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Commentary, opinion and intelligence for the New Zealand business community

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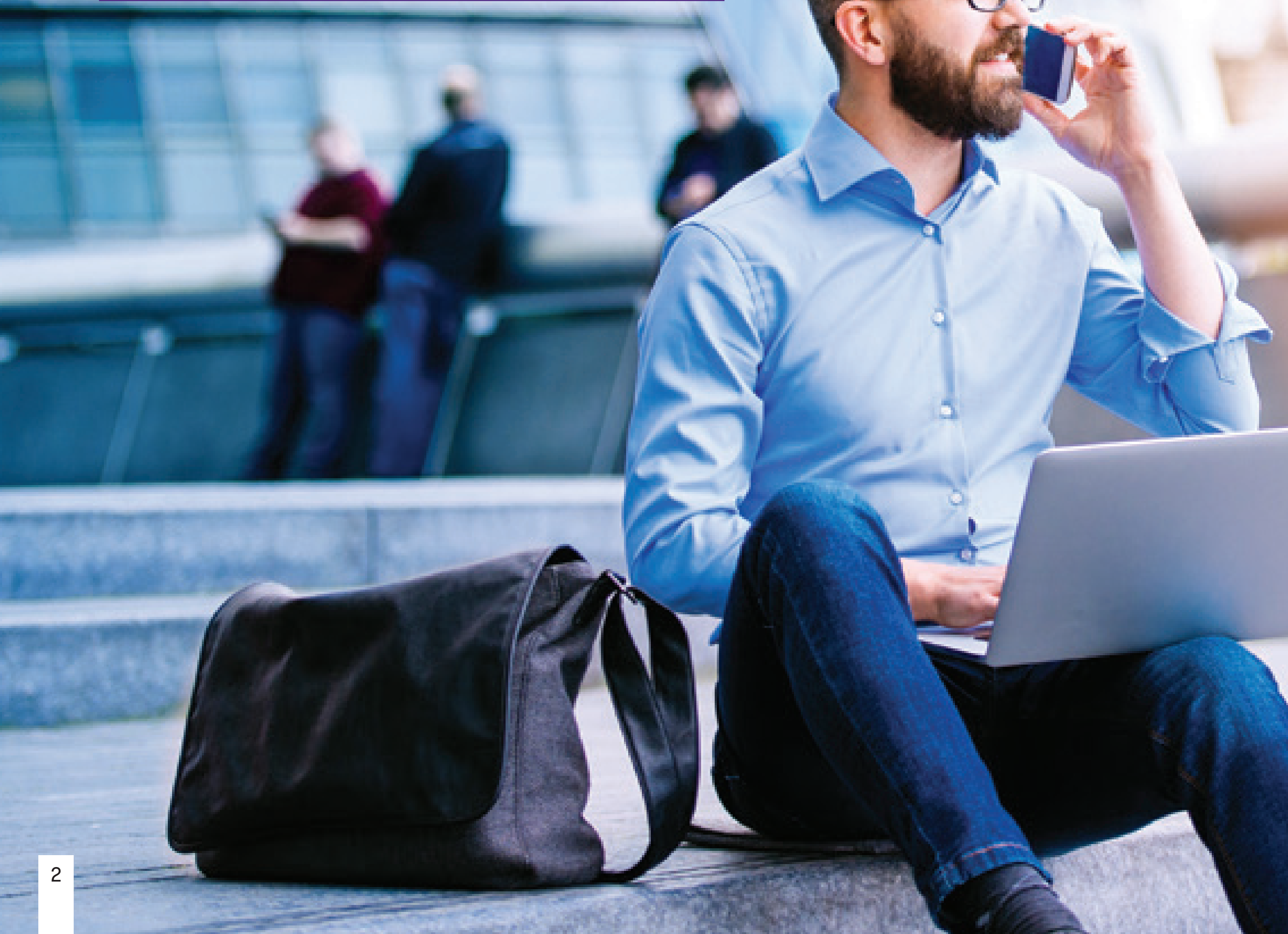
Brexit: What does it mean for NZ businesses?

A large number of Kiwi businesses need to think hard about what Brexit might mean for them before they approve their 2019 financial statements.



Be it a "no deal" or "delayed deal" that is ultimately agreed upon is creating a significant amount of uncertainty for both the United Kingdom and its trading partners.

What will the biggest impacts be?

Brexit's biggest potential impacts on New Zealand businesses will be on taxation, tariffs and customs. Any changes in customs controls at the borders will mean all New Zealand businesses exporting to Europe are going to be faced with the prospect of finding another efficient and effective way to get goods into the UK.

And once they're there, distributing those goods into Europe and vice versa may need to change. Traditional hub-and-spoke distribution models may be disrupted – regardless of whether the hub or the spoke is situated in the UK. Kiwi companies should be analysing their current distribution and considering how Brexit might change it. For example, if you have a wine business that exports to a single consignee in London, who then distributes your products across Europe? That model may no longer be as fast or cost-effective.

