

# BUSINESS UPDATE

Business Advisory Newsletter / December 2011

## Supercharge your business management

Without good governance businesses can expand too quickly. Inside we discuss how to supercharge your business without blowing a fuse.

### Also in this issue:

- Open all hours
- Penny and Hooper case update
- How safe are your assets?
- Tax updates



cutting through complexity

Welcome to KPMG's 2011 Business Update and thank you for your continued business during the year. Regular recipients will note that this issue has a revised look and format, as we look to find the most effective way of delivering this information to you.

You will find enclosed a brief survey in this respect so that we can ensure we provide the material you value most, in the best format for you. Please take a few minutes to complete the survey and return to Lisa Woolsey via the postage paid envelope included. To thank you for your assistance one lucky respondent will receive a meal voucher for \$100.

We would like to take this opportunity to wish you all a safe and festive holiday and look forward to working with you in 2012.

**Mark Kippenberger**  
National Managing Partner

[kpmg.com/nz](http://kpmg.com/nz)

# SUPERCHARGE YOUR BUSINESS MANAGEMENT

Good corporate governance should not just be seen as applicable to large listed or public interest entities. For a privately owned business governance is fundamental to providing leadership and direction for the organisation. It not only provides a framework for future planning and opportunity assessment, and the control environment under which business units operate, but helps define the culture of the organisation in terms of business practice and how the business is perceived both internally and externally by debt funders, other stakeholders, and future equity investors or purchasers.

Poor governance is a leading contributor to business failure. Without good oversight and direction businesses can expand too quickly, fail to respond to market changes, have a poor understanding of what generates or destroys enterprise value, and have poor capital structure or inadequate funding. Post the global financial crisis the lending criteria of debt funders has been significantly tightened. Debt funders are looking not only at the financials but at the leadership, governance structure, and financial reporting oversight of an organisation before approving new, or renewing existing, funding lines.

Many owners of private companies see obstacles to improving governance in their businesses, such as not having the time to devote to board and strategic matters and the cost of paying directors' fees. There is however more than one governance option for privately owned businesses in New Zealand, including engaging with professionals who provide more than just compliance services, utilising the services of a mentor or forming an advisory board, in addition to considering a constitutional board under the Companies Act 1993.

Engaging with a mentor or using an advisor as a sounding board is recognition by an owner that they could benefit from having an external perspective to help develop

and grow their business. A trusted advisor such as an accountant, lawyer or experienced colleague can provide these services in either a formal or informal capacity. Having set arrangements however does place the onus on the business operator to think about their business in a more strategic way, formalise their planning, and report (both financial and non-financial) against those plans. In terms of assistance with cost, NZTE (New Zealand Trade and Enterprise) has recently launched **a new voucher scheme** as a partial payment for the cost of management capability building services of eligible small businesses. The vouchers can be used to help you access training that builds your management capabilities, governance, and strategic plans, which in turn may accelerate the growth of your business. To be eligible for the vouchers your business needs to:

- Have fewer than 50 employees;
- Be registered for GST in New Zealand;
- Operate in a commercial environment;
- Be privately owned or a Maori Trust;
- Demonstrate a desire to innovate and grow.

Further information can be found at [www.nzte.govt.nz](http://www.nzte.govt.nz) or talk to a KPMG business advisory team member.

An advisory board formalises the benefits of a board without board members having to assume the legal obligations associated with being a director of a company. This lowers the threshold to obtain the skills of talented individuals who may not otherwise wish to take on directorships. Treat an advisory board like a formal board by having them review the business results and strategic plans as a constitutional board would. Final decision still rests with the owners and any decisions should be analysed, considered and ratified by the legal directors to ensure advisory board members are not subsequently determined to be “deemed or shadow” directors.

