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WORKING CAPITAL: INVENTORIES REQUIRE ATTENTION

GOODBYE TO THE BUDGET

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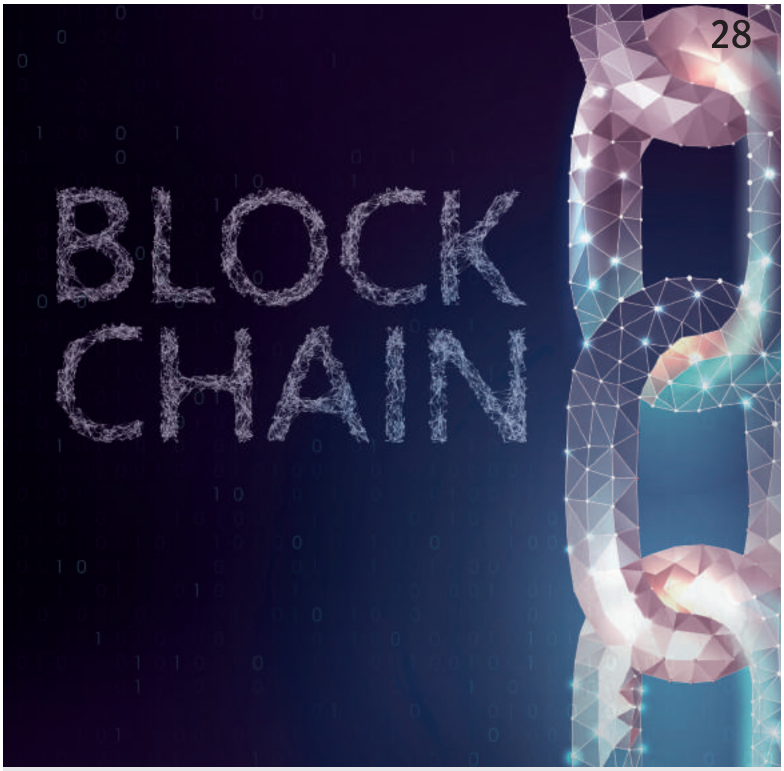

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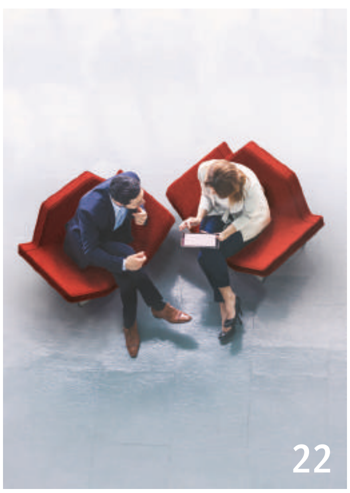

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Up Front

By the Numbers

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FROM THE EDITOR

Cash Needs to Flow

We've been conducting the Working Capital Scorecard, in conjunction with The Hackett Group, for a long time. Unfortunately, when it comes to working capital efficiency, in the last few years the 1,000 largest U.S. companies we track have been rather blasé.

That's not surprising. Sustained low interest rates have meant minimal returns on money market funds, for example, and on the liabilities side, cheap long-term debt. Why bother to squeeze every last dollar of cash from inventories unless the organization is strapped for cash?

The exception to the overall apathy, of course, is days payable outstanding. Average DPO for the scorecard companies has climbed 38% since 2008, to 56.4 days in 2017. (See our story, "The Hard Part of Boosting Liquidity," on page 38.)

Jacking up DPO is easy. In addition, many companies need to match cash outflows with inflows so as not to strain themselves financially. But there are also cash-rich companies that delay payments to their suppliers just because they have the leverage to force protracted payment terms or ignore an invoice.

No doubt the dynamic produces massive cash-flow benefits for the likes of Mondelez (average 2018 DPO, 140 days) and HP Inc. (114 days). But small suppliers would most certainly like the pendulum to swing back a bit, and it did in 2018: average DPO dropped to 54.8 days.

What would get corporate behemoths to go back to paying in 45 days on average, as they did in 2008? One of the forces at work: Artificial intelligence and machine learning are being deployed in integrated receivables solutions for the first time. These tools can help suppliers accept multiple kinds of payments seamlessly, manage some exceptions automatically, and speed up the task of reconciling payments with remittance information.

