Facing the future:
Insights shaping Australia’s business landscape
As a global business advisory firm, FTI Consulting helps organisations anticipate and overcome complex business challenges. Our track record includes some of Australia and the world’s most memorable events including corporate collapses, shifts in regulation, ponzi schemes and international crises.

In Australia, our teams have significant experience in helping our clients with challenges in e-discovery, corporate reputation, crisis management, restructuring, corporate advisory and M&A as well as acting as expert witnesses in areas such as forensic accounting, investigations, valuations, and construction related disputes. Our professionals are also well versed in industries currently facing the most disruption, such as retail, construction, telecommunications, media and technology, agriculture and mining.

This collective expertise gives us valuable insights into a range of critical business and economic issues that impact us here in Australia and globally, some of which we share with you in this publication. We hope you find these insights as informative, thought-provoking and enjoyable as we have.
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Business Transformation
The Rise of the Transformation Officer

We live in a volatile world in which the business climate is as changeable as the weather. And, like weather patterns, today’s business climate is more intense than ever.

Given that, it should come as no surprise that many businesses and investors are seeking to plant new seeds in more fertile soil, constructing new business models (while de-constructing old ones) on the fly, embracing more risk, and operating in ways designed to wrest survival, if not profit, from market volatility.

It also should come as no surprise that some businesses are less successful than others in doing so. These businesses, disrupted by new competitors and confronting market shifts often outside their control and influence, underperform and face existential crises. At that point, they are increasingly looking for outside assistance in the form of transformation officers – a role that has been growing and expanding in lockstep with our increasingly turbulent business world.

Dealing with a Price Flux

Price volatility is not unusual in commodities, but a greater-than 50 per cent drop in price within a single year will have consequences, particularly for companies that have failed to prepare adequately.

One such company, an Australian entity in the agricultural industry involved in marketing, warehousing and shipping products was in serious trouble.

The company’s shares crashed 65 per cent. Prior to the crash in share price the company had been in breach of its financial covenants for many months. At one point, it owed its lenders more than USD$400 million, based on mark-to-market positions.

The company’s shareholders were understandably concerned as, in their view, the board and management had not fully communicated the extent of its difficulties. In fact, management had locked the company into now-unprofitable trading positions (given the depressed price of the commodity) that extended for years.

The board blamed market volatility for the company’s troubles and expressed confidence that once the price rebounded – as in their experience it always had and always would – everything would be fine. The lenders, however, were less optimistic. They were concerned that, if the company was forced to liquidate its market positions, they would suffer hundreds of millions in losses, retrieving, at best, cents on the dollar.

Management had explored various liquidity and investment options, but had come up empty-handed. Many stakeholders had been calling for changes to the board, even though that might have only exacerbated the perception of the company’s difficulties and therefore made it even harder to preserve value.

Fortunately, the business had not exhausted all its options. Following a review process, and at the request of its lenders, the company engaged the services of a Chief Restructuring Officer (CRO), or, as it is increasingly being called outside the United States and Europe, a Transformation Officer (TO).

The CRO Role Spreads as Global Business Tills New Soil

A CRO is engaged as an interim manager, reporting to the board to advise, manage and operate an underperforming business, helping implement a recapitalisation effort with or without external funding.

In the United States, the CRO is most often installed as part of a bankruptcy filing to lead the enterprise through the proceedings and the resulting restructuring effort. This type of role has not yet gained great traction in the rest of the world due, in part, to more creditor-aligned political and legislative environments.

That is now changing.

A 2015 Fidelity report notes that less than half of the world’s largest economies are growing. Importantly, this “weakness is centred in emerging-market economies, where China’s downturn and the resulting plunge in commodity prices have led to a 26 per cent year-over-year decline in the value of global exports.” This means that more companies (especially in the commodities-dominated Asia-Pacific region) are experiencing more frequent downturns, headwinds and, consequently, operating losses. And
shareholders, worried about their investments, increasingly demand immediate (and sometimes precipitous) action.

This confluence of challenges demands a specific financial and operational expertise that most companies – such as this commodities firm – do not possess internally. And why should they? After all, most businesses are built with an eye towards growth. No company ever shrank to greatness.

This is where a CRO comes in – to provide that expertise and work with a company’s stakeholders as an independent experienced broker to preserve and promote a business’ value.

The role and function of the CRO primarily is to bring credibility (in the eyes of lenders and external stakeholders), experience and objectivity (in the eyes of the board, management and employees) to the restructuring (or transformation) process.

The CRO creates breathing room for a company to revisit and critique its strategy and business model while conducting ongoing operations in an orderly fashion.

In this way, the CRO helps create stability throughout the transformation process by acting as a trusted broker between involved parties, both internal and external. Ideally, the CRO drives consensus among all stakeholders regarding the direction of the transformation, the goal of which is always to preserve as much value and financial and human capital as possible.

Finally, where feasible, the CRO implements business improvement strategies intended to restore a viable business to operational health and place it on a sound financial footing.

But as the position of the CRO crosses borders, the title is changing.

What’s in a Name? A Lot

As CROs become more widely accepted outside of the United States and Europe, the name of the position is changing.

Restructuring, for example, is a charged word that can promote panic among employees who may fear they will be restructured out of their jobs.

The word ‘chief’ is also charged, as it may cause business leaders to question their own positions; that is, they may wonder, “If a chief is being brought in, what am I and what is my role?”

Transformation is less threatening than restructuring, and although a CRO can do just about anything, dependent upon the parameters established in his or her mandate, the title ‘chief’ is not necessary to communicate authority. And that’s why a TO (not a CRO) joined the executive team.

How the Transformation Officer Succeeded

At the lenders’ request, a TO was appointed by the board to protect their investment and preserve the intrinsic value they believed still existed in the company.

Working alongside the CEO and CFO (allowing them to continue their primary role of running the company without becoming overwhelmed by the details of rescuing it), the TO helped address and prioritise critical facets of the company’s operations and recapitalisation needs. With the TO moving forward, external stakeholders gained confidence that the company’s core competencies, key business drivers and risk management strategies were being preserved and improved.

Internally, the TO, by being industry agnostic, and in conjunction with other external advisors, convinced the board – which had experienced ups and downs in stock prices for decades – that this time it did not have the balance sheet to survive the current market volatility. Therefore, it would need to restructure its operations and adopt a more corporate approach while at the same time preserving its legacy and corporate DNA (a key board requirement).

Pursuing this strategy, the company was split into a process and manufacturing division, and a marketing division. The marketing division, which was essentially a trading book, was not saleable, and, by itself, the process and manufacturing division was not large enough to service considerable debt. Therefore, the TO, with the assistance of various skilled advisors, helped run a global sale process, finding parties with interest in the enterprise.

Ultimately, a long-established global enterprise involved in agriculture, food processing, shipping and finance took a near 50 per cent equity stake in the marketing business and a minority stake in the whole company, while assuming a board role. With this capital infusion and a well-executed trade-out of the business’s marketing positions over time, the company could pay back its lenders 100 cents on the dollar. This enabled the company to refinance with alternative financial institutions, which now were confident in the company’s long-term viability. The company then settled with all its banks in full, and a potential USD$400 million loss was contained to about USD$76 million – not ideal, but not a disaster.

In this way, the business weathered the storm and emerged better prepared and positioned for the next one, which will assuredly come. The firm’s board and management team are now more attuned to the risk management imperatives and corporate governance processes required in a volatile, globalised commodities market.
Readings from the TO’s Book

Every good TO knows that taking quick, timely action is critical to preserving value in a company in distress and that:

- when a company is confronting trouble, early interventions create options;
- the longer market underperformance or a cash crisis persists, the more swiftly a company’s options narrow, and the more vulnerable it becomes to competitors;
- the longer creditors are forced to wait, the more impatient they become and the less willing to compromise;
- the longer management and employees must operate under stress, the worse their performance becomes; and
- the longer a company appears weak in its market, the more its customers will lose patience, or the more those customers will try to take advantage of the company’s weakness.

And every good TO also knows that:

- if a company’s problems are addressed as soon as they appear, stakeholder confidence in the business can be preserved;
- confidence makes all parties more amenable to the compromises that will preserve the value they saw when they first lent money, bought stock or signed a contract to become a supplier or customer; and
- no change and no solution works forever; companies (and TOs) must remain open to adjusting strategies to address disruptions and shifting market circumstances.

Management, and even boards, typically have deep sector expertise that can convince them that a new situation is just like an old one. Because of that, executives will tend to fight the old war, not the current one.

The TO does not have these corporate memories and his or her expertise may not be sector specific. However, this independent position allows the TO the freedom to develop new strategies to address critical problems.

Empirical evidence supports the effectiveness of the TO role. A 2014 study by a global consulting firm reported that share prices for European companies recovered after approximately 11 months of restructuring when a TO had been hired. It took 26 months when a TO was not. As noted, time is never a company’s friend in a crisis.

But that doesn’t mean a TO can or should act hastily.

It is critical for a TO to work with the board and alongside the management team, and it takes time to earn their trust.

Simply replacing top corporate officers en masse is rarely an effective strategy as it is hard to replace their knowledge of the company’s strengths.

