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Commentary, opinion and intelligence for the New Zealand business community

THE RISK ISSUE

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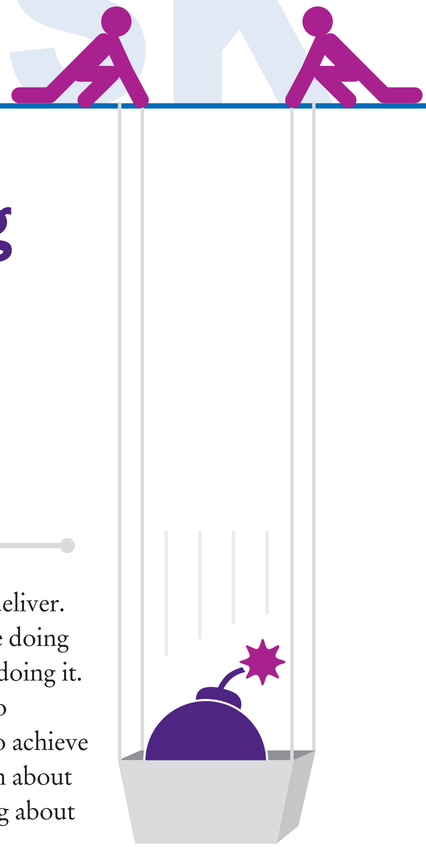

NZ companies not leveraging risk management

Grant Thornton's latest business risk report reveals that perceived risk levels are increasing with only 6% of respondents stating that their organisation faces less risk than 12 months ago.

'Risk on the Rise: a Snapshot of Business Risk in New Zealand', looks at risk management in the public, private and not for profit sectors and reveals that the velocity of risks is also increasing; 52% of organisations surveyed said that the risks they face are occurring more rapidly than 12 months ago.

The top three front of mind risks that survey participants think they'll face over the next 12 months are reputational, cyber and regulatory. So this, coupled with the perception of an increased velocity of risks reflects some of the more widely publicised issues in recent months – the breaches at Ashley Madison and Sony are text book examples of cyber and subsequent reputational risks.

This could be part of the reason why organisations have invested more in risk management, both in terms of budgets and tools such as risk management software. However, the survey results show that there's a decline in the perceived value of risk management in New Zealand organisations.

This means that opportunities to leverage risk management to drive strategic business discussions are being missed, which is concerning, when you consider the full benefit an active risk management strategy can deliver. The report indicates it is not what we are doing about risk management but how we are doing it.

Risk management's key function is to provoke discussions that drive action. To achieve this, there must be meaningful discussion about risks and what your organisation is doing about them.

There are several questions and actions around risk that New Zealand companies and organisations should incorporate into their business and strategic planning; do they have key risk indicators? Do they analyse events to determine the impact on their risk profile? Those that ask these types of questions get significantly more value from risk management than those organisations that just 'tick the box'.

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Cyber-attacks cost global business over $300bn a year

New research from Grant Thornton International's Business Report (IBR) survey reveals that cyber-attacks are taking a serious toll on business, with the total cost of attacks globally estimated to be at least US$315bn* over the past 12 months.

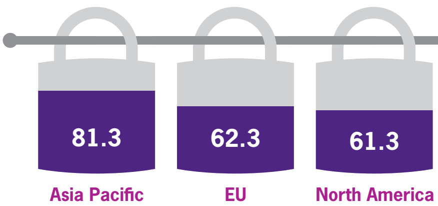
In New Zealand, only 26% of respondents surveyed see cyber-attacks as a threat in their sector and only 50% have a person specifically tasked with cyber-security. Sixty two per cent said they didn't have an IT privacy and security strategy in place.

High profile security breaches are becoming more common and without a comprehensive strategy to prevent digital crime, businesses are really putting themselves in the firing line.

Failing to shore up your cyber-defences can, at best, be costly and, at worst, threaten the very survival of a company. The direct financial hit that a business takes doesn't account for the long-term reputational damage and loss of trust that it suffers when its systems are breached. Operational damage can last for months; when US entertainment giant Sony was hacked in 2014, it couldn't deliver audited financial statements at the beginning of 2015 because its systems were still down.