Technology won't turn the tide, but maybe it will slowly push DPO lower. The tightening effect would cascade through supply chains and funnel cash to small and midsize companies that have the agility to innovate and create jobs. When large companies have accounts payable policies like waiting for two reminders from a supplier before paying an invoice, everyone loses.

Vincent Ryan
Editor-in-Chief

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EDITOR'S PICKS

MANAGEMENT
According to "Want a Better Decision? Plan a Better Meeting," cutting superfluous meetings "is perhaps the single biggest gift to an executive's productivity." What if a meeting is justified? Make sure participants know what kind of meeting it is, the article recommends. Read more on the McKinsey Quarterly website.

TECHNOLOGY
Executives casting about for the causes of digital disruption are probably looking in the wrong place. "Disruption Starts with Unhappy Customers, Not Technology," writes Thales S. Teixeira. Focusing on customer needs and wants, Teixeira claims, is a better response to disruption than chasing merger targets. Read the piece on the Harvard Business Review website.

FINANCE
In "Tesla's Travails: Curfew for a Corporate Teenager?" dean of valuation Aswath Damadoran updates his valuation of the car manufacturer. Damadoran valued Tesla at about half its stock price a year ago, but now says it's undervalued by "a small fraction." Still, he expects the stock to test shareholders' "patience and sanity." Read more at Musings on Markets.

Mark Bennington

INBOX

Our April/May issue featured an article about former Enron CFO **Andy Fastow's efforts at redemption** by speaking out on corporate ethics. In it, he acknowledged that he deserved to go to prison.

He also said he had been "trying to stay within the rules" but "was also, most definitely, trying to be misleading." The article suggested that Fastow believes human nature leads some people to do whatever they can to win, including "bending the rules."

CFO readers were not inclined to be forgiving—either of Fastow or of that choice of words.

"Andy didn't just bend the rules and use loopholes," one reader complained. "He structured deals and lied about side deals. Read his plea agreement. That is not bending."

Agreed another, "What Fastow and Co. did was a lot more than bending the rules. **They intimidated market analysts and manipulated energy in California that led to blackouts**.... Six years [in prison] was not long enough to deter the next Enron lurking out there somewhere. I don't think I would want to be in the same room with him."

A third audience member took a somewhat different take, claiming that Fastow and his colleagues "caused irreparable harm to all finance professionals in the U.S. and even abroad. The imposition of Sarbanes-Oxley, a direct result of the Enron fraud, increased the cost, time, complexity, and personal liability related to the preparation of U.S. financial statements."

An article about Sen. Bernie Sanders and Rep. Alexandria Ocasio-Cortez teaming up on a proposal to cap credit card interest rates provoked another negative reaction.

"Congress has never actually considered how a business will react or the consequences," a reader offered. "For instance, when bank fees and overdrafts were restricted, we saw ... charges for accounts with small balances. Yes, fees are high, yet it is not the percentage rate that is the problem, but people spending beyond their means."

Finally, there was a critical response to a story about the SEC's proposal to exempt small public companies from outside audits of their internal controls for preventing accounting errors and fraud.

"Without reliance on internal controls, **auditors will be forced to perform more substantive testing of transactions** in order to render an opinion," the commenter said. "This may be even more expensive, as the external auditor is not looking to take on more risk."

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STATS OF THE MONTH

HOUSEHOLDS IN DEBT

19
Consecutive quarters in which household debt has been rising*

$1.49 trillion
Total outstanding student loan debt

10.9%
Percent of student debt 90 days or more delinquent

15.09%
Average commercial bank interest rate on all credit cards**

8.3%
Percent of credit card debt 90 days or more delinquent

* As of the first quarter of 2019
** As of February 2019

Source: Federal Reserve Bank of New York. Federal Reserve Bank of St. Louis

TOPLINE

ACCOUNTING

Comments On Accounting Standards Come Too Late

Many wait too long to begin paying attention to proposed standards and communicating concerns. By David McCann

Accounting standard setters had been working on the new revenue recognition standard for more than a decade before the final rules were issued in 2014. There were multiple exposure drafts, so companies had ample opportunity to weigh in with any concerns. Much the same was true for the new lease accounting rules that debuted this year.

But did the preparer community take full advantage of the opportunities to communicate with the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB)?