The power of the pound

Another major impact may be on the value of the pound; after the June 2016 Brexit referendum, it plummeted against the New Zealand dollar and to date, it hasn't recovered its value. Whatever type of Brexit deal or exit ultimately transpires, there is going to be some volatility, and this will need to be assessed and reported in New Zealand companies' business strategies and financial statements.

The only certainty we have is that the value of the pound will continue to have an important impact on New Zealand's importers and exporters – and it is likely to be significant in terms of capital transfers between the two nations given we export approximately $3 million in goods and services to the UK and import of $2 million.

Going cold turkey

Official UK Government figures have been forecasting a 9.3% contraction in the economy after 15 years in the event of a no-deal Brexit, compared to a 3.9% smaller economy under Theresa May's (currently rejected) plan.

Whatever Brexit solution is finally delivered, it almost certainly will lead to higher customs duties, longer import and export lead times, and an increase in administrative costs. Cross-border operations and regulations will also be thrown into question. New Zealand businesses which trade or sell in the UK will still need to make forecasts and project cash flows, yet their ability to do this accurately will be seriously hampered.

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Let’s get technical: forecasting in the face of uncertainty

Company directors are going to need to disclose their assessments of Brexit in their annual reports to give investors and stakeholders an insight into which risks they are looking to manage. The most challenging areas of forecasting are likely to be:

Going concern.
At this point, assessing a going concern of business operations in the UK is going to require some careful analysis.

Impairment of assets.
The Brexit risk needs to be assessed when valuing non-financial assets – either in the discount rate or the forecast cash flow, but not both. For financial assets, more than one credit loss forecast may need to be reported, and consideration given to the potential loss in value of assets used as security. Once again, any significant risk will need to be outlined and discussed in financial statements.

Fair value management.
NZ IFRS 13 Fair Value Management requires the use of unobservable inputs – but adjustments after the reporting period are not permitted; so great care will need to be taken when assessing fair values.

Tax exemptions and liabilities.
EU tax exemptions and relief may no longer apply to UK operations which could result in some deferred tax liabilities that have previously gone unrecognised.

In some ways the possibilities are endless. The influence of Brexit is going to be a challenge for the accountancy profession; the story of what the deal has done to operations needs to be told, and industry professionals must do their best to anticipate what might happen in future forecasts and budgets.

Being mindful of the Brexit dynamics and properly disclosing them in financial statements will almost certainly mitigate its negative impact on your current business operations.

Although Brexit presents some unprecedented challenges for local companies, New Zealand directors can take heart: you can only do your best to forecast based on the information you have, and everyone’s in the same boat. It would be unreasonable for stakeholders to expect a clean, simple forecast with strong accuracy for any business operating in the UK right now.

Best practice will be to provide a range of outcomes in annual reports and financial statements.

This is a complex issue and your company’s response cannot be glib or simplistic. Take your time, think through the potential consequences – both direct and indirect – and reflect your insights clearly.

