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MAKING DISCLOSURE MORE EFFECTIVE

Flying High

Profits and performance are soaring at Delta

Paul Jacobson, EVP and CFO, Delta Air Lines

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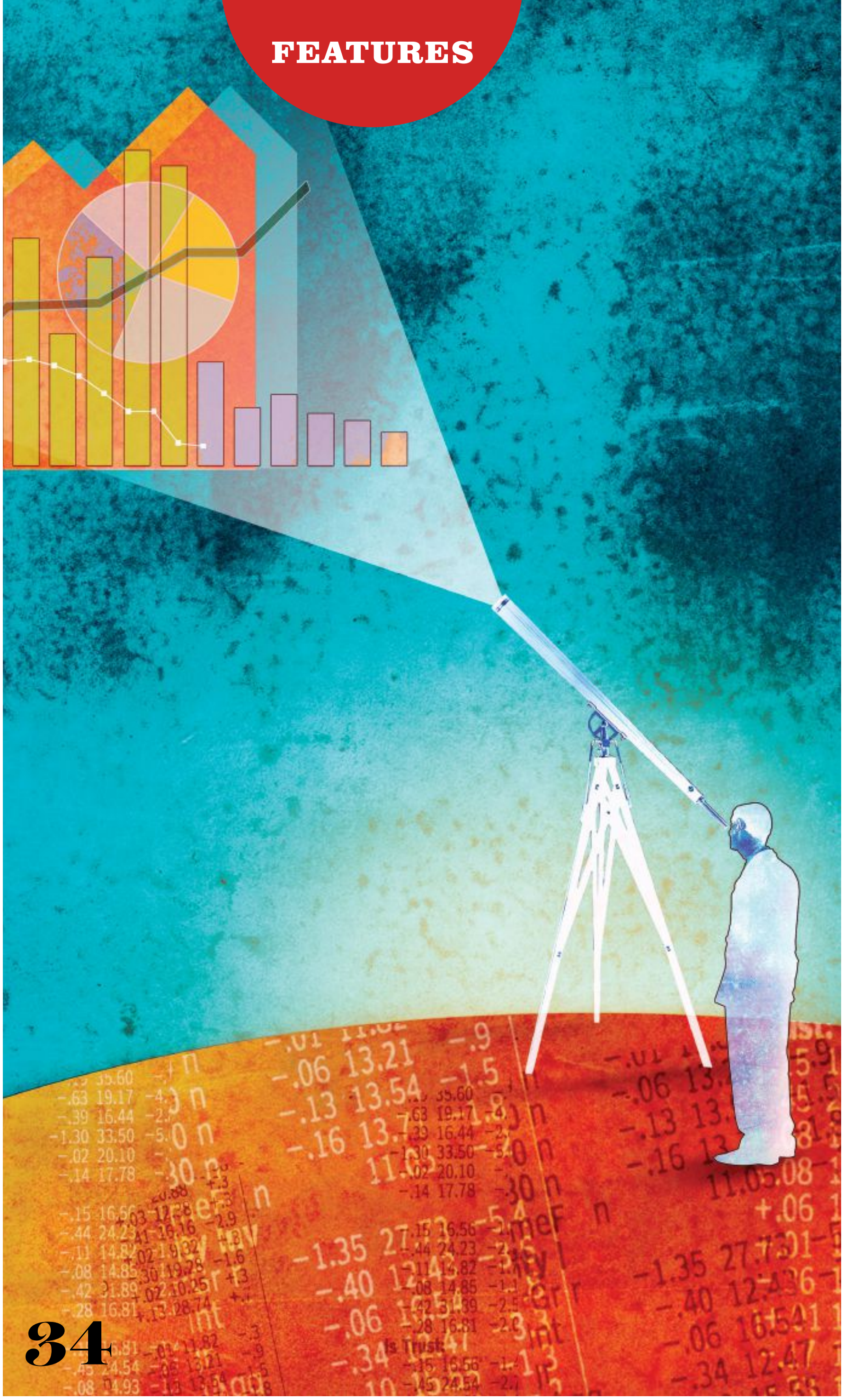
FEATURES

April 2016
Volume 32, No. 3



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CONTENTS

April 2016
Volume 32, No. 3

Up Front


20


24


26


48

By the Numbers

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FROM THE EDITOR

Change Is In The Air

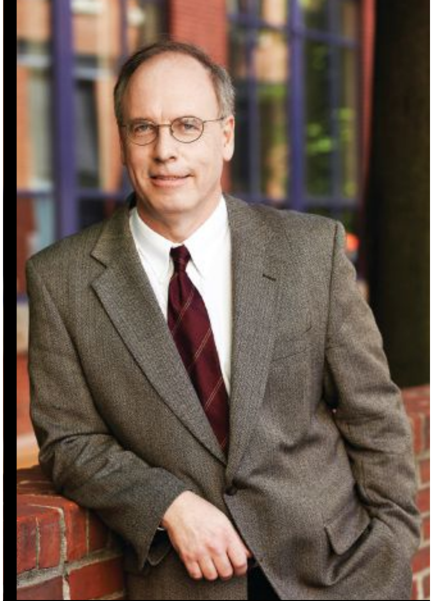
››What a difference a decade makes. In 2005, beset by soaring fuel prices and competition from low-fare carriers, Delta Air Lines filed for bankruptcy, joining several other major airlines in Chapter 11. In 2015, a healthy Delta reached new heights in profitability, thanks to low fuel costs and superior operational performance.

To an unusual degree, Delta is sharing its good fortune with its employees, giving its workforce a 14.5% base pay raise in December and distributing $1.5 billion in profit sharing (equal to more than 20% of wages) in February. Can the airline sustain its generosity when fuel prices climb? Deputy editor David McCann puts this question and others to Delta CFO Paul Jacobson in **"Flying High"** (page 30).

For years, companies' 10-K reports have been growing longer, denser, and less useful, owing in large part to increasing compliance requirements. Now, a movement is afoot to make annual reports and other disclosures more relevant and user-friendly, as we report in **"Rethinking Disclosure"** (page 34). With the blessing of the Securities and Exchange Commission, a growing number of companies are making their 10-Ks easier to read and navigate, "layering" information through summaries and hyperlinks and offering numerous charts and graphs. Material information and strategic context are in; boilerplate, outdated info, and redundancies are out.

By a large margin, 2015 was the warmest year for the planet since records began in 1880. In **"Hot Topic: Climate Change and Insurance"** (page 38) McCann asks why few property insurers take climate change into account when underwriting policies. The answer to that question, he finds, begins not in the skepticism of insurers, but rather in the difficulty of assessing climate risk and the industry's abundant capacity.

Edward Teach
Editor-in-Chief



EDITOR'S PICKS

INTERNATIONAL BUSINESS

As Brazil prepares to host the 2016 Summer Olympics in Rio de Janeiro, its economic, political, and public-health woes continue to mount. Read about them in Knowledge@Wharton, "What Will It Take to Get Brazil Back on Track?" at http://knowledge.wharton.upenn.edu/article/how-brazil-can-get-back-on-track.

LEADERSHIP

CFO's Corporate Performance Management Summit will be held in San Diego on June 8–9. The theme is "Driving corporate performance through financial initiatives." For more information, go to https://theinnovationenterprise.com/summits/corporate-performance-management-summit-san-diego-2016.

Kory Addis

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Should companies disclose more about their work force than the very minimal information they currently do? The question, which is being asked more frequently these days, was the subject of the latest "Square-Off" debate on CFO.com (**"Should Companies Expand Human Capital Disclosure?"** March 16). Two contributors took the stance that enhanced disclosure is unequivocally a good thing, while two others said, in effect, "Yeah, well, sort of."

Some readers had more caustic (yet humorous) reactions to the cheerleading for more disclosure.

"I'm all in," wrote one, "as long as HR has to compile the disclosures." If that occurred, the commenter mused, HR might be compelled to, for the first time, meet with the company's external auditor. The reader thereupon wrote a little play:

Auditor to HR leader (John): "I'm following up on employee turnover confirmations. We sent out 250 but got back only 3, so we have to do some alternative procedures to verify your regrettable turnover rate."

(John faints.)

Auditor: "John, are you OK? **All I need is for you to provide me a spreadsheet with the 250 names** and note whether each departure was regrettable or not."

John: "Spreadsheet? Did you say spreadsheet?" (Faints again.)

Meanwhile, another reader was perplexed that one of the debaters couldn't understand why employees are "reported only as costs," given that CEOs often call them companies' "most important assets."

THE BUZZ ON CFO.COM

"The short answer," the reader wrote, "is that the financial report is just that, financial. The financial measurement of people is cost.... **Human capital measurements will be subjective. Financial reports are already loaded with assumptions and estimates.** And what would the standards for human capital measurements be?

"Is it worth creating another reporting system? What is the marginal cost? We can certainly produce a bunch of statistics, qualitative measurements, ratios, and the like. Will these be good predictors of value?"

The debater in question, economist Laurie Bassi, offered a straightforward response: **"Firms are already disclosing all kinds of non-financial information in their sustainability and/or integrated reports.** Human capital disclosure is simply the next step in that evolution."

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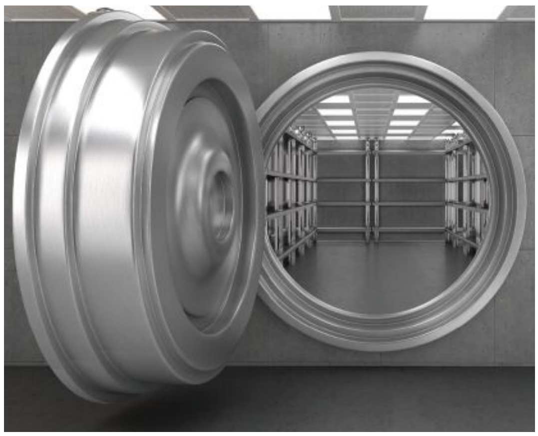
Topline

CAPEX

$300B in Capex Goes Unreplaced

A huge dollar amount has vanished from Corporate America's investment in capital expenditures.

Nearly $300 billion in capital expenditures cut by U.S. companies during the recession had not been replaced through May 2015, according to a 15-year study of capex by the Georgia Tech Financial Analysis Lab.



Capital spending for U.S. nonfinancial firms with revenues of more than $100 million dove "significantly during the recession," falling from a median 4.25% of revenue in 2008 to 3.43% in 2009 and 3.60% in 2010, Charles W. Mulford and Biro Condé, the study's authors, report.

Those capex shortfalls translate to a huge dollar amount—$296.5 billion—that has vanished from investment in the fixed assets of Corporate America, according to the study. And companies' reluctance to replace the spending on their property, plant, and equipment may be helping to slow the growth of the U.S. economy, according to Mulford.

To be sure, by 2012, capex had recovered to slightly more (4.39% of revenue) than it had been in 2007 (4.32%), before the downturn. Since the recession, however, companies have raised capex only enough to replenish their existing fixed assets each year, rather than hiking it to levels that would replace the missing $296.5 billion, says Mulford, director of the lab and a Georgia Tech accounting professor.

"There's no investment for growth," he says. "We're just barely investing to replace, and we're not making up for the lean years."

The study doesn't address whether corporate infrastructure is collectively decaying. "But it's implying that the fixed-asset base is getting older," Mulford says. "We're replacing things more slowly than we did before."

Where has all the cash that might have been invested in capex gone? Before the downturn, capex made up about 43% of operating cash flow, and fell to 31% during the recession. Then, capex spending resumed its prerecession level between 2011 and 2014, ranging between 41% and 44% of operating cash flow.

"Firms are apparently committing consistent

STATS OF THE MONTH

THE COST OF HEALTH

5.3%
Growth in U.S. health care spending, 2015

$7,786
Projected U.S. per-capita expenditure on health care, 2016

$11,681
Projected U.S. per-capita expenditure on health care, 2024

60%
Increase in average premium for employment-based health coverage by 2025

Sources: Center for Medicare and Medicaid Services; Congressional Budget Office amounts of operating cash flow to capital expenditures," the authors note. "However, any cash conserved by reducing capital expenditures during the recession has not been committed to increased spending in subsequent years."

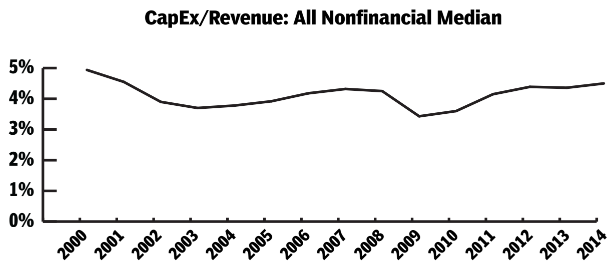
Instead, besides being held in reserve for a rainy day, much of the cash that might have gone into refreshing company infrastructure has ended up in stock dividends and buybacks, according to the Georgia Tech study. To be sure, the metric of dividends and buybacks as a percentage of revenue dove off a cliff between 2008 and 2009. But it shot up significantly through 2014.

Of course, many experts believe being "asset lite" is a boon to companies, enabling them to please investors with streamlined balance sheets and more efficient use of capital. On the other hand, companies' widespread decisions to hoard cash and invest in dividends and share repurchases rather than pump money into their hard assets has helped slow U.S. economic growth, according to Mulford.

Does the tepid investment in capex reflect the ongoing technology and automation boom and a resulting falloff in the need to invest in fixed assets? "Or is it a reflection of underinvestment [indicating that] we really need to have that move up? That's a question I really can't answer," says Mulford.

DAVID M. KATZ

CAPITAL LOSS



* Dates refer to the periods from June of the year listed through May of the following year.
Source: Georgia Tech Financial Analysis Lab, "A Time Series Look at the Level and Adequacy of Capital Spending: An Analysis Using Data from June 2000 through May 2015," February 2016

REPORTING

Reporting Fatigue Hits CFOs

Amid an increasingly demanding corporate reporting environment, CFOs are losing confidence in the effectiveness of reporting, with many complaining of reporting overload, according to a new EY survey.

The survey of 1,000 CFOs across 25 countries in organizations with revenue greater than $500 million found confidence across all key aspects of corporate reporting has fallen compared with 2014. The biggest decline was in "confidence in degree of compliance," with only 55% of respondents saying they are fully or somewhat confident, compared with 84% in 2014.