Not according to panelists at the 18th annual Financial Reporting Conference at Baruch College in New York.

"You don't normally see many companies participating in the standard-setting early on," said KPMG partner Prabhakar Kalavacherla, who was an IASB board member for five years, from early 2009 to late 2013.

"Leaving it to your auditors is not the only solution," he lectured the gathered accounting professionals. "Many times when a standard is revised or amended, in my mind the primary reason is that the standard setters did not get enough information to incorporate in the standard." In the case of the revenue recognition standard, many comments came in when it was too late, he noted.

Similar frustration was expressed by Scott Taub, managing director of Financial Reporting Advisors and a former deputy chief accountant and acting chief accountant at the Securities and Exchange Commission.

He said he talked to companies during implementation of the revenue recognition standard that were surprised at some of the changes they were forced to make to their accounting.

According to Taub, they said things like "nobody ever complained about our accounting in this area before, so why do we have to change?" and "why didn't anybody tell us this was coming?" Some of these companies hadn't even read the FASB exposure drafts, he noted.

Officials from one client company told Taub they didn't feel they should comment, because they had input on only three of the two dozen-plus questions standard setters had posed. Taub cajoled them to write in, and finally they did, adding their voices to some others in their industry that had similar concerns.

"As it happened, FASB and IASB agreed with them," Taub said. "The final standard took the approach this company wanted. I'm not sure FASB would have made that change if a few companies that initially had been reluctant to send a comment letter hadn't finally gotten the nerve to do so." He added, "It's not like you have to write a book in order to have your comments heard."

Amie Thuener, the chief accountant at Google, offered a view that in particular standard setters don't receive enough input on the cost-benefit equation of complying with new standards. She said she's more than once heard post-effective-date comments from FASB along the lines of "we didn't know that was going to be hard for you, that you didn't have access to this data."

According to Mark LaMonte, a former managing director at Moody's Investors Service, not only preparers but also financial statement users may drag their feet when it comes to commenting on proposed standards. "The users are often very late to the game in terms of understanding the impact of new accounting standards," he said. "FASB is certainly making efforts in terms of more user-focused outreach."

For his part, Taub indicated he was a big fan of the new revenue recognition standard. "It's frankly a lot easier to answer questions on revenue recognition now," he said. "Under old GAAP, I used to start my answers with, 'Well, that's not actually covered in the literature, but here's how those of us in the secret society have figured out how to do this.' Now, in all cases, we know what principles are supposed to apply." CFO

"The users are often very late to the game in terms of understanding the impact of new accounting standards. FASB is certainly making efforts in terms of more user-focused outreach."

—Mark LaMonte, former managing director, Moody's Investors Service

CYBERSECURITY

Scammers Target ACH Transactions

Now even this supposedly safer transaction method is under greater siege.

Automated clearinghouse (ACH) transactions are often considered safer and more difficult to compromise than paper checks and wire transfers, but that reputation might not last.

In 2018, 33% of organizations were subject to ACH debit fraud and 20% to ACH credit fraud, both up several percentage points from 2017, according to an Association for Financial Professionals survey of 600-plus treasury and finance executives. What's more, ACH was the only payment method that experienced a year-over-year increase in the percentage of companies that experienced instances of fraud.

"This new development indicates that fraudsters are now trying to use ACH transactions as vehicles for their scams as they move away from checks and wires," according to the AFP report. ACH transactions, of course, are increasingly popular and are cheaper than wire transfers.

How are fraudsters stealing ACH funds? In many instances, "it is usually not the payment method itself that is compromised but the processes leading up to payment initiation," the AFP explained.

Overall payments fraud using account takeovers—in which a scammer illegally gets access to a bank or online e-commerce account—is up, which could also partly explain the increase in ACH frauds, said the AFP. Most accounting systems only require a routing number and an account number to initiate a payment.

Business email compromise (BEC) schemes that target individuals responsible for payments through social engineering and other methods were the way 33% of respondents said fraudsters accessed ACH credits (a direct payment pushing funds into an account) in 2018, up from 12% in 2017.

