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Election 2017:
It’s not what we’re spending, it’s how we’re spending

This election season, lots of promises are being thrown around in the form of cash and prizes for all sorts of Government agencies. Once the election is done and dusted, how confident are you that these agencies are going to spend their piece of the pie well?

In 2015, Treasury issued Investment Management and Asset Performance in the State Services to provide an incentive mechanism that rewards good investment management and performance. While it seemed to garner little public attention, its implications are significant. As you would expect, it focusses first on the agencies who receive the most money – those that have large, investment intensive assets.

The programme enhances agencies’ ability to plan, prioritise and spend funding through a P3M3 (portfolios, programmes and project management maturity methodology) ratings system. So far, agency ratings have been positive, however, a weak spot identified from the reviews to date is the management of investment benefits. Benefits management is something most organisations struggle with; this often stems from a lack of rigour in the planning phases to define expected benefits and how they will be measured. While there’s room for improvement here, the biggest game changer is portfolio management.

Having completed several P3M3 reviews in both the public and private sectors in the last six months, I believe a bigger spotlight needs to be shined on this area. There are very few people in New Zealand – both practitioners and assessors – who know how to optimally execute portfolio management.

As you would expect, a lot of focus surrounds the actual implementation of investment decisions, and not enough time or resource is dedicated to what we should invest in to achieve the strategic outcomes for agencies and the New Zealanders that they serve.

Enter P3M3. This framework defines the best investment management characteristics of portfolios to help determine what an agency needs to do to achieve far greater returns from its investments. I believe a change in focus will have a far greater impact on the outcomes of investments in the public sector than the current impetus for monitoring implementation around less than robust investment decisions.

The real incentive to make this work is the investor confidence rating Treasury has introduced as part of this. If an agency gets a poor rating, the CE's delegation of authority is reduced and they have less ability to make big investments without their Minister's approval. Currently, the key issue is the current ratings are based on self-assessments; next year Treasury will engage third parties to review and assign ratings based on evidence that they have good investment management disciplines in place.

The continued focus by agencies on investment planning and decision making through portfolio management is critical if the public sector is to achieve better outcomes for New Zealand.

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Getting your business innovation-ready might not be as hard as you think

When your job title is 'Director of Innovation' there are two things you get asked a lot. The first is – what exactly is innovation? And the second is – so, how do you help companies become good innovators?

Now, we could spend a lot of time debating what innovation actually is. Arguably, it might have been one of human kind's greatest early feats; I mean, was the wheel the innovation – or the axel?

Whether you think innovation is art or science, let's just agree for the purposes of this article, that it is simply the ability of a company to continuously solve problems or create new value, that they can be paid for.

So how do you become good at doing this – or more importantly – organise your business to be innovation ready? Because undoubtedly in a decade where disruption and change are the new normal, it's no longer about 'innovate or die' – it's more likely 'do nothing and die!'

The good news is, it's mainly common sense. When you set out to build your business – tell me – did you imagine that you would:

- have a clear purpose and strategy that motivates people to work alongside you?
- align all your business activities to what your customers need?
- hire and reward great people that are interested in your customers?
- always understand new product and service-related technologies relevant to your industry?
- ensure any new product or service you built, was aligned to your strategy?

I doubt anyone reading this article would question when they started, that was their intent, which is great, as these are all the ingredients required at the foundation of an innovation ready business.

The problem is that a bunch of tricky things get in the way – it's called organisational complexity. As your company gets bigger, sticking to the basics gets a lot harder. Certain things keep you from your core purpose – such as compliance, managing non-performing staff, lumpy cash flow, and disruptive competitors.

I meet a lot of people that despite being super smart strategic operators, no longer talk to their customers or directly understand their needs - from talented product developers, who generate ideas from inside the building, to financial controllers who have no idea how much their organisation is spending on idea generation or failed product launches.

Complexity – and arguably 'busy-ness' – is the death-knell for innovation. Sticking to the core principles of what your business's purpose is, and remaining close to your customers' needs are still the cornerstones of strong innovation organisations. But it takes a little bit more than that to be great at innovation.

