

health adviser

Grant Thornton 

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"Batten down the Hatches" - Cashflow planning in an economic slowdown

A number of the economic indicators point to a potential slowdown of the domestic economy during 2006. While there appears to be a level of optimism amongst a number of industry sectors, it is apparent that the prudent business owner needs to be adopting and planning for the impact on trading conditions should the New Zealand economic environment begin to soften.

The reality is that for the business owner there are a limited number of initiatives to be explored and implemented that can ensure a smoother ride in the event of a "hard" or "soft" landing of the New Zealand economy.

The key focus in these times has to be cash preservation. There are some simple adjustments to the business owner's daily business practice and protocols that can contribute to this goal of cash preservation.

Forward planning for this is essential and the time to commence with these initiatives is now and not when the economic cycle turns.

1. Breakeven - Commence a review of the business's monthly fixed and variable overhead costs to gain an understanding of the fixed costs that need to be covered by the contribution after direct costs each month.

Gain an understanding of breakeven sales required on a monthly basis and measure this on a weekly basis.

Review the nature of the variable costs of your business and take a view based on the "wants versus needs" principle in relation to reducing these variable overheads.

2. Capital Expenditure - Review the current level and frequency of asset purchases in the business and the current authorisation process for capital spend. Implement policy changes for a temporary period so closer inspection can be undertaken as to the necessity of capital investment.

For required asset purchases consider the financing alternatives including plant financiers rather than traditional methods of funding via cash flow. In addition, there is the possibility of sale and leaseback of operating assets to create cash flow.

Consideration as to the benefit of retaining assets of the business that are surplus to requirements and turn into cash. Surplus land and buildings, plant or vehicles should all be considered.

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"Batten down the Hatches" (Cont)

3. Inventories - Review the current inventory requirements and the mix of inventory required for the business process. Brief the appropriate employees on the purchasing policies going forward and set minimum levels based on supplier lead times. Agree and set benchmarks for appropriate inventory levels in an attempt to manage down inventory to optimum quantities. Measure stock turn on a regular basis.

Renegotiate supplier payment terms especially in the case of an overseas supplier. Initiate and agree instalment arrangements for suppliers and ensure you commit to the agreement.

Fire sale slow moving inventory with the goal of creating cash.

4. Employees - Review headcount and the current organisational structure. Manage taking of annual leave in quieter periods. Review overtime requirements and manage accordingly. Consider operational requirements and capacity issues and the possibility of a four-day working week or removing a shift. Review current recruitment policy.

5. Review contribution - Undertake a detailed segmented review of the contribution made to the business's profitability by product, customer, machine, service function and employee. Gain a greater understanding of what makes the business money and is a contributor, and what product/customer is marginal at the contribution line.

Prepare an action plan to act on eliminating poor contributors in the event prompt action is required.

6. Customers - Review current credit terms offered to customers and undertake daily management of the accounts receivable ledger. Set weekly performance indicators as to aged debtor position and install "stop credit" policies on a more stringent basis.

Review security position on goods supplied and consider the registration requirements under the PPSA.

Improve invoicing cycle by invoicing completed jobs/products/services on a regular basis rather than at month end. Possibly consider offering a discount for earlier payment; however you need to consider the effective interest rate cost on this to the business.

7. Cashflow Cycle - Undertake a review of the business's monthly cashflow cycle by plotting and classifying actual cash inflows and outflows for the preceding three months. Get a good understanding of when the major cash costs of the business fall in the month. Use this understanding of the cashflow cycle to undertake monthly cashflow forecasts, which will be an invaluable tool in the event of tightening of the business's cash position.

In the event of an economic downturn the demand for the business's product/service may reduce which will impact on profitability. In the event of an economic slowdown there is a requirement to focus on cash preservation. Cash is the oxygen to your business and there are significant opportunities to tighten the business's policies and processes to ensure there is not a detrimental impact on the survival of your business.

Are you treating your employees as contractors?

It is very important that you know whether the people who work for you are employees or are self employed.

This was clearly illustrated in the recent Supreme Court decision in *Bryson v Three Foot Six*. Bryson was hired as a contractor by Three Foot Six to make models for Lord of the Rings. His work was terminated; he claimed he was an employee; the company claimed he was a contractor. The confusion and uncertainty surrounding "Employment Status" in general is reflected in the decisions by the Courts. Firstly, the Employment Relations Authority said contractor; the Employment Court said employee; the Court of Appeal said contractor and now the Supreme Court says employee.

The Inland Revenue have introduced guidelines to help clarify whether a person is an employee or a contractor (refer IR 336). Basically it comes down to control exercised by the employer, providing of equipment and training and whether you are responsible for operating the business, investing your own money and taking the risks.

So what if you do get it wrong and your contractor is in fact an employee? Firstly, it is illegal to treat a true employee as self employed to avoid deducting tax - so if you are doing this you may be prosecuted and fined. You will also be liable for the PAYE that should have been deducted, plus penalties and interest. Then there are accident compensation levies, student loan deductions, holiday pay entitlements and even personal grievance provisions to consider.

If you are deemed to be the employer you have to pay the PAYE - it is then up to you to get this back, supposedly from the contractor. This sounds easier than it is. The contractor (now the employee) could seek holiday pay, maybe look at a personal grievance claim and then at the end of the day say they have no money to repay the PAYE anyway - in short, a tricky situation to be in and obviously one to avoid.

