

A QUARTERLY PUBLICATION ON ACCOUNTING & AUDITING MATTERS

CLARITY

18

SUMMER

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CORPORATE GOVERNANCE – ELEMENTARY OR MISUNDERSTOOD?



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WELCOME TO THE SUMMER EDITION OF CLARITY



Welcome to our Summer 2018 edition of Clarity. Our aim is to deliver greater clarity and understanding to our clients on the current and emerging accounting and audit issues. We also look to provide thought leadership, and share our knowledge and expertise, in areas that will solve problems and create solutions for clients. We hope you find this edition of value and please feel free to contact your local Audit Partners for any further assistance.



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“ Governance actions include endorsing strategy, overseeing effective compliance and risk management processes followed by a rigorous board performance evaluation and a targeted education programme. When is the last time you did any of these? ”

GOVERNANCE IS ELEMENTARY... OR IS IT?

Alongside 'entrepreneurship' and 'innovation', I wonder if you agree with me that 'governance' is one of today's most frequently used phrases yet at the same time, one of the most misunderstood.

If you search for the term in Google, you will get nearly 61 million hits to choose from.

So, what exactly is corporate governance?

I started to set out what corporate governance means to me and in doing so the previously unknown scientific part of my brain kicked in, allowing me to plot these ideas into my own version of the periodic table of elements: the periodic table of corporate governance.

Definition

The non-negotiables. Key aspects of probity, accountability and transparency remain fundamental. Ask yourself whether you or those around you would actively strive to avoid these aspects. If the answer is yes, time to reconsider!

I also like the concept of stewardship which references the desire that hopefully at some point in the future the various parties involved will hand the enterprise over to new faces; for the time being they therefore act as stewards supporting views of sustainability in its literal sense.

Recent months in Australia and elsewhere have highlighted the critical role of culture in setting the expectations and standards for conduct and behaviour.

What are you willing to walk past and by default, tacitly endorse as acceptable?

Character

If your mind turns to Boards when you think of governance, then what does it mean to be a director? What is the character of an effective director?

Independence is one of the more obvious expectations while at the same time very

personal. Leadership, gravitas, questioning and the ability to be a good listener are also often quoted as character requirements.

When I talk to new directors, I particularly like exploring the concept of 'intelligent naivety' as well as a new phrase that I like: 'courageous authenticity.'

Do you display these characteristics when making your decisions?

Context

Context sets the environment in which your organisation operates. The Corporations Act therefore features strongly alongside the various regulators such as the Australian Securities and Investments Commission (ASIC), Australian Prudential Regulation Authority (APRA), Australian Taxation Office (ATO), Australian Charities and Not-For-Profits Centre (ACNC), Australian Stock Exchange (ASX), the various Local Government Acts and industry codes.

Do you fully understand how your entity sits within this context and how it influences your fiduciary responsibilities?

Relationships

Key relationships in governance include those around the boardroom table, the role of the Board Chair, and then through the CEO into the management team.

Governance relationships always flag one of the golden rules: conflicts of interest.

Do you know what they are, where they could arise and how to manage them?

Levers

Levers of corporate governance relate to the various tools, forums and processes at a Board's disposal.

Are you familiar with these as set out in the table? Do you actively use them?

Activities

Governance actions include endorsing strategy, overseeing effective compliance and risk management processes followed by a rigorous board performance evaluation and a targeted education programme.

When is the last time you did any of these?

Engagement

Shareholders, members, investors and analysts. How an entity pulls its governance levers and manages its activities to make decisions is typically then followed with communication of the results of all the above.

From that, returning to transparency, the 'continuous disclosure' rules and mindsets apply to all sectors not just those on the ASX.

How do you communicate?

Mechanics

Time allocation and ensuring appropriate time is spent on the things that matter sounds obvious. Investors - public and private - expect Boards spend as long as is necessary on Board business and not skip things just because the meeting is due to finish in 30 minutes time.

Where do you spend your time?

