

# risky businesses

Grant Thornton 

Grant Thornton periodical reporting on risk and improvement services.

## Harnessing your competitive edge through enterprise risk management

Technological innovation, globalisation, complex regulation and increased accountability at the senior management and board levels have all combined to significantly change the landscape of risk management today.

Managing risk has become increasingly complex due to the new web-based and technology-based economy and the emerging risks of e-business from online security to customer privacy. The complexity also comes from the increasing need for knowledge of local laws and customs; pervasive nature of information technologies and higher accountability standards for boards of directors and senior executives.

Unprecedented complexity of the regulatory environment has pushed firms for better risk reporting and more integrated and comprehensive risk management.

To help the market cope, new positions, tools, rules and even language have been created. There are new executive positions, such as chief risk officer, chief security officer and chief privacy officer. There has also been a proliferation of risk management software and other technology solutions as well as new regulation mandating certain risk management practices related to security, privacy, operations, compliance and economic exposures. Indeed, the term 'enterprise risk management' (ERM) has become part of the general business vocabulary.

### What is ERM?

ERM is defined as "... a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives." (Source: COSO Enterprise Risk Management - Integrated Framework. 2004).

### Understanding your company's risk appetite & risk tolerance

**Risk Appetite** is the acceptable balance between growth, risk and return. Strategy setting must be aligned with the entity's risk appetite. ERM, applied in strategy setting, helps management select a strategy within its risk appetite.

**Risk Tolerance** is the amount of variation the entity is willing to accept in achieving objectives. Risk tolerance, the acceptable level of variation around objectives, is aligned with risk appetite.

Understanding the risk appetite and risk tolerance enables the company to develop responses to various categories of risks identified which are strategically aligned with the objectives of the company. It also enables the company to design control activities i.e. policies and procedures that help ensure that the risk responses, as well as other entity directives, are carried out.

By taking an enterprise wide approach and top-down view, ERM helps define and set in place the understanding of risk tolerance and mitigating strategies.

### Current state of risk management

Risk and opportunity are inextricably linked. Past conventions and attitudes about risk as a hazard or threat have resulted in too narrow a view of the role of risk management in business. This is accompanied by a negative approach to risk as something to be avoided, reduced, or even sold.

The traditional approach to risk has lent itself to disparate risk management. This has caused risk management to be fragmented. Risk is usually treated at a transaction level e.g. hedging a foreign currency exposure, protection of copyright etc. This approach usually lacks strategic focus.

### The ERM approach

Applying the ERM approach presents a new paradigm to risk management. It provides a strategic, objective and clear view to risk management. The approach is positive, proactive, continuous, value-based, broadly focused and process driven. This is integral to creating value and managing a business.

ERM also provides greater confidence and relevant summary information to the board, CEO and management. ERM ensures risks and opportunities are being identified, analysed and managed on an enterprise-wide basis and aligned with a value creation business model of the company.

### Downside Risks

### Upside Risks



Risks to the fundamental integrity and reliability of key financial, operational, and decision-support processes, applications, and data

**Extreme Threat:**  
Business Failure



Risks to the efficiency and effectiveness of important financial, operational, and decision-support processes, applications, and IT infrastructures

**Pervasive Threat:**  
Suboptimal performance of important business process and IT



Risks to the organization's ability to react quickly, effectively, and in a well-controlled manner to business changes requiring flexibility

**Extreme Threat:**  
Less than "World Class" performance and lack of competitive advantage

With ERM, the organisation generates a broad spectrum of well-developed capabilities as well as:

- adopting coping strategies and avoiding downside risks
- embracing upside risk with a mix of exploitation and exploration strategies
- setting the tone at the top.

In developing the ERM capabilities, firms focus on the following attributes:

- establish goals, objectives and oversight
- assess business risk
- develop risk management strategies
- design and implement risk management capabilities
- monitor performance
- continuously improve risk management capabilities
- support the process with information for decision making.

The difference in the ERM approach is:

- risk management is everyone's responsibility
- focus on risk should be on the business portfolio, not discrete risks
- risk management is a culture, not a product or a transaction
- risk management (business and operational) should take a more formal and systematic approach
- risk and business management should be indistinguishable.

Basically, risk managers need to understand the business; business managers need to understand risk. This understanding empowers business managers and risk managers to work cohesively in the value creation for the business and enables them to aggregate risks and opportunities.

### ERM and innovation

Innovation is a need rather than a value and drives the competitive edge through the use of more sophisticated tools and technologies to create wealth. Such use of innovative approaches and complex tools presents a myriad of different risk considerations e.g. innovative financial instruments with different hybrid of hedging instruments present different risk considerations. Overseas expansion presents a completely different set of exposures, operationally, financially and environmentally.

By aligning certain key elements of an organisation, with its business model and strategies, companies can optimise risk, return, growth and capital. Taking an enterprise-wide view enables the company to aim at achieving the highest level of return possible from resources available to managers within defined boundaries. This enables the company to go forth in optimising risk, return, growth and capital for the enterprise as a whole.

This is facilitated with the knowledge and confidence that there is an approach that is:

- comprehensive, transparent, consistent and continuously improving
- one that aligns strategy, processes, people, technology and knowledge.