There were other significant declines in extent of benchmarking reporting (44% today vs. 66% in 2014), clarity and relevance of messages (45% vs. 67%), and consistency in application of key performance indicators (44% vs. 65%).

Only 39% of finance chiefs perceived reporting as being cost-effective, compared with 68% in 2014, and just 48% said their reporting was effective in securing the confidence of the board, a significant drop from 71% last year.

"CFOs need to step back and evaluate what they are producing and address concerns over confidence and effectiveness quickly," said Peter Wollmert, leader of EY's financial accounting and advisory services. "Corporate reporting will only serve its intended purpose if the CFO is confident of its value."

EY identified a number of reasons for the loss of confidence in reporting, including the increased complexity of reporting; growing demand, with finance leaders concerned there is a widening gap between the reports that regulators demand and the reports that other stakeholders, such as investors, require; and pressure on resources.

The survey also found that finance chiefs are feeling the ripple effect of increased scrutiny being placed on audit committees and supervisory boards. Eighty-four percent of respondents said that audit committees and boards have increased their overall attention on reporting in the past three years, with 34% saying that the attention has increased significantly.

"Audit committees are under the spotlight for how they carry out their responsibilities, and CFOs are in turn under pressure to provide more and more information," Wollmert said. **MATTHEW HELLER**

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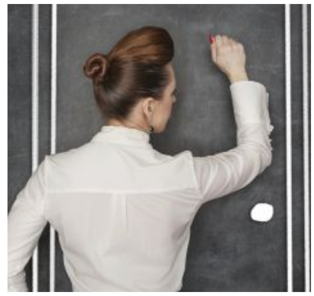
GOVERNANCE

Boardroom Doors Still Closed to Female Execs



More than three-quarters of qualified women have yet to serve on a board of directors, according to a new survey. The research firm Equilar and the U.S. 30% Club found that, of the 8,517 women who are C-level corporate officers at 5,000 U.S. public companies, 78.5%, or 6,687, have never sat on a board, and only 14%, or 1,191, are currently directors. By comparison, 17%, or 13,830, of 81,200 male executives are serving on boards.

"These figures expose flaws in the assertion that there are not enough qualified women available for board service," Equilar said.

As far as specific C-suite job categories, the survey found nearly 80% of the 788 females with public-company CEO experience had served on a board, but thousands of other board-ready women have yet to garner their first directorship.

Of the 1,815 women who have CFO or other financial executive experience, 77.4%, or 1,406, have not yet been a board member. The ratios were similar for female executives with operations (67.7%), technology (81.3%), and marketing (78.6%) experience.

"Too many organizations are still failing to consider thousands of qualified, board-ready women, missing a valuable opportunity to gain from the greater discourse, stronger decision-making process, and better outcomes associated with diverse boards," Peter Grauer, chairman of the U.S. 30% Club, said.

The U.S. 30% Club is a group of business leaders who have set a goal of having women in 30% of S&P 500 board seats by the end of 2020. **KATIE KUEHNER-HEBERT**

CORRUPTION

Harvard Study: Bribery Doesn't Pay

After a year in which Department of Justice prosecutions for foreign corrupt business practices fell to their lowest level in nearly a decade, the department is vowing to step up the pace in 2016. And corporate managers who take that pledge seriously have additional reason to intensify anticorruption efforts as a result of new research.

The research, published in an issue of the American Accounting Association journal *The Accounting Review,* used the anticorruption ratings of companies to assess whether bribery pays off in parts of the world where it's rife. The research found that, while going along with corruption does substantially boost local sales, its overall effect on a company's finances is nil.

"Weaker corruption controls and enforcement allow ... firms to generate higher sales growth in high-corruption markets," wrote the study's authors, George Serafeim and Paul Healy of Harvard Business School. "Yet, bribes are costly.... The low returns on equity on incremental sales in high-corruption markets for firms [that commit bribery] imply that the costs are not fully recovered through higher prices on corrupt contracts or through scale economies from increased sales."

In a sample of 480 large multinational companies from 32 countries, those with strong anticorruption programs had average sales growth over three years of 2.6% in high-bribery countries or regions, far below the 14.1% achieved by anticorruption laggards. Yet, that didn't translate to a greater gain in return on equity for the latter group compared with the former. "On average the sales growth and ROE effects are offsetting," the authors wrote.

The study's findings, says Serafeim, "should raise red flags even for managers whose actions are dictated by narrow self-interest, since we find these practices lead to increased likelihood of subsequent media exposure potentially damaging to companies and individuals alike." **DAVID MCCANN**

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HPT

$400,000,000
4.25% Senior Notes Due 2021
$350,000,000
5.25% Senior Notes Due 2026
Joint Bookrunner

January 2016

cpsi

$175,000,000
Senior Secured Credit Facilities
Joint Lead Arranger and Book Manager

January 2016

TRILOGY HEALTH SERVICES, LLC

$300,000,000
Senior Secured Credit Facility
Co-Lead Arranger and Bookrunner

December 2015

JW Aluminum®

$90,000,000
Senior Secured Credit Facility
Sole Lead Arranger and Bookrunner

December 2015

MARTIN RESOURCE MANAGEMENT

$355,000,000
Senior Secured Credit Facilities
Joint Lead Arranger and Sole Bookrunner

November 2015

ml MARKETLAB

$67,000,000
Senior Secured Credit Facilities
Joint Lead Arranger and Bookrunner

November 2015

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MOBILE

Ready to Wearable?

Wearable devices are projected to grow by leaps and bounds the next few years. As more vendors get into the wearable device market and as consumer demand rises, shipments should top 200 million by 2019, according to IDC's Worldwide Quarterly Wearable Device Tracker report.

For 2016, worldwide shipments are expected to increase 38.2% from the prior year, to 110 million. For each year until 2020, the sector should see double-digit growth, culminating in shipments of 237.1 million wearable devices in 2020, IDC says.

But in the interim, device makers are experiencing some growing pains. Sales growth of the Apple Watch is expected to slow in 2016 as consumers await a yet-to-be-introduced second-generation device; Fitbit slashed its first-quarter 2016 sales and earnings forecasts; Jawbone laid off 15% of its staff last November; and Apple co-founder Steve Wozniak recently questioned the tech giant's move into the "jewelry market."

The wearables market is, of course, in its early days. Boosting shipments will be the "proliferation" of new and different wearable products, IDC says, like clothing, eyewear, and "hearables." Moreover, smart watches will get "smarter," IDC senior research analyst Jitesh Ubrani says in the report. "It's time to start thinking about smarter watches—traditional watches with some sort of fitness or sleep tracking but are unable to run apps—built by classic watch makers," Ubrani says.

IDC also expects major improvements, including better user interfaces and apps, and connectivity. **K.K.H.**

TECHNOLOGY

Cybersecurity High on SMBs' Agendas

Less than one-quarter of finance executives at small and midsize businesses say their companies experienced a cyber attack in the last 24 months, according to a survey conducted by *CFO* in February. The 22% of SMB finance executives reporting an attack is about half of the 42% at larger companies reporting such incidents in the same period.

But cybersecurity is still high on the agenda for CFOs and other finance executives at small and midsize companies (those with less than $100 million in revenue), the survey found. It is a top 10 business concern for 57.5% of respondents and the number one business concern for 4.3%.

Nearly 40% of finance executives at SMBs say they will increase their total spending on cybersecurity within the next year, according to the survey. That 40% is somewhat less than the 62% of finance executives at larger businesses who say they will spend more.

What aspect of a potential cybersecurity attack worries finance executives at small and midsize businesses the most? Theft of customers' personal identifying information was at the top of the list, at 32.7%, followed closely by financial loss (31.4%). Reputational damage was the top worry for 26.2% of respondents.

Many SMBs have already taken concrete steps to strengthen security. About 56% of the companies surveyed have conducted employee awareness training, the most commonly cited measure taken, followed closely by a new assessment of cybersecurity risk (54.4%). But only 33% have developed an incident response plan (compared with 51% of larger companies—those with more than $100 million in annual revenue).

Less common actions taken by small business finance executives are buying cyber insurance (23.9%) or hiring a chief information security officer (9.1%).

Despite all these initiatives, small and midsize businesses recognize that there is still much to be done. When asked which area of cybersecurity they need to improve most, 27.6% of small business finance executives say "overall network protection"; 25.9% employee awareness; and 21.5% threat detection. Another 8.6% say their incident response plans still need work, and 7.8% cite endpoint detection of cyber threats.

Finance executives at small and midsize companies represented 233 of the total 362 respondents to the survey. **VINCENT RYAN**

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Restarting the IPO Market

To get initial public offerings going again, issuers may have to make their deals more enticing to investors. **By Vincent Ryan**

The last time initial public offerings were as unwelcome as they have been the last three months was the first quarter of 2009, when the Treasury Department was spending billions to stabilize banks and only one U.S. IPO priced. The quarter before that, the fourth quarter of 2008, was the same story: one deal.

Now, despite the absence of a mind-blowing financial crisis, the market is bogged down again. The first quarter of 2016 brought seven IPOs (as of March 18), raising proceeds of about $600 million. That's a far cry from the 27 deals that raised $4.5 billion a year ago by this time, or the 64 offerings that raised $10.6 billion in 2014's first quarter.

The oil glut, China's economic slowdown, renewed worries about Europe, and market volatility carry the blame for the stuck market.

"[When the equities] market is trading down, and when investors get nervous, they either go to cash or find large companies in safe industries [to invest in]. They abandon new companies," says Kathleen Smith, principal at Renaissance Capital, a manager of IPO-focused exchange-traded funds.

Says Dan Klausner, managing director in the capital markets advisory practice at PricewaterhouseCoopers and a former banker: "The buy side is worried about their existing stocks and positions; they're paying attention to other things."

Although Renaissance Capital's index of U.S. IPOs, IPOUSA, has turned around since early February, it was still negative for the year as of March 18, at -6.8%. In contrast, the S&P 500 returned to 0.28%. "The return on existing IPOs is the fuel that drives the performance of new IPOs," says Smith.

Just about any expert in IPOs expects the market doldrums to end. Klausner looks at the discounts on follow-on offerings to determine if the IPO window is set to open again. "If existing public companies can raise capital at discounts that narrow, that's a good sign," he says. "A big discount would be 10%; low single digits is good."
The CBOE Volatility Index (VIX) slid significantly below 20 in late February, a signal that markets may be calming.

For companies that have been waiting for signs that it's OK to get the wheels rolling on their IPO, though, there is plenty to think about before they launch.

A Reconciliation

The first companies out the door won't have it easy. Renaissance Capital calls these "IPO icebreakers." They "tend to have strong, secular growth profiles" and "defensible business models," says Renaissance. "Thanks to attractive valuations, they usually outperform the market by a significant margin."

The Renaissance report offers two examples, both from May 2009, soon after the post-Lehman market trough. One was OpenTable (now part of Priceline), whose technology platform helped restaurants increase traffic despite weak consumer spending. The other was SolarWinds, whose low-cost software provided an attractive option for price-conscious companies.

The sticking point for companies queued up to go public during the next IPO cycle will be reconciling the valuation differences between the private and public markets.

Whatever a company's private valuation, "it can't be disconnected from its public peers," says Smith. A peer's valuation has most likely contracted the last six months. But even if its valuation has bounced back, the normal IPO discount from public peers is 13% to 15%. With investors soured on companies that don't earn a profit, this time higher IPO discounts—as high as 30%—might be in order.

That's going to force some companies to downsize their offerings or even succumb to a "down round," or an IPO that values the issuer at less than the private valuation from venture capitalists. Both of these situations were already happening in 2015.

Companies that want to execute successful deals will also have to consider the following:

Use the FAST Act. CFOs who like the JOBS Act accommodations for IPO filers may want to take advantage of the Fixing America's Surface Transportation (FAST) Act, passed in December. The act allows emerging growth companies (EGCs) to keep their registration statements confi-

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dential longer—the public unveiling can be left until 15 days before the IPO road show, down from 21 days. In an uncertain market when plans get can get derailed quickly, six days can be meaningful. "It gives an issuer more time to make that decision whether to publicly file," says Robin Feiner, a partner in the capital markets practice at law firm Proskauer Rose. "They can terminate a plan without the world knowing."

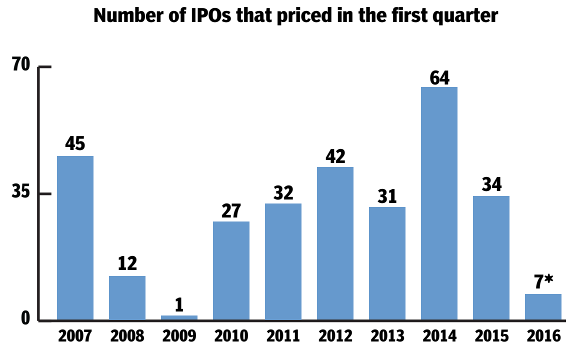
The FAST Act also allows, in some instances, a company to omit audited financials for a prior year if they would not be needed in the prospectus at the time of pricing. For example, before the FAST Act, if an EGC filed an IPO in December 2015 with an offering date in April 2016, it would have had to include in its SEC filing annual audited financials for 2013 and 2014, even though it would be adding 2015 full-year financials to its prospectus before the IPO. The FAST Act allows the issuer in the example to include only 2014 full-year financials in the initial registration statement. "You don't have to go back in time and report that older year [2013] and incur that cost," Feiner says.

Have a rationale for using a multiple-class structure. In a precarious market, it pays not to give investors any reason to avoid an IPO. Offerings in which an issuer has multiple classes of common stock, giving insiders and sponsors special voting rights, used to be difficult to launch. But in 2015, 24% of issuers used a multiple-class structure, up from 15% in 2014, and it didn't seem to hurt pricing or aftermarket performance, says Feiner.

The buy side accepts these structures when it's the only way they can get a piece of a quality company, says PwC's Klausner. However, investors will ask questions about the arrangement. Says Feiner, "You can't just put in a dual-class voting structure without a rationale for it."

Keep secondary components to a minimum, if used at all. As Proskauer says in its third annual study of the IPO market, "IPOs are increasingly unlikely to be a liquidity event." In 2015, only 19% of IPOs had a secondary component (in which some proceeds go to current stockholders), compared with 28% two years before, according to Proskauer. Volatile markets "prefer to see deals where the proceeds are going to the company and not to current stockholders cashing out," says Feiner. "In tougher markets, sometimes there will be pushback on a secondary piece."

