already high, Expo 2020, in addition to other growth, is estimated to require an additional 50,000 rooms in over 200 properties of all categories from budget through to luxury which is expected to create 100,000 new jobs in tourism and hospitality (out of 277,000 employment opportunities in total) the impact is therefore also bound to be felt in neighboring cities, particularly Abu Dhabi, as they absorb part of this demand. Pundits are expecting a significant boost in the previously predicted growth rates of 4 percent in the economy (Shanghai achieved 13 percent GDP growth in the five years leading up to the 2010 Expo)–BoA Merrill Lynch estimates a boost to the Dubai economy of US$23 billion between now and 2020 and Arabia Monitor predicts that total receipts from visitors to Expo 2020 could reach US$60 billion.

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>
> Anis Sadek

The legacy we all hope for is the development of additional vibrant business districts, incorporating leisure and retail, fully integrated into the global travel hub that is Dubai. The challenge facing the hospitality, leisure and retail sectors is how to sustain business beyond Expo 2020; careful planning is needed to avoid over-shooting the required development and for Dubai to build and maintain attractions and events that will encourage future visitors to the destination in the generations to come.

Cynthia Corby, Audit partner, construction industry leader, Deloitte Middle East

Q. How do you think Dubai's Expo 2020 win will affect the construction industry?

A. With Dubai winning Expo 2020 we will see renewed confidence in the already improving construction industry. In a market that relies upon confidence and optimism, this is a much-needed stimulus to create momentum for a renewed development and economic cycle. The largest ever Expo site is set to be built in the Jebel Ali Dubai World Central (DWC) area at a total cost of between US$2–4 billion. The secondary infrastructure spend will be upwards of US$8 billion, and will include construction opportunities in the transport, hospitality, retail and commercial sectors.

Dubai's Roads and Transport Authority (RTA) has announced that they will fast-track a US$1.36 billion expansion of Dubai Metro's Red Line to connect to DWC. Emaar Properties have announced that it has signed a memorandum of understanding with DWC to develop a massive (13.63 million sq.m.) golf-centred residential estate adjacent to the area surrounding the Expo 2020 site. These are the first of many announcements regarding large-scale projects being planned in the wake of the Expo win.

With all this extra infrastructure spend jobs will be generated with some estimates claiming 30 percent of the potential 300,000 jobs created by Expo 2020 will be in the construction sector alone. The government has also announced that all new and existing construction projects are going to be fast-tracked to be ready for 2020. The demand for skills and resources will of course increase and we would hope that a well-planned and phased development strategy will prevent the price for these resources and for talent from becoming disproportionately expensive.

I would like to take this opportunity to congratulate Dubai on winning Expo 2020. I am eager to see Dubai's theme of "Connecting Minds, Creating the Future" to continue to unfold as the plans for Expo 2020 start to take shape and pick up momentum, and look forward to being part of these exciting times ahead.

Jesdev Saggar, managing director, Infrastructure and Capital Projects, Deloitte Corporate Finance Limited

Q. How do you think Dubai's Expo 2020 win will affect the Infrastructure and Capital Projects (I&CP) service line?

A. Whilst my immediate reaction is that it will be positive, I think we need to be cautious and balanced on how the market should embrace the Expo 'euphoria.' Firstly, very few people understand what an Expo is, let alone its potential impact on Dubai. While all of Dubai's indicators are moving in a positive direction, the future remains challenging. Dubai has been dealing with the close out of its financial obligations over the downturn years and the lessons learnt during the close out of these obligations would be usefully applied to avoid this pressure as the Government is to embark on funding future infrastructure to meet the demands of hosting a global event. While challenging, that does not mean that it cannot be done, these challenges can be met with the right planning and coordination of spend across all the authorities. Expo, like any major event is all about coordination and planning and its success or failure will be a result of how well the authorities unite to capitalize on its potential. The construction sector will not be the only benefactor, but the difference between Dubai and some of its neighbors is that it acts decisively and those actions turn into results that we can all see and enjoy. Dubai must think smart about the project management office (PMO) for this project and simply handing it to a technical services provider might not align with the dynamic bid the Expo Supreme Committee submitted. Dubai needs more, Dubai expects more and Dubai deserves more. As a leader in the region, all eyes are on how 'Dubai does it' as that will be the template for others to follow. Dubai once again is the pathfinder and with that responsibility it should harness the talent it has developed locally before looking internationally for support.

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Cynthia Corby

Dubai once again is the pathfinder and with that responsibility it should harness the talent it has developed locally before looking internationally for support

Jesdev Saggar

Akbar Ahmad, Audit partner, financial services industry leader, Deloitte UAE

Q. How do you think Dubai's Expo 2020 win will affect the Financial Services industry?

A. When Dubai was officially announced as the host of the Expo, the outpouring of joy was phenomenal and very similar to what I had experienced when London was awarded the 2012 Olympics. It speaks volumes that Dubai and the UAE were able to get such overwhelming support from the global community when they were competing against cities and countries that had been vying and winning events such as the Olympics and the Football World Cup.

Dubai is gearing up to ensure that on an ongoing basis it is able to welcome 20 million plus tourists a year as opposed to hosting an event after which the facilities and infrastructure become white elephants

Akbar Ahmad

From a financial services industry perspective, while Expo 2020 will have a limited impact, in my view it will represent a milestone on a journey that looks to fulfill the vision of the leadership of the UAE. To keep it in perspective, the Dubai Government spend for the Expo 2020 is estimated to be US$9 billion over a seven-year period, the 2012 GDP for the UAE was approximately US$360 billion.

The real story in my view is the diversification of the UAE economy, both in Abu Dhabi and Dubai, in sectors such as aviation, logistics, financial services, manufacturing, real estate and in particular leisure and hospitality. Dubai had 10 million tourists in 2012 and currently competes with the likes of London, Paris, New York, Singapore and Bangkok and has ambitions to have 20 million tourists by 2020. Even during the crisis, we saw continued investments in infrastructure, logistics, tourism and hospitality which were required to support the current numbers of tourists. To achieve the ambition of 20 million visitors, Dubai is gearing up to ensure that on an ongoing basis it is able to welcome 20 million plus tourists a year as opposed to hosting an event after which the facilities and infrastructure become white elephants.

In terms of the banking sector, it has weathered the storm of the global crisis and is well positioned to support the continued growth and diversification of the UAE economy. There have been some lessons learnt from the crisis, within the sector we see the UAE Central Bank bringing in additional regulation to ensure the stability of the financial system such as mortgage caps, regulations on large exposure, financial institutions requiring a general provision of 1.5%, etc. We also see banks improving systems, controls and governance to address some of the shortcomings identified in the crisis, such as reducing their exposure to real estate, focusing on Small to Medium Enterprises, focusing on operating cash flows as opposed to asset valuations, etc. As a result, compared to where we were a few years ago, the cumulative non-performing loans have decreased, coupled with better impaired loan coverage ratios.

We also see the emergence of banks from the East increasing their credit exposures in the UAE and while some European and U.S. banks had reduced their operations, we are aware of a number who have reversed this decision as they see how strongly Dubai and the UAE have come through the crisis. It remains a very competitive sector and the challenge for Boards will be to deliver profitable growth in a measured and sustainable manner and ensure their institutions are better equipped during this period of growth to deal with the next downturn.

Rashid Bashir, Consulting partner, head of strategy practice, Deloitte Middle East

Q. How do you think Dubai's Expo 2020 win will affect the consulting and strategy landscape?

A. World Expo 2020 will certainly cement Dubai's status as one of the leading business hubs in the world. It provides further evidence of Dubai's ability to deliver on the global stage, alongside other leading cities. The real opportunity would be strengthening the Dubai brand beyond tourism, showcasing to the world Dubai and the UAE's diversified portfolio of economic sectors. In addition to construction, tourism and trade sectors, the wider economy is set to benefit enormously. This event, as part of the overall maturing state of the UAE's economy, will provide significant and sustainable business opportunities in the run-up to, and beyond, 2020.

Clearly planning for and securing legacy benefits would be critical for sustainable growth and avoid any potential cliff in terms of economic activity after the Expo. It is very encouraging to see the commitment from the leadership of Dubai in this regard. Although there are strategic plans in place for Dubai's, and the UAE's long-term development, it would be beneficial to develop a dedicated legacy plan to ensure that the event's potential as a catalyst to transform Dubai's economy is maximized. Over the next few years, major infrastructure and real estate projects must demonstrate how this investment will be leveraged post-Expo 2020 through sustained demand creation and legacy planning.