Clear, simple and honest communication – both inside and outside the company – is of paramount importance in a crisis. The TO must communicate what is going on, who is responsible and accountable for what, his or her objectives, and the time horizon for achieving results. The trust of the employees is what the TO most needs to achieve restructure success. And trust is earned when the TO demonstrates positive and sustainable outcomes quickly.

Anyone who looks at the world today can see that the global business environment is not going to become less complex or less volatile anytime soon. Consequently, the need for TOs will only grow, and any company, in any sector, should consider that option when confronted with building headwinds and evolving markets.

Mike McCreadie
Senior Managing Director
+61 3 9604 0612
michael.mccreadie@fticonsulting.com
For an Australian company running a base metal mine in Latin America through a Latin American operating subsidiary, it felt like a perfect storm. Historically, commodity prices fluctuate, but during the global financial crisis of 2007–2009, base metal prices fell precipitously. The company’s Latin American subsidiary faced claims from customers whose contracts called for advance payments with rebates if market prices dipped – as they had. The company needed a cash infusion to keep operating but, remember, this was in the middle of a financial meltdown: credit was hard to find.

These were external forces, outside the company’s control. But the subsidiary also had failed to communicate its cash squeeze to its stakeholders, which created an information vacuum that quickly was filled with concerns. Customers worried about their contracts; employees worried about their wages; lenders worried about the subsidiary’s ability to meet its debt obligations. Unsurprisingly, the lenders sought an independent business review, and the results confirmed their worst fears: the mine was in danger of insolvency.

The review led the company to appoint an administrator; the lenders appointed an Australia-based receiver from FTI Consulting to guard their interests and, hopefully, keep the mine open.

The receivers immediately began talks with the Latin American operating subsidiary’s unsecured creditors to discuss an informal restructuring. But as talks progressed, employee groups staked a claim to about $2 million in unpaid wages they argued were owed to them by the mining operation. After two months, and no restructuring options available due to the still plummeting base metal prices, lawyers acting for the employees escalated their claims, multiplying them by a factor of four. Riots erupted during the conflict over workers’ wages and local suppliers’ unpaid invoices. The claims against the mining operation grew so large that an informal restructuring was deemed impossible and the Latin American subsidiary had to enter local bankruptcy proceedings.

The losses ultimately stretched from Latin America to Australia.

And the worst part for the mining company and its stakeholders was that the crisis, and all the value it destroyed, could have been avoided.

**Mining Firms Caught in a Financial Vice**

The challenges the Latin American base metal mine faced were not unique. This past decade has been a particularly difficult time for multinational mining firms. They can face serious consequences, even in good markets, when they fail to act decisively.

During the global financial crisis, credit to support existing or new mining operations was in short supply. At the same time, commodity prices and currency exchange rates whipsawed, creating uncertainty about revenues used to fund operations. Then, as the financial crisis eased, commodity prices rose as demand from China spurred miners to increase production. But when China’s economy cooled, and demand for coal and iron fell, prices fell once again.

Today, many mining firms have improved their balance sheets by deleveraging, but high-cost producers and new projects still find it difficult to attract capital.

Those high-cost producers with significant debt are left with some difficult choices. To meet their financial obligations, they can try to raise equity at deeply discounted prices. They can sell off their highly-leveraged assets. They can enter joint ventures to get other firms to take on their operations and debt.
Or, they can file for bankruptcy.
These will always be difficult choices, but they will be somewhat less difficult – and have a greater chance of a successful outcome – if they are not made in the middle of a crisis.

Some mining executives believe they can weather a difficult patch by keeping calm and waiting for the market to improve. And, sometimes, they can. But it would be wiser for multinational mining companies to set up contingency plans for dealing with cross-border financial problems before there’s a squeeze. Not having a plan in place can make a manageable crisis unmanageable. The best decisions are rarely made under pressure. The time to communicate with lenders, for example, is when a company’s executives can see a looming cash shortfall, not after it arrives. Lenders are better able to listen to plans about addressing cash shortfalls when a company is still meeting its obligations. Once it stops, lender patience evaporates rapidly.

This need for contingency planning is particularly pressing for multinational firms with operations in the developing world, where the need to obtain and maintain a social licence to operate (that is, the understanding that the mine benefits everyone in the community, not simply its owners and investors) is hard won and easily lost. Unlike in the United States, the United Kingdom, Canada and Australia, the courts in nations where many mining operations are located often are not inclined to favour large corporations over local employees and suppliers. For that reason, appealing to the courts is rarely an attractive option for multinationals. In addition, courts in developing markets may take many years to resolve disputes without regard to the business implications of delay.

These factors in developing markets make it smart to avoid courts and also demonstrate the importance of proactive, clear communications with stakeholders. Both financial institutions and local community and labour groups need to understand the nature and extent of a mining operation’s challenges before they reach a critical stage. That awareness can create an environment in which it becomes possible to gain support for plans to restructure loans, for example, and to reach agreements with local suppliers and labour groups on payment schedules that can enable a mine to continue operating and creating value.

Failing to manage a situation before it becomes a crisis can invite conflicts that lead to greater losses. Lenders can become alienated and withhold the funds needed to keep operations going. The demands of labour groups only rise in a hostile environment, and suppliers who see lenders withdraw support will stop deliveries. Once this happens, a firm can lose its social licence to operate in the community, and nothing good ever comes of that.

**Knowing When to Ask for Help**

Active engagement can lead to a better outcome than the Latin American base metal mine operators experienced. For example, another Australia-based mining services company owned a subsidiary that built processing facilities for operations in Latin America. When the subsidiary faced overruns on several projects, its leaders realised its fixed-price contract terms would not cover its costs. As the overruns mounted, the subsidiary reached out to its head office and asked for help.

The head office hired FTI Consulting to review the company’s options for managing the Latin American unit’s financial crunch. FTI Consulting suggested that a special purpose vehicle (SPV) directly responsible for the Latin American unit (which itself was a subsidiary of a publicly held Australian firm) should come under the control of an external administrator in Australia to reduce the risk that financial problems from Latin America would come back to bite the publicly held Australian firm.

In the end, the SPV brought in an administrator to act as a mediator between local creditors in Latin America and the publicly held company in Australia. The parties agreed on an informal debt-for-equity restructuring with the Latin American operations’ major creditors that minimised stakeholder losses while avoiding a costly court battle.

The leaders of the SPV had a big problem. But their decision to seek outside expert help in an expeditious fashion, before everything fell apart, brought what could have been a crisis under control.

**Five Actions for Effective Cross-Border Crisis Management**

A deeper look at the mining services firm’s actions shows how and why it succeeded. The company took five actions to mitigate the risks of its financial crisis and exert as much control as possible over the outcome. Specifically, the firm:
Assessed the situation. The holding company in charge of the mining services firm reviewed the unit’s financial condition and assessed how it was likely to improve. The review led to the appointment of an external administrator who could act as an honest broker with creditors, local suppliers, labour groups and other stakeholders.

Alerted its creditors about the problem. The holding company explained to its creditors its internal review and its decision to appoint an external administrator to manage the situation in Latin America. This demonstrated the firm’s commitment to transparency. It showed that it took its financial problems seriously and was seeking help to manage them. This built confidence among key shareholders who therefore were receptive to appeals to share additional equity as part of a solution to the crisis.

Informed local stakeholders about efforts to address the problem. The fact that the external administrator communicated with all stakeholders – project owners, various legal advisors, the Australian Embassy and company employees in Latin America, not just shareholders – also conveyed the company’s seriousness and, in effect, secured the company’s social licence to operate. This created a sturdy platform for a solution.

After three months of negotiation with 100 different claimants to the projects in Latin America, the firm settled all claims, and in some cases reached compromises on terms acceptable to all parties. For example, the administrator divided claims into small, medium and large categories depending on the amount owed. Settlements offered full cash payments to small creditors. Medium creditors were offered 50 cents on the dollar, and large creditors could receive 50 per cent cash or the option to convert 100 per cent of the amounts owed to equity.

Maintained a strategic communications program. The company kept key stakeholders, including shareholders and employees throughout the group, updated about its progress in Latin America. Information was shared through a combination of stock exchange releases, internal memorandums and one-on-one meetings, ensuring consistent messaging.

Limited the mining service company’s financial exposure. By acting quickly, leaders of the mining services company contained the financial damage. Without this effort, the burden of meeting its financial obligations could have fallen to the parent company in Australia, hurting its standing with investors. And the success of the restructuring kept the facilities in Latin America in business.

Talking About Restructuring Is Hard to Do

While this kind of proactive engagement strategy may appear straightforward, many firms in the mining industry are loath to implement it.

One barrier is the very human tendency to believe that challenges can be overcome without external help. The troubles that most often lead to restructuring in cross-border mining operations – volatility in commodity prices, cost overruns, economic downturns – are financial management problems. As noted, commodities are always volatile, and mining executives may feel that they can weather any one storm as they’ve weathered previous ones. The risk of this attitude is that some storms can build until they become Category 5s, creating damage that is beyond repair.