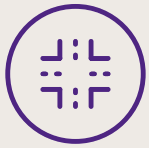
Here's my checklist of top five tips for complex, busy businesses to re-focus and put innovation and customer needs back in the front seat:

1 Have your own innovation methodology or model

There are plenty of methods out there. Whether you choose Design Thinking, Agile or Co-Creation, the most important thing is to test it and make it your own. Change the language, adapt the process to fit your culture. There is no such thing as the right way to implement innovation, just the right way for your business.

2 Define your cultural behaviours

Innovation is impossible without motivating people. And people respond best to behavioural cues that they are encouraged to follow – such as organisational values and behaviours. Peter Drucker is famous for saying 'culture eats strategy for breakfast'. At the heart of any great culture is a set of behaviours that everyone can relate to. For innovation to thrive, these normally include collaboration, failing-fast, empathy, build-to-learn.



3 Have a decision-making framework

Having good ideas is not the problem for fast growing companies. The ability to choose the right idea, and knowing when to invest in it, is the difference between those that get lucky, and those that get famous. One of the best innovation frameworks for making decisions came out of IDEO in the early 2000s: Desirability, Viability, and Feasibility. Here at Grant Thornton we have created a 'test' around these components so companies can evaluate the merit of ideas as a strategy team, before investing beyond MVP. Whether it's this method or another, always have a process for spotting a good idea vs an average one. And if in doubt, build a prototype, test it and let the results speak for themselves.

4 Know your risk appetite

There are many types of innovation. Some think it's all about disruption. We say you should be spending up to 70% of your efforts innovating your core business (or continuously improving and iterating what you are selling today to your existing customers). Don't drink the disruption 'Kool-Aid' – sit down as an executive team and map out how much of your innovation efforts you want to spend on high-risk innovation vs core. And plan accordingly – map out your activity as part of your strategic review each year. A useful framework for planning purposes is the HBR Innovation Ambition Model.

5 Hire the right people and give them the right incentives

It takes diversity to run an innovative business. But never under-estimate how hard it is to balance getting the incentives right for creative people vs strategic or technical people. It's not just about bean-bags and table tennis. Adopt a leadership viewpoint to design your culture to enable both fixed and learning mindsets to co-exist, know how to spot them, and know how to reward them if you want innovation to thrive. Don't succumb to unconscious bias – design your culture purposefully and don't be afraid to reward people differently. Innovation is human-centred and starts with you as a leader, motivating and rewarding your people for taking risks (or managing risks) that enable innovation.

To combat disruption and remain sustainable, you can't wing it anymore. Globally, business schools are now making innovation and design thinking core components of all business and management degrees. The future generation of business leaders now view innovation skill sets as critical to success – arguably as important as financial skill sets. So get back to the basics, and arm your business with the tools and processes you will need to shape a future that aligns with the vision and passion you had when you first founded your company.

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Reserves:
the top five questions asked by NFPs

Over the years, I have had several conversations with many different organisations about their reserves. The most common questions I've been asked are, how much should we have and what should we do with them? Is it ok to have a deficit and use some of our reserves? Where should we invest our reserves? How should we display them? Should we have a reserves policy?

My answer to all of those questions except the last one is "it depends".

1 How much should we have and what should we do with our reserves?

The most common answer about the amount of reserves I have come across is six months – and that is as good an answer as any. But six months of what? Does this include operating costs, operating costs plus enough funds to deliver outstanding projects and contracts, or wind down costs?

I believe the level of reserves and even in what form they are held depends on what they are being held for.

As a minimum, you should hold enough cash to allow three months operations if all income suddenly ceases plus an allowance for any possible redundancies, lease pay outs, holiday pay, costs to sell off assets, final accounting and taxation obligations.

It is very rare for all income to cease suddenly. There are often warning signs or patterns of income dropping away.

This level of basic reserve also helps to smooth out temporary cash flow needs in normal operations but obviously, cash reserves dropping below this level is a red flag that needs to be remedied.

If your income streams are very lumpy or uncertain, you want to hold more than this level as your basic level of cash reserves.

Extra reserves would depend on what you need them for.

The nature of your organisation and the environment it operates in will drive whether extra reserves over the basic one is required (or at least desired).