The decision in *Bryson v Three Foot Six* should be a timely reminder to all employers to review the status of their "contractors" and whether they are in fact employees.

Shareholders' Agreements

What is a Shareholders' Agreement?

A Shareholders' Agreement is a legal document, setting out the agreed position or understanding of the shareholders of a company on certain key issues. Formalising a Shareholders' Agreement brings a disciplined approach to identifying and considering key issues in advance, and agreeing how these should be handled. It supplements the Company Constitution, as the Constitution is often broad ranging and, in a standard form, doesn't focus in depth on all issues that may be of particular concern to the shareholders.

Once commenced the term of a Shareholders' Agreement is usually until there is unanimous agreement to sell or liquidate the company.

What types of issues are normally covered in a Shareholders' Agreement?

What is addressed in a Shareholders' Agreement depends on the nature and operations of the particular company, and the circumstances and particular concerns of the shareholders. Issues that are commonly addressed include the following:

- Capital structure.
- Pre-emptive rights (in relation to a shareholder wanting to sell their shares, having to first offer these shares to the other shareholders - sometimes shareholders wish to amend the standard provisions of the Company Constitution in relation to this matter).
- Funding - internal/external (including provisions relating to situations where the shareholders may have to contribute additional funds).
- Appointment and removal of directors.
- Organisational structure (including accountability processes and how decisions are made and reported).
- Shareholders consents - some decisions, of a material or significant nature, will require shareholder consent, such as:
 - material change to the nature of the company's activities;
 - capital expenditure over and above predefined limits;
 - purchase or divestment of the business or part of the business;
 - the issue of further shares;
 - any amendment to the Shareholders' Agreement or Company Constitution.
- Accounting/regulatory requirements.
- Distribution of profits (in relation to the dividend policy and what percentage of the profits are to be distributed as dividends).
- Death or incapacity:
 - buy-out provisions (including a methodology for assessing the value of shares upon the death of a shareholder);
 - keyman insurance and buy/sell insurance.
- Termination of the Shareholders Agreement (due to such factors as insolvency, cessation of business etc).
- Drag along/tag along provisions (including the rights of minority shareholders, upon the sale of a majority shareholding in the company to a third party).
- Resolution of disputes (ie, provisions relating to mediation or arbitration).
- Restraint of trade (if one of the existing shareholders was to exit the business).

Shareholders Agreements are a very useful tool, in terms of risk management. It sets out the "agreed rules", up front, in relation to dealing with potential issues that the company or its shareholders may face.

Entertainment Tax - How should you reward staff and referral sources?

As Christmas looms, many businesses will be gearing up to celebrate the festive season and to show their appreciation to staff and colleagues for their support during the year.

While not wishing to dampen the Christmas spirit, the tax consequences of this festive spending should not be forgotten. Being forewarned will avoid unexpected New Year surprises!

There are three categories of entertainment: Fully Deductible, Fully Deductible but subject to FBT, and 50% Deductible.

Fully Deductible: These expenses will be 100% deductible to the business:

- Meals while travelling on business
- Food/drink at a conference or training course that runs for longer than 4 hours
- Meal allowance for overtime
- Morning and afternoon tea i.e. biscuits, hot drinks, and shouts
- Promotions open to the public
- If an employee's salary package includes a taxable allowance for entertaining clients (fully deductible to employer)
- Entertainment consumed overseas

Some examples are:

1. Gifts of non-food or beverages to colleagues (most things will fall into this category)
2. Staff morning tea/afternoon tea
3. Team building conference (not including spouses)
4. Sponsorship of external sports team (classed as advertising and requires some link to the business).

Fully Deductible but subject to FBT: These expenses will be 100% deductible to the business, however they will be subject to Fringe Benefit Tax (FBT), meaning that an FBT return and payment will be required. Note that where spending is under the thresholds of \$75 per employee and under \$450 per

employer per quarter, no FBT payment is required. This commonly includes expenditure on gifts or benefits to employees (consumed at the employee's leisure)

Some examples are:

1. Gifts of food or beverages to staff (over the thresholds mentioned)
2. T-shirts/caps/jackets provided to staff (over the thresholds mentioned)
3. Sponsorship of employees' sports team (below the thresholds mentioned above).

Please note that the above mentioned limits over which FBT applies are expected to increase as a result of legislation which is likely to be passed shortly. The increased thresholds are anticipated to take effect from 1 April 2006.

50% Deductible: These expenses are only 50% deductible for both income tax and GST and require an adjustment in both returns:

- Entertainment incurred in relation to an existing or prospective business contact or client
- Entertainment of staff to maintain goodwill
- Entertainment which is necessarily incurred but the main purpose is business
- Entertainment expenses incurred mainly in connection with specific business transactions.

Some examples are:

1. Staff Christmas party
2. Christmas lunch/dinner for colleagues /referral sources
3. Food and wine provided to colleagues and referral sources
4. Gifts of food or wine to staff (below the FBT thresholds mentioned above)
5. Food and drink provided for a function on business premises.

Hopefully, this will give you a better understanding of the entertainment regime and usher in a happy New Year.

If you require further information on any of these topics or would like details on other accounting matters, contact your local Grant Thornton firm:

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