Because these issues in cross-border mining almost always involve external parties, such as lenders, and very visible stakeholders, including employees, subcontractors and local communities, it should be a matter of due diligence to seek outside expertise and advice. Perhaps that advice will confirm management’s outlook. But the risks of not seeking outside help far outweigh the cost of engaging it.

A second challenge to proactive engagement is implementing the response. Companies must determine the specific cause, or causes, of their financial problem and then focus on two tracks simultaneously: handling their communications about the situation and managing the fallout from the crisis. The mining services firm with a crisis in Latin America discussed its problems with stakeholders and developed a plan to settle with creditors based on their individual circumstances and relationships with the firm. It’s not enough to talk. Companies need to act, too.

Getting Ahead of a Crisis

Companies involved in the mining industry – those that operate mines and the many firms that provide services to them – need to remember that they operate in an environment in which they must maintain their social licence to operate while managing the effects of financial conditions, including fluctuating prices and macroeconomic swings. Although these economic factors are beyond their control, they should have contingency plans to deal with them when they arise, as they inevitably will.

Those plans should include engaging external experts to assess a gathering storm before it becomes a crisis and being able to communicate with stakeholders about unfolding conditions and the company’s plans for dealing with them. To manage a mining company effectively in times of financial crisis, it not only looks good to seek outside help, it is also cost effective.

Michael Ryan
Senior Managing Director, Head of Mining & Mining Services, Asia Pacific
+61 8 6430 1321
michael.ryan@fticonsulting.com
Changing Corporate Landscape
The Rise of the Antagonist

There is a groundswell of antipathy sweeping the corporate world and it is being fuelled by the rise of the antagonist. While it is positive that governments, companies and institutions are increasingly being held to account, the pendulum is starting to swing to the point where firms are facing a tsunami of opposition and hostility. This uprising is causing new and taxing challenges for organisations’ ability to engage their stakeholders and protect their reputations.

Before the global financial crisis in 2008, economic prosperity allowed companies and their stakeholders to pursue a win-win approach as there was enough to go around for everyone. With the trauma of economic and social upheaval now a part of business and the broader community, stakeholder engagement has shifted to become a zero sum game. One party’s win is another group’s loss. As a result, activists are becoming antagonistic and the playbook is increasingly based on the notion that you have to lose for me to win.

There is often a principled zeal to this rise of the antagonist. Their opposition to industries are framed as a moral challenge – be that banking, coal mining and even the sugar industry. This fervour almost takes us back to the 19th Century, where there was a sentiment that behind every great fortune was a crime.

Capital markets are increasingly being disrupted by investor activists. The media, facing its own existential questions, is investing heavily in investigative reporting to differentiate its offering. And in the online world, the rise of social media protest is adding velocity and complexity to the reputational challenges businesses face. What’s more, we see companies increasingly viewing ‘competitor depositioning’ as an acceptable communications tool in the battle for reputational leadership.

Yet the agitation is not being inflicted solely by external forces. In some cases the threat comes from within, especially in organisations where the importance of cultural proactivity has been ignored and poor ethical practices have been accepted as part of doing business. The result is a workforce that feels neglected but now has the wherewithal to make its dissatisfaction public.

Some of this activism is having a positive effect on corporate behaviour. The value created for shareholders by activism is difficult to argue with, even if the experience is painful for board members and their original strategic aims. And who can argue against the observation that a well-judged media investigation can be a force for positive change?

But whether it has a positive or negative outcome, boards are increasingly feeling the heat from these agitators and lasting personal and corporate reputational damage can be done without the appropriate planning and response.

New antagonists are appearing every day and what we are now seeing is the culmination of a series of waves that started with activist groups such as Occupy Wall Street. The movement then took root in the formal political process – first with opposition figures such as Bernie Sanders in the US and Jeremy Corbyn in the UK, then in government itself. Governments around the world have started adopting some of the antagonists’ wish lists. In response, activists have become emboldened and their calls have become more strident.

Technology is also changing the power equation. Pop up agitators can take on large corporates, who with structured reporting lines and disclosure laws, are sometimes at a disadvantage to the nimble decentralised activist.

In this environment, we are starting to see two trends emerge. First, is the prominence of the amateur agitator – groups who have traditionally not got involved in political or corporate issues. However, due to their commitment to a cause and the ease that social media affords them in building support and a profile, their arguments can gain significant traction. An example of this is in Australia, where one of the most prominent opponents of coal seam gas
is a group called ‘Knitting Nannas Against Gas’. A group of grandmothers, who when they are not knitting scarfs for their grandchildren, are protesting against non-conventional gas exploration.

The second trend is the commercialisation of agitators. This arises from groups who realise they can make money out of their activist campaigns. This includes business ventures that have come out of the consumer movement; shareholder activists that believe they can create value from their activist strategy; and even “black PR” firms who, like plaintiff lawyers from a previous era, use their skills against corporations.

In addition, traditional activists are learning from the new wave of agitators. Today, if a trade union wants to effect change, it does not need to threaten strikes, it can achieve many of its aims through an advertising campaign or a social media blitz.

**The Antagonists**

This paper outlines the different areas where we are seeing increasing levels of antagonism and provides some considerations around how companies should best prepare and respond.

**Investor Activism – The Gloves Are Off**

Investor activists are not a new phenomenon but perhaps their means of engagement is. Third Point’s ‘Broken promises’ attack on Dow Chemical – with video and website – is a good recent example of the sophisticated measures that activists are taking to convey their dissatisfaction with the way a portfolio company is being run. The same with bear raids, where independent research companies will take a short position in a stock and then issue heavily critical research in a highly public manner. The shares fall, the media weighs in and suddenly the target company has a major – sometimes existential – crisis on its hands.

The activists’ ability to surprise with the means and tone of their criticism is forcing boards to reconsider whether they feel ready enough to deal with such strong censure. Proactive, positive investor relations during peace time is key to setting context and establishing support when the activists turn their attention to you.

**Regulators – Anything You Can Do ...**

In much the same way, some regulators are becoming increasingly media savvy in the way that they approach litigation cases against companies. Nowadays, we see regulators using the media not just to maximise coverage of a case, but also to influence the legal outcome. It is important that boards aren’t surprised by this when they enter into litigation. Preparation and relationships are key. Often it is as much in the regulators’ interest to maintain good relationships with companies, so close partnership is important.

It is also important for business to understand the scrutiny regulators face. Despite the intricacies of complex litigation, the media and politicians will simply want to know – did the regulator win or lose. Likewise, although we can all accept a ‘buyer beware’ approach to regulation, the community feels most comfortable when no one will be worse off, despite the behaviour of the investor or consumer. That is a very high bar for any regulator.

**Government – Opportunity Knocks**

Sometimes, the most aggressive and damaging stakeholders in a crisis situation are political ones. Because political pressure can be exerted on them, governments’ natural reaction is to side with those affected by a crisis. In this turbulent political environment, some governments feel their reputations can improve if they come down hard on corporates. Given they are continually engaging with the media, the press will quote them liberally and watch their movements with keen interest.
Having a proper sense of the most influential – and outspoken – politicians and political commentators will be important. Get to know them during the quiet periods and make sure you understand what they need to be successful as much as getting them to understand your business.

**Employees – Know Your Frenemy**

Too many boards fail to recognise the importance of culture and its role in protecting their business’ external reputation. In too many instances, in recent years, we have seen endemic cultural problems have a lasting impact on reputation. Furthermore, according to FTI research, one-third of employees say they would leak information about their employer’s unethical behaviour. Employee loyalty is now shorter term and sites such as Glassdoor and social media provide open forums for dissent to be expressed publicly. And in dispersed workforces like Uber, it’s hard to manage that cultural consistency and unsurprising when employees take to the courts to make their arguments. Companies must take employee engagement seriously. Our analysis shows that crises caused by endemic cultural malpractice cause far more lasting damage than all other incidents. Employee opinions and communications intended for internal eyes only will find their way into the public domain, so make sure the messages are consistent.

**Media – Attack is the Best Form of Defence**

The traditional media industry is facing plenty of issues of its own – assailed on all sides by declining revenues, a loss of public trust, accusations of ‘fake news’ and pressure from alternative news sources. In response, increasing value is being put on investigative reporting as a means of differentiation, and this is having a potent impact on the way that companies prepare to respond. Add to that the arrival of campaigning PR agencies that are hired by competitor firms to feed outlets with negative news and reputational defence is starting to look a lot more complicated.

There are two critical elements to responding to the media in the correct manner. The first is to ensure that you have access to the right information in the immediate aftermath of a crisis. It is tempting to say something as quickly as possible, but it must be accurate. The second is to show empathy, especially in situations where people have been impacted, injured or worse. An authentic and genuine response counts for so much in a crisis. An absence of empathy can enrage and fan the flames.

**Social Media – Speed and Complexity**

Of course social media adds yet another level of complexity to all of this and means that companies are expected to respond ever more quickly to an unfolding crisis. The rise of the citizen journalist means everyone is a publisher and, as we often see, consumers are happy to be particularly vitriolic if they can hide behind the cloak of online anonymity. Furthermore, as we saw with the United Airlines incident, live video only adds further fuel to the flames.