Under a constitutional board, as result of recent case law, directors have become increasingly aware of obligations associated with a formal board appointment. It is likely that good directors will require extensive information and papers to support decision making processes. The recent Feltex case amongst others has highlighted that directors, in relation to their obligations under the Companies Act 1993 and Financial Reporting Act 1993, should:

- Exercise intelligent oversight of a company's affairs;
- Pay attention and give appropriate consideration to material placed before them;

- Take a diligent and intelligent interest in the information available; and
- Non-executive directors have the same obligations as executive directors.

A director is entitled to impose trust in others when exercising powers or performing duties and may rely on reports, financial and other information prepared or supplied, and on professional expert advice given by an employee, professional advisor, or by directors or committees. However, consider that a director is not relieved of the duty to pay attention to the company's affairs which might reasonably be expected to attract inquiry, even if outside the area of the directors' expertise and therefore they cannot solely rely on the skills of other directors or advisors.

Given the risks for both sides it likely that both the existing directors and the candidate will undertake due diligence on each other in terms of credentials and whether a working relationship can be formed. Therefore allow time for this process to take place.

When looking for the assistance in the area of governance, consider what skills are necessary for your business success and where are your gaps? Consider a good selection of candidates, particularly beyond those already known, and look at individuals who might not fit with preconceptions about 'suitability' but might challenge current thinking. Look beyond the stereotypical director or family member who is just there to make sure 'things don't move too fast' and consider those the company could benefit from in terms of production skills, marketing skills, commercial skills, industry knowledge and insights, or stronger financial management skills. In terms of identifying potential candidates, the Institute of Directors, industry bodies, local chamber of commerce, or professional advisors should be able to assist.

Increasing the level of governance through the use of **mentors, advisory boards**, or non-executive directors will require a shift from the traditional financial reporting model where financial accounts are prepared only annually, primarily for tax purposes, and budgets are prepared for the bank but are not used in assessing the financial performance of the business. Best practice would include budgets that that are reviewed quarterly with an updated year-end reforecast being prepared, against which management account actuals are reported each month. A balanced scorecard of performance measures (including key financial, operational, production and applicable non-financial measures) should also be prepared monthly.

In summary, one size does not fit all. Consider which option works best for you, the stage your business is at, and future direction you wish to take your business.

For more information please call Andrew Hawkes, or Tim White at KPMG or your regular KPMG Advisor.

# OPEN ALL HOURS

*"Retail is simple, but it ain't easy"* Sam Walton, founder of Walmart

The stage for "retail therapy" is moving and a struggle is growing in momentum for consumers buying online or opting for the physical shopping experience. In parts of Asia there is now evidence to suggest browsers try on clothes while 'shopping' then return home to buy online. Owners of physical stores need to take some responsibility for allowing consumers to commoditise their product & experience. Retailers response to the online option will shape consumers trading choices for years to come.

## **The retail experience**

Within the retail environment there is an unbalanced playing field between 'chain' retailers and independents. In many cases the former benefits from integrated information systems, retail trend analytics, effective stock purchasing with sale or return terms and very clear sales KPI's to keep the sales team focused & motivated. The latter benefits from owner passion & flair for their niche, superior service and loyal customers.

The 'chain' sector seems to be winning this battle, with consumers voting with their 'plastic' based on their assessment of value. The fact that the 'chain' retail sector seems to be growing indicates that price alone is being allowed to dominate consumers assessment of the value proposition. This in part can be influenced by the low level of training some retailers invest in their sales teams. Without further information with which to make an informed buying decision, consumers often associate value with price.

The consumer is experiencing two extremes of sales assistant. There are sales staff that simply exchange our cash for store product (clerks), or experienced sales professional staff that know their product, client base & understand the sale process. The latter cost a lot more, but if they deliver a strong multiple of sales above their wage, really do pay for themselves.

## **Begin with the end in mind**

I like the quote from David Brown, a retail mentor out of Retail Edge who believes retail owners should "buy stock based on what they intend to sell". A premise that belies underlying intent... that retailers should really plan stock down to departments, categories and lines that will comprise their planned store revenue, braking skews into both planned stock turn & mark-up (margin contribution).