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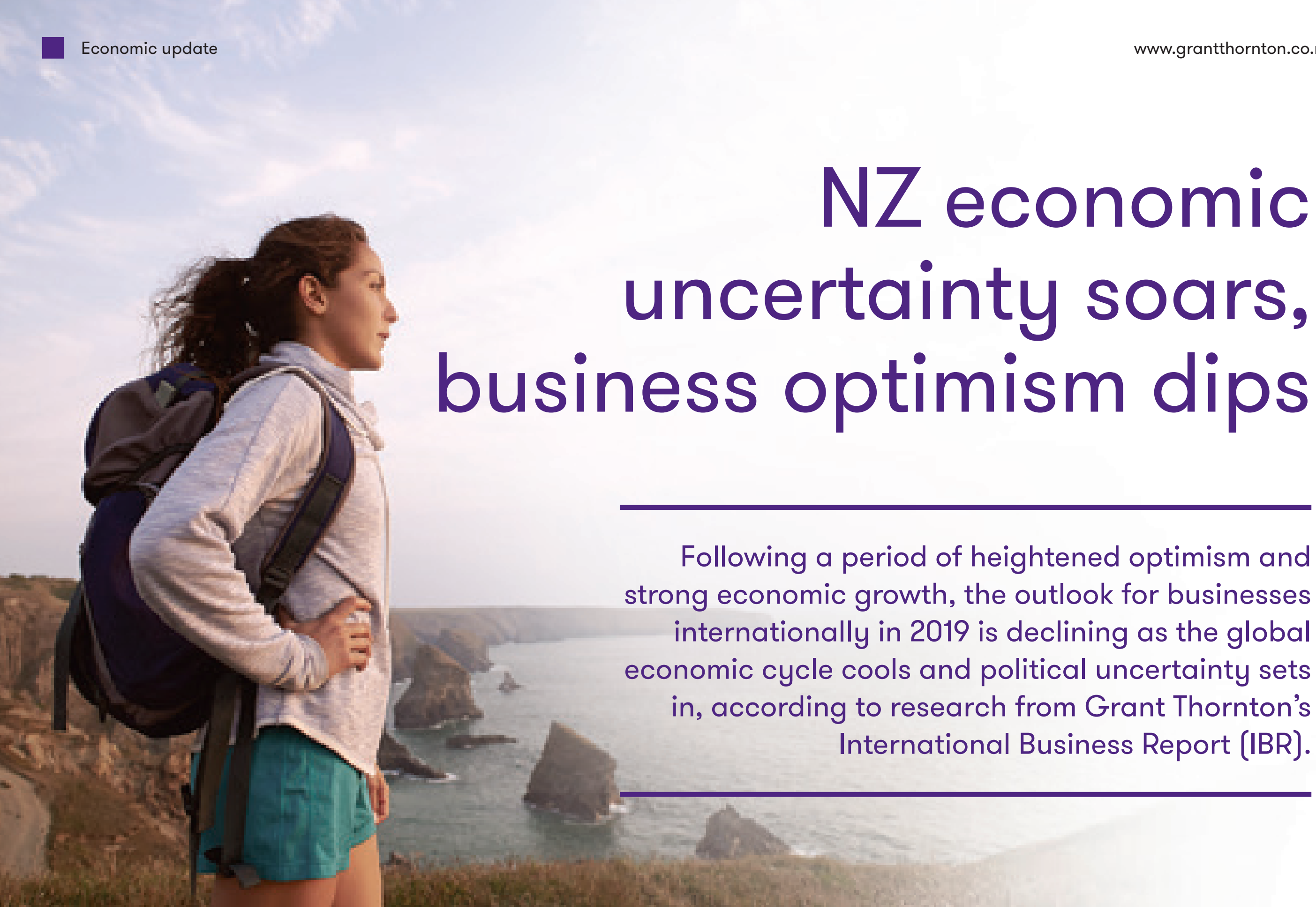

NZ economic uncertainty soars, business optimism dips

Following a period of heightened optimism and strong economic growth, the outlook for businesses internationally in 2019 is declining as the global economic cycle cools and political uncertainty sets in, according to research from Grant Thornton's International Business Report (IBR).

The research, which gathers responses biannually from business leaders in 35 economies, found that global economic uncertainty is now sitting at 50%, a significant increase from 28% in Q1 2018, and the weakest result in six years. Optimism throughout the global economy has also plummeted from 61% in Q1 2018 to 39% in the latest survey.

New Zealand business leaders' sentiments are following suit; survey results revealed that economic uncertainty has soared to 43% from 10% in the last year, and optimism has dipped to 70% from 76% in the same period.

These results demonstrate that business leaders know they won't have it as good as they did in 2018.

Although it may seem counter-intuitive, this point in the economic cycle presents the perfect opportunity to invest in capabilities and infrastructure, rather than following the traditional course of shoring up operations and reducing or even ceasing investment.

But there is some good news. Despite increasing volatility in international financial markets, forecasted GDP growth in goods and services sectors will contribute to optimism among business leaders as they know their business will grow with it.

Another positive is that our neighbours have bucked the global trend; optimism in emerging APAC* is at 57% and is most likely a result of integration and collaboration throughout south-east Asian economies. These countries are reducing their reliance on trade with China whose economic slow down is beginning to have knock on effects.

Strategic investment is the best way forward for businesses. This IBR report has also revealed a promising climb in R&D investment expectations among kiwi businesses surveyed, possibly due to the tax incentives which are expected to be available from the beginning of April.

Whichever strategy businesses choose to adopt, the time for implementation is now.