Structure

Much discussion on governance structures in recent years has focused on Board composition, skills matrices, Board size relative to workloads elsewhere and diversity.

Is 2018 the right time for you to consider how your decision-making bodies are structured?

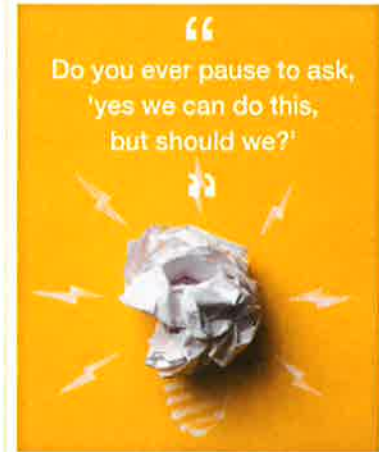
Attributes and Mindset

Attributes and mindset often focus on avoiding groupthink, avoiding complacency and acting on the 'red flags' which are inevitably found in the wake of a governance failure.

Do you look at others around you and ask: 'Tell me we don't do that, do we?'

'Don't tell me, show me' is a phrase heard a lot more around Boardrooms today.

This would be supported by a focus not just on 'what can go wrong' but also 'what must go right.'



In conclusion, at the heart of all this is, element 107: Decisions.

Governance is about how you make decisions - good ones, bad ones and indifferent ones.

I hope this table helps you consider how you make decisions in your organisation.

I would love to know what you think.

PKF advises organisations on their corporate governance structures and frameworks. To explore this article further and assess how you make your decisions, please contact Ken Weldin on 03 9769 2310 or your local Partner. ■

Periodic Table of Elements of Corporate Governance

PREPARED BY KENNETH WELDIN

1 G Governance	2 Dtm Don't tell me, show me	3 Cth A Conflicts of Interest	4 Col Conflicts of Interest	5 Context Relationships	6 Levers Activities	7 Engagement Structures	8 Mechanics Attributes	9 Mindset	10 FI Financial Inclusion	11 Cy Cyber Security	12 Ds Data Security	13 DVS Digital Strategy	14 Ch Challenge	15 If, wn If not, why not															
16 ASIC ASIC	17 Cch Company Charter	18 ASX ASX	19 Bch Board Charter	20 AC Audit Committee	21 Bc Board Charter	22 ComC Committee Charter	23 Wh Whistleblower	24 IA Internal Audit	25 EA External Audit	26 IT IT Systems	27 Erp ERP Systems	28 P&P Policies & Procedures	29 DoA Delegations of Authority	30 Re Remuneration	31 Pv Pay	32 Rf Risk	33 TT Talent	34 Ch Challenge	35 Sw,ncw Should we, not can we										
36 APRA APRA	37 ChC Chair v CEO	38 Sg Strategy	39 Cm Compliance	40 Bpr Business Process	41 Ed Education	42 Rp Risk Register	43 If Innovation	44 ScM Social Media	45 Cms Compliance	46 Ab Annual Reports	47 Ag Agenda	48 Dv Diversity	49 Cz Corporate Citizenship	50 Acm Accountability	51 Gh Governance	52 RvR Risk & Reward	53 Wmgw What must go wrong	54 M Materiality											
55 ATO ATO	56 DvM Directing v Managing	57 FR Financial Responsibility	58 CoSec Company Secretary	59 Di Director	60 Dn Director	61 Ds Director	62 D Director	63 CD Consumer Disclosure	64 Cr Corporate Reporting	65 Fr Financial Reporting	66 AGM AGM	67 Bcl Board	68 Nf Non-Financial	69 Sp Sustainability	70 Ls Leadership	71 Mi Mission	72 Cg Company Governance	73 bD Board Diversity											
74 P Purity	75 Ac Accountability	76 Tr Transparency	77 Eth Ethics	78 St Stewardship	79 Ts Trust	80 H Honesty	81 C Culture	82 Co Conduct	83 Bh Behaviour	84 Ns No-Surprises	85 Sr Structure	86 Pr Process	87 Cs Consistency	88 Cn Confidentiality	89 I Independence	90 Pe Perseverance	91 INv Intelligent Necessity	92 C At Corporate Authority	93 Qu Questions	94 L Leadership	95 G Ra Governance Risk	96 Tm Teamwork	97 Ov Ownership	98 Cl Clarity	99 Iq Intelligence	100 In Inclusion	101 Ls Leadership	102 Gr Governance	103 Cl Clarity