What measures are companies taking to combat such fraud? Reconciling accounts daily to identify and return unauthorized ACH debits (a direct payment that pulls funds from an account) wass the most commonly used, by 65% of respondents. About 63% blocked all ACH debits except on a single account set up with ACH debit filter/ACH positive pay, and 37% blocked ACH debits on all accounts. | VINCENT RYAN

Getty Images

TOPLINE

HEALTH BENEFITS

Do ‘Well-Being’ Programs Earn Their Keep?

The seemingly unending debate about the worth of employer-sponsored wellness and well-being programs didn’t get any closer to a resolution as a result of two studies released in April.

A survey of 164 large companies by the National Business Group on Health and Fidelity Investments revealed that the average per-employee financial incentive to participate in such programs is $762 in 2019. That’s down a tick from $784 last year, but nearly three times the 2009 figure of $260.

Also, 82% of the surveyed employers, all of which offer at least one well-being program, said they planned to continue or expand incentives over the next three to five years.

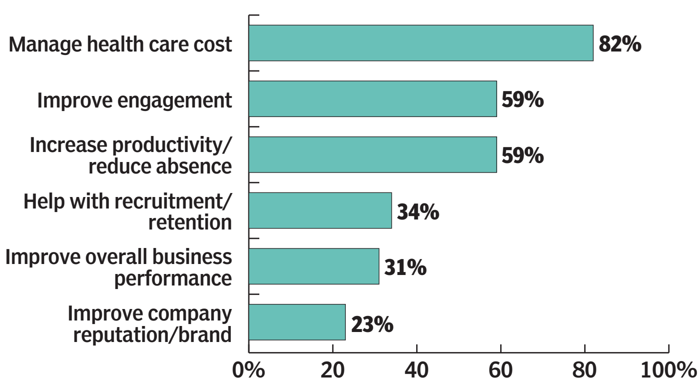
However, another study, by Zirui Song of Harvard Medical School and Katherine Baicker of the University of Chicago, offered a discouraging picture of wellness programs.

The research involved 32,974 employees of BJ’s Wholesale Club. Those at worksites offering the company’s wellness program did report some positive health behaviors: an 8.3 percentage-point higher rate of engaging in regular exercise and a 13.6 percentage-point higher rate of actively managing their weight, compared with employees at other worksites.

But there were no significant differences in other self-reported health and behaviors, clinical markers of health, or health care spending or utilization after 19 months, the study said.

The report concluded that despite employers’ increasing investment in wellness programs, “there is little experimental evidence” of such effects. | **D.M.**

Why Have A Well-Being Program?*



*Ranked by survey respondents as first or second most important objectives among the six areas of focus

Source: National Business Group on Health and Fidelity Investments, survey of 164 large companies

CAPITAL MARKETS

New Stock Exchange for Startups

The U.S. Securities and Exchange Commission has approved a new Silicon Valley stock exchange that could enable tech companies to go public more quickly while giving them time to develop products and services.

The Long-Term Stock Exchange, backed by Silicon Valley heavyweights including venture capitalist Marc Andreessen, would become the country’s 14th equity securities market.

The approval “advances our vision of a new way of being public for a generation of companies that aspire to build their businesses and generate value for decades to come,” said Zoran Perkov, the LTSE’s chief executive.

The LTSE touts itself as a market that would “help companies build lasting businesses and empower long term-focused investors by creating an ecosystem in which businesses are built to last.”

Many U.S. technology firms are unhappy with the arduous process of going public. Many wait for a decade, or more, to avoid the pressure to achieve short-term results and the expense of achieving sustainable growth.

The stock exchange was proposed in November 2018 by technology entrepreneur and startup adviser Eric Ries, who raised $19 million in venture capital to launch the project.

The Council of Institutional Investors declined to support the LTSE’s registration application, citing, among other things, the exchange’s proposal to give shareholders more voting power the longer they hold a stock.

The LTSE expects to begin accepting listings and trading later this year after completing administrative and technical steps. | **MATTHEW HELLER**

Getty Images

CAREERS

'Plan B' for Hiring Biotech CFOs

An explosion in the number of publicly traded biotech companies, combined with their strong preference for hiring from within the life sciences industry, has put intense pressure on the biotech CFO market, says recruiting firm Russell Reynolds Associates.

Not only do biotechs want someone with life sciences experience, they also want a sitting CFO in that field who has IPO experience, according to Russell Reynolds.