In addition to economic benefits in the form of job creation, Gross Domestic Product (GDP) growth and enhanced investment, the Expo will have tremendous social impact in terms of national identity, civic pride and community cohesion. The celebrations at the time of winning the bid indicate the potential of this international event to create a real buzz for Dubai and enhance its position as the magnet for talent in the region.

In addition to economic benefits in the form of job creation, Gross Domestic Product (GDP) growth and enhanced investment, the Expo will have tremendous social impact in terms of national identity, civic pride and community cohesion

Rashid Bashir

by **Mutasem Dajani**, United Arab Emirates regional managing partner, Deloitte, **Humphry Hatton**, CEO, Deloitte Corporate Finance Limited, **Anis Sadek**, Dubai managing partner, Deloitte, **Cynthia Corby**, Audit partner, construction industry leader, Deloitte Middle East, **Jesdev Saggar**, managing director, Infrastructure and Capital Projects, Deloitte Corporate Finance Limited, **Akbar Ahmad**, Audit partner, financial services industry leader, Deloitte UAE, and **Rashid Bashir**, Consulting partner, head of strategy practice, Deloitte Middle East

Countdown to FATCA…

The real challenges for senior management start now

By April 25, 2014, financial institutions across the Middle East will need to have entered into an agreement with the U.S. authorities (Internal Revenue Service or IRS) to comply with specific requirements set forth in the FATCA (Foreign Account Tax Compliance Act) regulations so as to avoid being subject to the penal 30 percent withholding on certain U.S.-sourced payments. One of these requirements is that each Foreign Financial Institution (FFI) will need to adopt a FATCA governance program and appoint a Responsible Officer who will take personal responsibility for FATCA compliance on its behalf. Non-compliance with FATCA could leave organizations and senior personnel open to significant financial and personal penalties. Appropriate action should be taken now.

Brief overview of FATCA

The U.S. treasury introduced the FATCA regulations to combat U.S. tax citizens evading taxation by hiding their income and assets in offshore jurisdictions. Under U.S. tax law, U.S. citizens are obligated to declare and pay taxes on all of their worldwide earnings regardless of where these earnings have been derived.

The FATCA regulations do not cover only U.S. citizens but a broader category of individuals including Green Card holders (permanent residents), those born in the United States and those with a significant presence in the United States, collectively referred to as 'U.S. Persons.'

The onus of compliance with FATCA regulations lies with the FFIs, who have until June 30, 2014, to initiate their respective FATCA compliance programs or else suffer tax withholding and severe reputational damage.

Serious non-compliance could result in legal consequences for the RO, the board, and senior management, and as such it is a matter not to be taken lightly

The FATCA compliance requirements

Every affected financial institution in the Middle East will be required to appoint a Responsible Officer (RO) who will take personal responsibility for ensuring that their respective establishment registers with the IRS via its online FATCA portal and enters into a FATCA agreement (the "FFI Agreement"). This must be done prior to April 25, 2014, to ensure inclusion on the initial list of participating FFIs, which will be published by the IRS on June 2, 2014.

The RO appointed by an FFI must be of a sufficiently senior level (i.e. board level or one tier below) to ensure that the correct level or authority is supporting this program. The RO will sign the FFI agreement, oversee a compliance program and periodically certify compliance to the IRS. Both the FFI agreement and the certifications will be subject to U.S. penalties of perjury.

The 3 main pillars of a FATCA compliance program

Classification Internal business classification will need to be undertaken on group, entity, products, accounts and payments. New and pre-existing U.S. customers will also need to be identified and documented based on a defined set of criteria provided by the regulations.

Reporting There will be two types of reporting, formal and informal. Formal reporting means the FFI will need to report to the IRS on individual compliant U.S. accounts and collectively on non-compliant accounts by deadlines as provided in the FATCA regulations. Informal reporting means the IRS may request documentation from the FFI at any given time and the RO will be obliged to comply with the particular requirements as, and when, requested.

Withholding The FFI will be required to withhold tax at 30 percent on certain U.S.-sourced payments to non-compliant individual and financial/entity accounts. The compliance program must ensure that there are policies, procedures and processes in place that are sufficient to meet the above requirements, and which are capable of providing the necessary assurance to a RO that the FFI is meeting these throughout the certification period.

The senior management of the business

The first step for the board of directors of every financial entity is to consider whether their respective entity is an FFI or not under the FATCA regulations. If it is an FFI, consideration will need to be given to determine if the FFI is in a jurisdiction that has signed an Inter-Governmental Agreement (IGA), which could be a Model 1 or Model 2 IGA. The RO requirement may be removed or reduced under a Model 1 IGA, but

nevertheless, the fundamental requirement for having a single senior member taking responsibility for FATCA compliance does not go away. As such, the board of directors will need to review and approve the policies and procedures drafted by the RO to ensure an effective and efficient FATCA compliance program, whether under a local jurisdiction IGA or directly with the IRS.

Responsible officer requirements

Assuming the FFI enters into a direct FATCA agreement with the IRS, there are two main certifications that the former will need to make to the latter:

- The first certification is required no later than 60 days after the final due diligence requirement deadline. This is the certification regarding the diligence requirements of pre-existing accounts.
- The second certification requires the ongoing review and verification from the RO and senior management that the FFI has established and maintains effective internal controls to comply with the FATCA regime.

The requirements of the RO require knowledge, support and changes across the business

Phase 1: Diligence requirements–initial commitment by the FFI

The RO must electronically certify to the IRS–with the full authority of the board of directors behind them–that the two clear requirements have been met, namely:

- The due diligence requirements in terms of existing customers was completed and performed in line with the FFI Agreement. Where required accounts could not meet the required obligations, there was the appropriate treatment of recalcitrant and Non-Participating FFIs (NPFFI); and
- A reasonable inquiry has been made to confirm that the FFI did not have any formal or informal practices in place to assist account holders to avoid FATCA.

Phase 2: Verification requirements–ongoing commitment by the FFI

The compliance program set up by an FFI that includes policies, procedures and processes adequate to meet the IRS FATCA requirements need to be confirmed by the RO collectively on behalf of the board and senior management, under the penalties of perjury, as per the legislation.

The certifications cover requirements and process changes across the business, detailed understanding of business processes and implementation is required.

The certification involves multiple aspects including confirmation that the compliance program is effective and has been reviewed, and that there are no material failures for each applicable certification period. If there are failures in the FFI FATCA regime the RO will be responsible for: declaring material failures, declaring the appropriate actions that will be responsible for remediating these failures and preventing them from reoccurring and also correcting the failures by paying the amount of tax due and amending returns as required.

If the RO is unable to make the certifications as described above, the RO must make a qualified certification and inform the IRS of the required corrective actions.

Serious non-compliance could result in legal consequences for the RO, the board, and senior management, and as such it is a matter not to be taken lightly.

Next steps

On July 1, 2014, the period covering ongoing certification begins. To be able to register, any RO will need to know that the business is taking steps towards compliance now. These would include: setting up a governance structure, implementing best practice policies and procedures and training and maintaining staff awareness.

The million-dollar question across FFIs regionally is how to meet these requirements, which impose a significant burden not only on the RO but any member of management tasked with safeguarding compliance.

The complex regulations will require changes to internal systems, control frameworks and processes and procedures. Putting strong FATCA policies and procedures in place now, with appropriate plan documentation, should provide a RO with sufficient comfort and provide an audit trail for internal reviews.

by **Ali Kazimi**, managing director, international tax services, Deloitte Middle East

Catching up to the West?

Challenging some common misconceptions about female leadership in emerging and growth markets

The global competition for talent, an ageing population in many western nations, the rise in the population of knowledge workers and common assumptions about the shortage of talent in emerging and growth markets, have all led to a situation in which many global companies are concerned about the acquisition and retention of talent. It seems strange, therefore, that these concerns have not produced greater progress in the advancement and retention of women. In the United States, for example, research on the progress of women in the workforce between 2000 and 2007 found that the percentage of female managers increased by only one percent (to 40 percent) and that the percentage of non-managerial female staff had not increased at all. Neither has the percentage of female corporate officers and board members of Fortune 500 companies.