This analytical approach quickly brings the responsibility of planning how to sell product into the realm of owners & sales teams. Selling needs to become a verb rather than a noun.

Too many retailers buy stock they believe will sell itself & once on the shelf will wait for exactly that. Stock does not have a voice, cannot move or interact so relies on staff to connect with a browser & have sufficient skill to determine the buying motivation & provide product options as solutions.

This of course happens, but not often enough.

### Take back the initiative

Let's start with stock. What to buy? A useful POS system is filled with evidence of exactly the information retailers can interrogate to plan future purchasing. Data on fast selling stock lines, average spend per transaction and customer profiles provides useful insight into understanding stock performance. Here owners need to understand the sensitivity of Return on Investment and in particular mark-up (margin contribution) and stock turn history. In some cases 80% of gross profit is delivered from one third of stock lines, making you wonder how other lines 'hold their spot' on your expensive real estate (shelf).

Terms of trade on stock can be critical to delivering bottom line profit. Again price alone is one component of 'value', but not all. Owners would be better served to pay a premium price (from your supplier) if this premium bought you small, regular quantities on a just in time basis and sale or return terms. A supplier cannot afford to think so short term that once the product is 'sold' to a retailer their problem is over. If retailers don't effectively sell through, they won't be reordering anytime soon.

### Leverage & deploy what you have

Too many retailers are focused on new customers when there often remains real growth potential from existing clients. The skill is to unlock the potential. Mostly the 'gold' can be sitting within a store database, providing effective client information is collected on purchase.

Effective sales strategies can be created from analysing the sales trends contained within a database. The reason why databases are often 'under used' is that the strategy requires owner/manager time rather than cash to deploy. Too many owners are time poor, consumed by a multitude of daily challenges at store level. Thus retail ownership requires effective task delegation at store level and freeing up time for owners to research the trends captured within their business systems.

The science component of successful retailing requires effective planning, leadership, time management, delegation and finally a motivated & engaged sales team. Don't make the mistake of believing the effective hourly rate of an owner is similar to your sales team, it is potentially much greater if owners use their time doing the things that matter.

The art of retail I will leave to each & every retailer, but suffice to say that the business niche they fill should embody an owners passion about their product and deliver a level of commensurate service.

### Independent Retail success

James owns a high margin/low stock turn business. James is a great example of an independent retailer who is passionate about his business, staff & local community. Moreover he drives a very successful business return (over and above salary) from the capital he has invested.

So what are the ingredients to James' success:

- Sets team member sales KPI, including monthly budget & understanding actions to achieve
- values his time, delegates many store functions to his team
- applies discipline to his working week, taking time every Monday afternoon to print off weekly sales reports
- Tuesday morning analysis of reports around product and team performance
- daily team meetings to focus staff on particular product lines, building product knowledge
- team bonus scheme that rewards achievement & behaviour that embodies service
- monthly individual team feedback on performance
- sufficient 'time out' to pull back & focus on the big picture
- continual investment in team sales skills, product knowledge & understanding client needs

James has a very effective store manager, and is vigilant about which matters he gets involved with.

For the most part James is highly effective in bouncing between daily store matters & wider performance of the business against budget & business plan.

James is very transparent with his sales team around both sales & margin contribution. So the sales team are very much aware of sales and margin expectation. They understand that stock is the ammunition they have to achieve their objectives and are fully engaged in creating a superior customer experience that equates to their business value proposition. James likes & expects sales team participation in what they stock, how they display and how they initiate dialogue with their customer base. There are no passive members on their team and customer loyalty to the store brand & culture is very strong.

### Conclusion

Chain retailers will always hold a niche as long as they compete in their commodity world where price dominates the value landscape.