IT privacy and security should be at the top of the agenda for all organisations. It's no longer a question of if your business will come under attack, but when.

*Estimated loss of business revenues to cyber attacks (past 12 months, US$bn)



Source: Grant Thornton IBR 2015

In New Zealand alone, the National Cyber Security Centre states that 190 security incidents were reported for the 12 months to June 2015.

According to the Grant Thornton IBR, cyber-attacks are estimated to have cost Asia Pacific businesses $81bn in the past 12 months, while firms in the EU ($62bn) and North America ($61bn) are also counting the significant cost of attacks.

At Grant Thornton, we believe IT privacy and security should support your business strategy. Businesses need a pragmatic approach that focusses on implementing measures specific to your organisation.

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The Health and Safety at Work Act 2015 and the tender process - risky business?

In the cut-throat construction sector, it is generally accepted that the tender process is the best way to achieve value. Tender, tender, tender is a common catch-cry in boardrooms – driven by the perception that tendering is the only way to get a good deal.

The tender process is contrary to the principles of the new Health and Safety at Work Act 2015 (HSW Act). Under the new legislation, which promotes collaboration and joint responsibility, there are potentially serious implications for directors, chief executives and senior management teams, who now have a personal duty to ensure safety on their projects pre-, during and post-construction.

The HSW Act aims to reduce the incidence of injuries and improve the safety of workers. It requires people conducting a business or undertaking to properly assess risks and hazards created by their activities and to remove or minimise them.

This is making directors sit up and take notice, with the threat of up to five years imprisonment and three million dollar fines, boards and management need to take as much interest in health and safety as they do in the bottom line.

The safety of workers during construction depends on the quality of a project's design. Indeed, many of the difficulties construction contractors face are the result of unreasonable pressure put on the price and build time by the client – common outcomes of the tender process. The HSW Act demands a collaborative approach – this means the biggest impact it will have in the construction industry will be on procurement methods.

Time for a rethink of the procurement process

The outdated tendering process and the new HSW Act are fundamentally opposed. Contractors submit their lowest price by cutting fat out of the project in the belief they will make their margin back through variations based on design flaws and scope changes.

The result is often an adversarial relationship developing between client (aiming for the best price) and contractor (most exposed to health and safety risk during construction), with the consultant squeezed somewhere in the middle.

Too many contracts are awarded on the basis of lowest-price tenders, only to see the final price increase significantly through contract variations and failure to meet quality standards or deadlines – which can increase health and safety risks.

The disaffiliated, cost-driven tender model precludes the opportunity for collaboration. Central to the new Act is a requirement for all who are responsible for safety to work together.

The ability to influence safety on a project is greatest in the early stages of a project. However, in a tender process the design documentation has already been completed before tenders open, so there is minimal opportunity for the contractor to influence Safety in Design (SiD) initiatives, despite it being the contractor who is required to put the theory into practice. SiD workshops are most often completed post-design by the consultant and client, while excluding the key participant – the builder. Consequently, the time constraints associated with the tender process mean a contractor might have only weeks to properly assess the risks

To thoroughly assess the risks associated with a project, the details must be inspected by the contractor, who is the expert in their field. This can only happen effectively at the design stage.

associated with the construction methodology. In tight timeframes, main contractors can also be forced to select non-preferred sub-contractors who are less safety conscious. The inevitable result is variations emerging and, in serious cases, safety can be compromised. Also liquidated damages limits contractors' ability to change or challenge design and details that may in themselves be unsafe to build.

To thoroughly assess the risks associated with a project, the details must be inspected by the contractor, who is the expert in their field. This can only happen effectively at the design stage.

An alternative approach – collaboration

Following health and safety law changes in the UK and Australia, on which our new HSW Act is broadly based, a collaborative approach to construction procurement has gained favour over tendering. This is because when it comes to health and safety, planning is the critical investment. The ability of participants to influence risk is greatest in the early phases of a project. Collaboration can be even more effective when the contractor and facilities operator have input into design, choice of materials and buildability (of both construction and maintenance).

In New Zealand, a similar move away from tendering to a collaborative approach involving the contractor during the design phase, aligned with the spirit of the HSW Act, is the obvious solution. Good standards of health and safety on a construction project start with the decisions made by the client who procures the work. It is at this stage that the whole health and safety climate of a project is established.