The situation is similar in Europe where women make up the numerical majority of college graduates and nearly half the workforce, yet they comprise only 11 percent of corporate executives. In the United Kingdom, only 12.5 percent of FTSE 100 directorships are held by women and the public administration, education and health services industries account for nearly four out of every five ethnic minority members in management positions.

Nevertheless, it is often assumed that the situation regarding the shortage of talent in emerging and growth markets is far worse. Many corporate leaders are scratching their heads, wondering what they are going to do to capitalize on the growth in these regions. They understand the trends and predictions: 50 percent of the world's population lives in developing and emerging countries; BRIC (Brazil, Russia, India and China) has

economic growth rates of over 6 percent and will dominate the world economy by 2030; 19 of the top 100 companies are from Brazil, Russia, India, and China; there is a growing presence of diversity in the workforce and among clients in terms of gender, age, ethnicity, nationality, sexual orientation, disability and so on. But many corporate leaders are not convinced that the solution to the talent shortage partially resides in making better use of female talent in these regions. After all, they argue, traditional beliefs and customs make it virtually impossible for women in these regions to study, to work, and to travel.

Is this assumption true for emerging and growth markets in general, and the Middle East in particular? And if it isn't, what can companies do to attract and retain such critical talent?

This point of view challenges some commonly held beliefs and misconceptions about women in emerging and growth markets and identifies some key best practices that companies have successfully employed to harness women's critical skills.

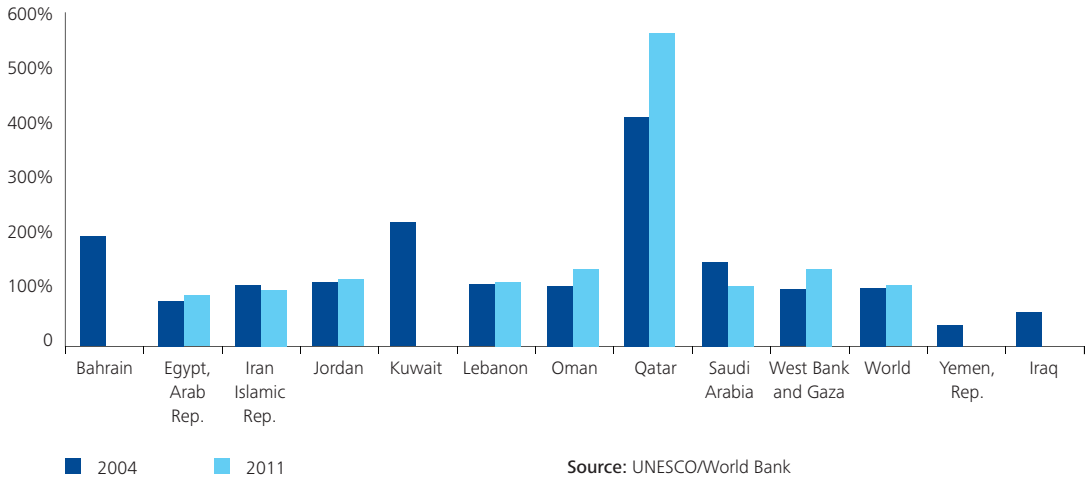
Emerging and growth markets are facing significant challenges in terms of attracting and retaining talent but some of these challenges are different from those experienced by traditional markets, and they are not necessarily getting in the way of resilient women rising to the top

Some common misconceptions about female talent in emerging and growth markets

Emerging and growth markets are facing significant challenges in terms of attracting and retaining talent but some of these challenges are different from those experienced by traditional markets, and they are not necessarily getting in the way of resilient women rising to the top. At the same time, employees in emerging and growth markets are not looking for the same attributes of employers as talent in the West. Certainly, factors such as competitive compensation, continuous training and development opportunities, clear career paths, and challenging work are attributes most employees would look for in an employer of choice. However, there are certain other attributes of equal or even greater significance in emerging and growth markets. In particular, many potential employees in these markets are looking for a commitment from prospective employers to the region, for corporate global citizenship, and authenticity.

Hewlett and Rashid (2011) and Hewlett and Leader-Chivèe (2012), in their research on winning the war for talent in emerging and growth markets, argue nevertheless that women are an important solution to talent shortages. Rather than being followers, such women can be regarded, in some respects, as role models for women in the West. Some of the misconceptions relating to female professionals in emerging and growth markets can be gleaned from the research of these authors who surveyed 4,350 respondents in BRIC countries and the United Arab Emirates (UAE), and 2,952 respondents in the United States. Respondents were college-educated men and women who participated in focus group discussions, virtual strategy sessions, and one-on-one interviews. What theses respondents had to say has subsequently been reiterated by a number of writers in the field.

Ratio of female to male university enrollments



Source: UNESCO/World Bank

Misconception # 1

Women in emerging and growth markets do not get access to educational opportunities.

In fact, 60 percent of women in Brazil, 57 percent of women in Russia, and 65 percent in the UAE are in tertiary education, compared with 58 percent in the United States and the United Kingdom.

In the Middle East, rising access to education and opportunities provided by the Internet are creating more opportunities for women. The World Bank says more women in the Middle East now attend university than men and, in contrast to the low numbers of women studying computer science and engineering in Western countries, girls throughout the Arab region are encouraged to enroll for the hard-to-enter university science courses because of good high school grades.

Misconception # 2

Women in emerging and growth markets do not aspire to top jobs.

Currently, 90 percent of women in the UAE, 86 percent in India, 80 percent in Brazil, 76 percent in China, and 60 percent in Russia aspire to holding a top job, compared to 52 percent in the United States. What's more, 11 percent of Chief Executive Officers (CEOs) in India are female, compared to 3 percent in Fortune 500 companies.

Women are also advancing as entrepreneurs. The number of women entrepreneurs throughout the Middle East region probably lies at about 15-20 percent. To put this in perspective, a Global Entrepreneurship Monitor study found 10 percent of the U.S. adult female population was involved in entrepreneurial activity in 2012, and 5 percent in Europe.

There are several reasons for the rise of the woman entrepreneur in the Middle East, and one is that the startup environment in the region has grown up with them. Many business incubators and accelerators have started up in major cities across the region in the last three years as well as across organizations and recognition and award programs specifically targeting women.

Misconception # 3

Women in emerging and growth markets are limited by domestic responsibilities.

The average workweek for women in Russia and China is more than 60 hours, and the average for women working at multinationals is generally longer than for those working at local companies. Although the vast majority of women in BRIC nations and the UAE have responsibilities towards elders, the majority would prefer to use hired help (than place family members in care) and live in an extended family environment. It is also common throughout BRIC countries for young couples to live with parents. This also provides support with childcare responsibilities.

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Misconception # 4

Women in emerging and growth markets cannot travel internationally.

Although the majority of female respondents in India, China, and the UAE felt that they would face family disapproval if they were to accept an international assignment, they nevertheless felt that mobility is crucial if they hope to advance in their jobs.

Misconception # 5

Gender stereotypes prevail in emerging and growth markets.

When asked whether they believe women are treated unfairly in the workplace because of their gender, women and men from the BRIC nations and the UAE had similar perceptions of stereotyping and bias. For example, 45 percent of both men and women in India and 36 percent of men and women in China felt that women were treated unfairly because of their gender. The figures for Brazil are 25 percent of women and 23 percent of men; for Russia 19 percent and 13 percent respectively, and the UAE 32 percent and 36 percent respectively. These findings tend to contradict what many believe to be the case in these regions.

It would appear from these findings that, like women in the West, women in these markets are making inroads into leadership positions in companies and as entrepreneurs. It would be misleading to argue, though, that progress in one region is far more advanced than in another. There is still a great deal of work to do around the globe. And, still today, many companies are not as committed as they could be to diversity initiatives integrated into business and talent strategies. For those who are, women are a critical source of talent, not only from a moral but also a business perspective.

So why should we target women as a remedy for the talent shortage?

The business case is clear, diverse and balanced teams improve an organization's bottom line. Inclusive environments drive stronger performance and sustainable business benefits. In fact, companies with more women on their boards were found to outperform their rivals with a 42 percent higher return in sales, 66 percent higher return on invested capital, and 53 percent higher return on equity.