Hence ERM enables managers to:

- maximise the expected returns and firm value for a given level of risk
- consider the impact of risk on capital i.e. both the adequacy of allocated capital and its exposure to loss
- achieve the company's target leverage and desired return on allocated capital.

Linking risk with opportunities thus allows management to harness its competitive advantage via business risk management!

## Tax Risk Management (TRM)

### The key: appreciation and management of tax risk

What makes for good TRM? Is it the processes you have? Or, the excellent adviser that is available at a moments notice? Or, is it the company's financial accountant who always has an answer to a tax question?

In truth, it is a combination of all of the above and more.

The purpose of this newsletter is to highlight TRM and its importance in light of the current regulatory environment.

### Background

With the recent spate of corporate collapses in Australia and overseas, the corporate regulators - more than ever - have placed corporate governance as a matter of utmost priority. Within this landscape of good corporate governance, is the need for good TRM.

The Australian Taxation Office (ATO) has put board members of Australian corporate taxpayers on notice regarding their duties and responsibilities regarding TRM. The ATO has forwarded letters to the board noting that one of the many important functions of the board is its awareness of TRM and their adherence to good TRM practices.

### So, what is good TRM?

The key to good TRM is an appreciation of the tax risks associated with the company/transactions and the ability to assess and manage that risk.

To have an appreciation or undertake an assessment means the company must have a good understanding of the tax issues and the systems in place to address these tax risks.

### What can be done to have good TRM practices?

The adoption of good TRM practices is a combination of the following:

- having a taxation policy approved by the board in place to guide decision making by the company
- ensuring that the company has appropriate resources applied to the tax function, be they internal or external
- ensuring the tax implications of significant transactions are assessed and advised on by an internal tax function/external tax adviser and, where material, signed by the board
- having good system processes and procedures to ensure things are done correctly and regularly reviewed

For example, can your system ensure a supplier has provided the correct Tax Invoice; is your system capable of obtaining the correct Input Tax Credit for meal entertainment expenditure and one that is in alignment with the Fringe Benefits Tax and income tax treatment adopted by the company for that expenditure.

### What are the current tax issues relevant for most corporate taxpayers?

Whilst it is not the purpose of this newsletter to produce an exhaustive list of issues, some that are most pertinent for corporate taxpayers in the medium to large sector of the market include the following:

- tax losses and utilisation of losses - can the company prove it has satisfied the continuity tests, being the 'continuity of ownership test' (at the first instance) and the 'same business test'
- dividend policies and franking of dividends - consistent payment of fully franked dividends that are in alignment with the taxpayers dividend policies projected to the market
- for companies that have transactions with overseas-related parties - compliance with transfer pricing documentation requirements to support those transactions that are on an arm's length basis

- international tax issues - has the company ensured it does not have an interest in an overseas entity whereby profit derived by that overseas company may need to be attributed to the Australian corporate taxpayer
- contractor/employment issues - is the company mindful of hiring contractors that under certain terms and conditions may be deemed employees with employment taxes applicable
- major acquisitions or sale transactions - has the company identified and resolved tax issues associated with significant transactions.

## Grant Thornton - Tax Services Group and TRM

The Tax Services Group (TSG) of Grant Thornton has extensive experience in the area of tax and the management of risk arising from taxation issues. As a consulting division within Grant Thornton the focus of the group has been the corporate client base of the firm and transaction work in assisting the firm's Corporate Finance division.

### Tax risk services

The TSG has the capability to deliver the following tax risk services:

- compliance reviews - ensure that items are historically correct
- systems reviews - a review of the input and outputs and review of policies and procedures
- preparation and implementation of corporate tax plans - the management of taxation obligations, risk and outcomes at the board level.

### Taxes

The TSG has experience in the following tax areas:

- direct taxes - corporate tax and associated areas i.e. tax consolidation regime, thin capitalisation regime
- indirect taxes - including goods & services tax
- other taxes - employment taxes, stamp duty, land tax and other withholding taxes
- international tax - controlled foreign company regime, foreign investment fund regime and transfer pricing.

### Recent experience

The list below is a guide to the recent tax risk work undertaken by the TSG.

- Specialist tax review of a significant infrastructure project with a cost of AUD \$1 billion involving three joint parties to the proposed project. The TSG advised one of the parties involved on the various taxation matters associated with their involvement, including management of thin capitalisation, application of the qualified securities tax regime and tax consolidation issues.
- Preparation and assistance in implementing a corporate tax plan for the board of an Australian listed company to highlight and manage utilisation of tax losses, manage its franking credit position and consideration of future dividend policy.
- Taxation due diligence for a dog food manufacturer covering all direct and indirect taxes for a period of three financial years and preparation of a tax due diligence report highlighting significant findings material to the transaction.
- Assistance with an off share market buy back of a listed public company and preparation with approval of a class ruling to the ATO.

### Why worry about tax risk?

With the recent spate of corporate collapses risk overall, as well as tax risk, has become a matter of high importance to the regulatory authorities. Recently, the Australian Taxation Office has specifically required the boards of public companies to address TRM. The TSG of Grant Thornton is able to assist with this in accordance to the level of engagement required, be it a review of historical tax position or systems reviews or the preparation and implementation of corporate tax plans.

If you would like to discuss any of the above, or any specific issues relating to your organisation, please do not hesitate to contact Shirley Liew or Andrew Rigele.

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