New Zealand-based contractors which have already adopted this approach have delivered very successful results for their clients. There are many examples of developments where contractors were involved in the initial design that are regarded by all participants as model projects, particularly in health and safety. Reducing health and safety risks is achieved through involving several parties in the design process, with shared ownership, as opposed to one entity directing the process. Importantly, if the contractor participates in the design phase, the design will reflect high standards of practical buildability, engineering and architecture – as well as compelling value for money. In fact, if managed properly, the savings can be considerable, particularly where transparent price contestability is still evidenced.

The intention of the new HSW Act is to ensure duties and risks are allocated to the party best placed to manage them. While collaboration and collective action underpins this approach, it requires strong leadership from the decision makers. If not taken seriously at the top of the tree, the implications for poor management can be crippling. Time to rethink obsolete processes in favour of collaboration – legislation now demands it.

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Don't let debt perceptions dictate your legacy

Grant Thornton advises medical practice owners at all ages and stages of the career. We know from experience that there are a growing number of mature owners who need to start thinking about how they will exit their businesses. Bringing in the next generation to take over a legacy often presents challenges that threaten a successful transition, which is why early engagement with an adviser is key.

Often the goals of younger owners drive change as much as those of retiring partners who want to access the wealth from the business that they have built throughout their career. We're increasingly seeing potential buyers only wanting to join group practices that run a profit share model. There's less interest in the traditional solo operations or cost sharing models that many practices ran successfully for many years. In time this may start to impact on the value of those businesses.

Surprisingly, the financial mechanics of agreeing on practice values and legally transferring ownership from individuals to a group entity, is where we see the succession planning process end for more than half of the practices considering doing it. Why? There are several possible reasons for this ranging from reluctance to change, to not fully understanding the process required to achieve change.

Any process of transferring value (yes, your practice probably is a valuable asset) means that someone or a group of people need to pay for it. This is one of the oldest and most basic tenets of commerce. Aside from that, the IRD requires that a transfer of an asset to an associated entity is undertaken at market value. It comes as a surprise to many sole traders that their business already owes them money, it just hasn't been stated in writing and no one sends a loan statement each month reminding them of that debt. Some practice owners will be repaid for that debt before they retire, others won't; simply through failing to plan.

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The top four fallacies about becoming a profit sharing practice

1 'Other partners in my practice don't work as hard as me'

Perhaps not, but you can't keep working forever and isn't it better to have a plan in place to ensure that the practice that you have worked hard to build up can be transferred? You want to reap as much of that value as you can rather than seeing it whittled away. You can set fair market salaries and appropriate profit share models to address this. Similarly, processes for managing those owners not pulling their weight need to be implemented.

2 'My fee base is worth more than the others'

We recommend engaging an independent valuer to ascertain the relative worth of individual practices. An agreement can then be reached by the future owners of the purchasing entity as to what they will pay for each practice.

3 'We can't afford to form one entity to buy all of our patient bases'

Healthcare practices are attractive to many lenders, more so than some other industries at times. And funding some of the merged group practice with external debt makes the entry price for a new doctor less expensive. Bank funding is not the only source of debt, as usually shareholders will leave some funds in the company as well. This needs to be proportionate to shareholding.

4 'I am too old to take on any new debt'

Your practice probably already owes you money. You have two main ways of getting repaid for that: sell it yourself if you can find someone willing to buy it, or work together with your colleagues to sell it to a jointly owned entity. Obligations to repay such debt are passed to future owners as part of the consideration for sale.

So, where do you start?

To achieve a successful outcome, the process really needs to begin with a strategic plan detailing what the practice is striving to be and what sort of culture the practice will operate under. Once an agreement is reached on what the future will look like, a plan needs to be developed around moving from 'A' to 'B'. Often a restructure will take place at the same time as other major transactions such as moving to a new building for example. This can mean that decisions need to be made around infrastructure as well as ownership.

The moral of the story is that to extract the value that your practice owes you, you need to act early and strategically with the support of your practice owners. This usually leads to a more cohesive outcome with joint ownership in the results and the creation of a practice that is fit and healthy for the future.