Globalization is also reshaping the talent landscape. Women make up nearly half the working population in many regions around the world, and policies and investments targeted at promoting women will be critical in a global economy increasingly dependent on the intangible assets of people, brand, and intellectual property. Employee commitment and customer loyalty will increasingly be positively influenced by gender parity in key decision-making roles. For many organizations, including Deloitte, diversity and inclusion is a shared business value. This is particularly the case in many professional services organizations that are in a people to people business. People are the biggest asset in many companies. Research also suggests that diverse teams better serve ever more diverse global clients and perform better in innovation, sales, number of customers, and market share.

Further to that, women perform 66 percent of the world's work, produce 50 percent of the food, and own approximately 40 percent of all private businesses in the formal economy. Women are expected to control approximately US$28 trillion in consumer spending by next year, yet remain gravely underrepresented at the helm of business organizations. The figures speak for themselves and are too important to be ignored by organizations. Several key factors seem to underlie good diversity practice; these include a compelling business case; a culture of inclusion with globally minded leaders that is supportive of diversity as drivers of innovation; and career customization and other initiatives to create a more inclusive and flexible culture.

Women make up nearly half the working population in many regions around the world, and policies and investments targeted at promoting women will be critical in a global economy increasingly dependent on the intangible assets of people, brand, and intellectual property

At Deloitte, as in most global companies, initiatives vary from member firm to member firm (or business unit to business unit) and are locally relevant. Some will have been implementing their diversity strategies for some years; others are just beginning this journey. For the vast majority, gender will be the major focus, but some may also prioritize ethnicity, people with disabilities, and GenY.

However, even though there is no "one size fits all" approach, what we have learned is that there are certain key critical success areas that help to embed diversity into an organization's ongoing business strategy. These include the following:

1. Build, socialize, and communicate the business case.
2. Engage champions across all levels.
3. Dedicate appropriate resources.
4. Set priorities and targets and effectively embed measures in the performance management system.
5. Commit to the formulation, implementation, and monitoring of locally-relevant diversity plans.
6. Define roles and responsibilities.
7. Integrate into business and talent processes, including the operating model and talent lifecycle.
8. Equip leaders with inclusive leadership competencies.

We can define an inclusive leader as someone who:

- Appreciates difference but still makes effective business decisions.
- Identifies and eradicates bias and exclusive behaviors in his/her team.
- Embeds inclusiveness into teams and relationships with clients.
- Understands diversity and can express his/her ideas about it.
- Is a business relationship builder, in the organization, his/her team, and with clients.

Women perform 66 percent of the world's work, produce 50 percent of the food, and own approximately 40 percent of all private businesses in the formal economy

This, in turn, requires abilities such as:

- An acceptance of complexity and a willingness to manage it.
- A commitment to making good business decisions in the interests of the customer and his/her employer.
- Self-awareness, flexibility, curiosity, and a willingness to learn.
- An openness to new ideas and an ability to listen and understand.
- Consistency, fairness, honesty, and assertiveness.

In other words, inclusive leadership is about reducing levels of unconscious bias. We all have our biases and we all make assumptions. However, these become particularly problematic when it comes to how we think about and behave towards groups that are under-represented in our organizations because of bias and traditional attitudes towards them.

For example, unconscious bias in recruitment is part of a larger challenge impacting diverse groups in business. The cascading impact of bias begins with how we define roles; the type of person we feel will be competent to perform them; how we read their resumes and our impressions of them in the job interview. But once a person is appointed, all kinds of other potential biases can impact on how they experience their working environment. These potential biases include levels of inclusion; recognition of performance; how we interpret mistakes; who we select for development opportunities and international assignments; as well as whom we promote and why we promote them. According to a recent study[1], recruitment and promotion decisions are likely to be influenced by a decision-maker's competencies rather than solely by the needs of the job. Recognizing this bias is the first step to remediation, but awareness is unlikely to be sufficient. Ensuring that recruitment and promotion decisions (as well as competency frameworks) are made by a diverse group

is critical. The study points to the importance of recruitment and promotion selection panels comprising individuals with diverse educational backgrounds or from diverse work functions.

Over the last 10-15 years, Deloitte member firms around the world have generally included these best practices in their diversity strategies. For example, Taj, a member firm of the Deloitte Touche Tohmatsu Limited international network, has not only achieved a very impressive figure of 58 percent female partners; in the last six years, it has also achieved 70 percent growth in a shrinking market and moved from a second tier firm eight years ago, to a recognized market leader–one tier above its competition.

Diversity lessons from Taj include some of the key examples of good diversity practice:

- Get Top Management commitment–if you don't have this, the rest will be much more difficult.
- Ensure you have a diverse set of people in the room when making important decisions and most certainly always and without exception when those decisions are about hiring and promotions.
- Ensure leaders have competencies in inclusive leadership.
- Measure promotions: female promotions, that is.

Conclusion

Although women in the Middle East are making great strides in commerce and industry, organizations that recognize the business value-add of female talent will continue to invest in their attraction, recruitment, development, and retention. The role of men and of leadership commitment and inclusive leadership in particular are crucial to this process. Women can educate and motivate themselves but it requires the combined dedication of both men and women to ensure that all of a region's talent is utilized optimally.

by **Vanessa Borchers**, global diversity leader, Deloitte Touche Tohmatsu Limited and **Linda Human**, global diversity director, Deloitte Touche Tohmatsu Limited

Although women in the Middle East are making great strides in commerce and industry, organizations that recognize the business value-add of female talent will continue to invest in their attraction, recruitment, development, and retention

Endnotes

1. Vasilopoulos (National Security Agency) and Thibodeaux (US Office of Personnel Management) reviewed archival multi-agency government wide survey data of 57 clerical and technical occupations, with 26,682 incumbents. Cucina (US Customs and Border Protection), Martin (US Office of Personnel Management)

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School's out, now what?

Meeting the skills challenge

Gulf Cooperation Council (GCC) governments are committed to policies of nationalization, but young people still seem focused on public sector jobs and those with the required technical qualifications are in short supply. Will this create a skills gap and, if so, how can it be filled in practice?

Growing economies but large numbers of unemployed youth

Around 60 percent of the GCC population is under 30 years old and the labor pool of nationals and expatriates grows annually. This reality underpins many of the continuing social and economic changes underway in the Middle East and effective vocational education is central to addressing them. A growing population means that the public sector can no longer sufficiently absorb school and university leavers as in the past.

In order to meet the challenges of youth unemployment in the region, governments are more actively promoting a policy of increasing employment for nationals and replacing expatriate employees. For example, Kuwait plans to reduce foreign workers by 100,000 a year while companies in Saudi Arabia have quotas of Saudi employees and risk having their licenses removed if they fail to meet these targets. However a British newspaper, the *Financial Times*, reports employer concerns that a combination of higher wage nationals with low or unneeded skills will threaten business sustainability. A challenge facing the region is how skills levels can be raised and attitudes changed so that people access rewarding and useful employment.

Vocational education can produce suitably prepared young people to enter employment but has a small proportion of nationals in enrollment. In relation to schools and universities, vocational training is, relatively, generally neglected in the Gulf region today. Saudi Arabia recognizes this situation and is in the early stages of expanding its vocational training system nearly fourfold in the next ten years through its Colleges of Excellence initiative. The Abu Dhabi Center for Technical and Vocational Education and Training, with its plans to open several centers, is a similar step addressing the challenge.

There is a need for a better understanding of the opportunities and needs of the GCC private sector when locals transition from school, if a better workforce balance is to be reached

Adjusting the skills balance between national and expatriates is critical if growth is to be sustained. In the region's three main economies expatriates make up 94 percent of the private sector workforce in Qatar and 90 percent in Saudi Arabia according to BBC research. Insead Business School estimates that Emiratis make up between 60 and 70 percent of the public sector but less than 5 percent of employees in the private sector. If public sector employment growth is limited there is a need for a better understanding of the opportunities and needs of the GCC private sector when locals transition from school, if a better workforce balance is to be reached.