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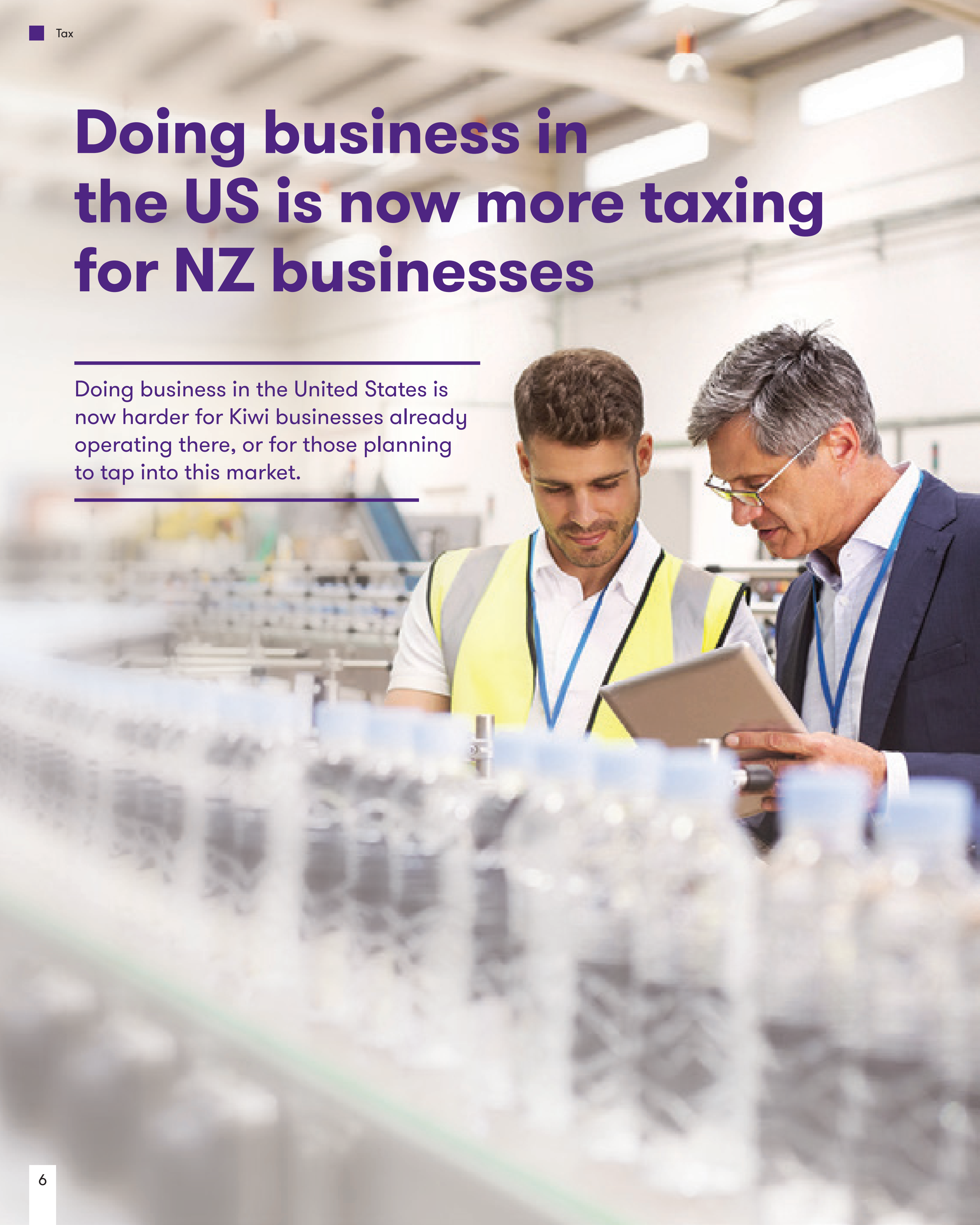
Doing business in the US is now more taxing for NZ businesses



Doing business in the United States is now harder for Kiwi businesses already operating there, or for those planning to tap into this market.

The catalyst for change came by way of the 2018 Supreme Court decision – South Dakota v. Wayfair ('Wayfair') which overturned a longstanding precedent requiring sellers to have a physical presence (eg, a shop, factory or office) in order for a state to collect sales tax. During the case, the Supreme Court not only acknowledged that the physical presence rule negatively impacted South Dakota's tax revenues, but that it "is unfair and unjust to those competitors, both local and out-of-state, who must remit the tax", recognising that market participants were no longer competing on an even playing field.

Now, all sellers in the state of South Dakota must collect and remit sales tax regardless of whether they have a physical presence or are simply trading via digital channels. The Wayfair decision has subsequently caused a domino effect across America and multiple states have either issued effective dates on prior passed legislation, or they have issued proposed rules in the form of legislation as to how sales and use tax will now be enforced.

The good news is that specific relief is available in most circumstances when the sales are to customers that are themselves resellers. However, to qualify for this concession, the seller has a duty to record sales accurately and collect any necessary exemption or resale certificates.

"is unfair and unjust to those competitors, both local and out-of-state, who must remit the tax."

The bad news is that some states have adopted a 1 July 2018 enforcement date, with most choosing 1 October 2018 or 1 January 2019. Also, the threshold as to when sales and use tax becomes relevant is quite low in most states. So, if you haven't done so already, you may now need to take immediate action to become compliant.

It is also important to note that you may need to examine the taxability and sourcing of the products and/or services provided as the sales tax treatment may vary by state.

The sales and use tax is not like New Zealand's GST which is largely neutral on a B2B basis, as it can be recovered in most situations – this, instead, is a final cost to the purchasing party. If it is not correctly accounted for, it will become the seller's liability.

You will need to determine when the thresholds are likely to be breached, requiring the collection and remittance of sales tax. And you will need to develop the compliance processes necessary to distinguish in which state the sales occur, whether the sales are taxable or not and what the local filing obligations are. If your business is operating in a state (or states) and has a registration, collection, and filing obligation, it is best to become compliant sooner than later to minimise the risk of penalties and interest.