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Eight killer questions every CFO should ask about lease accounting

If your business leases assets to generate income, a recently issued standard on leases, NZ IFRS 16 published by the International External Reporting Board XRB has the potential to significantly change what you currently report in your financial statements from 1 January 2019.

The key change is that almost every lease obligation (a liability), together with the accompanying "right to use" the leased equipment (an asset) will now end up being reflected in your balance sheet. There are exemptions for short-term leases and leases of low value assets.

Here are eight killer questions that every CFO should consider before entering into future contractual arrangement to lease assets. If you find yourself answering "yes" to any of the questions noted below, you should seek out a copy of NZ IFRS 16 Leases to learn more about the changes to lease accounting.

1. Are you subject to financial covenants?

If you lease assets and have tight debt to equity ratios, the new requirements will almost certainly make your situation worse. All significant lease commitments will be deemed a financial liability and need to be recognised in the statement of financial position. There will no longer be a distinction between operating and finance leases for lessees so leverage and capital ratios will deteriorate when the new standard comes into effect.

2. Do you renew your lease arrangements after the initial term has expired?

If it is reasonably certain that the lease arrangements you enter into will extend into a second or third term, then this must be taken into consideration when determining the lease liability that you must reflect in your balance sheet. The longer you lease an asset, the greater the lease liability that will need to be recognised at inception.

3. Does the lease agreement contain any contingent rental conditions or residual value guarantees?

To ensure that the liability (and of course the corresponding "right-to-use" asset) is not understated in the balance sheet, the XRB has introduced some additional elements that need to be taken into consideration. The XRB's goal in including these factors into the determination of the liability is to reflect the economic substance of the arrangement – taking into account all, not just some, of the cash flows associated with the leasing arrangement. Term option penalties and residual guarantees all now need to be explicitly taken into consideration. Variable payments that depend on an index or rate should be included in lease liability/asset based on using index/rate at the commencement date. But be careful - other variable payments (eg, payments linked to sale or usage) are excluded from lease liability/asset.

4. Are you likely to change the period over which you will lease the asset after entering the contract?

If this is likely, NZ IFRS 16 now requires you to recalculate your obligations under the leasing arrangement and adjust the financial statements accordingly. For some this will not be a huge imposition, but if you are a large and complex organisation with hundreds of lease contacts, this has the potential to be hugely time consuming.

5. Are you using spreadsheets to track your lease arrangements?

For some organisations, this probably won't be a suitable solution. It can be argued there is a time and a place for everything, but now might be a good time to evaluate the robustness of the controls and systems that support your lease accounting processes because in many instances an upgrade may be needed.

6. Do your deferred tax calculations include leasing arrangements?

For the time being it is unlikely that our legislation surrounding the tax treatment of operating leases will change, so when the lease commitments end up being reflected in company balance sheets, many new temporary differences will be created. Given that temporary differences (as defined in NZ IAS 12 Income Taxes) multiplied by the applicable tax rate generates the deferred tax liability or a deferred tax asset that will need to be reflected in the financial statements, those who prepare financial statements shouldn't underestimate the amount of work associated with accounting for this component.

7. Are your staff performance incentives based on operating cash flows or EBITDA basis?

There will no longer be straight line recognition of rent expense in income statements (unless the exemptions for short-term leases and low value assets are adopted). Lessees rent expense will end up being front-loaded because of the interaction of effective interest being used to reduce the recognised financial liability coupled with the depreciation of the "right to use" asset. Because interest and deprecation will "replace" rent expense, EBITDA and operating cash flows will increase when the standard comes into effect. Taking some time out to assess the impact of these accounting changes is strongly recommended so that remuneration protocols are appropriately aligned with financial reporting expectations.

8. Are you a lessor as well as a lessee?

The good news is that accounting by lessors is not materially changed. Accordingly, a lessor continues to classify its leases as operating leases or finance leases, and to account for those two types of leases differently. However you need to be mindful that there are enhanced disclosures to be provided by lessors that will improve information disclosed about a lessor's risk exposure, particularly to residual value risk.