Boys drop out of education, girls stay longer

Education represents a way towards this goal. According to Alpen Capital (GCC Education Industry study–2010) the number of students in the GCC region is expected to grow from 9.5 million in 2010 to 11.3 million in 2020. At present enrollment rates at primary and secondary level are above 90 percent for almost all Gulf countries as education is free and compulsory for all GCC nationals. At the tertiary level, however, there is a disturbingly low average of 23 percent enrollment rate across the region, worse than in many developed countries. Deloitte's February 2011 report Mind the Gap found Finland (93 percent), the United States (82 percent), Italy (67 percent) and the United Kingdom (59 percent) have all achieved greater rates of tertiary enrollment.

Enrollment rates for tertiary education are particularly low for men. A lower number of young males have been entering higher education than women, according to data from the World Bank. With fewer job opportunities for women, they tend to continue in education for longer. In Dubai for example, some 75 percent of those enrolled in public universities are women while only 25 percent are men, according to the Dubai Knowledge and Human Development Authority.

This arises due, in part, to GCC governments providing relatively high-paying employment for male nationals with minimum qualifications, so naturally they are choosing this path over gaining more qualifications or a career in the private sector. But as the national population grows, governments become less interventionist, and countries experience spending slowdowns, there will be fewer public sector jobs available. This makes it important for more young men to consider private sector employment routes and stay in post-school education to get the appropriate qualifications.

There needs to be more joined-up thinking

The education systems of the GCC countries should ensure that students finish their education prepared for a future that requires them to be globally competitive. There needs to be even better coordination between the Ministries of Labor, Education, Higher Education and the private sector (through Sector Boards and Chambers of Commerce), to ensure that today's educational reforms

will provide tomorrow's skills requirements. This will require thorough and ongoing analysis of labor markets and extensive communication of findings with students, parents, employers, schools, universities and colleges.

Emphasis should be placed on skills such as creative thinking, team work, purposeful writing, problem solving, research, innovation and technology. Regulations should be developed to ensure that each country has a curriculum and testing system that reflects this style of learning that users can understand.

Although debate continues over whether students should be taught in Arabic or in English, it is certain that proficiency in both is vital for today's students. Reformed vocational education should safeguard the status of Arabic and traditional cultural values.

There needs to be effective coordination between K-12 and higher education and technical institutes in order to encourage more students to continue into post-school education, particularly vocational education. Universities and technical institutes must create better awareness of the benefits of their opportunities. Efforts to make entry routes into vocational training and higher education more flexible should be developed further. The provision of flexible part-time or second chance routes to qualifications would increase the chances of these qualifications being achieved. This should include greater use of part-time study and computer-assisted learning.

Employers must play their part

Students need to be better informed about the labor market. Improved careers advice and employer engagement in schools and vocational training is important in supporting parents and students in the decision making process so that labor market realities are understood when choosing majors.

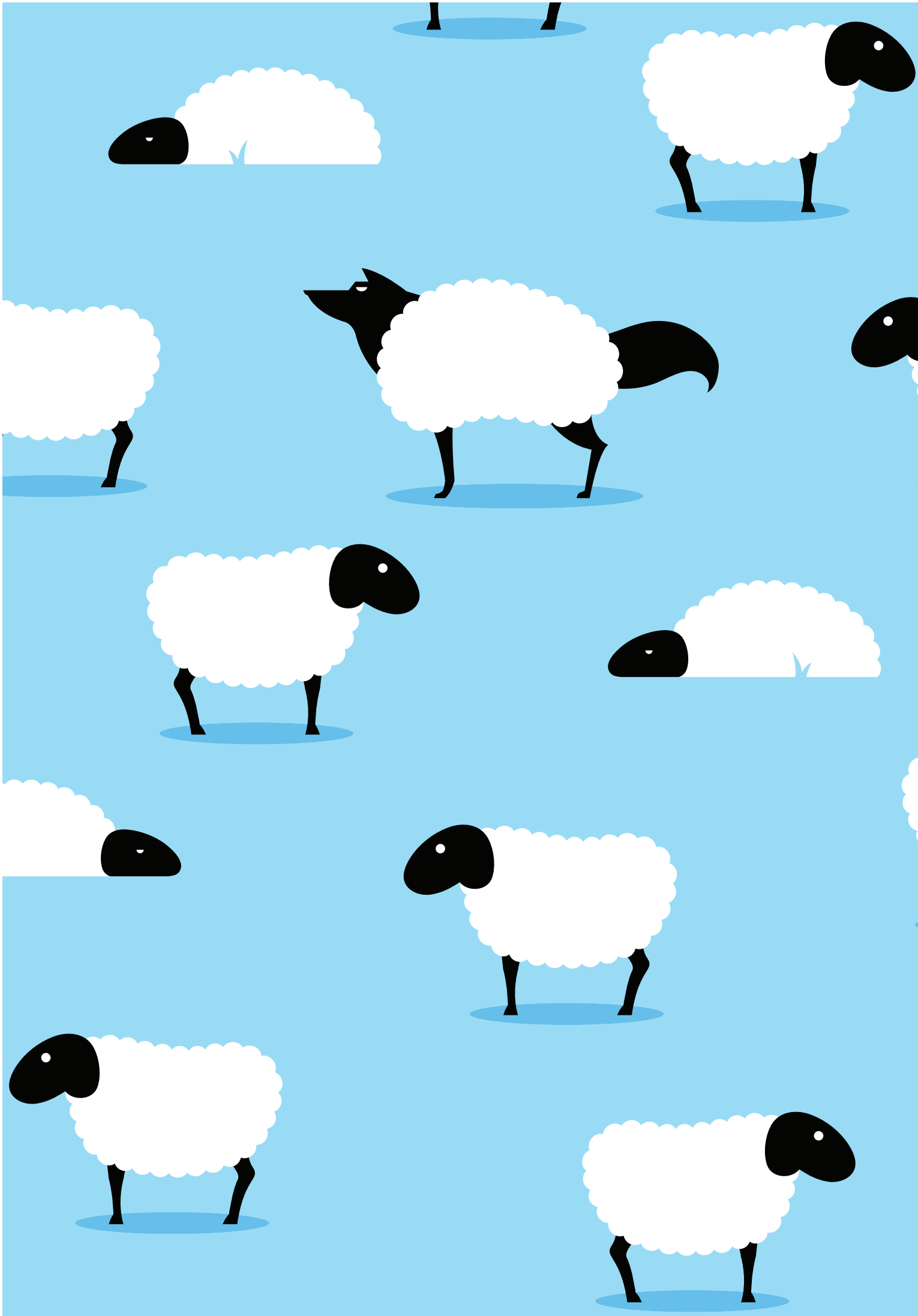
Emphasis should be placed on skills such as creative thinking, team work, purposeful writing, problem solving, research, innovation and technology

Quality in vocational education must be safeguarded. Assessment of vocational learning should be practical and linked to the demands of the workplace, independently monitored and with standards that are consistently applied and internationally recognized–ideally with significant employer input and support.

Sector boards that bring together employers and vocational training providers have the capacity to improve the status and responsiveness of vocational training in the region. The United Kingdom's Council for Education and Skills (UKCES) and Norway's National Council for Vocational Education and Training have done this. By providing a forum for collaboration, sector boards have the potential to impact on the way vocational learning is designed, delivered and assessed so that employers' needs are met and employment opportunities created.

Whatever the direction of the journey to improve and increase vocational education, we suggest that public and private sector collaboration is critical. Reform will need to be state-initiated but with private sector involvement and support with no tolerance of poor performance.

by **Richard Barrett,** leader of Education and Skills consulting services, Deloitte Middle East



Procurement fraud

Should the Middle East be concerned?

Major infrastructure activity is occurring over much of the Middle East with significant construction work being undertaken on behalf of government agencies in areas such as airport terminals, hospitals, port facilities and transport networks. In addition, multi-billion dollar projects are being undertaken in the oil and gas industry. But the incentive to win major contracts can lead individuals and even companies to engage in corrupt and fraudulent behavior. Staff within the procurement or project management divisions of contracting organizations may be exposed to inappropriate inducements such as bribes and corrupt offerings. So how does procurement fraud happen and who should be concerned?

The UK National Fraud Authority defines procurement fraud as "a deliberate deception intended to influence any stage of the procure-to-pay lifecycle in order to make a financial gain or cause a loss. It can be perpetrated by contractors or sub-contractors external to the organization, as well as staff within the organization."