Here are some questions we are commonly asked in terms of what the Wayfair decision means for businesses.

1. How do I determine which states I need to file in first?

Knowing what the thresholds and effective dates are in each state is critical in determining where you need to file and when.

First, you need to determine those states in which you have met the requirements for filing; the effective date of those states will dictate when you need to register and begin filing. For those states with effective dates that have passed, you may need to consider the potential exposure

and remediation options for periods in which the thresholds were met but returns were not filed. It is also important to note that you may need to examine the taxability and sourcing of the products and/or services provided as the sales tax treatment may vary by state.

2. When do I need to start registering and filing?

While some states have used the legislation resulting from Wayfair as a template for their provisions, others have created their own standards; when viewed in the aggregate, the thresholds and effective dates applied by each state are currently inconsistent and non-uniform.

3. What is required in terms of documentation and exemption certificate requirements?

Maintaining accurate records is key for sellers, as this documentation is used to substantiate exempt transactions, particularly in the event of an audit. For accurate, cost-efficient sales tax collection, you need to:

- make a correct tax calculation at the time of sale
- report your sales and complete your filing on time
- maintain proper documentation on any sales made either to exempt entities or for an exempt use.

As a best practice, it is recommended that you begin collecting and maintaining the required certification for all exempt sales, as all states that impose a sales tax are likely to enact some form of thresholds.

4. What are the implications for manufacturers selling raw material as opposed to finished goods?

Nearly all manufacturers will be affected by the Wayfair decision. Even those manufacturers who don't sell to end-users may be required to register for sales tax collection in states where the thresholds are met. States require certain documentation to be maintained by sellers, such as properly completed resale or customer-level exemption certificates, to substantiate an exemption. Without proper documentation, the transaction becomes taxable.

5. Does the Wayfair ruling apply to any software-as-a-service (SaaS) transactions?

Businesses selling SaaS, cloud-based, and other digital goods or services that historically had a small footprint due to the nature of their business may now be subject to additional sales and use tax collection and remittance requirements if the thresholds are met and the state imposes sales tax on these items.

Establishing the source of cloud-based and other digital goods for tax purposes has historically been a challenge for both states and sellers.

The lack of physical delivery makes the location of delivery unclear, and states may determine the source of transactions in an inconsistent, non-uniform manner. For example, states may base the tax on where the seller resides, the address of the purchaser stated in the receipt or contract, or on the locations of both of the server and user(s), which may be in multiple states, thereby obliging the seller to render taxes in all of those states. In any case, it is critical to capture and maintain complete sales information used to make sourcing determinations in case of an audit.

6. Are there any income tax implications on the horizon?

While Wayfair specifically addressed whether specific states can require an out-of-state seller to collect sales tax when the seller lacks an in-state physical presence, there are some states that have had laws in place for years that apply to corporate income and franchise taxes. To the extent that companies relied on historical sales tax physical presence standards in determining their income and franchise tax filing footprint, there may be tax exposures in states where the threshold for income and franchise tax purposes is met but no filings are being made.

Additionally, while states have not yet provided significant guidance on income and franchise tax implications since the Wayfair decision was issued, states may feel emboldened to consider--and potentially enact--legislation changes applicable to state income and franchise taxes.

A list of the latest thresholds and effective dates can be found on grantthornton.co.nz/insights.

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Could entrepreneurship in primary care disappear at the stroke of a pen?

Minister of Health, David Clark recently suggested to Dr Kate Baddock, Chair of the New Zealand Medical Association that general practitioners need to consider different business models to address concerns about business sustainability.

That same week, the New Zealand Medical Journal published an article about the Ministerial review of our health system; it stated that if goals of equity and the original intentions of the 1938 Social Security Act are to be delivered on, the review will need to consider options for practice ownership. One option offered in that piece was for Government to acquire all general practices and for GPs to become employees of the State. The Medical Journal article reminds readers of the original intent of the current institutional arrangements that have been in place since 1938 that were agreed between the health profession and the Government of the day, which sought to put all health professionals onto the Government payroll. The New Zealand branch of the British Medical Association back then fought and won the right to retain the personal arrangements between doctor and patient so as not to erode the doctor-patient relationship.

If the concept of nationalising our primary healthcare system becomes reality, the hard work and personal investment GPs have put into becoming qualified, establishing primary care infrastructure, offering diverse services targeted at their respective population bases, and putting their own capital at risk to do all of this for their communities, will be in vain. Public ownership of primary care services will not be the panacea to all ills in the sector. Diversity will inevitably reduce. Opportunities for work life balance for GPs could also reduce. The joy and satisfaction of running your own business along with the tangible and intangible rewards of that will disappear. For some GPs, the financial return as an employee could be substantially less than it is now. Will those GPs wish to remain in the sector or will they seek other opportunities? Will the public sector accommodate those wanting to offer services that fit within primary care in a broad sense but are a 'little out of the box'? The spread of resources will inevitably be consolidated in some areas and improved in others that are currently less well served.