IPO Market Shuts Down



* As of March 18.
Source: Renaissance Capital

Says Klausner: "You want to provide the shareholders with liquidity, but you don't want to do that at the expense of the company." However, sometimes secondary pieces are added for good reason, like when the primary offering is too small to create a liquid market in the stock.

Disclose material weaknesses. There is a growing tendency to report material weaknesses in the registration statement. From Oct. 1, 2014, to Sept. 20, 2015, nearly a third of the 217 companies that went public reported a material weakness, according to a study by PwC's deals practice.

"Investors generally recognize that these companies are not as sophisticated as larger organizations in terms of resources, processes, and controls," PwC writes. "Even though full compliance with the documentation and testing of [internal controls over financial reporting] may not be immediately required, pre-IPO companies, particularly those with less than $500 million of revenue, should consider using the registration process as an opportunity to provide appropriate warning to the market regarding [material weaknesses] if one exists."

Be ready. Who knows how long the IPO market will be open when it does rally. In 2015, many companies had a long wait in the IPO queue, due partly to market conditions: the average time between submission of a first registration statement and pricing of the offering rose to 149 days last year, from 124 days in 2014. Frozen IPO markets can take some time to thaw. But companies that want to go public should be preparing anyway.

"The IPO markets might be tough now, but if a company is considering an IPO, even if it's not going to do it until 2017, it's not too early to start thinking about financial statements, corporate governance, capital structure, and other things," Feiner says.

Feiner counsels issuers to get through the registration submission process with the SEC as soon as possible, so that they're in control of the timing. "Once the company has cleared all [of the SEC's] comments, then it and the bankers can determine when is the right time to go from a market perspective," she says.

What issuers may find this time around, though, is that success will hinge largely on price. For Klausner, price is always the key piece. The issuer's valuation has to make it worthwhile for the asset manager to pick up the prospectus "and do the work" on the stock, says Klausner. "You have to be at a price that gets them interested, or they are not going to pick it up." CFO

New Lease Standard Could Inflate Balance Sheets

FASB's updated lease recognition rule will make some companies look less efficient than they really are. **By David M. Katz**

In a long-anticipated move that could make corporate balance sheets look a good deal fatter than they seem today, the Financial Accounting Standards Board has updated its lease accounting standard. ¶ Under the new guidance, companies that lease property or equipment will be required to recognize on their balance sheets assets and liabilities for leases with terms of more than 12 months.

As with current generally accepted accounting principles (GAAP), how lease expenses and cash flows are reported will depend on the lease's classification as a finance or operating lease. But unlike current GAAP, which requires only capital leases to be recognized on balance sheets, the updated standard will require both kinds of leases to be recognized on the balance sheet.

Public companies will have to start complying with the new standard for fiscal years and interim periods within them beginning after December 15, 2018. For all other entities, the leases update will take hold for fiscal years starting after December 15, 2019, and for interim periods within those years beginning after December 15, 2020. FASB will permit application to report early under the new rule.

The wide-scale recognition of leases on the balance sheets of companies under the new rule "will significantly increase their assets and liabilities, in some cases without any related change in their equity," says Kimber Bascom, the global leasing standards leader at KPMG. "So basically, it makes the organization look bigger if they have a lot of leases."

That might give investors the impression that the company is less efficient in its deployment of capital than previously. "To the extent that investors may not have thought of leases as part of the population of the company's assets and liabilities in the past, this now gives them a different perception about how lean an organization is in accomplishing its business objectives," adds Bascom.

"CFOs will clearly want to be prepared to communicate with investors about their business and the nature of their leasing arrangements, and in all likelihood will want to make the case that even though the accounting has changed, the fundamentals of their business are the same," he says.

From FASB's perspective, the huge amount of lease assets and liabilities that were going unrecognized was "one of the last remaining holes in off-balance sheet accounting that needed to be filled," FASB vice chair James Kroeker says.

Based on 2014 public company filings done in XBRL format, FASB technicians found approximately "north of a trillion [dollars] in undiscounted lease obligations that are reported in the footnotes," he says, noting that the board found "the economic size" of that number a "compelling" reason to add the transparency of bringing that amount back on the balance sheet.

Kroeker adds that FASB found through its investor outreach efforts that credit rating agencies, along with many "industry focused analysts and ... more sophisticated investor[s]" were already "estimating lease obligations and adding them, in their analysis, to entities' balance sheets."

He adds, "Of course, the standard doesn't change [companies'] economic position in any way, shape, or form. All it does is add neutrality and comparability to those entities that choose to finance through leases [in addition] to those who choose alternative means to finance capital.

"That doesn't mean that finance professionals, the treasurers' group, the controllers' group, or the CFO aren't going to get questions about the impact," Kroeker notes. "This just puts investors on a more level playing field."

The FASB vice chair contends that although bringing the accounting of operating leases onto the balance sheet represents a big change, the update does so in a way that eases the transition by enabling companies to use

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their existing processes and systems.

"We've done that by keeping the dividing line between capital and operating leases, leaving unchanged the accounting for operating leases in the income statement and the statement of cash flows," he says.

In addition, FASB is "simply bringing onto the balance sheet the future unpaid lease obligations in an operating lease by recording an equal right-to-use asset and an obligation to pay for those leases," according to Kroeker.

"It's done in a way that doesn't disrupt existing systems and processes," he says, "and adds transparency to the previously unrecorded obligations of those leases." CFO

Lease Accounting: Four Action Items

Finance chiefs will need to assess the effects of the FASB leasing update so they can plan.

To successfully implement the new lease accounting rules, CFOs should focus on four key action items from the outset:

1. Analyze existing contracts and make the best use of new lease agreements. Lease agreements often involve not only real estate, but also equipment, automobiles, and other industry-specific leased items. Understanding the impact of their terms and conditions will be critical to successfully navigating the new requirements and their resulting financial reporting and business impacts. This may require a substantial effort to identify all of the organization's leases and accumulate the lease data necessary to apply the new guidance.


Kimber Bascom

The new accounting rules may affect how companies approach new leases, and may prompt them to renegotiate some existing leases. Executives may want to more critically analyze lease-versus-buy decisions, and perhaps negotiate different terms and conditions in lease agreements to manage the impact of the new rules. Finance chiefs will need to think about how the new rules will affect shareholder's equity, leverage ratios, and capital requirements.

2. Ensure executive sponsorship of the adoption process and set up a team approach. Implementing the new leasing rules is more than a compliance exercise. Ensuring buy-in from key executives is critical for strategic and effective adoption. But compliance will also be challenging. For example, the new rules require some lessees to change the reported balance sheet and income statement amounts for leases during the lease term, even if the lease contracts have not been changed. Given the widespread, and potentially material, effect these requirements will have on a company's financials, companies will need to set up processes and controls to address the new risk points. This effort will likely need cross-functional coordination to ensure timely identification of circumstances that affect lease accounting.

3. Define a roadmap early on to streamline adoption and final implementation. Besides the accounting changes, the new standard requires companies to disclose more qualitative and quantitative information about their leases. Companies will need to develop a detailed implementation plan tailored to their industries. The plan should include activities required by each business group, a schedule for completing key activities, and the recording of important milestones. Forming a dedicated project management team will help companies identify key objectives, set a timeline, and create governance protocols.

CFOs should also think about whether their companies have appropriate systems, processes, and internal controls to capture completely and accurately the lease data needed to comply with the new rules, including the expanded disclosure requirements.


Dean Bell

4. Prepare to communicate more information about leasing transactions to investors. The disclosure objective of the new standard is to provide financial statement users with enough information to assess the amount, timing, and uncertainty of cash flows arising from leases. Key balance sheet measures and ratios may change, affecting analyst expectations and compliance with contractual covenants.

Analysts and investors will take a close interest, focusing on valuation and the effect on financial results and leverage ratios. Currently, many analysts adjust financial statements for off-balance-sheet lease obligations. After the new requirements are applied, analysts will be able to see a company's own assessment of its lease liabilities. CFO

Kimber Bascom is KPMG LLP's global leasing standards leader and Dean Bell is KPMG LLP's lead partner for new leases standard implementation.

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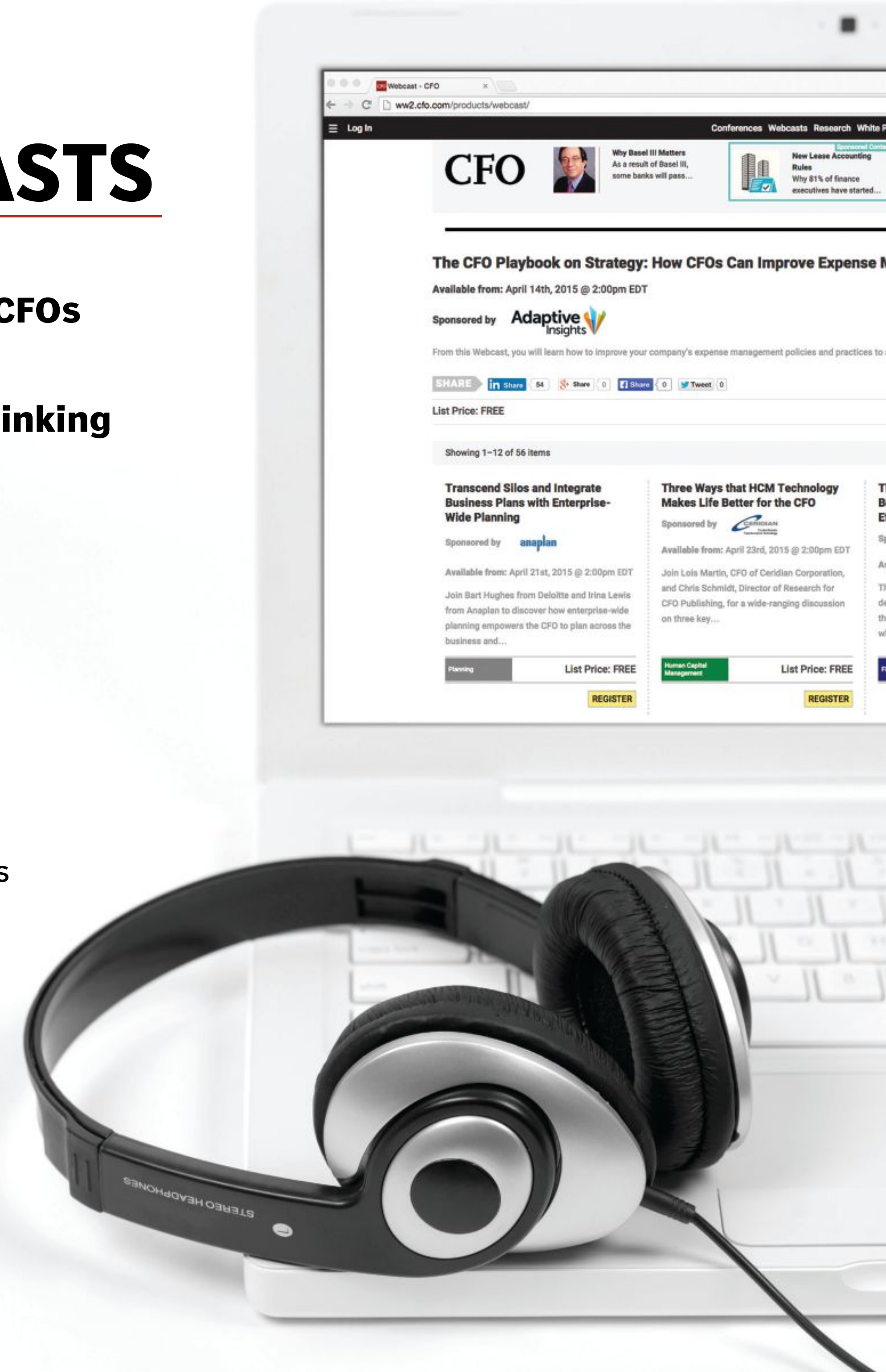

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Knee-Deep in Escheat

States are vigorously enforcing unclaimed property laws, which could pose a financial hit for unprepared companies.

By Kendall Houghton and Matthew Hedstrom

Many states across the country have increasingly come to realize the financial importance of unclaimed property laws. Under these laws, a "holder" of unclaimed property has the obligation to report and remit property to a state after the property has remained unclaimed by its owner for a specified period of time (usually three or five years, depending on the state).

States are stepping up their enforcement as a politically acceptable alternative to raising taxes. In fact, for many states, the sale of unclaimed property is a significant source of operating funds. A recent report by California's Legislative Analyst's Office reveals that proceeds from the sale of unclaimed property comprise the fifth-largest source of revenue to the state's general fund.

As these unclaimed property laws, and the states' administration and enforcement practices, continue to evolve, it becomes more important for CFOs to keep pace with developments. Savvy CFOs can avoid stepping in an escheat mess that could impact the bottom line.

Every state has and enforces a unique set of escheat laws that apply to businesses that hold many different kinds of obligations, including: uncashed accounts payable/vendor checks; customer credit balances; uncashed payroll checks; uncashed benefit checks (non-ERISA); vendor credits; customer credits, uncashed royalty checks; gift cards/stored-value cards; uncashed/unused rebates; bank accounts; securities; and customer stock/brokerage/IRA/mutual fund accounts.

While states have dramatically increased their enforcement efforts in this area in recent years, many businesses are still unaware that they have filing and reporting duties. Even where a compliance process is in place, that process is often far from comprehensive. Consequently, many companies do not have a proper escheat compliance function that complies with state law.

Moreover, as part of their stepped-up enforcement, states have outsourced compliance examinations to third-party firms. This has resulted in significant disruption and financial harm to businesses that hold unclaimed property—especially when audits are conducted by third parties that are generally compensated on a contingent-fee basis.

Over the past few years, the number of contingent-fee audit firms auditing on behalf of states has increased. Each employs unique methods and practices, but a unifying characteristic of these firms is their aggressive assertion of liability. In a related but troubling recent development, audits have increasingly become less about whether a company has technically adhered to a state's unclaimed property law as written and more about the state attempting to dictate certain market conduct. For example, life insurance and brokerage-industry audits designed and conducted by Verus Financial LLC have entailed efforts to enforce non-statutory dormancy standards, which often have the effect of overriding legitimate contract terms and industry-specific state regulations and practices.