Procurement fraud can be separated into two distinctive sections: The period of time before any contract is awarded, and after a contract has been awarded.

Pre-contract stage fraud includes fraud related to the submission process–such as the premature opening of bids, altering bids, unjustifiable extension of time limits and falsifying bid logs and documents–bid-rigging schemes, as outlined in the box on the right, and leakage of information–where bid information is directed to a particular bidder to provide it with a competitive advantage.

Pre-contract stage fraud includes fraud related to the submission process–such as the premature opening of bids, altering bids, unjustifiable extension of time limits, controlled bid opening and falsifying bid logs and documents–bid-rigging schemes and leakage of information, where bid information is directed to a particular bidder to provide it with a competitive advantage

Bid-rigging schemes
Most bid-rigging fraud schemes involve collusion between competing companies during the bidding process.

Bid suppression scheme
One or more competitors agree with at least one other competitor to refrain from bidding or agree to withdraw a previously submitted bid so that a decided contractor's bid will be accepted.

Complementary bids/Bid rotation schemes
Complementary bidding occurs when competitors submit token bids that are too high to be accepted. Such bids are not intended to secure the buyer's acceptance, but are merely designed to give the appearance of genuine bidding.

Phantom bids scheme
Creating dummy companies to submit a variety of bids on a single contract. That way, they give the appearance of vigorous competition while actually bidding against themselves.

Bid tailoring schemes
Staff within the awarding company structure the contract specifications to ensure that they favor a particular bidder.

Post-contract fraud schemes include:

Accounting mischarge schemes: These involve knowingly charging unallowable costs to the buyer, concealing or misrepresenting them as allowable costs, or hiding them in accounts where it is thought that they are unlikely to be detected.

Labor mischarge schemes: Where contracts include payment for labor, contractors falsify the numbers of staff employed and/or hours worked in order to inflate their invoices and payments received.

Product substitution schemes: Once a contract for supplies and products has been awarded, suppliers may attempt to provide inferior quality supplies or products in order to save costs. These schemes can be very sophisticated and intended to deceive the buyer into believing that the inferior product is actually genuine.

Conflict of interest: Including key fraud scenarios, whereby buyers may be silent partners or directors in supplier organizations and purchase on behalf of the awarding company from these organizations; or where relationships between purchaser and vendor may compromise the correct and ethical decisions/actions of the purchaser.

Single source supplier schemes: Where specific goods and services are required, companies may enter into a single source supplier contract. This potentially has fraudulent ramifications in the event of overpricing by the supplier and collusion between buyers and the supplier to source product from a single supplier when it is available through other suppliers at cheaper prices.

False invoicing schemes: Suppliers either on their own or by colluding with the project staff inflate invoices, create false invoices or provide duplicate invoices for goods and/or services.

Most procurement functions, by necessity, require complex information management systems. However, this complexity in itself also leads to procurement fraud risk.

So what enables procurement fraud and how can it be prevented?

Most procurement functions, by necessity, require complex information management systems. However, this complexity in itself also leads to procurement fraud risk.

Management systems rarely provide seamless end-to-end transparent data. Different parts of the procurement data such as vendor, customer, payment and receivables data may reside on different systems, which may not be easily reconciled. There needs to be a data mining capability within all the systems to allow for sophisticated analytics to be undertaken.

Data quality issues can also cause problems. Failing to clean vendor data could result in duplicate vendors being listed within the system. This provides an avenue to change addresses, bank accounts and payment details. Lack of controls around vendor creation and management is a major procurement fraud risk.

Educating contractors and suppliers about the organization's code of conduct, ethical stance on fraud and corruption, and ensuring that they sign an acknowledgement of compliance is one of the measures that can be taken to prevent procurement fraud

However, there are several measures that can be taken to prevent procurement fraud, namely:

- Thorough control and adequate performance measures throughout the whole, complex contract and procurement processes.
- Develop fraud risk, business ethics and compliance training programs. These greatly assist in supporting a good corporate culture to help in reducing procurement fraud risk.
- Establish a fraud risk management group with direct reporting lines to an audit or risk management committee.
- Implement a whistleblowing policy and process for all staff, contractors, suppliers, and customers.
- Educate contractors and suppliers about the organization's code of conduct, ethical stance on fraud and corruption, and ensure that they sign an acknowledgement of compliance.
- Provide incentives for contractors and suppliers to create and adopt their own fraud control and ethical policies and procedures.
- Embark on a proactive data mining detection program of the entire procurement data.
- Conduct ongoing fraud risk assessments across the procurement system.
- Ensure that all staff members provide a conflict of interest declaration.
- Ensure that a robust code of conduct exists which includes specific gifts and entertainment protocols.
- Establish a policy of staff rotation within the identified high-risk groups such as buyers.
- Undertake enhanced background checking of new employees entering the high-risk groups.
- Develop a fraud control plan.
- Undertake ongoing internal audit activity into specific areas of the procurement cycle.
- Perform background checks on vendors and contractors.
- Implement a debarment policy to exclude suppliers and contractors that are known to have participated in any illegal or unethical activity.

Conclusion

Major capital and infrastructure project activity within the Middle East is set to continue into the foreseeable future. Procurement fraud can be one of the most significant types of fraud faced by organizations within the region, in terms of financial loss, reputational damage, and complexity. A number of high-profile procurement fraud instances that have already occured in the GCC indicate that fraud prevention programs are either not always in operation or are ineffective. Combatting procurement fraud requires organizations to undertake a systematic and structured approach that must be championed by the executive and senior management.

by **David Clements**, principal director, forensic, Deloitte Corporate Finance Limited (regulated by the DFSA)

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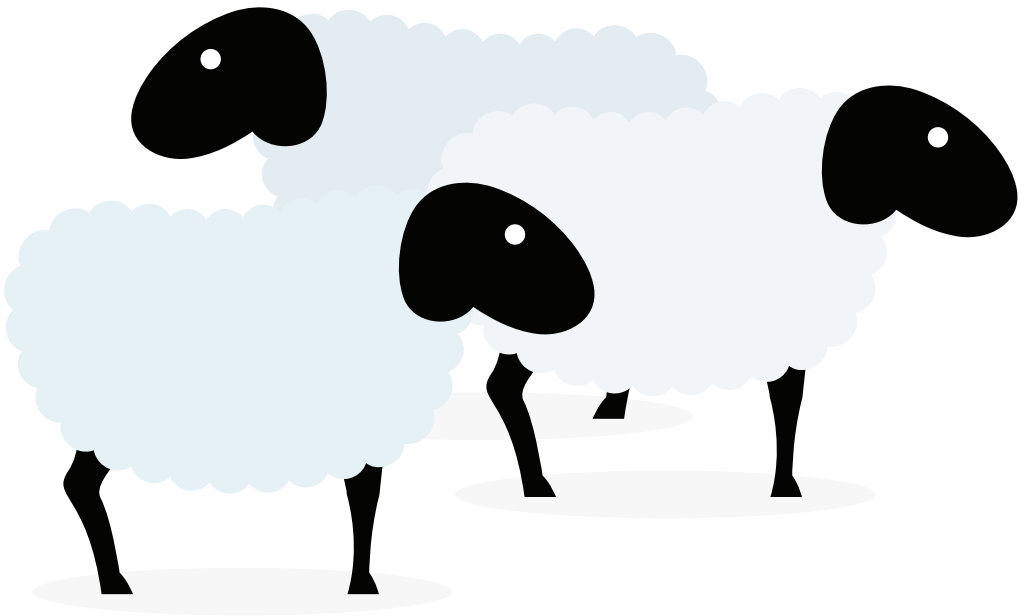



Category 3
Category 4
Series 1
Series 2
Series 3

Some common mistakes to avoid in estimating and applying discount rates

One of the most critical issues for an investor to consider in a strategic acquisition is to estimate how much the company being acquired is worth. On the back of the 2008 financial crisis, a valuation is being looked at not just as a static value at a point in time, but more as a basis for developing a post-acquisition operation plan to drive value accretion and minimizing risk. As such, the Discounted Cash Flow (DCF) analysis is being more frequently used to value companies.

The discount rate is an essential component of the DCF-based valuation, which can be tricky to get right. In this article, we explore the reasons why estimated discount rates may differ between practitioners.