> Public ownership of primary care services will not be the panacea to all ills in the sector.

Every business needs to look at its sustainability and general practice is not an exception. Aging infrastructure, aging population bases and an increase in transfer of clinical care from secondary services down to primary care without additional funding, are some of the current issues in primary healthcare.

Yes, there are challenges in owning and running any business. Customer demands are becoming more complex. Customers sometimes don't pay. Premises age and need replacing. Owners age and need replacing. A multitude of external regulations like Health and Safety legislation and income tax need to be complied with. But the personal rewards of running and growing a business typically allow business owners to overcome those challenges.

When we advise general practitioners about ways to increase their returns, we encourage lateral thinking; otherwise inertia creeps in to any business that isn't challenged to do things differently. Tweaking the model of care is always at the centre of those conversations. However, discussions about increasing efficiency and capacity always circle back to one common theme: the lack of funding; more specifically, the rate of increase relative to the rising complexity of demands on practices and restrictions on increasing co-payments charged is insufficient.

From the outset, these factors create a business model that severely lacks commerciality. A third, less frequently acknowledged frustration is the inadequacy of the fee review process. In my view, the poor financial returns of many practices would warrant a case for a fee review based on lack of reasonable financial reward for risk taken; however, the complexity and cost of making such a submission tends to deter most from embarking on that process. The funding gaps have become so great that a mere co-payment review – that has to be justifiable to the patient paying it, is not going to adequately redress the revenue situation in a meaningful way.

I can recall many conversations with practices around increasing capacity in their business. These discussions usually always come back to the ever-increasing costs of sourcing and employing additional skilled labour whether it be additional doctors or nurse practitioners. I admire the tenacity of many practitioners in less affluent areas who have been taking home less remuneration per hour than their locums for years. Clearly some of the additional funding sought for general practice needs to be targeted at upskilling and expanding the workforce.

Continuing private sector subsidisation of primary care at current levels runs the risk of a complete collapse of service delivery in some areas, and a subsequent loss of public confidence in primary care.

A closer meeting of minds around the funding of general practice is needed; one which recognises that funding needs to increase to accommodate the aging of populations, multi-cultural population needs, and the additional costs to deliver services in remote areas. Meanwhile, GPs need to utilise business resources as effectively as possible to maximise rewards for risks taken.

The Government has well publicised their 'Wellbeing Budget 2019'. A key gauge on the achievement of that will be seeing the final quantum of additional funds allocated to primary care.

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Property developers: when can you start recognising profit?

Louis Glickman famously surmised the best investment on earth is earth; however, as a property developer, you need to know when you can recognise the profit on that investment.

Once upon a time, developers could start to recognise the profit they expected to receive on real estate developments over time during construction. However, when the New Zealand Accounting Standards Board issued NZ IFRS 15 *Revenue, from Contracts with Customers*, they introduced a “no alternative use” model to more clearly delineate when and how revenue can be recognised by property developers.

So what does no alternative use actually mean? For example, how is it applied when dealing with a contract for the sale of a single residential apartment contained within a multi-unit complex currently under construction, as opposed to apartments that are completely built on spec? It usually depends on the property developer’s ability to demonstrate that it meets the following criteria set out in NZ IFRS 15:

- At all times throughout the duration of the contract, the property developer is entitled to an amount that compensates them for performance completed to date (eg, costs incurred to date plus a reasonable profit margin), and
- What the property developer is creating does not create an asset that can have alternative use.

For the purposes of illustration assume that a property developer enters into separate contracts with customers for the sale of each individual unit in a high-rise apartment complex.

Determining whether an alternative use exists for individual apartments involves significant judgment based on careful consideration of the facts and circumstances. For example, could the apartment block be converted into business offices? Specific guidance on how to assess alternative use has

> "Guidance on how to assess alternative use is hard to locate; there are few if any so called 'brightlines' in NZ IFRS 15."

been hard to locate because there are few, if any, so-called 'bright lines' set out in NZ IFRS 15. However, two broad categories have now emerged to help property developers more confidently conclude whether they are constructing assets with "no alternative use".

1. Substantive contractual limitations

Substantive contractual terms exist when they prevent the property developer from redirecting a specific unit under contract to another customer.

If a substantive contract provision makes it impossible for a property developer to redirect a specific apartment to another customer, even though other units in the complex might be similar, then that apartment does not have an alternative use to the developer because it's legally obliged to transfer it to the original customer.

This could be accomplished by including a contractual term naming the specific unit being sold (eg, Apartment 730) or describing its attributes in enough detail that substitutability is effectively restricted (eg, the southwest facing corner unit on the 7th floor). However, a contractual restriction may not be substantive if, for example, it only represents a protective right that does not effectively restrict the vendor from physically substituting a largely interchangeable asset should something unforeseen happen (eg, a natural disaster or insolvency).