Retailers (like all consumers) carry around a complex 'value proposition' matrix that enables them to make buying decisions. For independent retail stores to continue to prosper, owners & sales teams must accept greater responsibility to deliver a truly positive shopping experience to consumers.

An independent retailer could be so much more effective through integrating the science of sales data and stock performance into their business decision thinking. Sales performance data enables the right messages to be directed to the right clients. Providing sufficient structure enables this to happen.

If you would like to discuss this further please call Mark Kippenberger or your regular KPMG Advisor.

This article appeared first in NZRetail issue #700



## PENNY AND HOOPER VERDICT:

# WHAT DOES IT MEAN FOR YOUR BUSINESS?

The recent dispute involving Messrs Penny and Hooper has come to an end with the Supreme Court decision finding in favour of the IRD. The Supreme Court upheld the Court of Appeal's view that the setting of commercially unrealistic salaries constituted tax avoidance.

Penny and Hooper were both orthopaedic surgeons trading in their personal capacity, but restructured their businesses to trade through companies, owned by family trusts. The companies employed the surgeons for substantially less than what they had been earning prior to the restructure. However, their work load and the nature of work did not change. The Supreme Court stated that while the structures used were valid business structures, the yearly setting of a non-commercial salary constituted tax avoidance.

In response to the finding the IRD has provided guidance, in the form of Revenue Alert RA 11/02, on circumstances in which it considers tax avoidance would arise.

Based on the Revenue Alert, the IRD will look into all aspects of an arrangement, in order to come to a conclusion on whether or not diversion of personal income through other entities, such as companies and trusts, amounts to tax avoidance. The Alert identifies the following factors as being relevant:

- The commercial reality of the service provider's business structure,
- How profits have been distributed in substance and whether the employee and their family benefit from all profit distributions,
- Whether the remuneration paid to the individual providing the service adequately reflects their contribution to the business' profits,
- Whether there are other reasons, apart from tax, for justifying departure from the norm.

The Alert also identifies situations where a below market salary could be justified, as follows:

- To fund planned capital expenditure,
- To retain profits within the business to provide for future financial difficulties,
- Where profits are down, but most of the profits are still distributed to the service providers, or
- The business relates to a charity and the individual receives less to maximise the charity's return.

The IRD acknowledge other situations may arise in which it would not be possible to pay a market salary. However, if a business cannot afford to pay a market salary, the IRD would equally expect that it could not afford to make significant distributions (such as dividend payments) to associated entities.

Amongst accounting practitioners the heart of the Penny and Hooper case has been the question of whether private companies, which derive income from personal services performed by its employees, need to pay those employees a market salary. However, the Revenue Alert indicates the IRD may not stop at requiring a fair market salary. The IRD has stated that it is:

"more likely to examine arrangements where the total remuneration and profit distributions received by the individual service provider is less than 80% of the total distributions received by the controller, his/her family and associated entities."

Paying a commercially realistic salary may not necessarily satisfy the IRD, as the IRD's focus appears to be on the amount of income received by the service provider as a proportion of the total distributed. It is generally understood that disclosures to the IRD are being handled centrally to ensure taxpayers are treated consistently.



# HOW SAFE ARE YOUR ASSETS ?

**Trusted insider cheated family firm** (New Zealand Herald 2 April 2011)... how many times have you read that, probably a lot but you have shrugged it off with; that couldn't happen to our company, we're a tight knit bunch and John started with Dad... Of course, it may get you thinking but then other things take priority and nothing is done.

Why do people do this? Is it greed, is it a social problem like gambling or drug addiction, is it tough financial times, or is it just that they see an opportunity? Whatever it is, it's unfair and not right! Not only is there the obvious financial loss but there is also the personal toll on everyone who works in the company. It's pretty soul destroying to find out someone you perhaps respected or worked alongside is a thief, and then there is the shadow of doubt that is cast on everyone else as a consequence.

Maybe it's time to do something to minimise the risk of this happening to your company.