This all adds even higher levels of emotion to crisis situations. The temptation to fire back in responding to aggressive accusations is strong. Companies need to test their crisis protocols under the most realistic and intensive conditions, in order to get a true feel for how a crisis might feel and evolve.

**Technology – Bots and Algos**

Sometimes the antagonism doesn’t even come from humans! Bots are amplifying news, retweeting and spreading news, regardless of its accuracy or levels of vitriol. This automation serves only to further increase the velocity of a crisis and machine learning also has the ability to reinforce the echo chamber for readers, which can often be bad in a crisis.

Taking these additional technology factors into account when planning your crisis response is vital. Where might online information go and how quickly might it catch fire? As ever, preparation and consideration of all eventualities, is critical.

**Conclusion**

Many of the audiences companies deal with are not new, but their means and sophistication of communication are becoming increasingly aggressive in tone and tactic. This is forcing organisations and their boards to think differently about how they engage with these audiences and protect and promote their reputations. How to deal with these antagonists is a new and important consideration.

A recurring theme throughout this piece is that there is no substitute for being prepared. In an increasingly challenging corporate and political environment, management teams must take the threat of activism seriously and prepare to counter it across multiple fronts. The old adage of repairing the roof while the sun is shining has never been more apt.

This means having a crisis preparation plan to account for all outcomes. It means having a clear idea about which stakeholders will have most influence during a crisis – both positively and negatively. And it also means using ‘peacetime’ to provide context to your followers – what you are trying to achieve as a business and why – so that they understand the rationale for your response in a time of crisis.

**Robert Skeffington**
Senior Managing Director
+61 2 8298 6101
robert.skeffington@fticonsulting.com

**James Melville-Ross**
Senior Managing Director
+44 (0)20 3727 1361
james.melville-ross@fticonsulting.com
M&A: Protect the Value of the Deal

The objective of every transaction is to enhance shareholder value. So why don’t they all achieve that objective? No matter how much due diligence you do, it is not until the deal has closed that a purchaser truly learns what ‘lies beneath’.

The potential repercussions from a deal turning sour are many and can ultimately result in irreparable reputational damage. If this is something you want to avoid, keep reading!

Completion does not mark the end of the M&A process, nor does it mean the risk has subsided. In fact, what lies ahead is a lengthy and often challenging process of business integration.

Another much less planned, but equally important process, is the preparation of the completion accounts and resulting purchase price adjustment. This can have a significant impact on the ultimate purchase price (and therefore the measure of returns) and yet is often barely given a second thought.

Having helped clients through many post-acquisition disputes, acting either as expert determiner or for one of the involved parties, we often see significant consequences from this process that could have been avoided. For example:

• A purchase price adjustment resulted in an increase in the price paid by more than one-third of the base consideration.
• A target was ultimately placed into voluntary administration within a year of the transaction and then became the subject of lengthy litigation against the vendors and insurers.

The Devil is in the Detail

Sale and purchase agreements (SPAs) often include a preliminary calculation of the target’s anticipated net working capital or net asset balance at the closing date. It then allows for a ‘true-up’ mechanism to adjust for variations between this anticipated balance and the balance ultimately delivered. The complexity of this process is often underestimated in the documentation. This complexity is generally revealed only when the parties end up in dispute and the matter is in the hands of an accounting expert, arbitrator or in court for determination. By then it is too late, although the risks could have been mitigated from the start.

In our experience, the prevailing causes of disputes in purchase price adjustments are:

• A mismatch between the party with the documentation and the party with the knowledge – The adjustment is based on the completion accounts prepared by the purchaser, who has acquired the books and records. However, the SPA usually requires that the completion accounts be based on the accounting principles used historically, of which the vendor has the best knowledge.
• A ‘template’ approach is adopted – While saving time in drafting the SPA, this approach often results in costly disputes down the track due to the many nuances in business models and accounting practices. A ‘one-size fits all’ approach will rarely be appropriate for your situation and therefore can be very dangerous.
• Accounting standards are not ‘black and white’ – Almost every line item in a balance sheet involves judgment. If a sale agreement is ambiguous, parties naturally seek to interpret it in a way that enriches their own position. The standard notes to the audited accounts do not contain sufficient detail to eliminate the risk of misinterpretation of the accounting ‘principles, policies and procedures’ required to prepare the completion accounts.
• Accounting standards are not prescriptive – There is no prescribed accounting standard for calculating working capital. The accounts included in the working capital balance will vary by company. Poorly constructed and/or vague completion adjustment clauses in SPAs result in differing – and even opportunistic – interpretations.
Avoiding Pitfalls – Preserving Value

The best way to avoid completion adjustment disputes is to be very specific when describing all aspects of the purchase price adjustment mechanism in the SPA. Clearly state the balance sheet items that should be included or excluded. If possible, include an example calculation that is reviewed and agreed upon by both parties. Preparing a ‘worked example’ may highlight potential areas of ambiguity or disagreement. It is important to precisely define all terms – a key gap we see in many SPAs. Identifying potential problem areas before a deal is signed could save the purchaser and/or vendor significant time and cost.

In our experience, it is also important to clearly define the accounting principles, policies and procedures that should be adopted for the completion accounts. Simply referring to those adopted in the preparation of the baseline accounts does not provide sufficient detail to avoid a dispute.

Agreeing a methodology to value significant and judgmental accounting estimates, such as inventory obsolescence and bad debts, is very important. Approximately two in every three post-acquisition disputes we have been involved with has related, at least in part, to these issues.

Most importantly, involving a specialised accountant with experience in post-acquisition disputes when drafting the SPA will minimise the risk of such a dispute.

The Law of Unintended Consequences

Earn-out arrangements merit their own special discussion because the risks are even greater. The clauses often are more complex and therefore increase the likelihood of a future dispute. If you are entering into an earn-out arrangement to limit your risk, think carefully! Earn-out clauses pose particular challenges for vendors, such as:
• no access to records post-completion;
• lack of involvement in business decisions that may affect earn-out calculations; and
• the natural changes and economic factors that influence results.

As time passes, the likelihood that these challenges will significantly affect the earn-out calculation (particularly as it is prepared by the purchaser) increases.

Consider the following to mitigate earn-out risks:

• Include a right-to-audit clause. Provide full access to the books and records and set out the frequency of such procedures.
• Clearly outline the purchaser’s duties related to the ongoing operations of the business.
• Ensure the earn-out model relies on financial measures that are clearly defined.
• Avoid a ‘stepped’ calculation. For example, where one dollar more (or less) of earnings can result in a change in the earn-out payment of several millions of dollars, the possibilities for manipulation must be considered in the context of the subjectivity of accounting estimates.

**Buyers Beware of the Window Dresser**

There are plenty of cases where the management of target companies have engaged in ‘window-dressing’ to make the company appear more attractive or valuable to potential purchasers. Private companies are particularly prone to this behaviour, which can be costly to a purchaser and a reputational risk to a vendor.

It is not unexpected that a target company’s forecasts will be prepared with some element of optimism by painting a picture of high growth and quick returns. The risk for the vendor lies in the insufficient disclosure of assumptions. If these are clearly explained, the risk of any claim of misleading and deceptive conduct will be minimised.

Vendors must remember that post-completion, the purchaser will have full access. The buyer will have the company’s documents and employees. Those former employees will be working for the opposing party in any litigation – and they know where the bodies are buried. Incentives may be offered to staff to help their new employer identify the overstated assets and revenue and the understated provisions and expenses.

The negotiated transaction price will often be based on multiples of EBITDA for the valuation. Therefore, if the base year EBITDA has been manipulated (by even a small deviation) then the multiple amplifies the impact of that manipulation. For example, a $1 million error in EBITDA can result in a $5 million to $10 million inflation in the price paid for a company on a five-times or 10-times multiple of EBITDA valuation.

Purchasers should remember that while they are entitled to rely on the vendor’s warranties that the accounts present a true and fair view, proving in litigation that a warranty has been breached or there has been misleading and deceptive conduct is a difficult and costly exercise with an unpredictable outcome.

Furthermore, once the process goes into litigation, the risk of reputational damage increases significantly. The vendors will be accused of a lack of disclosure and the purchasers will be accused of insufficient due diligence. And this ‘dirty laundry’ may receive a public airing.

**Minimise Risk – Maximise Value**

Time and time again we hear of companies announcing impairment charges, resulting in a significant slump in share price and attracting negative media attention, not to mention lengthy litigation and investigation into the conduct of the parties involved. As we know, litigation and investigations can be costly for both parties, not only in dollar terms but also in reputational impact.

While some factors that determine the success of an M&A deal fall outside the control of the purchaser or vendor, there are strategies to minimise investment risk. Both parties should ensure completion account clauses are carefully drafted and all terms are defined. Purchasers should be rigorous in their due diligence and build clawback mechanisms (such as purchase price adjustment procedures or conditional, deferred consideration) into the SPA.

But remember, not even the most clever clawback clause can recover the reputational damage of a bad deal publicised on the front page.