The escheat bottom line is about *your* bottom line. CFOs should be aware of this multistate compliance regime and be prepared to:

- Manage exposures through robust compliance procedures
- Manage the financial statement implications of such established or contingent liabilities, or both
- Effectively conduct an audit defense, if necessary
- Implement changes in accounting policies and procedures, as well as in business models (contracts, customer terms and conditions, and the like), that optimize compliance and may additionally offer planning opportunities.

CFOs can effectively conduct internal compliance self-reviews in order to gauge current levels of escheat compliance and to identify sources of exposure, which in turn can yield effective risk management strategies. A self-review process may be undertaken in conjunction with the defense

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of a single-state or multistate unclaimed property audit.

An abbreviated list of CFO best practices to effectively manage an audit defense or internal self-review includes:


Kendall Houghton

• Assign a "lead" in-house counsel or project management professional to oversee the self-review, audit defense process, or both. Be sure to allocate ample time and resources to this person.

• Manage internal expectations regarding the duration and work required to conduct the internal self-review and to establish best practices.

• If under audit, execute an effective confidentiality and nondisclosure agreement with the audit firm. In an age when data privacy and security are highly regulated at both the federal and state levels, and any security incident involving a company's confidential data (including personal or financial data of employees, shareholders, and customers) could be catastrophic, it is important to manage these risks in the context of a contractually outsourced compliance examination.


Matthew Hedstrom

• Consider a potential voluntary disclosure agreement (VDA) strategy in conjunction with the company's audit defense strategy.

• Review underlying business practices and transactional models implemented by the company or an affiliated group, which may be the source of escheat exposures. For example, ask whether and how contingent obligations are recorded; what terms and conditions pertain to business-to-business and business-to-consumer transactions and instruments; and what are the contractual limitations periods for asserting claims to property.

As recent news indicates, "escheat happens," and the states' spotlight on unclaimed property is not going to go away. As unclaimed property compliance isn't a one-size-fits-all approach, CFOs should remain vigilant in understanding its nuances. CFO

Kendall Houghton is a partner and co-leader of law firm Alston & Bird's Unclaimed Property Group. Matthew Hedstrom is a partner with the group.

Unsure of Reporting's Value

An EY survey finds only 55% of CFOs are confident their reports comply with all reporting needs.

Amid an increasingly demanding corporate reporting environment, CFOs are losing confidence in the effectiveness of reporting, with many complaining of reporting overload, according to a new EY survey.

The survey of 1,000 CFOs across 25 countries in organizations with revenue greater than $500 million found confidence across all key aspects of corporate reporting has fallen compared with 2014. The biggest decline was in "confidence in degree of compliance," with only 55% of respondents saying they are fully or somewhat confident, compared with 84% in 2014.

There were other significant declines in the extent of benchmarking reporting (44% in 2015 vs. 66% in 2014), clarity and relevance of messages (45% vs. 67%), and consistency in application of key performance indicators (44% vs. 65%).

Only 39% of CFOs perceived reporting as being cost-effective, compared with 68% in 2014, and just 48% said their reporting was effective in securing the confidence of the board, a significant drop from 71% last year.

"CFOs need to step back and evaluate what they are producing and address concerns over confidence and effectiveness quickly," Peter Wollmert, leader of EY's financial accounting and advisory services, said. "To delay means that the timeliness and accuracy of reporting will continue to affect performance. Corporate reporting will only serve its intended purpose if the CFO is confident of its value."

EY identified a number of reasons for the loss of confidence in reporting, including the increased complexity of reporting; growing demand, with finance leaders concerned there is a widening gap opening up between the reports that regulators demand and the reports that other stakeholders, such as investors, require; and pressure on resources.

The survey also found that CFOs are feeling the ripple effect of increased scrutiny being placed on audit committees and supervisory boards. Eighty-four percent of respondents said that audit committees and boards have increased their overall attention on reporting in the past three years, with 34% saying that the attention has increased significantly.

"Audit committees are under the spotlight for how they carry out their responsibilities, and CFOs are in turn under pressure to provide more and more information," Wollmert said. CFO

MATTHEW HELLER

Common Misbeliefs That Lead to Unprofitable Pricing

A company that assumes it has more control over price than it actually does can make some costly mistakes. **By Marwaan Karame**

The pricing of products and services is among the most critical decision processes in every business. Despite its importance, it is also one of the most misunderstood areas. There are two primary misconceptions that can be fatal: (1) Management has control over price; and (2) Pricing must cover all costs.

Misconception #1: Management has control over price. The illusion of price control is understandable. It seems obvious that a manager has complete control over the price of the products and services the company sells. You simply state your price and then market it. However, although managers have control in that respect, what they don't have control over is whether a customer will pay that price. In other words, managers forget that price is usually an outcome, not an input.

Ultimately, the price that a business can command is driven by market dynamics (supply vs. demand), differentiation (value-added products and services), and competitive positioning (economic cost advantage).

The illusion of price control can be especially disastrous during economic downturns, especially in organizations that focus on managing profit margins. By trying to hold on to margins by not conceding to the pricing pressures in the market, volume invariably declines. As a result, achieving success in maintaining margins by stubbornly ignoring market forces comes at the cost of market share, asset utilization, and ultimately economic profit.

Despite worsening conditions, managers often maintain their conviction in the hope that competitors will come to their senses and follow the company's lead. They can become trapped in a downward spiral that accelerates as they confuse "market denial" with "pricing discipline." It is often too late when reality sets in, and as a last resort, there is a mad scramble to cut prices and reduce costs.

Sadly and all too often, these belated cost-cutting efforts require a sledgehammer rather than a scalpel.

Misconception #2: Price must cover all costs. "Price must cover all costs" and "we need to charge more to cover our overhead" are variations of the same misguided message that often stems from misreading a costing problem as a pricing problem. These managers think that price must not only cover the marginal cost of "doing business" but also the "total cost of being in business." In accounting terms, they focus too much on total cost rather than variable cost.

Admittedly, determining which costs to consider when making a pricing decision is not always straightforward. The following simple case study can illustrate and help to avoid the misconceptions of which costs need to be covered when making a pricing decision.

Assume HypothetiCo Inc. is a typically stable business that has sold 1 million units of "stuff" at $100 per unit, generating $100 million in revenue in the last 12 months. The company outsources the production at a cost of $50 per unit. Beyond these direct variable costs, the company has fixed contractual costs of $45 million that won't expire or are unavoidable, or fixed, for the next 12 months (i.e., leases, contracts, capital charges).

Consequently, the company has generated a profit of $5 million in the last 12 months, which is the $100 million in revenue less $95 million in total cost ($50 million direct variable costs plus $45 million unavoidable costs). Historically, management has used cost plus a "reasonable" margin to set prices, in which it uses the total cost of production of $95 per unit ($95 million divided by 1 million units) as the basis for the cost per unit.

Most recently, the company's sales rep warns that if HypothetiCo doesn't match a competitor's price by discounting 10%, it will lose its biggest customer. That customer accounts for 50% of revenue. Management tells the sales rep that the company can't af-

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ford to drop the price by 10% because it can't cover its costs ($90 price minus $95 total cost per unit = $5 loss per unit). Management estimates that if the company drops the price it will lose roughly $2.5 million ($5 loss per unit times 500,000 units).

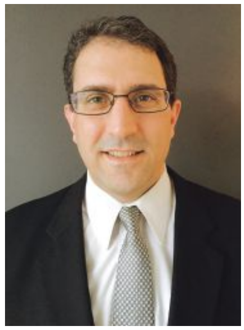
Management also fears that if it lowers the price, the rest of its customers would learn of the price cut and demand the same pricing. Management projects the loss could then grow to $5 million. However, in reality, the company would be better off discounting the price, even if all its customers wound up getting the same discount.

Consider what happens if HypothetiCo loses its top customer. It will sell 500,000 units to other customers, presumably for $100 per unit. Revenue would therefore be $50 million. The variable cost at $50 per unit would be $25 million. But the company would still have the $45 million of fixed cost. Profit would plummet to a loss of $20 million, based on $50 million in revenue less $70 million of total cost ($25 million plus $45 million).

Losing the big customer would certainly be disastrous for the coming year. Worse, the decline in volume would make the total cost per unit higher, which might induce a misguided management team to raise prices on the remaining clients, possibly leading to more loss of volume.

On the other hand, what if HypothetiCo meets the top customer's pricing demands? It will sell 500,000 units for $100 to other customers and 500,000 for $90 to the top customer. Revenue would therefore be $95 million. Variable cost at $50 per unit would be $50 million, which when coupled with the $45 million of fixed cost would lead to a breakeven profit, based on $95 million in revenue less $95 million of total cost (same as last year at $50 million plus $45 million). Breakeven isn't great, but it's much better than losing $20 million.

And what if the other customers demand similar pricing? Total revenue would drop to $90 million and the company would run a loss of $5 million. Again, hardly a great year but not as bad as losing $20 million.



"Achieving success in maintaining margins by stubbornly ignoring market forces comes at the cost of market share, asset utilization, and ultimately economic profit."

›› Marwaan Karame, Fortuna Advisors

Variable vs. Unavoidable Costs

When all costs are considered in pricing decisions, managers are effectively assuming that total costs increase and decrease as a function of volume, when in fact this is not the case. As long as the price exceeds the "variable" or "marginal" costs of "doing business," any amount of revenue will generate a contribution to profit that can offset the unavoidable costs of "being in business."

However, the example of HypothetiCo poses a conundrum. Don't we need to consider all costs, because a company can't exist long-term if it's unprofitable? The answer has two parts.

The first is that cost needs to be considered in the context of the decision. In the context of a short-term transactional decision, as in the illustration above, the transactional variable costs of "doing business" are the only costs that matter. Since the unavoidable fixed costs will be incurred next year regardless of whether the company gets the business or not, it might as well generate some contribution profit to offset the unavoidable cost of "being in business." Shortsighted efforts to recoup sunk costs by charging an above-market rate usually lead to lost contribution profit and, as shown above, less overall profit.

However, in the context of a long-term strategic decision of whether a company should "be in business" (businesses to enter or exit), all costs for the most part are avoidable or semi-fixed and hence should be considered when thinking about pricing decisions.

In other words, if the above case occurred in a downturn and management felt all would revert to normal a year later, the short-term decision should be to accommodate the top customer. If, instead, this situation was viewed as sustainable and was not likely to revert to the previous pricing norm, management must question whether it should be in business. Can the outsourced manufacturing be done at a lower per-unit cost? Can any of the fixed costs be cut?

Second, recognizing that prices are an outcome of market economics and competitive position and not an input should stimulate different questions, such as "How can we improve our technology and innovate our processes so that we can differentiate our product with a cost structure that is profitable under any competitive price pressure?" Although there are some costs that management can't control and are dictated by market economics, such as fuel costs in the airline industry, even those costs can be mitigated by management choices, through the processes they choose to transform inputs to output; the markets and customer segments they choose to serve; and the businesses they choose to enter or exit. CFO

Marwaan Karame is a partner at Fortuna Advisors.

A Charmed Strategy

Alex and Ani's CFO explains how focusing on the "meaning" of jewelry has produced sustainable growth. By David M. Katz

"Diamonds are a girl's best friend," says Jayne Fitzpatrick-Conway, the CFO of Alex and Ani, a supplier and seller of bangle bracelets, when asked about her favorite kind of jewelry. ¶ Indeed, Fitzpatrick-Conway, a Harvard MBA with a consulting background at Bain, admits to having a particular attraction to finance and strategy jobs in the jewelry industry. That career pattern seems to have originated in her previous post as the finance chief of CIRCA Brands, a global reseller of previously owned luxury jewelry.

Courtesy Alex and Ani

Alex and Ani sees the Middle East as a key growth market for its bangle bracelets.

At Alex and Ani, however, the strategy focuses not so much on bling and impulse buying as it does on establishing "meaning" and generating long-term relationships with customers. "Where some might view us a jewelry company, consumers have loyalty around the meaning of our jewelry and their emotional connections to those meanings. That's what gives us sustainable growth, beyond [being] just another jewelry company," says Fitzpatrick-Conway.

She was a key player in a similar approach at Dunkin' Brands, where, rising to the position of chief strategy officer, she led the strategic planning process for the national expansion of the Dunkin' Donuts brand that employed the "America Runs on Dunkin'" campaign. "People thought we were a donut company, when we were really delivering a consumer value proposition around beverage [that is, coffee] loyalty," she recalls.

Fitzpatrick-Conway, who has been with Alex and Ani since June 2014, credits her boss, company founder and CEO Carolyn Rafaelian, with establishing the strategy. While the products the company sells must be beautiful, they also must spawn personal associations in buyers to keep them coming back, the CFO says.

Maintaining that connection is significant in the selling of charm bangles, since consumers tend to wear stacks of them on their wrists. As an example, Fitzpatrick-Conway offers an anecdote. At a restaurant one day, she observed a woman describing her stack of bangles to another woman. "She literally went down each and every bangle, and she had either an occasion or a person or a reason why she had this bangle," says the finance chief.

Focusing more on meaning than stylishness or glitter makes buying jewelry "so much stickier and the customer ultimately more loyal," says Fitzpatrick-Conway.

In line with that effort, Alex and Ani, which takes in about $300 million a year in revenue, constructed a web application last year that asks customers to plug in certain personal preferences when they register for it. The app, which, like the firm itself, has a distinctly New Age feel, provides app registrants with their birthstones, zodiac signs, native trees, and personal flowers. Then it offers them charm bangles, as well as rings, earrings, and necklaces, adorned with their personal symbols, all ranging from about $18 to $38.

An Online Offensive

The app is part of an overall thrust to increase the Cranston, Rhode Island-based company's online sales, which it forecasts will grow more than 30% a year over the next three years. Fitzpatrick-Conway notes that industry analysts no longer gauge the value of retail shares merely in terms of comparative sales figures generated by brick-and-mortar stores, "but, rather, combine the entire b-to-c platform."

The company's move into digital technology will be aided by the recent appointment of Oscar Salazar, one of the founders of Uber, the online car service, to Alex and Ani's board. Although the jewelry distributor is fundamentally different from Uber, the aim is for Salazar to advance "the notion of creating a technology that fundamentally, radically, alters the normal thinking of the particular industry," she says.

"It's less about trying to Uberize Alex and Ani than having somebody

"Consumers have loyalty around the meaning of our jewelry and their emotional connections to [it]."