Although these questions are important, like most financial reporting standards, the devil is in the detail and there will be more questions to consider. If your organisation is a public benefit entity (ie, a public sector or not for profit organisation), the good news is that for the foreseeable future, these changes are unlikely to impact you.

However, if you are a for-profit enterprise that is required to follow general purpose financial reporting, now is the time to consider the future implications of this new standard because, whether you chose to adopt it early or not, it has the potential to significantly reshape future financial statements.

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Women make up less than a quarter of APAC business leaders

The Asia-Pacific (APAC) region continues to make slow progress in getting women into senior roles within companies. Grant Thornton's latest annual survey of 5,520 businesses in 36 economies highlights that just 23% of senior management roles in APAC are held by women. APAC countries with the highest proportions of leadership roles held by women are Philippines (39%), Thailand (37%) and Indonesia (36%), while the lowest proportions are reported in Japan (7%), New Zealand (19%) and Australia (23%).

The new research also finds that almost one in three (31%) APAC businesses have no women in leadership. In New Zealand that number is even higher at 42%, a startling increase from 37% last year.

In terms of the percentage of senior positions held by women, New Zealand's results remain unchanged from last year, which showed a significant drop from 31% in 2014, and still well below our long run 12-year average of 27%. This keeps us at 28th place.

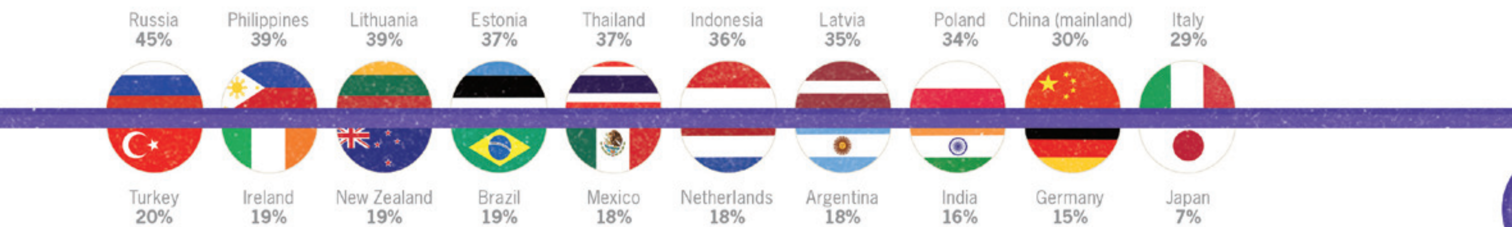
In 2004, we could be proud of our third position on the league table of other countries surveyed, but now we've formed part of the global report's bottom 10 group. This demonstrates New Zealand's dwindling numbers of women in senior management and the percentage of businesses with no women in these roles at all.

The continuing downward trend for no female representation in senior management roles for New Zealand businesses is concerning. The global average has remained relatively static over the last five years at around 33%; in New Zealand we're currently sitting at 42% this year compared to 26% in 2012, so we're clearly moving in the wrong direction.

Progress in developed economies is simply not happening fast enough. Companies across developed nations have talked the talk on diversity in leadership for long enough. It's time to put their promises into practice and deliver results.

There is no one size fits all solution

Senior roles held by women by country (top and bottom ten)



Source: Grant Thornton IBR 2015

to the world's leadership diversity shortfall but, as outlined in our new report, making progress will require the collaboration of companies, governments and women.

Societal norms around leadership and the implementation of remuneration parity need to be addressed. The report explores how businesses approach leadership and what leaders, especially female leaders, are looking for.

Women are more concerned about the recognition of their ability and earning a higher salary than men, which could reflect the ingrained biases they have faced on their way to the top. Men usually take it as read that their efforts will be appropriately rewarded, this is unfortunately not always the case among women.

Women need to put themselves forward for new roles and articulate what they want from a senior leadership role, including pay. Businesses need to acknowledge that women are less likely than men to initiate negotiations, so they should talk about money and get it out in the open. Firms also need to reassure women that they will be able to make a real difference if they reach the top and, critically, that their efforts will be recognised and appropriately rewarded.

Women need to put themselves forward for new roles and articulate what they want from a senior leadership role, including pay.