**Dawna Wright**
Senior Managing Director, Head of Forensic Accounting & Advisory Services, Australia
+61 3 9604 0604
dawna.wright@fticonsulting.com

**Natalie Quinn**
Senior Director
+1 604 601 5615
natalie.quinn@fticonsulting.com
Not in My Name: Assessing and Managing Third-Party Risk in a Global Business

Global value chains are the new normal for many businesses. The actions of suppliers, agents or partners in a foreign jurisdiction can have a direct impact on corporate reputations and expose companies to a range of financial and legal risks. Knowing who you’re doing business with and what they may be doing in your name is the only effective way to assess and manage the risks.

In 2013, major grocery chains throughout Europe were swept up in what has been termed ‘The Horsemeat Scandal’, as horse meat rather than beef was found in the products of several major supermarket players. This resulted in financial and reputational damage to companies throughout the supply chain.

In the aftermath, it became apparent that there was a lack of knowledge about who was in the supply chains of these major businesses. One study showed that only 38 per cent of companies knew the identity of the suppliers to their suppliers (Tier 2) and none had information beyond those.

Food contamination is just one of a number of risks in global value chains. Tech giants have been impacted by reports of unsafe and unethical labour practices and more locally, several fast-food chains have had to manage the fallout of the illegal labour practices of their franchisees. Not knowing who you’re really dealing with and what they may be doing is often most acute at the time of an acquisition, as a major US private equity firm found out when it acquired a seemingly successful company in China.

While the CEO seemed competent and clearly charismatic, six months after the acquisition it was revealed he had convictions for embezzlement and strong ties to organised crime.

Community Expectations are Shifting

Regulators and consumers alike continue to place greater responsibility on companies for actions taken by representatives and partners.

The US Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act allow for companies to be held liable for the actions of agents and partners and failure to identify and remediate issues also increases liability.

Companies are also being held to greater account on issues such as human rights, environmental and ethical practices which are gaining regulatory attention and influence the decisions consumers make about certain brands. Regulations in this space will likely place a greater responsibility on companies to both detect and prevent a broader range of ethical problems within their value chains.

In Australia, the next likely area for reform will be human rights with the government currently conducting an inquiry into introducing a modern slavery act in Australia and the issue now also being taken up by the Federal Opposition – upping the political stakes. While the eventual shape of legislation remains to be seen, submissions to the inquiry have called for a range of measures from mandatory reporting, compulsory due diligence requirements, sanctions and the appointment of a special commissioner.

In other jurisdictions, legislation has remained at the lighter end. The UK Modern Slavery Act, for instance, requires companies with annual revenue of more than £36 million to make an annual disclosure of the steps they are undertaking to identify and prevent slavery and human rights abuses in their supply chains. The California Transparency in Supply Chains Act requires similar disclosure and the EU is in the process of introducing similar provisions.

While the eventual form of Australia’s legislation will likely be close to these examples, it is safe to assume companies will be the subject of some form of regulation. For businesses already regulated by Australia’s Anti-Money Laundering and Counter Terrorism Financing Act (2014) (AML/CTF), enhanced due diligence into customers and business partners is already a mandated requirement. The trend will likely see more companies having to closely examine the identity, reputation and activities of those with whom they do business.
What is Effective Due Diligence?
The term ‘due diligence’ is a confusing one and often applied across numerous areas, from financial and legal to operational issues. The action a company takes to investigate corruption, bribery or other ethical issues is sometimes termed ‘reputational’ or ‘investigative’ due diligence, or ‘know your customer/supplier’ (KYC).

The terms cover a range of activities from simply identifying whether a customer is a real person, as is common in the retail banking sector, through to more in-depth investigations and audits of the identities, track records, reputations and activities of companies and individuals.

Deciding what level of inquiry is needed relies on a mature risk assessment which takes account of the general risks involved in doing business in different countries and the specific areas of the company’s operations which may provide opportunities for bribery and corruption or give rise to other ethical issues.

A risk-based approach is mandated under the FCPA and most AML/CTF regulations. However, many companies have a limited understanding of what and where the risks are.

Key Warning Signs of a Potentially Risky Deal
While actual third-party risks will vary from company to company and transaction to transaction, there are some key red flags that should trigger a more cautious approach.

• Complex corporate structures – while there can be legitimate reasons for using multiple subsidiaries and off-shore business registration hubs such as the British Virgin Islands, many fraudulent and corrupt companies use these to hide the identity of the real owner or to make tracing revenue and asset ownership more difficult. Making sure you know who the actual beneficial owner of the company is can help avoid potential problems. In a recent case, FTI Consulting discovered the assets claimed as owned by a potential joint venture partner were actually owned by a different company. Had the transaction proceeded, our client would have been left with a shell company of very limited value and complex litigation across three jurisdictions in order to recover any funds.

• Unknown relationships and companies – in many parts of Asia, some successful business people have a network of overlapping financial interests that present risks of rigged tendering, collusion and complex conflicts of interest that can significantly hamper ongoing operations. Unauthorised subcontractors are also common in Asian value chains and can introduce unethical and unscrupulous links without the knowledge of the contracting business.

• Above average revenue – revenue and profits well above the industry norm should be a trigger for further investigation. In one case, FTI Consulting discovered a company had ‘borrowed’ an entire factory and employees for the purpose of fraudulently inflating assets and estimated revenues prior to the sale of the business.

• Government links – understanding a company’s links with government is critical. In many locations, close involvement with the government can increase the risks of bribery and corruption. It is also important to consider any licences or permits granted to the business or any subsidies they receive. FTI Consulting has noted numerous examples in Asia of key operating permits being revoked due to the discovery they were issued corruptly.

With the original owners long gone, the buyers and investors have little hope of recouping their losses. Government links can also expose companies to breaches of international trade sanctions and to politically exposed persons, which can carry serious penalties including fines and imprisonment.

• Government subsidies – companies receiving government subsidies should also be looked at critically. On behalf of one client, FTI Consulting discovered the manufacturing business it was about to buy into made more money from government subsidies than it could from selling its products.

What's Involved and When?
The above list is by no means exhaustive and unfortunately there is no one size fits all approach to managing third-party risks. Different countries pose different profiles of reputational and ethical risk and a thorough risk assessment is essential.

Where higher risks are identified, there are a number of ways to obtain the right intelligence to assess, mitigate or even avoid becoming entangled in the issues of a potential business partner.

Corporate and public records can:
• provide insights into ownership structures and financial track records;
• a history of involvement in litigation or regulatory issues can show a business’ track record of compliance and ethical conduct; and
• social media is often a good place to locate public comments about a company and to identify links which may pose a risk.

Taken together, they can paint a rich picture of a company’s history.
In many parts of Asia, however, there is no substitute for direct observation and intelligence. Discreet site visits and inquiries through knowledgeable sources can reveal issues that otherwise would go undetected. For instance, FTI Consulting was able to identify that a company in China was engaged in illegal labour practices by interviewing former employees. Had these gone undiscovered, they would have caused a major US corporation significant financial and reputational damage.

Deciding when to undertake an investigation depends on the circumstances. However, the costs involved are often significantly less than the expenses of full financial and legal due diligence. A due diligence investigation can help avoid wasted time and money and often highlight issues that can inform contract negotiations.

Pulling back the curtain and examining the claims made by a potential business partner is essential. The process of due diligence needs to be approached as a critical review that questions the claims presented and seeks to identify any issues before a transaction proceeds.

While no due diligence process is foolproof, when exposing your reputation to the actions of another party forewarned is forearmed.

Murray Lawson
Managing Director
+61 2 9235 9317
murray.lawson@fticonsulting.com
Facing the Future
Predictive coding and technology-assisted review (TAR) have sparked considerable discussion among e-discovery practitioners and lawyers around the world. Predictive coding uses machine learning to make predictions about the relevance of documents in discovery.

These discussions have been taking place for years in the US, but the technology has just started to gain meaningful ground in the UK, and more recently in Australia. While adoption in Australia is accelerating, the legal industry is questioning and debating the extent to which predictive coding results can be defended and whether it is truly a reliable method for more effectively leveraging the effort of human reviewers in e-discovery.

Machine-learning technologies such as predictive coding bring many benefits to the legal industry — particularly in its ability to reduce datasets quickly, find important information early and save considerable money on document review.

With document sets growing exponentially, lawyers are struggling to navigate the data in an efficient and defensible manner. Predictive coding can automate many of the time-intensive manual processes involved with keyword search, filtering and data sampling to prioritise likely responsive documents and can usually dramatically reduce the number of non-responsive documents that need to be manually reviewed. But the technology is often considered to be a black box, lacking transparency into how results are obtained.

At the same time, many lawyers understand that the existing human processes are imperfect, and often result in inconsistent responsiveness coding. Predictive coding can provide equal or even improved precision when compared with manual methods or keywords that have not gone through a sample-based refinement process. The technology can be relied upon for consistency in making the same call time after time, based on what has been learned from the set of human-reviewed training documents. This ability to automate much of the document review process increases efficiency and can improve accuracy and quality control. The key is for lawyers to be careful about selecting tools that genuinely allow control over the processes and visibility into coding decisions.

Understanding the benefits, defensibility and accuracy compared with human review, and testing to see how effective various methods, including predictive coding, can be on the particular matter, are important first steps that many Australian legal professionals are beginning to take. Beyond the initial acceptance of the technology as a viable option, there are additional considerations for lawyers, including flexibility and balance.