The insularity that marks the biotech sector is exemplified by the average 15.4 years of industry experience among its current finance chiefs, Russell Reynolds reports. Among their "comparable peers" at S&P 500 companies, the next-most-insular industry is industrials, where CFOs have an average of 8.3 years of industry experience.

Reality portrays just how unrealistic biotechs' view of an ideal CFO is: 62% of finance chiefs at public companies in the sector were first-time CFOs when they took their current job, according to Russell Reynolds.

That still trails the 75% of non-biotech finance chiefs who were hired into the role with no experience.

When a biotech isn't able to hire the precise kind of CFO it prefers, where else should it turn?

"Targeting senior finance leaders within large pharmaceutical companies known for developing their finance talent can be a good place to look," the recruiting firm says. "Additionally, prior experience in investor relations, investment banking, or internal leadership roles that require selling ideas to senior executives and boards are strong foundational experiences."

And while investment banking has long been considered "a fertile hunting ground" for biotech CFOs, the firms "are increasingly open to considering equity research analysts and corporate development officers," says Russell Reynolds. | D.M.

LEADERSHIP

CFO Role Gets Tougher

Most CFOs likely would agree that the job has only gotten tougher in recent years. While that's a subjective viewpoint, a new analysis may offer some objective evidence for the statement.

Using publicly available information, KPMG studied the backgrounds and experience of the CFOs at 100 technology and communications companies globally, as well as the immediately prior finance chiefs at the 75 companies for which such information was available.

The chosen sectors are "currently at the front of digital disruption, where continuous change, constant adaptation, and rapid innovation have become part of everyday life," KPMG wrote. It added that the sectors "offer very relevant learnings for other industries that have yet to feel the full force of digitization."

Here are some notable differences between the current and former CFOs:

• 79% of the sitting finance chiefs were external hires, compared with 58% of the prior ones.

• 40% of the existing CFOs had "strategy experience" prior to taking the job, against 24% of the former ones.

• 36% of the new-generation finance chiefs had prior operating experience, where the same was true for just 20% of the ex-CFOs.

KPMG defined "outperforming" finance chiefs as those who satisfied two criteria: (1) their company outperformed the NASDAQ composite index during the CFO's tenure and (2) the CFO either remained in the role for at least five years or moved up to a new, higher-level role.

While the overall outperformance rate was 41% for the entire dataset, it was 50% for finance chiefs with prior operating experience.

KPMG advised aspiring CFOs to "consider a lateral move outside the finance function to build strategic and operational experience prior to pursuing a CFO role." The firm further recommended that candidates "be willing to look outside of their company, and even their sector, to accelerate their career path." | D.M.

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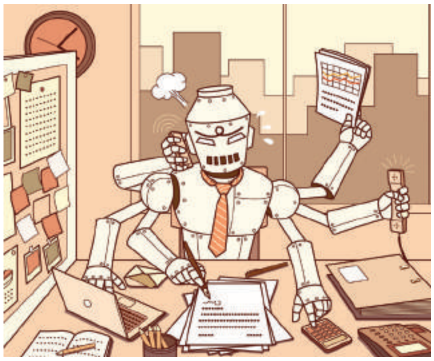
TECHNOLOGY

Advanced Tech Takes Over Finance



It would surprise no one to hear that finance functions are increasingly employing automation and advanced technologies. Even so, the pace of adoption is eye-opening.

A survey by Grant Thornton and CFO Research asked 378 senior finance executives about their usage of advanced analytics; artificial intelligence (AI); blockchain and distributed ledger; drones/robots; machine learning; optical character recognition; and robotic process automation (RPA).

The research revealed that for just about every key finance discipline, the use of one or more such technologies has shot up in just the past 12 months.

In a similar survey a year ago, 25% of respondents said they were using advanced or automated tools for budgeting and forecasting. In the new survey, 42% said the same. The trend surely will continue, as 90% of those surveyed—all at companies with at least $100 million in revenue—indicated they expected to do so within two years.

For accounts payable/receivable, the rate of usage swelled from 35% in 2018 to 47% this year; the proportion is expected to reach 91% by 2021.

For some disciplines, the rate of advanced-technology usage this year is double—or more—what it was last year. That's the case for corporate development/strategic planning (rising from 18% to 42%) and risk management (from 20% to 40%). Those figures were forecast to be 83% and 81%, respectively, two years from now.