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“ Many companies use an outsourced whistleblower hotline that provides an independent, fully resourced 24/7 service staffed by experienced investigators who not only provide the right level of support to the whistleblower, but also ensures that the right questions are being asked and appropriate evidence is secured.

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ENHANCED WHISTLEBLOWER PROTECTION – NEW LEGISLATION LOOMS IN 2018!!

Whistleblowers are one of the most likely means of uncovering fraudulent behaviour, yet the personal cost associated with doing so cannot be underestimated.

There have been many examples of whistleblowers here in Australia and overseas who have paid a heavy price, both personally and professionally, in acting ethically and reporting inappropriate behaviour.

Thankfully the Australian Government has recognised these shortcomings and is set to introduce reforms that will provide confidence to whistleblowers that they will be protected, especially if they are victimised as a result of their actions.

The reforms, likely to apply from 1 July 2018, include:

- Expanding the categories of whistleblowers qualifying for protection to include ex-officers and ex-employees and their relatives;
- The inclusion of companies, bank, insurers, superannuation entities and their trustees into the new regime to ensure a more consistent approach across the industry;
- Broadening the scope of conduct that may be subject to protected disclosure;
- Permitting anonymous disclosures that protect the identity of the whistleblower;
- Granting immunity in respect of the information that the whistleblower may provide;
- Expanding the protections and redress for whistleblowers including access to compensation in case of reprisal;
- **Requiring all public companies and large proprietary companies to have a whistleblower policy.**

The last bullet point will have implications for a significant number of companies, who need assistance with the development of a policy that adheres to the new requirements.

From a corporate governance and reputational perspective, an effective whistleblower policy helps reinforce a culture of transparency, honesty and accountability within an organisation.



A well-defined whistleblower policy is an effective means of ensuring that employees, suppliers or other stakeholders can be confident in coming forward if they have witnessed something suspicious or unethical.

An effective whistleblower policy will define the types of improper conduct, provide the whistleblower with information as to their course of action and the protections in place.

Many companies use an outsourced whistleblower hotline that provides an independent, fully resourced 24/7 service staffed by experienced investigators who not only provide the right level of support to the whistleblower, but also ensures that the right questions are being asked and appropriate evidence is secured.

From an investigative perspective, following an appropriate course of action is critical as it has been estimated that 22% of whistleblowers lose lawsuits due to a lack of compliance with the law.

The mandating of a whistleblower policy for public and large proprietary companies in 2018 will represent another legislative obligation for larger companies to comply with. Its introduction will however no doubt serve to assist Australian companies identify fraudulent activity and unethical behaviour, which will save the corporate Australia more than what it will cost. ■

For more information, please contact your local Partner

REPORTING & NON-REPORTING ENTITIES

The definition of a reporting entity is an entity where it is reasonable to expect that there are users dependent on a general purpose financial report (GPFR) to gain an understanding of the financial position and performance of the entity, and to make decisions based on this financial information and other information contained in the financial report. These users could be shareholders, members, employees, creditors, lenders or potential investors. A non-reporting entity is where those charged with governance have determined that there are no users dependent on a GPFR. In this situation, a non-reporting entity is permitted to prepare a special purpose financial report and not a GPFR.

Accordingly, it is very important for those charged with governance to document whether an entity has users dependent on GPFRs to enable them to define the entity as either reporting or non-reporting. This will then determine the financial reporting framework to be used. Examples of reporting entities include listed public companies, large private companies with external shareholders who have no access to financial information other than the annual financial report and public interest entities such as educational institutions. Examples of a non-reporting entity include private companies with a small number of shareholders all of whom are employed in the management of the business, not-for-profit associations and very small private companies.