Flexible to Scope and Size

There is a common misconception that predictive coding is beneficial only for large, complex matters. But in reality, the technology is applicable across the spectrum, so long as it is implemented correctly. We’ve seen many small cases where predictive coding was exactly what was needed to get the job done quickly and cost-effectively. As an example, one client that had not previously used any form of TAR was looking for a fast way to find the key facts in a case. There were only 50,000 documents, but the timelines were tight and an extremely small team was dedicated to the case. Using a continuous active learning (CAL) approach, our client was able to review a small sample set, and ultimately find a high percentage of relevant material in a very short time, reviewing less than half of the documents.

For matters that involve a high volume of responsive documents, it often makes more sense to implement full-scope predictive coding, rather than just CAL. Likewise, for cases that involve a mix of hard copy and electronic documents, it is better to deal with the paper documents manually, and use some form of predictive coding on the electronic documents to balance the manual work with a highly efficient approach for the digital portion. These variables are reminders that predictive coding can be flexible.
for many different matters, and decisions about which approach to take should be based on a case’s unique needs.

Balancing with People and Process

It is important to view predictive coding technology as one tool in a larger workflow that also includes visual analytics and data mining, people and established processes. Every predictive coding matter should involve experts who offer legal, technical and statistical expertise, can guide the team through the process and help the legal team become comfortable with the technology. Involving an expert third party can assist with decision-making about which issues in the case would benefit from predictive coding, assigning the number of documents to review in the training set and designing iterative workflows. The right people working with the technology through transparent processes will also help demonstrate the defensibility of the results, as can the use of data mining to substantively understand the results. This becomes increasingly important as the size and complexity of a matter scales.

Court Rulings

Recent rulings in the Victorian Supreme and Federal courts have shown some judicial acceptance of the use of TAR. Although these matters were specific about how the technology should be applied, they offer some initial guidelines for legal teams looking to adopt a similar approach. Lawyers should pay close attention to any current and future judicial rulings on predictive coding and begin to understand how it works so they are able to defend its use in courts. Landmark rulings around predictive coding in the US and the UK are also demonstrating to the Australian market how the technology is being used and approved on the global stage.

For corporations, predictive coding can dramatically reduce datasets before they go to outside counsel and bring e-discovery costs under control. Thus, law firms are facing increasing pressure to offer more efficient and competitive review budgets. Beyond this pressure, firms are also proactively working toward ways to work smarter and more cost-effectively for their clients. Law firms that are strategic about leveraging advanced analytics and predictive coding to help clients save money are increasing their repeat business and adding more value to the e-discovery process.

As this trend continues, it is crucial for in-house and outside counsel to understand the nuances of applying predictive coding and how to determine which type of cases will benefit most. They must also be prepared to address the use of predictive coding early in a case and clearly define parameters with opposing counsel and the courts to ensure that all parties are on the same page with its use.

Paul Hunter
Principal Research Scientist
+61 3 9448 2845
paul.hunter@fticonsulting.com

Phil Smith
Director
+61 3 9448 2814
phil.smith@fticonsulting.com

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Guarding Against a Ransomware Attack

Ransomware can be a very effective means of extorting money by breaching IT security to encrypt or make data inaccessible to its owners and users.

Organisations need to stay one step ahead of cyber criminals to be able to prevent an attack, or to minimise the impact if they fall victim to a security breach.

The global cybersecurity attack known as WannaCrypt or WannaCry exploited vulnerabilities in older versions of Microsoft Windows to lock users’ files and demand a ransom to release them. It claimed at least 200,000 victims in about 150 countries.

Fortunately, Australia was spared the full force of the attack because it took place on a weekend here, so ransomware emails were less likely to be opened to spread the malware through corporate IT systems. However, there have been copycat variants of the malicious code, so the risk has not yet been entirely contained.

Employee Engagement is a Vital Defence

This ransomware event clearly demonstrates that employees can be a weak link in your cyber defences. This is why employee education and engagement are so important.

With targeted cybersecurity awareness training, employees can become effective protection against cyber threats for your organisation.

FTI Consulting recommends implementing a comprehensive and ongoing cybersecurity staff awareness training program to educate employees to detect current and emerging cybersecurity threats, and to clearly articulate your organisation’s expectations about threat mitigation and management.

Reduce your Organisational Risk

Organisations need to ensure they have the strategies and controls in place to protect against computer viruses or other malicious software to minimise the threat of a ransomware attack.

Updating anti-virus and malware software and investing in security monitoring systems with the latest threat information and signatures is the first line of defence.

Organisations should follow the Australian Defence Signals Directorate’s Strategies to Mitigate Cybersecurity Incidents for further protection from cybersecurity incidents and threats. This includes installing the latest system security updates or patches; only running trusted software on systems; increasing user authentication and access security; and regularly backing up important data offline.

Prevention, Detection and Response

FTI Consulting also recommends undertaking a threat and vulnerability assessment of your organisation’s cybersecurity risks and the specific security controls required to prevent and mitigate these risks. This should be completed as the first step in a broader cybersecurity control plan that will guide future strategic and tactical management of cybersecurity risk.

Response to a cybersecurity incident or data breach requires a sound forensic investigation to determine the nature or circumstances of the attack and the potential security improvements required to minimise the impact of similar incidents in the future.

FTI Consulting also recommends implementing a monitoring and detection capability to help identify and respond to cyber incidents at the earliest possible stage.
Be Prepared

Cybersecurity preparedness should start well before any breach occurs, because a poorly managed response can have long-term consequences for your brand, reputation, valuation and licence to operate.

Given the significance of the consequences, your organisation needs to be ready to take command of a situation through proactive communications and ensure the accurate representation of facts. Robust crisis communications and reputation management plans need to be developed and embedded to respond rapidly and effectively to a cyber attack throughout the crisis.

The recent ransomware offensive demonstrated that a cybersecurity strategy founded on a comprehensive risk and security program to anticipate and prevent attacks should be a vital part of a corporate strategy.

FTI Consulting provides a full suite of tailored support, together with analysis and counsel to assist in the detection, prevention and management of threats and breaches.

**Geoff Peck**
Managing Director
+61 402 890 019
geoff.peck@fticonsulting.com

**Rebecca Harrison**
Director
+61 3 9448 2820
rebecca.harrison@fticonsulting.com
Industries in the Firing Line
Retail Leasing Must Turnover

Retail leasing is fraught with conflict. On one hand, landlords desire certainty of income and to maximise the value of their investment. On the other, tenants commonly want to minimise their overheads and ensure their rent reflects the performance of the store.

A compromise of sorts has seen various forms of turnover rent clauses negotiated into a range of retail leases over the years (in particular for supermarkets, department stores, and larger specialty store networks in shopping centres), whereby the tenant would generally pay a fixed base rent, plus a variable ‘turnover’ rent component directly linked to annual revenue performance.

Traditional turnover rent clauses worked effectively when we all shopped conventionally in-store. There was no disputing a retailer’s turnover and little debate about the definition of the term ‘turnover’.

However, in an era where we are increasingly shopping online, are turnover clauses still relevant, at least in their previously accepted forms for some retailers? Many retail landlords will not yet have had the opportunity to address the impact of online sales (particularly for longer term leases) and how they are impacting store revenue and therefore turnover rent payable.

With Amazon in Australia, the amount we spend online is poised to increase (especially as Australia’s online sales penetration is lower than similar western economies) and there will be fierce competition for the traditional in-store shopping dollar.

Amazon provides businesses of all sizes with the opportunity to scale – to reach a much greater market without having a significant retail footprint or associated staffing costs. Subsequently, new ecommerce ventures will be born and established online businesses will expand. Hybrid (in-store and online) retailers will simultaneously feel the pleasure and pain of the world’s dominant online player.

This, combined with slow growth in household income and continued challenging retail trading conditions, has placed pressure on retailers and resulted in a number of stressed operators, which will impact retail landlords in the short to medium term - if not already.

Amazon’s arrival will further alter Australia’s retail landscape and may be the catalyst for further changes to the traditional retail tenancy and retail lease model.

As a result, landlords may bear the brunt of the online impact and a broader change in shopping habits. We see the potential for:

- some collateral damage, where underperforming stores and sites will be under pressure and some will ultimately downsize or close;
- downward pressure on rents as stressed retailers attempt to renegotiate lease terms in an effort to turnaround struggling locations; and
- a reduction in total rental income as a result of existing lease agreements and turnover clauses not adequately addressing or capturing the leakage to online revenue in turnover rent calculations.

Government Intervention

In amending the Retail Leases Act 1994, which came into effect on 1 July 2017, New South Wales legislated how online revenue for turnover calculations could be dealt with, broadly summarised as follows:

- Turnover rent excludes online revenue except where the goods are delivered or provided from the shop, or the transaction takes place while the customer is at the shop.

A tenant is not required to provide information to the landlord regarding online transactions except where the goods are delivered or provided from the shop, or the transaction takes place while the customer is at the shop.