›› **Jayne Fitzpatrick-Conway, CFO, Alex and Ani**

who can really push you from a strategic perspective on how you can deliver," she adds.

The finance chief feels that the products the company distributes are especially well aligned with its digital goals. "It's small, it's easy to ship," she notes, and "digital may be a place where we can have a more uniform differentiated consumer experience that we can really control from a standardized level."

In contrast, although the firm tries to train its retail employees (whom it calls "bartenders" to connote a certain relaxed, European quality) in a standardized approach to selling, "there's always a variability [according to] the specific attendant [and] how they execute the interaction with the customer," says Fitzpatrick-Conway.

"We feel like it's highly more controllable in a digital environment. And, more importantly, [digital is] what the consumer's asking for," she adds.

Hanging On To Bricks and Mortar

To be sure, the company isn't planning to give up on brick-and-mortar stores anytime soon. In the past five years, Alex and Ani has grown from a company of 25 people to a chain with 65 retail stores and more than 1,000 employees.

Under Fitzpatrick-Conway's guidance, the jeweler plans on opening 25 to 30 U.S. retail locations by the end of this year, besides opening stores in Australia and the Middle East. In the latter case, the locations will be in wealthy countries like Saudi Arabia. "We continue to be very interested in the Middle East simply because women really only have their arms and their feet to display accessories, and obviously the wealth of that market is tremendous," she says.

However, she adds, the company "will not enter international markets in the absence of having a high degree of confidence that we have the right partner who has the right infrastructure to execute to our necessary level."

Still, Alex and Ani may have reached a plateau in terms of revenue growth. "I will say we've had strong growth though many years. Obviously, when you have a higher number to grow from, it becomes harder to keep the absolute percentages the same," says Fitzpatrick-Conway.

With new growth tough to come by in its current privately held form, is the company setting its sights on an initial public offering? (Two private equity firms, San Francisco-based JH Partners and British-based Lion Capital, each hold a 20% stake in Alex and Ani, according to news reports.)

"We're always evaluating liquidity events," the CFO acknowledges. And the company's January vertical integration with Cinerama, its affiliated manufacturing company, could eventually make one more likely.

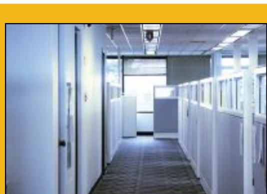
The move stands to buttress the company's brand by making it a manufacturer as well as a distribution and fulfillment company. "Under the Alex and Ani umbrella, if we would ever have a liquidity event, we would trade at a much higher multiple than [Cinerama] would as a small manufacturing facility in Rhode Island," she says.

The integration would also enable Alex and Ani to boost its reported earnings by making the relationship between the distribution and manufacturing more efficient. But an IPO would require at least two years of audited financial statements, and the company is only just beginning to prepare for its first complete audit by Deloitte and Touche.

In turn, the audit could be complicated by Alex and Ani's new, complex relationship with Cinerama. "We did not buy Cinerama as a legal entity," Fitzpatrick-Conway explains. "We bought all the component pieces associated with the Alex and Ani business. But Cinerama is still a legal entity that could operate in noncompeting categories."

Thus, the company won't be IPO-ready until at least 2017 "and likely maybe beyond that," she says. "So we have no large liquidity plans at this time, particularly with the acquisition of our assets from Cinerama and our focus on integration." CFO

Editor's Choice



Far from the Corner Office

"Compliance is facing challenges to perform as a strategic partner" to the C-suite, an Accenture survey says. While corporate demands for compliance support are increasing, the stature of the compliance function is falling. Of more than 150 compliance officers polled in 2016, 31% reported to the CEO, compared with 39% in 2015 and 40% in 2014.

CFO Paul Jacobson
at the Delta Flight
Museum

ON THE RECORD

Flying High

Soaring profits at Delta reward shareholders and employees alike, says CFO Paul Jacobson.

A CFO INTERVIEW WITH

PAUL JACOBSON
EVP and CFO, Delta Air Lines

The airline industry beckoned to Paul Jacobson from his childhood, when, as a seven-year-old, he dreamed of becoming a pilot. Years later, after graduating from Auburn University in 1994 with a degree in aviation management, Jacobson briefly worked at aircraft maker McDonnell Douglas. Then, he headed to Vanderbilt University for an MBA.

"Before classes even started I sat down with my placement director, who asked what I hoped to get out of business school," recalls Jacobson. "I said I wanted to get a job with an airline, preferably Delta. I'm not exaggerating when I say that he spent the next two years trying to talk me out of it. He said airlines were a terrible business, and they didn't value MBA talent."

Undeterred, after Jacobson earned his degree in 1997, he landed a financial analyst position at Delta Air Lines. "Every day since then has been a labor of love," says Jacobson, who rose through the ranks to become CFO in 2012. "I love this industry, and I knew it had a lot of potential."

There were a few bumps along the way—particularly the carrier's fall into bankruptcy in 2005—but today Delta is flying high, outperforming its major competitors on most operational and unit sales metrics. And, although revenue grew by less than 1% last year, to $40.7 billion, pretax profit soared by 29% to a highest-ever $5.9 billion, thanks largely to the plummeting cost of fuel. Delta's stock reached a postrecession high of $52 in December.

Not only have shareholders benefited from the performance, so have the airline's employees. In a startling display of largesse, Delta gave all employees other than its unionized pilots and upper management a whopping 14.5% base pay raise on December 1. That was on top of a 3% hike in April of last year. And in February, Delta distributed $1.5 billion in profit sharing to employees—equal to 21.4% of their wages.

Recently, Jacobson spoke with *CFO* about Delta's generosity and the challenges of responding to ever-changing market conditions. An edited transcript of the conversation follows.

Stan Kaady

What is unique about being the CFO of an airline?
The business is inherently unique. Every industry has its challenges, but when you look at the global reach of the big U.S. airlines today, we have a very diversified portfolio across the globe. At the same time, we sell a perishable product—as soon as the plane leaves the gate, our opportunity to sell a seat on it is gone.

When you combine those two things, we have to be able to change rapidly in response to events like the Paris attacks and the Zika virus [by reducing or redeploying capacity in accordance with shifts in travel demand]. We have to be nimble.

What does "nimble" mean, in practical terms?
It starts with discipline. This industry historically has been very highly levered. After we completed our integration with Northwest [Airlines] in 2009, we started a process of improving the health of the balance sheet and shoring up our resources. Since then we've paid down over $10 billion of debt, which has reduced our interest expense by almost a billion dollars a year.

The second thing we have to do, every single day, is be in a position where we can react to changing market conditions. [CEO] Richard Anderson is fond of saying that a plane is like a hotel—except if a local market is down, we can pick up our hotel and move it somewhere else.

Now, there are pros and cons attached to that, because [the other airlines] can do that too, which makes the business inherently competitive. We just have to make sure we're investing in things that will drive sustainable operational performance and financial wherewithal.

But hasn't consolidation made the industry much less competitive than it used to be?
I wouldn't say that at all. The airlines are bigger for sure, but if you look at the pricing dynamics, all the evidence is there that it's still very competitive. The industry's unit revenues were down for most of 2015, and most analysts are saying [that will continue] at least through the middle of this year. The competitiveness has changed a bit. It's not just about price. Price is still a very important piece, but we've really competed across value chains. Where you see Delta really changing things is with operational reliability, customer service, product amenities, and so on. So the competition becomes much more far-reaching.

Let's talk about Delta's employee compensation. Do you appreciate how unusual it is for employees to get the kind of financial boost that yours have gotten recently?
We recognize that. Delta is filled with people who care deeply about the company and serving our customers. And I don't think it's any coincidence that [there is a correlation between] our operational performance and customer satisfaction versus our competitors, and the profit sharing and overall compensation [with which] we reward our employees.

But isn't the profitability that drove the pay raises and high profit sharing transitory? No one can expect fuel costs to keep falling or remain at historically low levels forever.
Low fuel prices are a big component of it, but at the same time we have to make sure that we continue to drive the business for margins. Our year-over-year fuel-expense [forecast] is a snapshot in time. The reality is that we sell tickets up to a year in advance, and we really don't have a clear view of fuel costs more than a couple of weeks out.

We have to be careful not to get complacent because we got a little bit of benefit on fuel. We have to remain disciplined and stay focused on cost management and driving a superior product, leading to better revenue performance.

The International Air Transport Association recently released a survey of airline CFOs, concluding that their profit expectations have moderated for 2016.
I think that's right. Airlines' revenue performance was a bit disappointing in 2015 versus expectations heading into the year. For the industry it could have been better. But when you sit in my seat and have a healthy respect for the [profit-challenged] history of the airline business, it's performing really well right now.

There's some concern that the economy will slow down this year. Is there anything you can do to mitigate the impact of a potential falloff in travel volume?
It goes back to what I said earlier about global events and uncertainty. We have to be prepared for that next storm. The real key is shoring up our balance sheet, funding our pension plans [beyond minimum required funding levels] and being disciplined with capital expenditures and costs. Then, if something happens, we have a much better foundation to change the business according to the differing economic landscapes. We've been able to do that pretty well through our diversified portfolio.

In the past, because of the weaker foundation, that had been done by taking things away—taking amenities away from customers, taking [job] security away from employees. That type of whipsaw effect doesn't drive any sustainability at all, and it's honestly part of the reason why airline economics had been given such a bad rap for so long.

CREDIT WHERE CREDIT IS DUE:
"[An investment-grade] credit rating is a testament from the rating agencies about balance sheet quality and the company's stability. It will help us in all aspects of the business where credit is involved."

If we're going to change that, every time we make a product improvement or an investment in the operation, we have to commit to its sustainability. If we're going to put a product on board our airplanes, it has to be a commitment that we're making to customers. If we provide a benefit to our employees, it has to be a commitment that we're making to the employees.

In your January earnings call, CEO Anderson said he thinks Delta will achieve an investment-grade credit rating this year. Right now, the only U.S.-based airlines that have that are Southwest and Alaska, which aren't global carriers. How much would that rating mean?
A credit rating is a testament from the rating agencies about balance sheet quality and the company's stability. It will help us in all aspects of the business where credit is involved.

But I think more importantly, it's a sign of our differentiation. We've been focused on getting to an investment-grade balance sheet, whether we got the rating or not, since 2009. Paying down debt and proactively funding our pension plans have gone a long way to improving our credit quality. [*Editor's note: In February, shortly after this interview, Moody's Investors Service raised Delta's credit rating to investment grade.*] **INTERVIEW BY DAVID McCANN**

Rethinking Disclosure

Encouraged by the SEC, companies are finding new ways to make 10-Ks and other disclosures more relevant and reader-friendly.

By Edward Teach

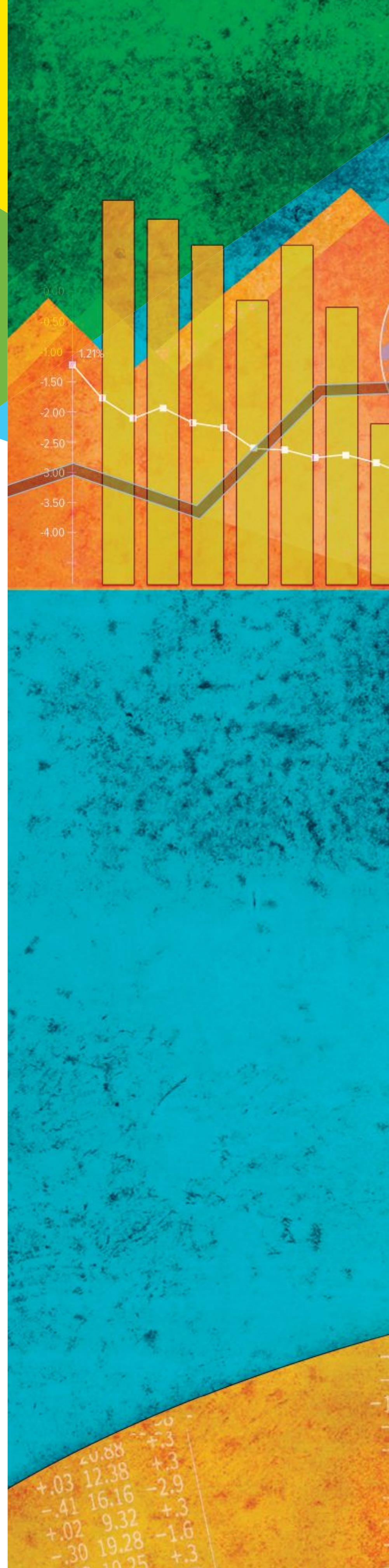
In December 2013, the Securities and Exchange Commission sent a report to Congress on Regulation S-K, the disclosure rules for public companies. Although its JOBS Act mandate was to investigate ways to simplify the registration process for so-called emerging growth companies, the SEC concluded its report by calling for a comprehensive review of the disclosure regime for all public companies.

Today, while the agency continues to review the disclosure requirements in Regulation S-K and Regulation S-X, which addresses financial statements, a growing number of companies are pursuing disclosure improvement on their own—with the encouragement of the SEC. General Electric, Target, Honeywell, Intel, and American Express are some of the more prominent firms that are making their 10-Ks clearer and more readable, using more charts and graphs to present financial and other information, whether on a printed page or a website.

"We have seen concrete progress by companies working to make disclosures clearer and more understandable, in particular by removing redundancies or unnecessary information," SEC chairman Mary Jo White said in a December speech.

Such progress can come none too soon. In a study released last month, researchers at the University of North Carolina's Kenan-Flagler Business School showed that the length of the median 10-K more than doubled from 1996 to 2013, from 23,000 words to more than 49,000 words—a tad longer than, say, *The Great Gatsby*.

New compliance requirements from the Financial Accounting Standards Board and the SEC drove most of the increase in length, with three topics—fair value, internal controls, and risk factors—accounting for "virtually all" of the increase. (The study, "The Ever-Expanding 10-K: Why Are 10-Ks Get-



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ting So Much Longer (and Does It Matter)?" by Travis Dyer, Mark H. Lang, and Lorien Stice-Lawrence, can be downloaded from the Social Science Research Network.)

At the same time, the annual reports studied by the researchers displayed rising levels of redundancy and complexity, or "Fog," referring to a widely used index that measures the readability of text by analyzing sentence length and the frequency of complex words. According to the Fog index, readers needed 21.65 years of formal education to comprehend the median 10-K in 2013.