If a particular entity is defined as a reporting entity it is required to prepare a GPFR. This means that all Australian Accounting Standards must be applied in the preparation of the financial report. However, if an entity is defined as a non-reporting entity it only needs to prepare a special purpose financial report, which does not need to apply all of the Australian Accounting Standards. A special purpose financial report only needs to apply the measurement and recognition Australian Accounting Standards with limited disclosure.

There are benefits and risks associated with each reporting framework. Arguably the most important risk to address is whether a particular entity is correctly defined as either a reporting or non-reporting entity. If the definition of the entity is incorrect the Australian Securities and Investments Commission (ASIC) will investigate those charged with governance for preparing an incorrect financial report and therefore breaching the reporting requirements of the Corporations Act 2001 and Australian Accounting Standards. The lesson here is to make sure that the entity is correctly defined as

either reporting or non-reporting and match the correct financial reporting framework.

Those charged with governance should also explore the benefits of producing a GPFR even though the entity is non-reporting in nature. There may be opportunities for potential new users to learn more about the entity and its activities and operations. Or there may be stakeholders that value the additional information provided in a GPFR. The downside to this is the cost of preparing a GPFR which would be significantly more than a special purpose financial report.

Some listed companies use a GPFR as a marketing document to promote their activities and demonstrate their social responsibility and standing within the community. Non-reporting activities could also produce a GPFR to promote themselves in a similar way.

Another risk that needs to be explored by those charged with governance is the level of disclosure in a GPFR which may inadvertently provide information to a competitor. It is essential to ensure that if the reader possibly includes a competitor looking for a competitive advantage, then careful attention needs to be made in the preparation of the GPFR to ensure its disclosure is minimised to that required by statutory rules and guidelines.

The concept of a Reporting and Non-Reporting Entity and the significance of the definition is important to the financial report prepared by an entity and the associated benefits and risks. It is necessary that those charged with governance understand the concept and seek outside advice where needed to ensure that their decision is appropriate and correct. ■

Your local PKF office can assist in making an assessment.



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“ The Amendment will allow the preparation of GPFRs using Reduced Disclosure Requirements, if the SGE is not publicly accountable, and does not specifically require the GPFRs to be audited. The ATO recommends that evidence be held to demonstrate that the GPFRs have been prepared in accordance with Australian Accounting Standards/ International Financial Reporting Standards (IFRS) and that the best way to demonstrate this is through an audit.

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SIGNIFICANT GLOBAL ENTITIES VERSUS THE ATO

Tax avoidance by multinational corporations remains a contentious issue for the Australian Taxation Office (ATO). Recent news publicity has revealed that large multinational companies had reduced their tax bill by a combined \$5.4 billion across 2013 and 2014 by offloading profits to offshore divisions.

This prompted the implementation of the *Tax Laws Amendment (Combating Multinational Tax Avoidance) Act 2015* (the Amendment) and an amendment to the *Taxation Administration Act 1953*, which requires Significant Global Entities (SGEs) to lodge general purpose financial reports (GPFRs) with their annual tax returns if reports are not lodged with Australian Securities and Investments Commission (ASIC). The GPFRs will then be lodged with ASIC and put on the public register. The SGE may also be required to lodge transfer pricing documentation within 12 months after the end of each income year. The above measures commenced on 1 July 2016.

A SGE is defined on a periodic basis for both Australian-headquartered entities and local operations of foreign-headquartered multinationals by the *Income Tax Assessment Act 1997*, if it is one of the following:

- A 'global parent entity' whose 'annual global income' is A\$1 billion or more;
- A member of a group of entities consolidated (for accounting purposes) where the global parent entity has an annual global income of A\$1 billion or more.

The application of the Amendment and the provision of GPFRs will allow the ATO to better determine if any tax advantages have been gained, and allow the application of the *Multinational Anti Avoidance Law* (MAAL) to impose a Diverted Profit Tax (DPT).