Companies need to look to redefine leadership in a manner that will attract women to senior roles – that means recognising the need for collaboration and dialogue. Businesses need to create environments in which women feel confident that they will be heard and valued, and know they will be supported through transitions and difficult moments. The proper mechanisms to ensure that leadership is compatible with family commitments should also be in place.

We know that businesses with diverse workforces can outperform their more homogenous peers and are better positioned to adapt to a rapidly changing global business environment. – if opportunities are likely to change, a wide range of perspectives is critical to navigating new landscapes.

The full report *Women in Business 2016: Turning promise into practice* is available at www.grantthornton.co.nz/2016-wib.pdf

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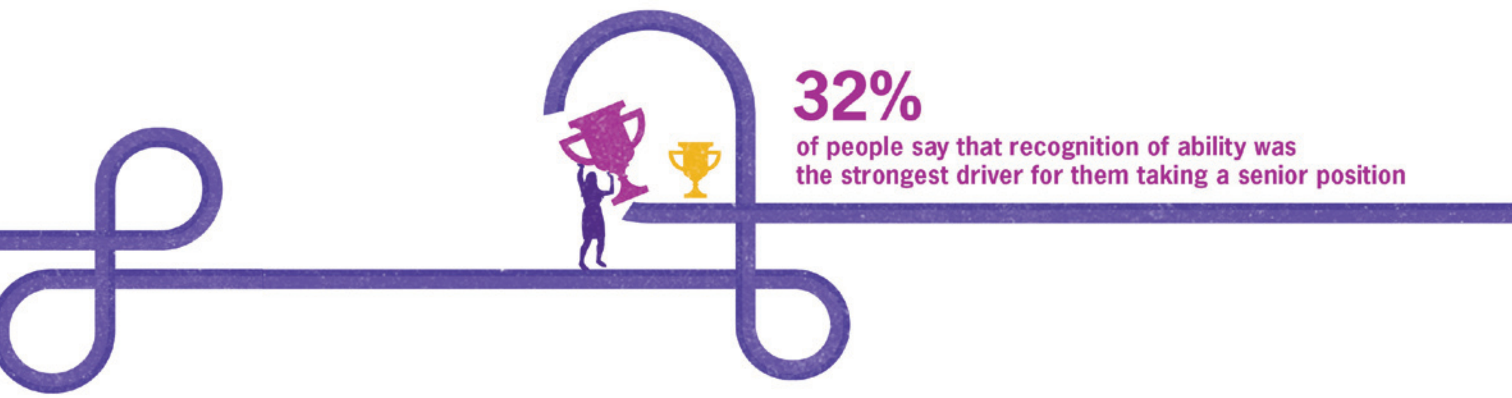

Online GST:
an old tax on new services

The introduction of a taxation bill which proposes to charge GST for online services is a hit to the pocket that won't be popular with Joe Public, but it's a positive step to ensure New Zealand's tax base is protected.

This change was signalled last year and is already in place in the EU, Norway, Switzerland, South Korea, Japan and South Africa. An estimated $270m NZD is spent annually on online services which means that more than $40m of GST is lost each year. This is expected to increase at a rate of 10% per annum.

This legislative change is important for New Zealand. GST is a consumption tax and a significant contributor to our country's overall tax take.

Remote services include:

- supplies of digital content such as e-books, movies, TV shows, music and online newspaper subscriptions
- online supplies of games, apps, software and software maintenance
- webinars or distance learning courses
- insurance services
- gambling services
- website design or publishing services
- legal, accounting or consultancy services.

This new bill isn't creating a new tax; it's simply extending an existing tax to services that didn't exist when GST was introduced.

The bill targets non-resident suppliers of remote services. They will be required to register and account for GST on services provided to non-GST registered customers if they are expected to exceed the GST registration threshold.

There will be plenty of non-resident suppliers who won't bother to comply, or may even choose not to deal with New Zealand customers, but they will be the small players. There also may be consumers who will try to mask their residency to bypass the GST cost.

However, large operators already need to deal with this obligation and there's going to be more uptake in other countries - Australia joins the ranks from 1 July 2017. These providers will collect the majority of the revenue which makes this a worthwhile initiative in New Zealand.

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