We also provide an overview of some of the common mistakes to avoid in estimating and applying discount rates.

1. There are varying approaches to determining a discount rate

The discount rate is an investor's desired rate of return, generally considered to be the investor's opportunity cost of capital. The Weighted Average Cost of Capital (WACC) represents the average cost of financing a company debt and equity, weighted to its respective use.

Essentially, the K_e consists of a risk free rate of return and a premium assumed for owning a business and can be determined based on a Build-up approach or Capital Assets Pricing Model (CAPM). While both these approaches should theoretically result in the same discount rate, in practice the estimated discount rates will differ between companies, markets and geographical areas due to judgments by different valuators around some of the key components of the discount rate.

$$K_e = R_f + (RP_m + RP_i) + RP_s + CRP + RP_z$$

(based on the Build-up approach)

$$K_e = R_f + (ß \times RP_m) + RP_s + CRP + RP_z$$

(based on the CAPM approach)

R_f = risk-free rate, RP_m = market premium, RP_i = industry premium, RP_s = size premium, CRP = country risk premium, RP_z = company specific risk and ß = beta

$$WACC = K_e \times W_e + K_d \times W_d$$

K_e = cost of equity, K_d = after tax cost of debt, W_e and W_d = proportion of equity/debt based on market value

Illustrative Example (WACC calculation)

Let us walk through an example. Assume that an investor intends to value a private U.S.-headquartered company ABC & Co that operates schools in the United Arab Emirates and the United States. The common approach to calculate a WACC would be as follows:

WACC using CAPM

	U.S.	UAE
U.S. nominal 10-year treasury bond	1.8%	1.8%
Inflation differential		1.4%
Risk-free rate	**1.8%**	**3.2%**
Unlevered beta	0.50	0.50
D/E	5%	5%
Tax rate (assumed nil for U.S. as well)	0%	0%
Levered beta	**0.53**	**0.53**
Market risk premium–U.S.	6.0%	6.0%
Country risk premium–UAE		0.8%
Size & specific risks	2.0%	2.0%
Cost of equity (rounded)	**7.0%**	**9.0%**
After tax cost of debt (Kd)	**5.0%**	**5.0%**
WACC rounded	**7.0%**	**9.0%**

WACC using Build-up

	U.S.	UAE
U.S. nominal 10-year treasury bond	1.8%	1.8%
Inflation differential		1.4%
Risk-free rate	**1.8%**	**3.2%**
Market risk premium–U.S.	6.0%	6.0%
Country risk premium–UAE		0.8%
Industry risk premium	-2.6%	-2.6%
D/E	5%	5%
Size & specific risks	2.0%	2.0%
Cost of equity	**7.2%**	**9.4%**
After tax cost of debt (Kd)	**5.0%**	**5.0%**
WACC rounded	**7.0%**	**9.0%**

Notes:
1. Inflation differential based on the Economist Intelligence Unit long-term forecast
2. Beta and debt/equity based on Morningstar industry beta for educational services sector
3. Market risk premium based on historical implied risk premium on U.S. equity market
4. Country risk premium sourced from Prof. Damodaran's research based on sovereign credit rating by Moody's
5. Industry risk premium sourced from SBBI Valuation Essentials handbook
6. Size and specific risk as per judgment based on market dynamics, school operations, competitive advantage, etc. As this is subjective, it would be appropriate to apply a range of values, thus arriving at a range of WACC estimates.

2. Estimating the Ke is subjective

While the Kd (after tax cost of debt) is relatively easy to determine, in estimating the Ke there are differing perspectives amongst valuators on certain of its key components. Summarized below are some of these areas of judgment that may result in different discount rates:

- **Risk-free rate (Rf):** Government bonds are generally used as reference for deriving the Rf. However, we often notice valuation practitioners using the bonds with varying durations (e.g., 10, 20, 30 years) as a proxy for Rf, resulting in a difference in the discount rate. The selected Rf should match the duration of the underlying cash flows.

In practice the estimated discount rates will differ between companies, markets and geographical areas due to judgments by different valuators around some of the key components of the discount rate

- **Beta (ß):** The ß represents the correlation of industry or business sector with the economy. A challenge in the Middle Eastern region is the lack of liquidity in the local markets and inadequate data for the correlation analysis. This has resulted in practitioners relying on ß determined from different sources (such as Prof. Ashwath Damodaran's publications) and personal experience and judgment.
- **Country risk premium (CRP):** When estimating the Ke based on data from a developed market, an adjustment needs to be considered for the country risk. While there is some convergence amongst valuators on how to determine the CRP, there is a difference of opinion on if and how to adjust the total CRP to reflect a company's exposure to country risk.

The discount rate is applied to determine the present value of future cash flows and represents the investor's appetite for risk and the underlying uncertainties in the cash flows. The higher the implied risk the higher the discount rate is and the lower the value, and vice versa.

Example (estimating Ke)

Risk-free rate

The nature of ABC & Co is such that operations are expected to be for an indefinite period. As such, longer maturity as proxy for Rf is more appropriate (e.g., a 30-year maturity treasury bond with a yield of 3% will result in a higher WACC).

Beta

The number of companies listed on the UAE stock exchanges, and data thereof, are limited. While the beta of public comparable companies within the same country/region should be used, we have used an industry beta based on developed markets. In the educational sector, the beta of developed and emerging markets is the same.

Country risk premium

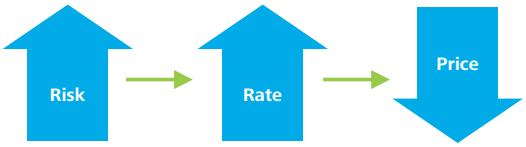
Let us now assume that the operations in the United Arab Emirates include revenue derived from international activities in the United States. As such, the UAE business is not 100 percent exposed to local country risk. One approach may be to adjust the total CRP based on the CRP portion of the total earnings that are exposed to local country risk (say 80 percent adjustment for ABC & Co).

3. The overall discount rate is dependent on the risk in the cash flows

The discount rate is applied to determine the present value of future cash flows and represents the investor's appetite for risk and the underlying uncertainties in the cash flows. The higher the implied risk the higher the discount rate is and the lower the value, and vice versa.

Two separate streams of cash flows will not have the same risk and return profile. While a generic discount rate based on market observations, say an industry WACC, may be used as a rough guide, it does not necessarily represent the appropriate discount rate for all companies in that industry.

Rate of return lever



4. Common mistakes to avoid

Having highlighted the issues, we draw on our experience and highlight below some of the common things to bear in mind when estimating the appropriate discount rate and performing a meaningful DCF analysis:

a. **Match the discount rate to the risk**
Each stream of cash flow has a specific risk structure. For instance, if the cash flows are distributable to equity holders only, cost of equity should be considered (not WACC).

Two separate streams of cash flows will not have the same risk and return profile. While a generic discount rate based on market observations, say an industry WACC, may be used as a rough guide, it does not necessarily represent the appropriate discount rate for all companies in that industry.

b. **Match the real and nominal cash flow and discount rate**
Use a nominal discount rate for nominal cash flows that integrate expected inflation or use a real rate for real cash flows (common in mining companies).

c. **The Rf should be consistent with the time period**
The selected Rf (risk-free rate) should match the duration of the underlying cash flows e.g. using the long-term rate for a going concern valuation into perpetuity, or say a 10-year rate as proxy for a mine that runs out of mineable ore in 10 years.

d. **Use alternate ways to determine the ß**
The ß is commonly sourced from industry resources including industry ß or comparable company observations. However, in the absence of sufficient trading volumes and of market liquidity required to estimate the ß (as is characteristic of Middle Eastern markets), using the Build-up approach to estimate the Ke is preferable, given that it limits the judgment in the WACC arising from estimating a ß.

e. **Adjust the CRP for the company's exposure to country risk**
The CRP should reflect the risk of the company based on its operations in that country, not be a factor of where the company is incorporated/listed. As such, the CRP needs to be adjusted based on the relative exposure of the company to the subject country to take into consideration the risk that can be diversified by virtue of the company's earnings that have an exposure to the risk in the local country.

f. **Assess overall reasonability of the discount rate**
Where possible, the discount rate should be cross-checked using an alternate approach. Apart from calculations based on two separate approaches (CAPM/Build-up), observation of average industry discount rates and comparing the implied capitalization rate to multiples of broadly comparable companies will provide a good indicator of the reasonableness of the discount rate.