MAAL gives the Commissioner the ability to cancel any tax benefits an SGE, and its related parties, obtained by the scheme and will also open the SGE up to increased penalties for tax shortfalls arising from its application. The increased penalties include a levy of 40% on the diverted profits, payable within 21 days of an assessment.

The ATO explains that an entity is also a SGE for a period when the Commissioner makes a



determination in relation to the relevant global parent entity, where:

- Global financial statements have not been prepared, and;
- It is reasonable to conclude that the annual global income of the global parent entity would have been A\$1 billion or more.

In addition, from 1 July 2017 administrative penalties are doubled if it is found that the SGE:

- Did not take reasonable care in preparation of GPFRs;
- Applied a tax position that is not reasonably arguable;
- Is unable to provide documents when required and the Commissioner determines the liability without the document.

Failure to Lodge penalties have also increased and can carry penalties up to \$525,000 if over 112 days late.

The Amendment will allow the preparation of GPFRs using Reduced Disclosure Requirements, if the SGE is not publicly accountable, and does not specifically require the GPFRs to be audited. The ATO recommends that evidence be held to demonstrate that the GPFRs have been prepared in accordance with Australian Accounting Standards/International Financial Reporting Standards (IFRS) and that the best way to demonstrate this is through an audit.

For further information regarding SGEs, and guidance on the switch from special purpose to general purpose financial reports please contact your local PKF office. ■

HUNTING FOR THE REAL VALUE OF GOODWILL....

Australian Accounting Standards (AASBs) 3 and 138 provide for goodwill that has been “acquired” to be taken up as an intangible asset on an entity’s balance sheet. However, the treatment for internally generated goodwill means the costs are more likely to have been expensed in the statement of profit and loss. This raises the question of the value of goodwill on the balance sheet and is arguably why this historical goodwill is of little interest to management. A goodwill balance based on past events is of limited use to management and investors who are more interested in the future and, more likely, in determining a goodwill value based on future earnings rather than using future earnings in assessing the value of historically acquired goodwill primarily for financial reporting purposes.

Two similar businesses may have developed in different ways, one via acquisitions with potentially significant goodwill on its balance sheet and one by developing and expanding its own business and intangible assets, with therefore little or no purchased goodwill on its balance sheet. The different treatment of these outlays may have an impact on the profit and loss and balance sheet of each business, even though they may have spent similar amounts building their businesses and market share. This makes the comparison of these businesses more difficult for the investor and other users of the financial statements.

AASB136 requires annual impairment testing of goodwill and other intangible assets, such as those with an indefinite useful life. The assessment of impairment testing can create headaches for both management and auditors as they are required to make significant judgements on several fronts including:

- Assessment of appropriate cash generating units;
- Valuation modelling;
- Future profit estimates; and
- Cash flows.

It is no surprise the assessment of goodwill has been the source of many Key Audit Matters (KAMs) in the 2017 financial reporting season. The Australian Securities and Investments Commission again highlighted “impairment testing and asset values” as an area of its enforcement focus in its *Quality of financial report alert* in May 2017. Management and auditors are also more likely to take a more conservative approach to future profitability during difficult economic times leading to impairment of intangible assets and a potential hit to the bottom line when it would be least welcome.



“As a business grows and develops the purchased goodwill booked at historical cost may have little connection with the ongoing business.”

The question of how these intangible assets can be taken off the balance sheet also needs to be considered. As a business grows and develops the purchased goodwill booked at historical cost may have little connection with the ongoing business. In the past, these intangible assets would have been amortised over time, however the only option is to impair the balance, despite possible continued strong profitability and no impairment indicators.

Potential investors and analysts tend to eliminate balances such as intangible assets and impairment expense when determining their own assessment of the goodwill of relative businesses. This is likely to have little or no correlation with the value of goodwill on the balance sheet, raising the question as to the usefulness of the carrying value of goodwill in accordance with AASBs to the users of financial statements. ■

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