KPMG Fraud Barometer (released March 2011) reported that fraud is on the rise and that the most common type is accounting fraud that generally involves internal staff; that is by an employee or management. It also states that management fraud tends to outnumber employee fraud in both number and size and this is most likely because management is more likely to be in a position to access information, override controls and then have the ability to conceal the fact.

The first step you should consider is to take a close look at the company's internal control procedures;

- do they prevent misappropriation and if a theft does occur are there procedures in place that will detect it?
- is there adequate segregation of duties so that an individual is not capable of misappropriation and then concealing it?
- are there open communication lines so that employees can report suspicions or fraudulent things they see?
- is there a culture that stealing is not right and won't be tolerated?

These questions can all be addressed with a robust and transparent system of internal control. Maybe you think your policies are robust but when was the last time they were independently reviewed?

Unfortunately however, something happens that raises your suspicions. Maybe you have asked a question of your employee and they just can't give you a straight answer or they are taking forever to get back to you... Maybe a customer has contacted you with a query on cost or service that just doesn't sit right... Maybe certain expense amounts seem unusually high... Maybe the level of credit notes being passed increases for no specific reason... Maybe stock losses are increasing... Maybe you think business is humming along but the lack of cash flow just doesn't add up...

Then it is time to take action and quickly. There are many clever tools available to look for anomalies. Computer Assisted Auditing Techniques (CAATS) can be run over the company financial data that will identify unusual transactions such as those over a certain value, that have a repetitive nature, that are processed out of ordinary business hours, or to unusual bank accounts. Often theft can go undetected because it goes on for long periods of time at consistent levels and becomes the norm. The trouble with this is that the perpetrator can't take holidays for fear of the fraud being discovered so it is important employees are encouraged to take their leave, not only for their own well being but to provide an opportunity for job rotation and possible detection of fraud.

You may be worried about how the team will take these initiatives; perhaps they will feel it is an invasion of trust. This is a very valid concern, however we often find employees welcome such reviews. Often they feel exposed and want to be exonerated of any wrong doing. Employees want systems to be tight, they need to feel trusted.

We all want to believe our people are honest and loyal and in the majority of cases they are, but then there is always that one, that rotten egg, that one that lets the team down, and who pays? You!!

If you think it's time your company took a closer look please call Ann Tod or your KPMG Advisor.

## Proposed changes to livestock valuation schemes

Under the current legislation, it is easy to swap between the Herd Scheme and National Standard Cost (NSC) livestock valuation methods. A paper has been released focusing on the Government's concerns about farmers having the ability to switch between the methods to derive tax-free gains when livestock values are increasing, or tax-deductible write-downs when livestock values are decreasing.

Government officials have suggested that the following changes be made:

- Once a farmer has elected to use the Herd Scheme, the election is irrevocable, or
- Livestock election timeframes be altered to reduce advantages that can be acquired by farmers under the existing election framework. (Under the current legislation, a taxpayer is required to provide 2 years notice in writing to cease valuing their stock under herd scheme and move to another valuation method.)

Under the first alternative, any election would survive transfers between associated persons, to remove the ability to work around the changes by using multiple entities.



Lastly, the IRD proposes that the ability to use certain valuations, when trading ceases, should also become more restrictive.

Submissions on this paper closed on 30 September 2011. KPMG has made a submission on this paper and we look forward to seeing the final outcome.

## Repeal of gift duty

Gift duty was abolished on 1 October 2011. This means there is no duty payable under the Estates and Gift Duties Act 1968 on any gift made on or after 1 October 2011.

We are advising however that it is important to seek advice from your solicitors and us before contemplating any gifting post 1 October. Whilst the gift duty no longer applies there have been no changes to other legislation that deals with the disposal of property and other potential implications of making large gifts.



## Removal of depreciation on buildings

Again it is a timely reminder to consider the impact of the removal of depreciation on buildings when working out your 2012 tax position. For a lot of you, this is a significant change and some who have had the benefit of losses for some time will now need to be thinking about paying tax. Have you fully identified the fittings within your property which remain depreciable?