In late 2016, it is understood Coles agreed to include a percentage of online sales revenue as turnover under the lease of its Eden Rise store in Melbourne.
Other landlords will also likely be actively seeking to capture ‘click and collect’ purchases, and online purchases by households within a certain radius of a store, within turnover figures to structure rent and calculate turnover rent provisions.

This will no doubt become an ongoing national topic of conversation and the definition of ‘turnover’ will be a hotly contested consideration during negotiations for new leases and renewal of existing leases.

**FTI Consulting’s Outlook**

Landlords will seek to future proof their leases and, for longer leases, may seek to include provisions that allow for a periodic review of any turnover rent mechanism, to ensure it remains relevant and reflects market conditions through the course of the lease.

Landlords will become more focused on arresting revenue leakage and will look for ways to attribute online revenue to physical stores.

Traditional or ‘all-inclusive’ turnover definitions may become a thing of the past. Landlords and tenants will be more focused on defining terms such as turnover, and on expressly negotiating what is and is not included in turnover.

Landlords will request that tenants disclose accounting information regarding online transactions in support of turnover calculations.

Following New South Wales, other States and Territories may feel compelled to amend their retail leasing legislation in response to the impacts of new technology and changing consumer purchasing behaviour.

In response to these ongoing changes, landlords will need to consider how they structure their lease agreements. They may ultimately need to reach more sustainable and/or relevant rental structures in an effort to attract and secure new tenants and to ensure existing tenants remain viable at their centres.

**Seeking the Right Advice**

We understand that some landlords, even in recent examples, are already taking a seat at the negotiating table (and will increasingly have to do so): in order to retain tenants, sustain foot traffic and sure-up their cash flows.

If you have any questions about the structure of your lease agreement, or have any general retail business queries, seek the right advice for your business; one that allows your business to find the right operating model in the newly forming retail landscape.

**Kate Warwick**
Senior Managing Director, Head of Retail & Consumer Products, Australia
+61 3 9604 0636
kate.warwick@fticonsulting.com

**Glen Smith**
Managing Director
+61 2 8247 8032
glen.smith@fticonsulting.com

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Counting the Cost Of Delay & Disruption in Construction

Delays and disruptions are endemic in the building and construction industry and lead to time and cost overruns. In this article we discuss why identifying delays and/or disruptions early, and good record keeping are essential in managing corrective action effectively, quantifying the financial impacts and demonstrating liability.

Delay and Disruption – The Distinction
Delay is time related and disruption is productivity and/or production related. A delay may cause disruption, disruption may cause delay, and often both occur at the same time.

Loss Caused by Delay
A contractor’s claim for further payment as a result of delays is typically made under the following:

Direct additional construction costs: A contractor will usually incur additional site labour costs for working over a longer period, overtime and/or on multiple shifts.

Site overheads: Often referred to as preliminaries or indirect job costs, these relate to items such as site huts, toilets, equipment and plant used to carry out the work. When work is delayed, the contractor may incur additional costs to keep these items onsite for longer. If contract terms permit, the valuation of these claims will be based on agreed rates for site overhead items. However, most often, a claim for additional payment is based on a loss and expense or a damages assessment and is calculated based on the actual additional costs incurred. This information generally comes from the contractor’s cost account and/or cost records.

Head office overheads: These types of claims are rare as most contractors can accommodate the additional work using existing resources. However, because resources were tied up on the delayed project, a contractor may be denied an opportunity to take on another project that would have contributed to the payment of head office overheads. To recover this ‘lost opportunity’, the contractor must provide evidence that it declined invitations to tender because it did not have the capacity to undertake a new project because of the delayed project.

Loss of profit: Contractors may claim a reduction in turnover or loss of profit because of the delay. A contractor must demonstrate that, had there been no delay, it could have used the lost turnover profitably elsewhere. Even if it was making a loss on the project, the question is what the contractor would have done with the money it received it at the proper time. If the contractor was making a loss at the time, a sum equating to the loss of profit is recoverable if the loss of turnover increased the contractor’s loss.

Subcontractors: Main contractors may receive claims for delays from subcontractors. These delays can be caused by the main contractor, the employer or both. If it relates to delays caused by the employer, the main contractor may make its own claim to recover additional costs paid to the subcontractor.

Quantifying Loss Caused by Disruption
The most common causes of disruption are loss of job rhythm caused by premature moves between activities, out of sequence working, and repeated learning; work area congestion caused by stacking of trades, increase in size of gangs; and increase in length or number of shifts. However, these are also symptoms of a contractor’s poor site management and therefore are not recoverable.

There are several ways to calculate losses caused by disruption, including:

• actual costs;
• total and modified total cost;
• project comparison studies;
• speciality industry studies;
• general industry studies;
• the measured mile;
Counting the Cost Of Delay & Disruption in Construction continued

- baseline productivity;
- system dynamic modelling; and
- earned value analysis.

The measured mile and baseline productivity methods are generally seen as the most robust methods. Both compare production and/or productivity during one or more periods when:

- the contractor’s progress on site was not impacted by the employer;
- the contractor’s progress was impacted by the employer; and
- avoids any comparison with the tender — thus avoiding the argument that the tender was inadequate.

The same principles apply to subcontractors who are disrupted by the main contractor and so on down the supply chain. In fact, it is essential the main contractor ensures its subcontractors properly assess losses caused by disruption as these will most likely form the basis of their own claims to the employer.

Avoiding Global Claims for Delay and Disruption

Good record keeping is crucial in avoiding (or successfully claiming) additional costs caused by delay and/or disruption.

If not properly tracked over the course of a project, it becomes difficult later to link them to a cause retrospectively and the contractor then lacks sufficient evidence to demonstrate entitlement to those additional costs.

This leads to global claims that are often rejected in negotiations and judicial proceedings because they do not demonstrate the actual cause for the additional costs.

Record Keeping

To support the assessment of delay and/or disruption claims, a contractor’s cost recording and record keeping system must capture information that demonstrates:

- additional costs were incurred;
- those costs relate to the delay and/or disruption alleged; and
- why those costs were incurred.

For example, a contractor should be able to identify additional head office, administrative and support costs caused by a delay and/or disruption from those incurred during the non-impacted period. If they cannot, it will be nearly impossible to demonstrate the additional costs caused by change and/or breach, prove the loss and recover the additional costs for which the employer is liable.

Records should also identify the functions of the staff being claimed and demonstrate that their undertaken tasks correspond to the cause of delay and/or disruption. It is quite easy to identify staff costs when 100% utilised for a specific period, but less easy if only partly used in functions relating to the delay and/or disruption.

Further, site establishment costs may be incurred for off-site staff and it will be necessary that they be distinguished through appropriate timesheets. Similarly, head office staff may be based on site but who are working on more than one project. Again, the time spent on the project in question needs to be recorded appropriately.

Labour costs that increase due to delays and/or disruption are generally difficult to monitor and control, particularly when the main contractors subcontract much of their work. In this situation, most often the additional labour costs will be the subcontractor’s but becomes the main contractor’s loss when payment is due. Once the subcontractor has been paid, the main contractor must demonstrate the loss to the employer and show that the payment was reasonable. Therefore, subcontractors must also prove their loss to the main contractor. The main contractor needs to ensure this is done properly to be paid itself.

Conclusion

If the costs of a delay and/or disruption are not tracked properly, almost certainly there will be problems quantifying the loss and apportioning liability. While setting up the right cost recording systems around an existing system is not always easy, ultimately it will assist with identifying delays and/or disruptions early in the project cycle so that corrective action can be taken, and the financial effects effectively quantified.

Robert Gemmell
Director
+61 7 3225 4929
robert.gemmell@fticonsulting.com
Risk and Reputation
True Independence – Preparing for the Banking Executive Accountability Regime

To comply with the proposed banking executive accountability regime, it is crucial for financial services licensees to appoint genuinely independent experts to check the effectiveness of frameworks for detecting and responding to misconduct.

The government’s announcement of the introduction of the regime has heightened the responsibility of senior executives to conduct their operations with integrity, due skill, care and diligence.

Under the proposed banking executive accountability regime, the Australian Prudential Regulation Authority (APRA) will be able to disqualify senior executives and strip them of their bonuses for failing to conduct their business “consistent with good prudential outcomes”. The regime would also include fines of up to $200 million for this failure.

The regime parallels the UK senior managers and certification regime, which requires senior managers to take reasonable steps to prevent non-compliance occurring or continuing in their responsible business unit.

Maintaining robust risk management, governance and compliance frameworks will assist senior executives in meeting their obligations. Important components of the framework are early detection and prompt responses to instances of non-compliance.

Recent incidents have indicated that there may be weaknesses in licensees’ frameworks, including:

- ineffective and untimely detection;
- poorly scoped and inadequate investigations; and
- unfair and deficient remediation.

The appointment of an independent party to review the frameworks and confirm their effectiveness would identify any weaknesses.

We consider it necessary to appoint genuinely independent experts to provide assurance over licensees’ detection systems, investigations and remediation processes.

ASIC Regulatory Guide 100: Enforceable Undertakings sets out the factors the Australian Securities and Investments Commission (ASIC) will consider in determining whether the expert can exercise objective and impartial judgment. One consideration is, “whether the Expert has previously reviewed the transactions or compliance systems that are to be evaluated or has designed or implemented those systems”.