Other reasons for reserves could include:

- database or other IT project replacements
- moving premises
- funding for potential legal cases (large ones)
- future conferences or sporting events
- large strategic projects
- restructuring/amalgamations.

The nature and frequency for the reserve would drive the amount, timing and even how the funds are invested.

Cash versus equity

One of the more arcane challenges I see is that the organisation will label and separate part of its accumulated funds/equity as its reserves. One of the problems with this approach is that readers of the financial statements (year end or part year) could be forgiven for thinking the $350k in the equity statement marked as basic reserves is available for immediate use.

In fact, equity is simply the balancing item between recorded assets and liabilities (what the organisation owes outside parties). In plain terms, this means that the equity could be partially backed by furniture, goodwill, software, computers and other assets that actually have very little ability to be converted to cash.

I monotonously advise anyone that will listen to me that the reserves amounts should be reflected in dedicated cash and near cash. As a minimum, the basic reserve should be covered by actual cash. The other reserves should be covered by actual cash, near cash (debtors) and longer-term investments.

2 Is it ok to use reserves to fund deficits?

I don't see why not. If you have reserves that exceed your basic reserve levels and your planned projects or needs – and if the deficit year is planned and is a result of new initiatives or delivery of strategic outcomes – why not?

Even if the deficit level is unplanned, that is what the reserves are for too – to smooth out those unexpected events – but they may need to be replaced.

3 Where should we invest our reserves?

I get asked this a lot, but it's a tricky one. It's particularly tricky as I'm precluded from law on giving investment advice (I'm not a registered investment advisor) but I can give general advice on process and concepts.

Usually, I tell organisations three main things:

1 Get professional advice. If you have $1m+ of cash reserve you really need some expert help. Both to discharge your obligations to stakeholders and to understand what options are out there
2 Just because you have the same assets/reserves at the end of the year as the start of the year does not necessarily mean you are doing well at investing. You have an obligation to make the most out of all assets and review their effectiveness to the organisation (financial or to help deliver outcomes). This is particularly relevant to property you own
3 Ask your bank to use sweeps (automatic transfers of balances to interest bearing accounts). The worst investment return is giving free money to your bank

4 How should we display our reserves?

I am a big fan of "jam jar" accounting. This means that if you have different reserves, I suggest displaying them separately on your balance sheet in the equity section and having a detailed note that outlines the reasons and targets for the reserves. This note would mirror your reserves policy.

You may even have dedicated investments on the asset side mirroring the reserves.

The display of your reserves and commentary about intended use is a great tool for AGMs, funders, members and donors to understand why you have that stack of cash on the balance sheet.

In your internal management and Board reporting, I find a graph reporting on the reserve levels on a month-by-month basis is useful for tracking and monitoring (and identifying any shortfalls).

New reporting regime

While the new reporting regime for charities is a great opportunity for the sector to share a common way of presenting their financial statements, there are a few wrinkles in how income is recognised that could have a significant impact on income in advance balances.

Now in some situations, your organisation might have to recognise the income when received and it will flow straight to your equity.

This may cause confusion for funders and the public, so having detailed information on reserves in your financial statements may assist with the perception that your organisation does not need any more money…

5 Should we have a Reserves Policy?

Yes. Whether it is for communication to stakeholders, to comply with reporting requirements or to drive investment decisions, a Reserves Policy is a critical Governance process to assist in the sustainability of your organisation and to achieving its strategy long term.

In fact, a lot of the information above can be codified in a Reserves Policy. A Reserves Policy should include:

1 A description of why you have certain reserves and the trigger points for using them
2 Each reserve should be linked to risk, that is, degree of probability and level of impact – low, medium, high, very high
3 A description of what level of funds are required in each reserve, how this is calculated and a comparison of current level versus target
4 Perhaps some guidance for each reserve on the type of investment that can be held to fund them. For example, your base line reserve should be held in a form that is easily turned into cash, a reserve to move buildings in six years' time could be held in a longer term, less fluid form
5 Details on the process to review the policy, when it was reviewed last and who can authorise changes
6 If you have a SIPO (statement of investment policy and objectives), the reserves policy and the SIPO should be aligned

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Property investment: tax considerations to get your house in order

When Kiwis contemplate investment options, the natural go-to for many is the property market. Capital growth in the commercial and residential sectors have been performing well, and interest rates are at historic lows and look to stay that way for a while yet.