Example (adjusted WACC):
We present an adjusted calculation of the WACC for ABC & Co based on the CAPM approach to be 9% to 11% for the U.S. and U.A.E. respectively, after making changes to the following variables:

- R_f–Using a 30-year yield
- CRP–Adjusted downward by 80%
- RP_z–3% and 4% for inherent risk in aggressive cash flows

	U.S.	UAE
Old	7%	9%
Adjusted	**9%**	**11%**
Implied Capitalization	*11x*	*9x*

Example (recalculated WACC):

	U.S.	UAE
U.S. nominal 30-year R_f	3.0%	3.0%
Inflation differential		1.4%
R_f	**3.0%**	**4.4%**
Levered ß	0.53	0.53
RPm–U.S.	6.0%	6.0%
CRP–UAE		0.2%
K_d	**6.0%**	**6.2%**
Size & specific risks	3.0%	4.0%
K_e (rounded)	**9.0%**	**12.0%**
K_d (assumed)	**5.0%**	**5.0%**
Debt	5%	5%
Equity	95%	95%
WACC	**9.0%**	**11.0%**

5. Concluding remarks

No single discount rate will work in all circumstances, nor is there a compelling argument for why one approach may be better than another, as illustrated in the example above. Considering this and the subjectivity in estimating certain variables, practitioners will continue to have different views on a discount rate, resulting in potentially significant variances in the values. It is therefore important to know the key areas of judgment, use the appropriate approach based on the information available and investment objectives, and cross-check the reasonability of the discount rate using alternative approaches such as average industry discount rates and the implied multiples.

by **Munish Mohendroo**, director, valuation and modelling services, Deloitte Corporate Finance Limited (regulated by the DFSA)

It is important to know the key areas of judgment, use the appropriate approach based on the information available and investment objectives, and cross-check the reasonability of the discount rate using alternative approaches such as average industry discount rates and the implied multiple

Deal maker or breaker?

Technology in M&A transactions

For some major companies in the Gulf Cooperation Council (GCC) countries, including leading banks and financial institutions, information technology (IT) is taking a more central role in the business, not only in delivering superior performance but also as a source of defensible competitive advantage. As GCC firms continue to grow through mergers and acquisitions (M&A), the requirement to invest in technology-driven innovation has increased the prominence and visibility of information technology to board-level attention.

Yet for many regional investors the inherent value and true cost of IT is often not assessed and captured within an M&A transaction. This is partly due to the traditional perception of IT as a back-office support function, but also because the specialist skills required in assessing the benefits of IT within a deal context are in rare supply. Research by Deloitte[1] has found that information technology can often be the largest cost category for organizations and the biggest enabler of synergies in an M&A transaction. Involvement of IT early and throughout the merger or acquisition process is often critical for effective execution and the subsequent realization of benefits.

What should investors look for?

Given the inherent value gained through effective leverage of IT operations, investors should consider the adequacy, benefits and risks of a firm's technology capabilities to discover any significantly material risks and identify inherent value. In the context of a merger or acquisition this would include the following:

- How does the target IT strategy align with its growth strategy? An investor should expect to see clear alignment between firm strategy and the role of IT in enabling or supporting implementation.

- Where is the investment in IT being directed? A firm's project portfolio should be oriented toward innovative new products and services (possibly leveraging emerging technologies or new service concepts) as well as initiatives to improve operational efficiency.

- Where is IT on the maturity curve? Are service failures or slow response times indicative of systemic operational problems and will these likely cause integration challenges for the acquirer? Leading GCC companies are investing in delivering mature, stable IT operations and infrastructure.

- Is IT leveraging resources effectively? In most industries, investors would expect to see firms that develop IT core competencies or strategic centers of excellence as well as leverage third party resources and specialist suppliers based on service demand.

> Involvement of IT early and throughout the merger or acquisition process is often critical for effective execution and the subsequent realization of benefits

Inclusion of technology diligence for a regional acquisition

For a leading UAE-based investment firm, inclusion of technology diligence provided deeper operational insight and commercially significant key findings for an acquisition target (a regional remittance services provider). This included the following:

- **Capturing performance upsides, including synergy enhancements**
  Identification of potential revenue enhancements through the adoption of new programs designed to provide new business services, along with alternative ways in which technology could provide significant value such as the development of interfaces between internal and third party regional banking applications.

- **Accelerating delivery**
  This involves an assessment of the current and forecast project portfolio, including business case reviews, alignment to strategic requirements and resource considerations.

  Translating existing and future business requirements into viable technical solutions is critical to IT program success and ensuring that demands of business users are met.

- **Identifying cost saving initiatives**
  Looking at operational and capital IT expenditure to determine key trends, performance relative to peers of similar size and operations and the key reasons for over-investment in IT.

- **Providing risk management and control**
  Identifying potential risks, issues and dependencies that could affect company operations, such as the reliance on payment technology services, adequacy and oversight of the customer information database.

- **Adherence to reputational and regulatory requirements**
  Assessing the firm's adherence to regulatory requirements including stringent checks undertaken for anti-money laundering and new client acceptance procedures as well as recording cross-border payment flows.

Incorporating technology diligence into the deal cycle

As GCC companies continue to grow and operate across multiple jurisdictions, there will be an ever increasing demand for the IT function to deliver innovative new products and services, improve operational efficiency and ensure adherence to all applicable laws and regulations. This is especially the case for companies who operate or have business partners in the highly regulated markets of Western Europe and North America.

Moreover, with automation becoming more pervasive and critical to business operations, it is imperative for investors to include technology considerations early into the transaction lifecycle, particularly in the due diligence phase. This will help not only avoid potential erosion of deal value but also uncover additional opportunities to realize operational benefits. For many new companies in the region, such as digital advertisers, online retailers (business-to-business and business-to-consumer providers), strategic use of information technology feeds into their business model and could be the deciding factor between deal success and failure.

Given the inherent value gained through effective leverage of IT operations, investors should consider the adequacy, benefits and risks of a firm's technology capabilities to discover any significantly material risks and identify inherent value

Are you thinking about the technology implications for your deal? If not, you may not fully realize the value or risks in the business being bought or enhanced synergies that could be realized.

by **Zaid Selman,** manager, transaction services, Deloitte Corporate Finance Limited (regulated by the DFSA)

Endnotes

1. M&A Information Technology Best Practices, Janice M. Roehl-Anderson. September 2013

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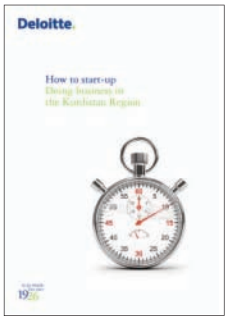

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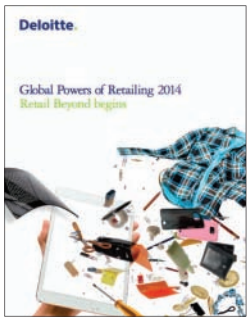

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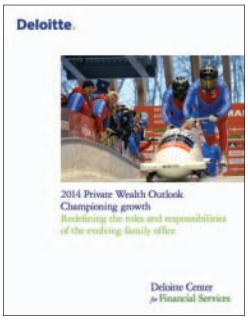

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Championing growth
Redefining the roles and responsibilities of the evolving family office

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Riding the current wave of activity

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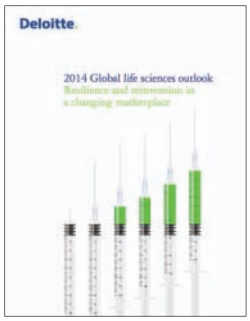

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2014 Global health care outlook
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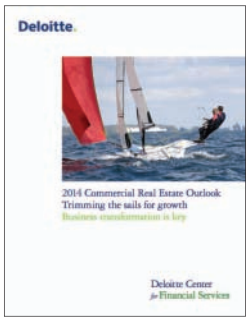

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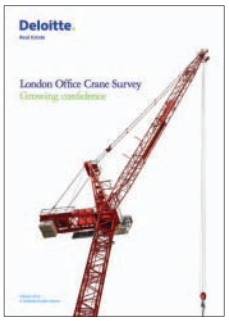

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