Detection

As noted in the recently published ASIC Report 515, Financial advice: Review of how large institutions oversee their advisors, ASIC found that licensees identified 80 per cent of serious non-compliance through audits, customer complaints and business intelligence or whistle blowers, rather than through the use of monitoring and supervision systems.

Although the use of data analytics has been cited by ASIC to be a “useful and efficient method” to improve the timely identification of non-compliance, many licensees are still developing and implementing data analytics-based detection systems.

Even where data analytics systems have been installed, the detection systems sometimes have failed to identify non-compliance on a timely basis.

It is challenging to design and implement effective detection systems. Each licensee is unique and needs to develop a system that works within their individual business constraints, processes and norms. There is no ‘one size fits all’ solution.
Obtaining independent assurance over the effectiveness of detection systems is a crucial step, but it is often overlooked regardless of whether the design and implementation of the system has been outsourced or developed internally.

**Investigation**

Where potential misconduct has been detected, licensees need to investigate whether actual misconduct has occurred. This can be done by internal and/or external parties. The investigation to determine the cause and extent of the misconduct needs to be comprehensive, timely and transparent.

Where the investigation involves complex issues and is conducted internally, an independent expert that can provide assurance about the robustness of investigation is essential to ensure the credibility of the investigation findings.

Where the investigation is conducted by an external party, it is important to ensure they are genuinely independent.

The independence of the external party is critical as recent incidents suggest engaging an external party that lacks independence can result in the process being perceived, at best, as unreliable, or worse, a ‘whitewash’.

**Remediation**

In circumstances of non-compliance, how licensees respond to the incident is a strong indicator of the health of its risk management culture.

ASIC sets out the steps licensees need to take in conducting client reviews and remediation following incidents of non-compliance in ASIC ‘Regulatory Guide 256: Client review and remediation conducted by advice licensees’.

Where the non-compliance involves complex issues or an Enforceable Undertaking, ASIC recommends the appointment of an independent expert to provide assurance about the effectiveness of the governance, design and operation of the review and remediation process.

**Conclusion**

The government’s initiative has made licensees and their senior executives more accountable in ensuring their businesses are conducted with integrity, due care and diligence.

Maintaining effective risk management, governance and compliance frameworks will enable senior executives to discharge their obligations. Detection and response systems are key components of the frameworks.

Engaging genuinely independent experts to provide assurance over the effectiveness of the detection systems and remediation processes, and where appropriate over the conduct of investigations, will place licensees and their senior executives in a stronger position to respond to regulatory concerns and contribute to restoring public confidence.

**Glen Unicomb**
Managing Director
+61 2 8247 8085
glen.unicomb@fticonsulting.com

**Andre Menezes**
Managing Director
+61 2 8247 8038
andre.menezes@fticonsulting.com
The Modern Slavery Act Arrives Down Under

Today, ‘modern’ slavery is a harsh reality for an estimated 24.9 million people. Defined as slavery, servitude, forced labour, debt bondage and deceptive recruitment for labour or services, modern slavery exists in some form in the operations and supply chains of organisations in 161 countries.

However, only a handful of governments have legal frameworks to protect workers. The Australian government is proposing to join their ranks with a modern slavery act modelled after the one established in the UK in 2015. It will likely put forth a new set of reporting obligations to foster transparency across the operations and supply chains of multinational organisations. The obligations will improve the information available to consumers and investors so they can make more informed decisions.

Although Australia has not proposed penalties for non-compliance, a rough passage through the parliament may see punitive measures included before the laws are enacted. Regardless, pressure from consumers and other stakeholders makes compliance in a company’s best interests.

With this increased scrutiny and raised expectations on the horizon, companies doing business in Australia will need to take a comprehensive look at their infrastructure and determine if their policies, procedures and culture are up to regulatory standards. Multinationals especially will need to be aware of the heightened global consequences that are expected to follow, similar to the precedent set by the UK. The act may be introduced into parliament in the first half of 2018 to take effect later in the year, but Australian businesses are urged to act sooner.

Murray Lawson
Managing Director
+61 2 9235 9317
murray.lawson@fticonsulting.com

Rebecca Harrison
Director
+61 3 9448 2820
rebecca.harrison@fticonsulting.com

Australia Cracks Down on Modern Slavery
The Australian government is planning to introduce a Modern Slavery Act sometime in 2018.

What You Need to Know: Compliancy 101
No penalties have yet been proposed but companies risk their reputation by not making information publically available.
Here’s what the regulatory bodies want to see

Penalties
Both the Labor Opposition and the Joint-Standing Committee on Foreign Affairs and Trade have expressed support for penalties and the establishment of an Anti-Slavery Commissioner.

Transparency
Requirements are intended to improve transparency for consumers and investors. Increased scrutiny will raise expectations of corporate social responsibility.
Key Features: The Ins and Outs of Reporting

Many suggested measures will start to shape the legislation. Below are a few key features that companies need to know before filing reports.

**Who will have to report?**
Likely any business with annual revenues of AUD $100 million will be required to report across all industries and sectors. That includes corporate bodies, unincorporated associations, superannuation funds and authorized deposit taking institutions (ADIs).

**Mandatory Reporting Criteria**
Companies will likely have to report against four broad criteria:
- Structure, operations, and supply chain.
- The risk of being affected by modern slavery.
- Policies and process to address modern slavery.
- Their due diligence process.

**Approval of Reporting**
Reporting requirements will need to be signed by a company’s director within five months of the end of its financial year.

**Public Ledger**
Either the government or a third party will provide a free searchable database of statements that is publicly accessible.

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**Company Compliance: Remember your ADCs**
As companies consider their level of compliance, they will need to advise, develop and consult (ADC) internally and better determine their level of compliance.

**Advise**
on internal and external communications around addressing modern slavery, including political and stakeholder engagement and managing increased scrutiny on your business.

**Develop**
corporate governance guidelines, cultural change programs, and internal anti-slavery policies to better identify and manage risks from slavery across an organization.

**Conduct**
a risk assessment and audit of your supply chains, procurement agreements, systems and operations as well as awareness seminars for the boards, executives, and employees.
Shareholder activism is becoming more prevalent in Australia than anywhere in the world besides the United States, and it’s growing fast, according to FTI Consulting’s 2017 Global Shareholder Activism Research.

In 2016, 78 shareholder campaigns were activated in Australia, and 48 were started in the first half of 2017. If that level of activity continues, the proportionate growth (19 per cent) of shareholder activism in Australia will soon be on a par with the US (20 per cent).

The research examines the nature and occurrence of shareholder activism campaigns and susceptibility to activism across 14 jurisdictions. In 2016, Australia’s risk level was ranked third behind the US and Canada.

Agitating for Change
There are many factors fuelling the growth of shareholder activism in Australia, including the relatively low shareholding threshold (5 per cent) required to call an extraordinary general meeting and nominate directors, and recent regulatory changes that allow certain types of coordinated behaviour between investors without triggering ‘associate’ provisions in the Corporations Act.

Consistent with other parts of the world, shareholders in Australia are most likely to agitate for the removal of a CEO or other board member, or for board representation. However, unlike other jurisdictions, quests to affect recapitalisation represent the third most common type of activism in Australia. Activists overseas stage more campaigns over remuneration or the sale of a company.

Tips for Managing the Risk of Shareholder Activism
1. Keep your directors up-to-date with contemporary activist tactics, responses and case studies.
2. Conduct a crisis simulation or scenario training to test how well your organisation, management team, and board is prepared for and responds to a shareholder activism campaign.
3. Monitor share trading and filing activities.
4. Analyse registered shareholders to understand their motivations and influencers.
5. Promote good shareholder relations with institutions and individual investors – don’t just talk to them when you need their vote.
7. Do your homework – how does your company look through the eyes of an activist?
8. Communicate with activists to understand their track records, strengths and weaknesses.

Research Methodology
The Strategic Communications segment of FTI Consulting conducted secondary research to map the regulatory environment of 14 critical activist investor jurisdictions. The Global Shareholder Activism Map presents activist campaign data as at 30 June 2017, sourced from the Activist Insight group. The map examines nearly 5,400 activist campaigns, and excludes those aimed at amending bylaws as they are often automatic fillings from passive investors.

FTI Consulting developed an index to indicate country-specific activism threat levels, which encompasses current campaign trends, corporate governance changes, and the likelihood of future activism. FTI Consulting’s Global Shareholder Activism Map is updated regularly to reflect the most recent developments by country and highlight new trends in global activism investing.

Shaun Duffy
Senior Managing Director
+61 8 9485 8817
shaun.duffy@fticonsulting.com

Shane Murphy
Senior Director
+61 8 9485 8804
shane.murphy@fticonsulting.com
About FTI Consulting

FTI Consulting is an independent global business advisory firm dedicated to helping organisations manage change, mitigate risk and resolve disputes: financial, legal, operational, political & regulatory, reputational and transactional. FTI Consulting professionals, located in all major business centres throughout the world, work closely with clients to anticipate, illuminate and overcome complex business challenges and opportunities.

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