## Changes to working for families tax credits

For the year starting 1 April 2011, if you receive any of the following types of income you will need to advise the Inland Revenue Department as these will need to be included as income when calculating your working for families' tax credits.

- Attributable trustee income
- Attributable fringe benefits
- PIE income
- Passive income of children
- Income of non-resident spouse
- Tax exempt salary or wages
- Pensions and annuities
- Other payments that exceed \$5,000 per year
- Income equalisation scheme deposits

These changes are significant and are as a result of changes the Government made in attempt to tighten up who is entitled to receive these credits.

It is important to note that these changes also apply to the definition of parent's income for student allowance purposes.

**For questions on any of these topics, please talk to your regular KPMG advisor.**



## PASSIONATE ABOUT THE BUSINESS OF RUGBY

Twenty national teams playing 48 matches over 45 days in New Zealand – that was Rugby World Cup 2011 and the world's third largest sporting event. KPMG New Zealand was at the very heart of this festival of rugby after winning a competitive bid that saw the firm appointed Official Supplier of Accounting and Tax Advisory Services to the Tournament.

KPMG expressed this sponsorship with an integrated campaign to bring the firm's association with the Tournament to life. The most visual element of the campaign was the KPMG Auckland building wrap. The building wrap featured an image of the Manu Samoa rugby team on one entire side of the building on Viaduct Harbour Avenue, with the opposing side in Fanshawe Street featuring a large image of the Webb Ellis Cup. The wrap caught the attention of passers-by and became a central focal point in Auckland, often used as a backdrop for television news stories and photo opportunities during the Tournament.

The building wrap promoted KPMG's Official Supplier status and, at its unveiling, launched KPMG's dedicated RWC 2011 campaign website, [www.insidethebusiness.co.nz](http://www.insidethebusiness.co.nz), which featured stories on the businesses and individuals involved in RWC 2011 and the role they played in making the Tournament a success for New Zealand.

It was exciting to bring visual elements of RWC 2011 inside the KPMG offices too. Each office was decorated with literally hundreds of metres of flag bunting and reception areas received a rugby 'make-over' with lift doors covered in decals featuring rugby imagery amongst other elements.

We were proud to be involved as an Official Supplier to RWC 2011.

# WE'D LIKE YOUR FEEDBACK

In order to provide you with relevant business information we'd like your feedback and input on what you'd like to see our Business Update newsletter and in our seminars. To thank you for your assistance one lucky respondent will receive a meal voucher for \$100

Please use the **postage paid envelope** to send back your feedback or if you prefer you can also:

**Fax** to 09 367 5874

or scan and **Email** to [lwoolsey@kpmg.co.nz](mailto:lwoolsey@kpmg.co.nz)

Thank you for your time and input.

**Name**

**Company**

**Email**

**Business Update** (Please circle)

1. Have you previously received this by email? **Y N**
2. Do you read this? **Y N**
3. Do you pass this on to others in your business? **Y N**
4. Do you find it useful? **Y N**
5. Would you prefer to receive this by email, or as a hard copy? **Email Hard copy**
6. Is there any other content you would like us to include?
7. How often would you like to receive the Business Update? **Quarterly Six monthly**

## **KPMG Seminars**

KPMG presents several business seminars to our clients. Some seminars are general business and others are more sector specific for example; Agribusiness, Tax, Insurance.

1. Are you interested in attending KPMG seminars? **Y N**
2. If you have previously attended, what content was most relevant to you and your business?
3. Are there any specific topics you would be interested in hearing about?

## **Other KPMG Newsletters**

1. Do you receive any other regular emails from KPMG (e.g. Field notes, Tax updates etc)? **Y N**
2. If yes, which email newsletters do you receive?
3. Which newsletters/topics are of interest to you?

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