Top executives are just as frustrated as investors with the opacity of their reports. Leslie Seidman, a former chairman of FASB, moderated a panel during a forum on disclosure effectiveness last fall. "Many companies said that their own senior executives had got to the point where they didn't understand what the key messages were in their own financial statements," says Seidman, now executive director of the Center for Excellence in Financial Reporting at Pace University's Lubin School of Business.

"Many companies said that their own senior executives had got to the point where they didn't understand what the key messages were in their own financial statements."

LESLIE SEIDMAN, former chairman of the Financial Accounting Standards Board

CLEARING THE FOG

Now, many companies are working to clear the fog from their disclosures. "They are starting to experiment," says Neri Bukspan, a partner in EY's financial accounting advisory services practice and EY Americas Disclosure Leader. "They have made greater use of charts, graphs, and tables. Some have even changed the concept of the annual report altogether. They've made it a website with a link to their 10-K, and they've introduced summary annual reports that also show how the company has performed against key goals."

41% of respondents said that reducing narrative disclosures in favor of charts, graphs, and infographics was an area of focus to improve financial reporting.

"Companies describe [improving disclosure] as moving from a compliance mind-set to a communication mind-set," says Seidman. "They have much more flexibility in their earnings releases and investor presentations, and I think they are finding there is more flexibility in the way they tell their stories in the 10-K and 10-Q as well."

In 2015, EY and the Financial Executives Research Foundation surveyed more than 120 finance and accounting executives from companies in a range of industries. Three out of four (74%) respondents said their companies were taking action to improve disclosure effectiveness. More than half (53%) said the main reason for improving disclosures was the influence of the management team, while 22% said the SEC's initiatives were the primary driver.

Efforts to improve financial reporting focused primarily on three areas: disclosing material information and eliminating immaterial information (cited by 80% of respondents), reducing redundancies (77%), and eliminating outdated information (70%). Forty-one percent of respondents said that reducing narrative disclosures in favor of charts, graphs, and infographics was an area of focus, while 19% said that making greater use of technology, such as a website or interactive display, was a priority.

The documents that companies improved most often during their disclosure initiatives were 10-Ks and 10-Qs, cited by three out of four respondents. Of those reports, the part companies improved the most was the Management's Discussion and Analysis (named by 40% of respondents), followed by the notes to the financial statements (25%) and description of the business (18%).

Just over half (56%) of survey respondents reported that their companies' disclosure effectiveness efforts had meaningfully improved financial communication, compared with 41% who reported marginal improvement and 3% who reported no improvement. And for nearly 4 out of 10 companies, better disclosure meant better process efficiency: 30% estimated they saved, or expected to save, one to three days in the preparation of their financial statements, while 9% saved four days or more.

Disclosure effectiveness, comments Bukspan, "is not just about improving the 10-Ks and 10-Qs. It's about improving a company's entire communications line with investors, from the periodic filings to the proxy statements, from the investor presentations to the investor relations web pages."

ELEMENTS OF STYLE: GENERAL ELECTRIC

One company that is striving to improve all aspects of its communication with investors is General Electric, the $117 billion industrial giant. "We're passionate about disclosure reform," says Christoph Pereira, chief corporate, securities, and finance counsel at GE. The company started its reform initiatives several years ago by re-

GE's integrated summary report combines information from the annual report, proxy statement, and sustainability website.

vamping the proxy statement, and then moved on to earnings releases.

Last year, GE redesigned its annual report, adding an introduction and summary that places the company's financial information in a strategic context, according to CFO Jeffrey Bornstein. The 14-page summary in the 2015 10-K contains information on, for example, major portfolio changes, performance against operating goals, business-segment summaries, industrial margins, and more—all summarized through concise text and a profusion of charts, graphs, and infographics.

GE's latest 10-K and full annual report weigh in at 218 pages and 245 pages, respectively, but they are much easier to read and navigate than earlier versions. Pereira says the company has spent a lot of time improving the MD&A and discussion of risk factors, and for 2015, GE also simplified the presentation of three footnotes: postretirement benefits, stock-based compensation, and financial instruments.

What are GE's guiding principles for compiling the summary report? Pereira mentions three. "First, we organize information around topics," he says. An example is the page on capital allocation, which begins with a comment from CFO Bornstein. In a single page of charts, GE shows how much capital it expects to have available from 2015 to 2018; how much it spent over the past three years on dividends, buybacks, restructuring charges, growth funding, and acquisitions; and how capital allocation drives results in terms of organic revenue growth, free cash flow, operating profit margins, and returns. "It would take a fair amount of time for an investor to compile that information from the traditional 10-K," says Pereira.

A second principle is to "tell investors what we think is the most critical information from an investment standpoint, using the lens of management," says Pereira. Thus, for example, while the 2015 10-K lists 12 risk factors, the introduction zeros in on what GE sees as the four most critical enterprise risks: product quality, cybersecurity, liquidity through a crisis, and global compliance.

"If a company says there are 45 risks we worry about, there's not much an investor can do with that," comments Pereira. Meanwhile, in the 10-K, the 12 risk factors are organized by type of risk: strategic, operational, financial, and legal and compliance.

A third principle is to provide a strategic, forward-looking context for understanding the 10-K. "We are trying to articulate what GE's investment thesis is," says Pereira. The summary report helps answer the question. One page, for example, is devoted to the company's new digital organization, which aims to capture and analyze GE product data through sensors, software, and analytics. "Internally, this is huge," he says. "It may be the future of the company, and we're putting enormous resources into it." Yet, such new initiatives typically find little coverage in traditional 10-Ks, no matter how significant they may be.

ON THE SAME PAGE

In March, GE unveiled a new disclosure document: the annual integrated summary report. Combining critical information from the company's annual report, proxy statement, and sustainability website, the 68-page report aims to give investors "a comprehensive and concise view of GE" by linking strategy, performance, governance, compensation, and sustainability. "When you go online, the fewer clicks you need, the more efficient you are. It's the same with disclosures: The fewer steps it takes investors to get the necessary information, the better," says Pereira.

We want to "tell investors what we think is the most critical information from an investment standpoint, using the lens of management."

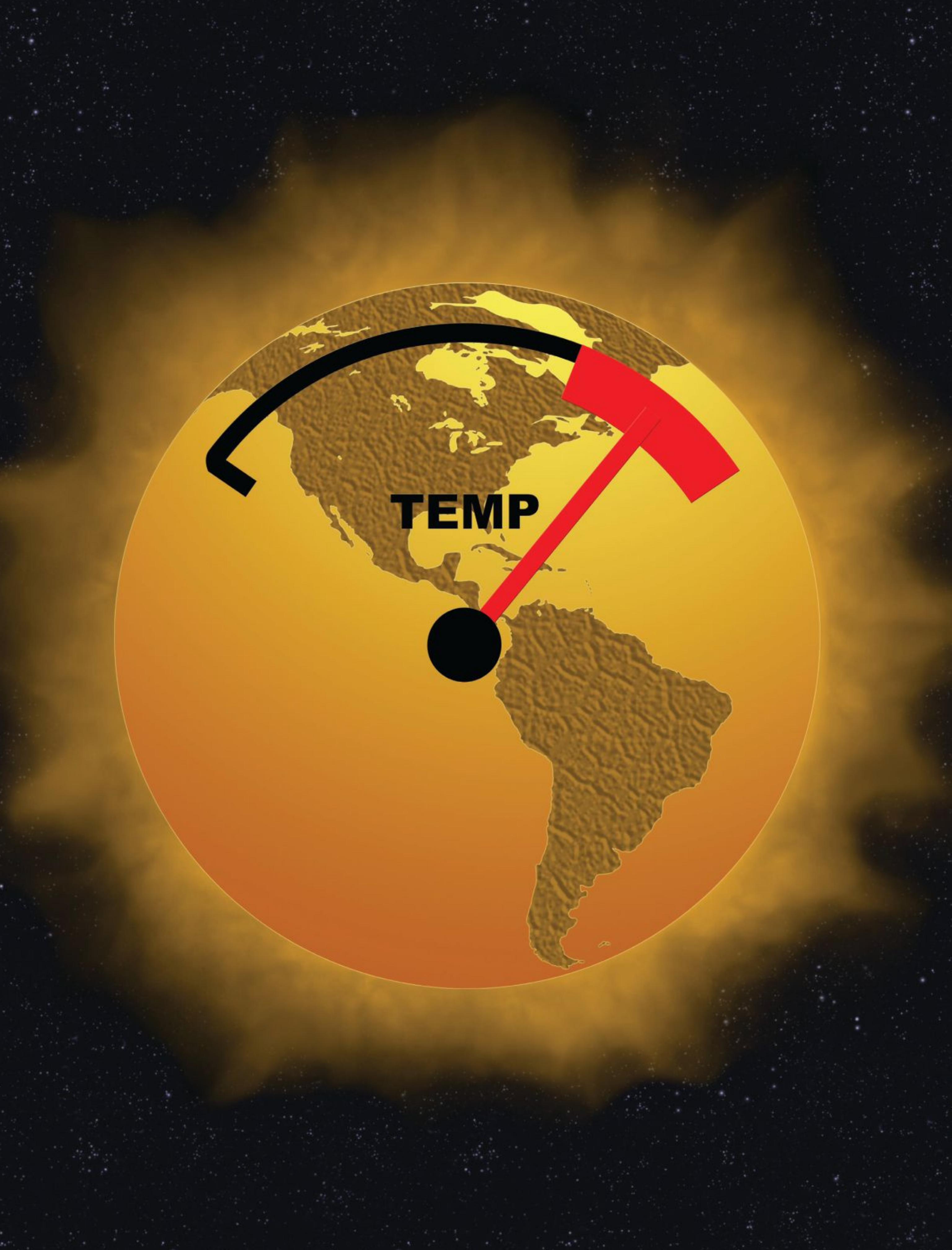
CHRISTOPH PEREIRA,
chief corporate, securities, and finance counsel at GE

Pereira says investor feedback on GE's revamped disclosures has been "very positive," including favorable comments on the summary reports from passive institutional investors. "They don't really do a formal analysis of the company, and they don't have time to go through hours of investor presentations. But they have to make voting decisions every year," he says. The summary reports are "a good tool to quickly bring them up to speed on what's been going on at the company, what's the strategy."

The improved annual report also serves an internal audience. GE has 333,000 employees in more than 180 countries, and it isn't easy to keep everyone abreast of the company's overall goals and strategy. Senior leadership has encouraged employees to read the summary reports, to make sure everyone is on the same page, says Pereira. "GE is a large, complicated company," he says. "To the extent you can unify around clear themes, it's always helpful." CFO

EDWARD TEACH IS EDITOR-IN-CHIEF OF *CFO*.

Courtesy GE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Hot Topic: Climate Change And Insurance

More and more companies are persuaded that climate change is real. So why aren't insurers factoring it into property insurance premiums? **By David McCann**

If you're a doubter on climate change, take notice. ¶ The 2016 edition of the World Economic Forum's annual Global Risks Report lists "failure of climate-change mitigation and adaptation" as the greatest risk facing the world over the next 10 years. That was the collective judgment of 742 surveyed experts and decision makers drawn from business, academia, civil society, and the public sector. ¶ Also, at a November conference in Paris hosted by the United Nations, 195 countries vowed to take actions designed to limit global warming. At press time, a total of 154 U.S. corporations had pledged their support for the United States' effort.

"That global event engaged a lot of corporate leaders," says David Gardiner, a sustainability consultant to businesses and nonprofits and an environmental adviser to the Clinton administration during the 1990s. "Neither countries nor companies take these kinds of public pledges lightly. They know they're going to be held accountable, at least by the public, if they don't do what they said they would."

Indeed, on top of polishing their public image, companies are being good citizens of the world when they pitch in with initiatives like reducing greenhouse-gas emissions, increasing their use of renewable energy, and being more energy efficient.

From a purely business standpoint, considerations of where and how to build facilities (or alter existing ones) to lessen climate risk have moved up the risk management priority list. Such moves can ward off costly business stoppages caused by extreme weather events. Perhaps more significant, on an ongoing basis, they also earn lower property insurance premiums.

That seems to suggest that property insurers are taking climate change into account when underwriting policies. Oddly—at least to those not close to the insurance industry—insurers are not doing so, for the most part.

➸ Business as Usual?

Even with the world increasingly gripped by concern over climate change, and despite insurers looking closely at the implications of a warming planet for their business, the industry appears to be pretty much in business-as-usual mode.

"There is work being done to incorporate climate risk as a reasonable consideration in pricing and reserves as an industry-standard best practice," says Lindene Patton, an attorney and independent consultant who worked for Zurich Insurance for 17 years before leaving in 2014 as chief climate product officer. "But it's not there yet."

Not only is that work "not there yet," there doesn't seem to be a particular sense of urgency to get there.

"It's not presently possible, given the current state of climate science, to take the output of climate-change models and apply them directly to insurance pricing," concurs Bob Hartwig, who as president of the Insurance Information Institute serves as a de facto spokesperson for the industry.

And that's not a huge problem, he suggests, pointing out that regardless of public impressions of climate-change-driven devastation, storms have wreaked relatively little damage to insured property since Superstorm Sandy flooded the Northeast in October 2012. (See graph, next page.)

"Coming out of Paris we heard a lot about the negative consequences of climate change, and very good points were made, but as a very practical consideration, the amount of capital available to insure against natural perils has never in history been as great as it is today," Hartwig says, noting that it's been 10 years since a hurricane last made landfall in Florida.

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That's the kind of talk that is maddening to climate change scientists and activists.

There is great variability from decade to decade in terms of how many tropical storms mature into hurricanes and become damaging landfall events, notes Kathleen Miller, an economist and scientist with the National Center for Atmospheric Research. "People get lulled into a false sense of security when we go through a quiet period," she says. "While there are questions as to the number of hurricanes [there will be over time], results of work done in this area indicate that the ones that do form will be more intense and damaging."

Last October's Hurricane Patricia became the most intense storm on record in the Western Hemisphere just before slamming into the southwestern coast of Mexico. It did not, however, hit a heavily insured area. The same was true of other big storms that have struck Central America and Southeast Asia in the past few years.