So, you can't go wrong with putting money into bricks and mortar, and capital gains are tax free…right? Our wonderful Kiwi colloquialism sums up the answer: "Yeah, nah".

Although no official capital gains tax exists in New Zealand, there are several provisions contained within the Income Tax Act that enables the taxman to take his slice of the action. Inland Revenue have actively increased their scrutiny within the property sector over the past few years and have been proactively educating taxpayers about their obligations. This has increased general awareness, but I still see plenty of tax train wrecks that could have been avoidable had appropriate advice been obtained from the outset.

Back door capital gains tax

Obvious examples where property gains are and should be taxed include those generated by land dealers, developers, builders, and speculators. This is completely fair and reasonable as any gains generated simply represent taxpayers' business profits.

Less obvious areas include when the property owner is 'associated' with a land dealer, developer and builder, and the property is sold within 10 years of acquisition (or in some cases 10 years from completing building improvements). The 'associated' definition is very broad, and has essentially been designed to inhibit persons involved in such activities, or those connected with them, from holding property on capital account.

But wait, there's more. If you undertake development or division work in relation to property you own within 10 years of acquisition, and that work is 'more than minor,' you could get whacked with the tax stick too. This can in some instances adversely impact simple subdivisions of personal property.

There is of course the new brightline test that was introduced to tax gains generated on the sale of residential land if sold within two years of acquisition. The brightline test does not apply to the main home, but it will apply to holiday homes and rental properties if sold within two years.

The sleeping giant of tax provisions

A particular provision which could really come home to bite unsuspecting property owners applies when more than 20% of the increase in value of the property relates to (broadly) a rezoning change, or the likelihood of one. Under Auckland's Unitary Plan, many properties could unwittingly fall within this category. Although it seems harsh to tax capital

gains in this situation, the law is clear that when properties are sold within 10 years, they will be subject to tax.

A range of exemptions and deductions can be claimed to provide relief from the above provisions when specific criteria are met; however they are fact specific and need to be closely worked through. Assuming that any gains generated from the disposal of investment property are tax-free is dangerous, and in certain situations can turn a good investment into an average one.

Structures for property investment

A question that is often asked at the outset is: what kind of structure works best for property investment? Like most things in tax, there is no cookie cutter approach to answer this; the sensible reply is "it depends". You need to determine what your core focus is, and what is important to you:

- Do you want simplicity?
- Are you worried about commercial creditors and asset protection?
- Do you need to refinance debt?
- Are you retaining your current home for investment purposes but upgrading to a newer more expensive one?
- Do you need to income split?
- Do you want protection from relationship property issues?
- What other investments do you hold?

Ranges of options exist which cater to different needs, including:

- Personal ownership
- Partnership
- Look Through Company
- An ordinary company
- Family trust
- Limited Partnership

Your specific situation will determine which structure going forward will provide you with the best answer. Variable factors that require your consideration include:

- whether your property will operate at a tax loss
- your intentions with the property
- the amount of equity in the property
- plans to purchase additional properties
- if compliance costs exceed any benefits.

As you can appreciate, most tax matters aren't straight forward, and the evolving nature of tax policy and legislation can create what seems like an unnavigable environment of smoke and mirrors. What's more, solutions and responses to those changes are dependent on your own specific situation and future plans; so it pays to get your house in order to avoid getting lost in a tax mire. Forewarned is forearmed.

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We're growing in Christchurch

Grant Thornton New Zealand has made a number of key appointments to its Christchurch team to meet the demand for our services in this growing city and the Canterbury region.

Christchurch is in an exciting phase of growth and we are seeing the Christchurch business community flourishing as the rebuild period continues. A number of top New Zealand organisations are expanding their presence in the city and local businesses are thriving.

The firm has appointed four new partners and an associate in Christchurch this year, to strengthen its offering and refresh the team with new skills and energy:

These new appointments are all positive additions and strengthen our growing practice. It is an exciting time for our team, both in the national firm and on the ground in Christchurch. To learn more about our new team members, visit **grantthornton.co.nz/meet-our-people**

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