2. Practical limitations

A practical limitation exists if the developer incurs significant economic losses in repurposing the asset for another use. For example, an apartment that is highly customised for a buyer does not likely have an alternative use if the developer would need to incur significant costs to reconfigure it for someone else or they could only sell the unit at a significant loss.

For non-customised apartments, such practical limitations may not exist. That said, while individual apartments in some complexes may be fairly standardised, contractual provisions are often present that act to restrict the developer from redirecting a specific unit to another customer. In situations like this the no alternative use criterion would be met.

Various regulators around the world generally agree that when evaluating the no alternative use criterion, the property developer must consider whether it could sell the completed asset to another customer without incurring a significant economic loss. It's also interesting to note that in making that assessment, if customisation only takes place in the final 20% of build, that factor should not be taken into consideration.

A word of warning: the time to comply is now

This reporting standard came into effect for any reporting periods beginning on or after 1 January 2018, so if your balance date is on or after 31 December 2018, careful consideration of the "no alternative use" principle should be top of mind, because the amount of revenue recognised to date, and the consequential profits that result might have to change.

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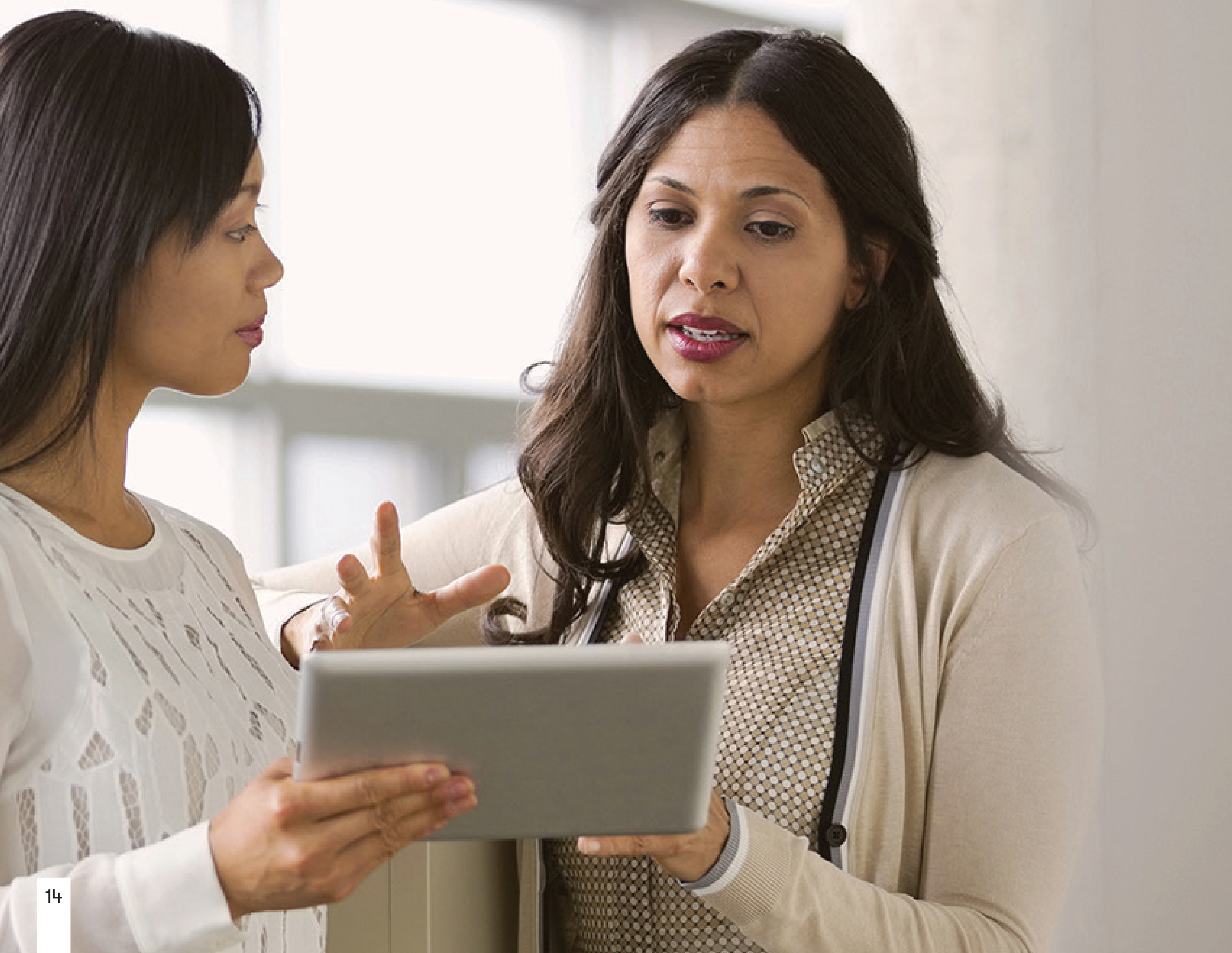
The business case for gender diversity in senior leadership

Gender diversity in business leadership is a no-lose proposition, yet progress is still slow.