"There have been significant losses that don't show up on insurance companies' balance sheets," notes Cynthia McHale, a former underwriter and manager of Accenture's insurance practice, who is now insurance program director at Ceres, a nonprofit sustainability advocate. She adds, "The industry tends to speak in generalities and not engage in deep or complete discussions on the issue of climate change and insurance. We're pushing them to get deeper into it."

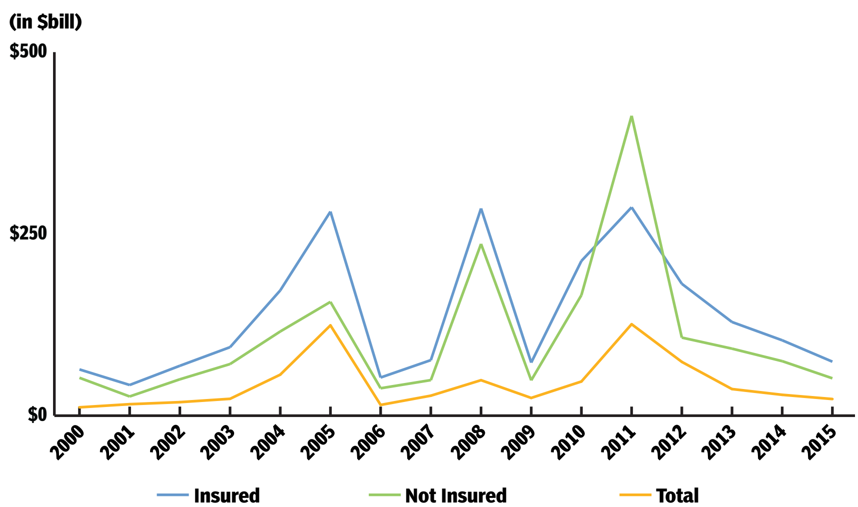
Regardless, the big capital pool Hartwig mentioned has been the driver of falling catastrophe insurance premiums over the past two years. Risk adviser and insurance broker Willis Group Holdings predicted in an October 2015 report that such premiums would decline further this year, by up to 15%.

Even times of heightened extreme-weather activity, such as 2005, a record year for hurricane damage, don't change industry fundamentals. "It's not for the insurance industry to pass moral judgments on climate change," says Hartwig. "It's for insurers to assess their risk and price it accordingly."

Indeed, insurers may not even be trying to take "climate change," per se, into account at all. "The risk is about probable loss, frequency, and severity," says Christopher Smy, global environmental practice leader for Marsh, the world's biggest insurance broker. "They don't necessarily have to label it."

For commercial-property insurance buyers, even if their premiums are not at risk, their credit ratings may be. Standard & Poor's said in an April 2015 report that since 2005 it had identified at least 60 instances where natural catastrophes were the main or a material contributing factor in corporate credit downgrades. "The more frequent extreme climatic events many scientists predict could adversely affect companies' credit profiles," S&P wrote.

Natural Catastrophe Losses, 2000–2015



* Full-year total estimated in December 2015
Source: Swiss Re

Technical Challenges

Just why is it so difficult to incorporate climate risk into property insurance premiums?

It's particularly puzzling given that climate scientists are now able to confidently state that climate change is a probable contributing factor in certain extreme weather events. A report from the American Meteorology Society (AMS) that assessed 2014 weather events identified human-caused climate change as a partial or likely factor in California's wildfires, Argentina's heat wave, droughts in two African areas, and extreme rainfall and heat waves in Europe.

Climate modelers use present and historical weather and climate data, as well as knowledge of atmospheric physics, to create models that can replicate weather patterns of the past. Once a model can do that consistently, it can then be used to more confidently forecast future patterns, explains the editor of the AMS report, Stephanie Herring, a scientist with the National Oceanic and Atmospheric Administration.

But forecasting—beyond the very short term, that is—inevitably is more difficult, particularly when it comes to hurricanes. While there are precipitation records going back more than 100 years and temperature records much older than that, the hurricane observation record did not begin, for all practical purposes, until the satellite era, Herring notes.

Among 76 catastrophe modelers surveyed at the Reinsurance Society of America's 2015 convention, only 6% said they consider climate change in their work more often than "somewhat frequently," and 50% said they rarely or never do so. (See chart, below.)

"There are more technical challenges in using models to replicate hurricane activity in the future," says Herring. "I can imagine what the insurance industry is struggling with."

A Nuanced View

Patton, the former Zurich executive, has a unique perspective on the relationship between climate change and the insurance industry. In addition to being an attorney, she has a degree in biochemistry and a master's in public health with a focus on pollution engineering.

"At Zurich and in my jobs prior to that, I always worked in a space where science, underwriting, and the law met," says Patton, who co-authored a book called *Climate Change and Insurance* that was published by the American Bar Association.

Her background gives rise to a nuanced view on forces that have so far caused climate change to have little impact on property insurance pricing.

Much civil litigation, Patton notes, turns on the concept of what "a reasonable person" would have done, as well as the related concept that personal experience informs what a reasonable person would do.

"That idea is embedded in the fabric of our society," she says. "For example, procurement regulations say you're going to build this bridge or waste-water treatment plant or levee using 1970s rainfall tables, because what happened then is what's going to happen now. There's a socioeconomic structure that's supported by different types of law, like litigation and administrative law, in which the environment is considered consistent.

"So, climate change upends what people in their personal experience know about weather. That's why, in the debate that's been going on for the past 10 years, there's been a focus on challenging the science. How precise is it? How much do we really know?"

Insurance, she points out, in theory is supposed to be an ex ante financial instrument, where insurers over time build up capital to use for paying damages that occur later. But today, the vast majority of property insurance policies carry 12-month terms.

"Pricing is complicated for events that are low-frequency and catastrophic. There is a 'who should pay' question."

» **Lindene Patton, attorney and consultant**

"Pricing is complicated for events that are low-frequency and catastrophic," Patton says. "There is a 'who should pay' question. When regulators evaluate insurers' price projections, they wonder why an insured that has a policy with an insurer in state A for this year, but is planning to move to less-risky state B next year, should pay for a loss that probably won't happen in state A for several years or longer."

The same principle applies to a company that switches to a different insurance carrier with a different risk appetite, she notes.

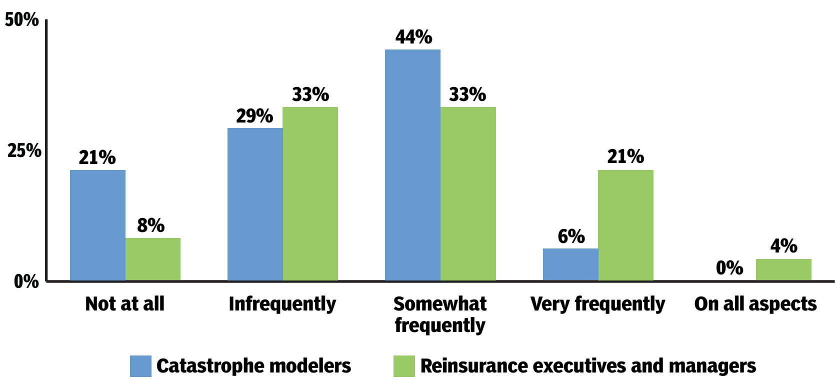
As a related example of the historical-pricing bias and the who-should-pay dilemma, she points to a dispute between New York City electric utility Con Edison and state utility regulators following Superstorm Sandy. The storm caused enormous flood losses in lower Manhattan, including the destruction of some ConEd facilities where expensive transformers were sited. Since all of a utility's costs must be passed through to ratepayers, ConEd submitted a budget that included work to rebuild new transformers several feet higher, which entailed physical restructuring of the facilities.

The regulators balked, saying there was no reasonable evidence that such an event would happen again, says Patton. They wanted ConEd to provide proof of climate change.

Then Columbia University's Sabin Center for Climate Change Law filed

Warming to the Idea

Do you currently consider climate change in your work?



Source: ICF International, survey of 186 reinsurance executives/managers and catastrophe modelers, conducted at the Reinsurance Association of America Conference 2015.

Courtesy Lindene Patton

an intervener claim in the ratemaking, saying that if ConEd rebuilt with transformers in the same locations, it wouldn't be meeting its duty to ratepayers.

So ConEd was able to say to the regulators, in effect: Do you want us to pay the costs to fight this litigation, and pass those on to our customers? Or should we actually pay to respond to climate change? The utility commissioners didn't want to do either of those, so they convened a series of meetings that lasted for months. In the end, ConEd got its way.

"So, who should pay?" says Patton. "In this case, the answer was that consumers should pay, because it's the rational, efficient thing to do in the face of climate change. But it was a big fight because there was no mechanism in the law that governed rate approvals in a way that acknowledged climate change. And it's way more complicated to understand how that might change in the insurance industry than in the utilities industry."

Corporate Influencers on Climate Change (North America)

MOST POSITIVE		MOST NEGATIVE	
Company	**Grade**	**Company**	**Grade**
Tesla	B	Koch Industries	F
Apple	B-	Phillips 66	F
Google	B-	Valero Energy	F
Modelez	B-	Exxon Mobil	E-
Cisco	B-	Comcast	E-

Source: Influence Map, a UK-based nonprofit. Grades are based on how supportive or obstructive companies are on a range of climate policy issues.

Have Catastrophe, Make Money?

Can any part of the insurance industry's slow pace of response to climate change be attributed to willfulness? Could it be that catastrophes are good for business?

Warren Buffett, whose Berkshire Hathaway has an insurance division that contributes a large portion of the conglomerate's income, told shareholders in a February open letter that they don't have much to fear from climate change.

While claims costs have risen dramatically over the years, he wrote, that's been largely a product of inflation. As inflation pushes costs up, they're promptly matched by increased premiums. If catastrophic events do become costlier, "the likely ... effect on Berkshire's insurance business would be to make it larger and more profitable," according to Buffett.

He added, "As a citizen, you may understandably find climate change keeping you up nights. As a homeowner in a low-lying area, you may wish to consider moving. But when you are thinking only as a shareholder of a major insurer, climate change should not be on your list of worries."

Reinsurers, who write policies that help insurance companies pay off on catastrophic claims, have been far more vocal on climate change than their clients.

Swiss Re CEO Michael Lies told a news conference last September that governments should be in front of the issue. "We expect political courage to move in a direction that shows responsibility towards future generations and [an] interest in defending the sustainability of this planet," he said.

Andreas Schraft, managing director for catastrophic perils at Swiss Re, tells *CFO* that the risk of losses is not so much of a concern, because, to Buffett's point, insurers and reinsurers can deal with that year to year by raising prices following catastrophic events.

"What we are concerned about is that if risks become too big, they may become unmeasurable," he says. "That's why we want people to understand the long-term consequences of decisions they make today, so the world is resilient and remains insurable."

For example, companies should be aware that if they build a factory today, it's going to be there, in use, for at least 25 years and probably longer, Schraft says. "We know that as it gets warmer, sea levels will rise even more. If you are on a coast, dams and levees and other flood-protection measures may not be enough." Some coastal cities could indeed become uninsurable at some point, he warns.

Patton, meanwhile, says she can't in good conscience blame the insurance industry for proceeding cautiously.

"People are quick to attribute bad intent, but I don't think there's any here," she says. "Executives who run companies have duties to their shareholders, who expect those executives to run those companies consistently with the rules that apply. They can decide to be more sustainable, but if that will potentially affect business or shareholder returns, they must warn shareholders."

Gardiner, the former Clinton administration adviser, is reluctant to let off insurers too easily, considering the global risks posed by climate change.

"The insurance industry can and should be an advocate for the kinds of policies that reduce climate change risk," he says. "There's hardly a company out there that couldn't be more energy efficient." CFO

DAVID McCANN IS A DEPUTY EDITOR OF *CFO.*

Red Skies And Blue Oceans

First-quarter results from the Duke/*CFO* Business Outlook Survey raise a note of caution.

By David W. Owens

The results of the Duke University/*CFO* Magazine Global Business Outlook survey for the first quarter of 2016 bring to mind the cautionary saying, "Red sky at morning, sailors take warning." Finance and corporate executives in the survey are anxiously scanning the horizon for any signs of the red glow of a new recession. In particular, they are keeping a wary eye fixed on a stubbornly low-growth, low-inflation economic environment.

The survey, which concluded on March 4, generated responses from more than 1,600 finance and corporate executives from companies of all sizes, including 665 executives from the United States and Canada, 169 from Asia, 170 from Europe, 486 from Latin America (including Mexico), and 145 from Africa.

In the United States, executives believe that there is about a 3 in 10 chance that the U.S. economy will be in recession by year-end 2016, double the 16% chance predicted 9 months ago. They see the biggest risks coming primarily from the slowdown in China, and secondarily from economic slowdowns in other emerging economies and in Europe. But executives also are concerned about the uncertainty created by the unusually chaotic run-up to this November's U.S. presidential elections.

These factors presumably underlie the slight downturn in confidence that U.S. executives have in the economy. Their rating of economic confidence dipped slightly in the first quarter, falling to 58.6 on a scale from 0 to 100 after two successive quarters in which it hovered around 60.

U.S. executives' confidence in their own companies held steady at 66 on a scale from 0 to 100. But some warning signs are evident in the first-quarter survey. In particular, inflation remains extremely low—possibly too low. While this means that the U.S. Federal Reserve is reluctant to raise interest rates beyond nearly imperceptible levels, it also means that companies feel handcuffed when it comes to raising their own prices. U.S. executives are not expecting price increases to reach the 1% mark over the next 12 months, constraining the growth outlook.

31%

Average probability U.S. executives give for a new recession in 2016

At the same time, U.S. executives expect wages and salaries to rise by just over 3%, and health costs to rise by 7%. Feeling the squeeze between lower growth and higher costs, expectations for earnings growth have plunged this quarter, as have expectations for dividend payouts.

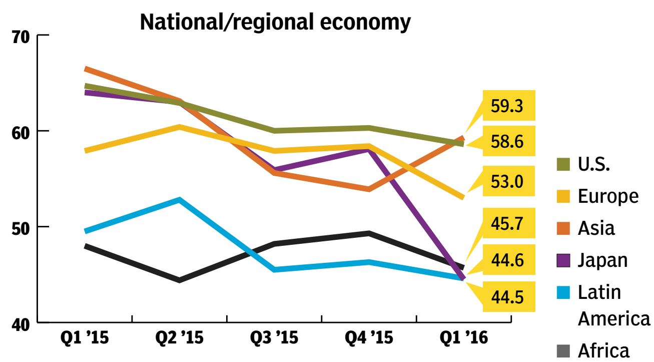
CLOUDY OUTLOOK OVERSEAS

Executives from other parts of the world see similar risks for recession in their own countries. Perhaps most alarmingly, respondents from China peg the chance of recession before year-end at 33%, as do executives from Japanese companies. Capital spending is expected to increase over the next 2 months by only 2% in Japan and 4% in China, compared with about 7% averaged across the rest of Asia.

The confidence of Japanese companies took a

Globally, executives start to see clouds on the horizon

Finance executives rate their optimism about their domestic or regional economy*



*On a scale of 0–100, with 0 being least optimistic

Source for all charts: Duke University/CFO Magazine Global Business Outlook Survey of finance and corporate executives. Responses for the current quarter include 629 from the U.S., 144 from Asia (outside of Japan), 25 from Japan, 170 from Europe, 486 from Latin America (including Mexico), and 145 from Africa.

sharp turn for the worse this quarter, plummeting to 44.5 out of 100—lower even than the outlook in Africa (45.7). Executives from China are more hopeful, boosting the economic outlook rating back to 56.4 from a historical low of 47.7 at the end of 2015.

Similarly in Europe, finance executives assign a 30% chance of recession for their domestic economies by the end of 2016. Optimism about domestic economies declined to an average of 53 out of 100 this quarter, falling off from levels near 60 throughout 2015. European executives expect employment to remain flat over the next 12 months, and wages to grow only at the rate of inflation—an anemic 1.4%.

In Latin America, the situation has grown the most dire in troubled Brazil. There, respondents give the economy a 74% chance of falling into recession by year-end. Economic confidence is extremely low in Brazil and Chile, at about 37 out of 100, and employment levels are expected to contract in both countries.

Economic confidence is much stronger in Mexico (70) and Peru (63). Even so, respondents from Mexico also see a 30% chance of recession this year, similar to levels seen in the United States, Asia, and Europe.

COST CUTTING, COMPETITION, AND BLUE OCEANS

In this quarter's survey, U.S. executives also weighed in on the steps their firms would take to remain competitive in an extended low-inflation environment. Opinion was divided on whether their companies would be helped or hurt by low inflation. When asked to assume that core inflation stayed between 0% and 1% for the foreseeable future, 35% of the respondents thought that the effect on their company would be positive, but 27% thought it would be primarily negative.

Executives from the smaller companies expressed concern that they would fall by the wayside, unable to compete with larger and better capitalized firms. But a little less than half of the respondents (47%) felt that the most severe impact of a low-inflation environment would be to substantially diminish their ability to raise prices to keep pace with rising costs.

In that regard, many respondents fell back on traditional responses to slow growth—cut costs wherever they could. For many, headcount was an obvious target. So, for example, an executive from the financial services industry wrote that his company would "curb and cut back on staff; freeze salary increases and bonuses; and rely more on outsourced staff."

A respondent from the manufacturing sector summed up similar responses from many of his peers when he wrote, "We would work to reduce our operating costs as much as possible, including reducing headcount. We likely would be unable to raise prices, so we would need to be more efficient and effective in production to lower costs."

However, in a market where everybody is doing the same thing, a more forward-looking strategy may well be to do something different. In that regard, a financial services executive advocated for the use of better sales analytics tools, in order to ferret out higher-yielding customers. In the manufacturing arena, a respondent said that his company would take "steps to increase productivity via plant floor automation and re-engineering our products."

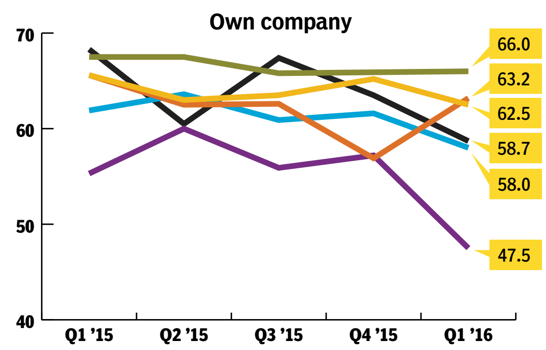
And a few visionaries foresaw the need for a complete change in business model. As one respondent wrote, to beat the competition his company would "need to make our product unique." An executive from the services/consulting sector said that his company would "hire the best and the brightest and continue to pump cash into evolution of our product/service offerings," while one from the wholesale/retail industry would "add a new line of products or services to go along with core products."

And a manufacturer wrote that, after taking advantage of technology to reduce labor costs, his company would also "move more towards value-added manufacturing and away from low-value distribution." Another peer from manufacturing said his company would "develop new products; add value to current products through R&D; extend the customer base; and look for blue oceans"—that is, competitive spaces that can be captured through innovative and unique product offerings rather than through market-share wars.

Such transformations, of course, demand a more aggressive strategic approach, a rigorous focus on implementation, and commitment to looking forward rather than back. For those companies, the time to start thinking about tomorrow is today. CFO

U.S. corporate confidence holds steady

Finance executives rate their optimism about their own companies' financial prospects*



*On a scale of 0–100, with 0 being least optimistic

Finance Innovation For the Future

A recent report from CFO Research suggests five actions to prepare finance professionals for the future.

By Chris Schmidt and David W. Owens

Tomorrow's business world will look different from today's. And it logically follows that tomorrow's finance teams will look different as well. Professionals joining the world of finance can look forward to a career that is more deeply engaged with, and contributes more value to, the businesses they support.

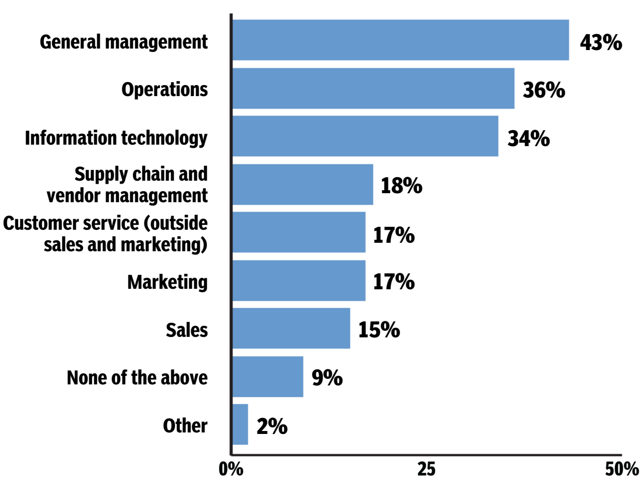
Those were key themes emerging from a recent global survey of more than 1,500 finance professionals in large and midsize firms, conducted by CFO Research and sponsored by SAP. Titled "Thriving in the Digital Economy," the survey sought to gain an understanding of what finance professionals from all levels see as the source of their future success.

With information of all types, structured and unstructured, being generated from more sources than could have been imagined only a short while ago, companies' success will depend increasingly on their ability to capture that data, analyze it, and make immediate decisions under rapidly changing conditions. Eighty-five percent of survey respondents agree that, over the next five years, their companies' success will increasingly depend on their ability to adapt to the rapid pace of change and greater business complexity. For 84% of the respondents, success will also mean being able to translate the flow of data into swift and decisive action.

As a result, companies are increasingly looking to their finance functions to serve as information analyzers, not just data caretakers. To meet these expectations, finance teams of the future will also need to seek out the kinds of sophisticated information tools that can best support them in meeting the new demands they take on.

FIGURE 1

"What other types of work experience are you most likely to seek out, in order to advance in your career?"



Percentage of respondents
Note: Up to three responses allowed.

6%

Percentage of finance executives who report that their company has the capability to employ real-time analytics today.

FIVE WAYS FORWARD

Where exactly does an ambitious finance professional go from here in order to survive and thrive in a changed world? Survey respondents point out five ways to prepare for success.

1. To become a leader, expand your view. Finance professionals are focused on what they need to learn in order to help the business run better, not just their own function. In preparing to take on broader leadership roles within their companies, they want to know the entire business better.

To gain this kind of understanding and advance in their careers, respondents say they are most likely to seek out general management experience (43%) and operations experience (36%). In keeping with the demand for more advanced analytical capabilities and information tools, nearly as many (34%) will seek more experience with information technology. (See Figure 1.)

2. Turn finance into a team of in-

formation analyzers, not data caretakers. Finance professionals at all levels express a clear vision of a more collaborative working environment, where increasingly sophisticated financial analysis is tied directly to swift, decisive business actions. That kind of interconnectivity is likely to grow beyond the virtual walls of a company, touching on external as well as internal partners within the company's extended value chain.

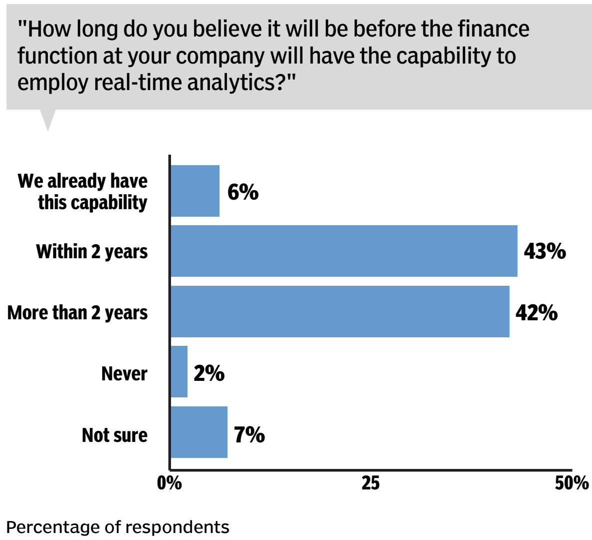
Finance professionals of the future are poised to take on even larger roles in all aspects of value creation for their businesses. To do so, they see a clear need for more collaboration, greater self-sufficiency in their use of technology, and a more forward-looking analytical view. Ultimately, they see themselves transforming from data caretakers to true information analyzers.

3. Adapt technology to a new generation of finance professionals. Survey respondents say that their future success depends on new ways of working that are collaborative, flexible, and up-to-the-minute. To foster this kind of work culture, finance professionals believe their companies must bring their enterprise IT up to the standards that consumer IT—smartphones, tablets, apps—has established for speed, flexibility, and ease of use.

In fact, survey respondents believe that this transformation is required to meet the work needs of a new generation of finance professionals, which expects instant access from anywhere, anytime. Nearly three-quarters (73%) of the survey respondents believe that their companies will be pressured to bring enterprise information systems in line with consumer technologies in order to meet the future challenge of attracting and retaining top finance talent.

4. Transform expectations, and extend the use of advanced analytics throughout all functions. In the future, the finance function's influence throughout the enterprise will be based less on its ability to keep track of the numbers and more on its ability to unpack what those numbers mean for the direction of the business. In fact, respondents say that becoming even more involved with strategy development and execution will be essential for the finance function—along with developing advanced information processing capabilities.

FIGURE 2



As finance's reach becomes longer, there may be an opportunity to expand the use of advanced analytics into even more areas. Respondents say that advanced analytics currently are focused primarily on business analysis/decision support and forecasting, and less so in areas such as production/operations, pricing and sales, and risk management.

However, finance professionals see the potential for a "substantial, measurable financial benefit" from increased use of advanced analytics in virtually any part of a company. That includes back-office areas such as human capital management and IT management.

5. Strengthen your expertise—educate yourself about real-time analytical capabilities. In order to keep up with an increasingly fast-paced decision-making environment, finance professionals know that they will need to employ all the technology tools at their disposal. Advanced technologies will be the platform finance teams can use to vault forward. At the same time, only 6% of respondents report that their finance functions already have real-time analytics available, and fully half of the respondents don't expect to be able to employ real-time analytics for at least two years. (See Figure 2.)

Respondents say that the largest barrier to adopting real-time capabilities is cost (35%), but the next largest number of finance professionals (23%) simply don't think these capabilities are available right now.

In line with their expanding mandate, finance functions will need to be able to evaluate the multitude of technology providers in the market and the diverse range of capabilities they provide. The value of "digitalization," enabled by widespread automation, will no longer be restricted simply to gathering data faster or storing larger volumes of it. Rather, advanced technologies offer the potential for actual transformation of the finance function, and by extension, of the business itself.

The future looks bright for a career in finance. By focusing on the five areas highlighted by this survey, finance professionals can become a "business partner of choice" in their enterprise (as one CFO participating in the research termed it) and fulfill a vision for their own bright future as well. CFO

THE QUIZ

A World of Tax

Although the effective rate for many companies is much lower, finance chiefs still smart over the United States' top marginal corporate income tax rate of 39%, the highest such rate among the 34 countries in the Organization for Economic Cooperation and Development. How much do you know about tax rates in the rest of the world? Take our quiz and find out.

1. This country has the highest corporate income tax rate in the world, 55%:

   A. Chad
   B. United Arab Emirates
   C. Malta
   D. Zambia

2. Among countries with a corporate income tax, these two countries have the lowest marginal corporate tax rate in the world, 8.0%:

   A. Albania and Iraq
   B. Macao and Oman
   C. Paraguay and Qatar
   D. Turkmenistan and Uzbekistan

3. The U.S. is one of four countries that have a corporate tax rate over 35%. How many countries have corporate tax rates between 0% and 20%?

   A. 36
   B. 44
   C. 55
   D. 68

4. Ten countries currently have no general corporate income taxes, including three of the countries below. Which of the countries below does have a corporate income tax?

   A. Bahamas
   B. Bermuda
   C. Bahrain
   D. Montenegro

5. In 2003, the worldwide average top marginal corporate tax rate was about 30%. In 2015, the average rate was approximately:

   A. 19%
   B. 23%
   C. 26%
   D. 29%

6. Rank these regions by average top marginal corporate tax rate, from highest (28.77%) to lowest (18.70%):

   A. Africa
   B. Asia
   C. North America
   D. South America
   E. Europe
   F. Oceania

7. Rank these groups of nations by average top marginal corporate tax rate, from highest (30.70%) to lowest (22.37%):

   A. OECD
   B. G7
   C. EU
   D. BRICS

Source: Tax Foundation, "Corporate Income Tax Rates Around the World, 2015," study of 173 countries and tax jurisdictions

Answers: 1-B; 2-D; 3-D; 4-D; 5-B; 6-A, D, C, F, B, E; 7-B, D, A, C

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