Grant Thornton International has been surveying thousands of businesses annually since 2004 about the levels of gender diversity in leadership roles globally. The 2019 report Women in Business: Building a Blueprint for Action has just been released; we're seeing some incremental improvements but no real sea change.

In some ways this is surprising, given the commercial benefits of diversity are well-established: higher performance, more innovation, a better work culture, and better connections with a wider range of customers, not to mention the impact on bottom lines.

In other ways, perhaps the lack of progress is to be expected. Many companies have unconscious biases and ways of thinking that aren't conducive to positive change.

Slow progress in the face of complacency

Once upon a time, New Zealand was ranked relatively high among other countries for its gender equality in business. Our ranking dropped significantly four years ago, and it continues to plateau; this could be attributed to complacency kicking in. It can be easy to tell yourself, "Yes, this is a problem in general, but it's not an issue in my business." Unfortunately, our research over the years shows that's not the case.

Instead, we see only incremental improvements over the years when it comes to gender equality in senior management positions. There are some positive signs: most encouragingly, 87% of businesses worldwide have at least one woman in senior management, up from 75% last year and 66% in 2017. We've also hit an all-time global high of women filling 29% of senior management positions, up from 24% on 2018. However, when put in perspective, this is less impressive when compared to the 2004 survey results of 19% of senior management roles, showing a disappointing lack of progress in 15 years. It's thought that 30% is the tipping point at which we'll start to see gender parity really kick in.

Embedding policy in company culture

How can that target be reached and then surpassed? Equal pay, non-discriminatory recruitment and flexible hours were just three of the policy recommendations from last year's Women in Business report, but policies alone don't generate the kind of change we'd like to see. This year's report spells out some of the practical actions that businesses can take to improve diversity in their senior management teams, including:

- **Reviewing recruitment approaches.** Gender diversity is hampered by entrenched recruitment bias and the tendency for 'mini-me' hiring. This can be overcome; this year's report revealed that when one multinational business began requiring diverse candidate lists, its rate of women in leadership roles jumped from 17% to 30% in four years.
- **Mentoring for women who want to make the step up.** One study found 32% of women believed reaching the C-suite was a reasonable goal, but that rate increased to 49% of those with a mentor and 61% with a sponsor.
- **Flexible working.** Both flexible hours and the ability to work remotely contribute to better retention of top performers. One study found 83% of women with work flexibility aspired to senior leadership roles, compared to 54% of women without.

These simple adjustments can lead to big improvements to how Kiwi businesses hire and retain excellent employees. Making only a handful of small changes can have a positive impact on the current and future women in your workplace.

Diversity drives innovation and profits

For those business owners who believe there's no gender diversity problem in their own companies, I would urge them to actually measure their success on this front. What percentage of the senior management roles are filled by women? And how many women are waiting for a seat at the table?

If fewer than 20% of management positions are held by women, your business is hampering its own success. This year's research indicates that there is a clear relationship between diverse management teams and revenue increases when creating innovative goods and services. Innovation only increased significantly when women held more than 20% of management positions.

Even without expert studies dedicated to this subject, it's common sense that diverse teams of people will generate more diverse ideas and be less likely to fall into the trap of groupthink.

Grant Thornton's own global CEO, Peter Bodin, says he's seen it with his own eyes: "I know from my own personal experience that gender diversity leads to higher performance, a more inclusive culture [and] more balanced decisions."

Changing the culture at the top

Women still face more barriers to progress than their male counterparts, including lack of access to professional development and networking opportunities. Caring responsibilities beyond their work remains a barrier for 25% of women, however this is also the case for 21% of men surveyed for this year's report.

New Zealand's first father, Clarke Gayford, made international headlines in 2018 when he took time off to be a stay-at-home dad while his partner Jacinda Adern continued in her role as Prime Minister. Some of the negative responses to this arrangement were startling – the level of astonishment was another indication of how slow progress has been when it comes to challenging traditional gender roles. But it does demonstrate that they are being disestablished, and having it happen at the highest level of government sends a powerful message – one that also needs to come from the top tiers of company culture. When the senior management team leads by example, it becomes a group that women aspire to join, where they feel accepted as a leader. When the senior leaders all look the same, that sends a message to anyone who doesn't fit the description: You don't belong here.

An inclusive culture is a way to foster diversity, creativity, productivity and a much more enjoyable workplace – everyone's a winner. That means making diversity part of the everyday conversations at your business, rather than merely a talking point on International Women's Day. We need to make this a living, breathing part of every company's culture.

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