Significant upward trend lines were also found for financial planning and analysis, financial reporting and controls, tax and compliance, and treasury/working capital management.

Among the individual technology categories, the usage rate of both AI and RPA jumped from 7% in 2018 to 25% this year. Similarly, machine learning went from 8% to 30%.

Almost 4 in 10 (38%) respondents deployed advanced analytics, up from 24% a year ago. | D.M.

COST MANAGEMENT

Cost-Reduction Mentality Shifts

The strategic mindset behind cost-reduction efforts has shifted over the past two years, a new report asserts.

In Deloitte's first biennial global cost survey, in 2017, respondents were in "save-to-grow" mode, with companies typically using cost reduction to help fund growth initiatives in an improving economy.

The latest survey of 1,219 executives worldwide reveals evidence of companies evolving into what Deloitte calls a "save-to-transform" mindset.

Savings are being invested in transformative technologies and infrastructure that can both (1) drive operational efficiencies that bring additional cost savings and (2) allow companies to compete more effectively in an increasingly digital business environment, the report says.

Yet reducing costs seems to still be the top reason for implementing new technologies.

That's as one might expect for robotic process automation, with 80% of respondents citing the impact on cost as a reason for implementing it.

48% of companies have attacked costs over the past two years by developing or implementing automation.

But cost is the top rationale even for using artificial intelligence and cognitive technologies: 76% cited it as a reason for implementing, compared with 59% for enhancing product/service capabilities and 56% for increasing revenue.

"Companies that relied on more traditional cost management methods in the past are now finding that digital solutions can open the door to a whole new level of savings," Deloitte's report says.

The research showed that more companies have attacked costs over the past two years by developing or implementing automation (48%), AI/cognitive technologies (42%), or improved ERP infrastructure (41%) than deploying traditional cost management practices.

The traditional practices include implementing new policies and procedures or strengthening compliance mechanisms (41%), creating new positions to drive cost management (34%), and improving processes for forecasting, budgeting, and reporting (34%). | D.M.

Getty Images

HUMAN CAPITAL

Gig Workers Aren't Employees

The U.S. Department of Labor said that service providers working for an unidentified virtual marketplace company were independent contractors rather than employees and should be treated as such under the Fair Labor Standards Act.

The DOL's opinion came in an April 29 letter in response to a question from counsel for the company, which operates in the "on-demand" or "sharing" economy. The letter applies only to one, unnamed company but is seen as an indicator of how the department will decide how workers in the gig economy should be classified.

The DOL said it considered the degree of the potential employer's control over workers in determining their classification, citing the fact that gig economy workers can work for competitors and have highly flexible shifts.

Additionally, the DOL pointed out that the relationship between the virtual marketplace and the workers was not permanent; that the company does not invest in facilities, equipment, or helpers on behalf of the workers; and that the workers do not receive a predetermined amount of compensation.

The agency's opinion comes as rideshare companies Uber and Lyft and house-cleaning company Handy face lawsuits over their classification of workers as independent contractors. Platforms that classify workers as employees would be responsible for health insurance and would be forced to follow federal minimum wage laws.

And workers classified as employees are up to 30% more expensive than contractors, according to some studies.

Backing the virtual marketplace's belief that its workers were independent contractors, the DOL noted that the contractors in question "are able to work full-time in [the company's] virtual marketplace, but most of them choose not to do so, which may indicate that they are pursuing other jobs outside the company's platform." | **WILLIAM SPROUSE**

STRATEGY

For Aflac, Slow Growth Means Extra Cash Flow

And for CFO Fred Crawford, investing the excess cash means weighing opportunities against the baseline return afforded by stock buybacks. By David McCann

Start-up companies are well known for operating in the red during their early growth phases as they spend heavily on sales, marketing, and research and development to establish strong positions in their markets. Then, at some point in their success journey, they may lower the percentage of revenue directed toward those efforts and begin to turn a profit, albeit while growing more slowly.

But in some cases even mature, long-established companies are able to rake in profitable cash when in low-growth mode. Such is often true for insurance companies. It's very much so for Aflac, the leader in the supplemental insurance space in the world's two largest insurance markets, the United States and Japan.

"The bad news for a mature insurance business is that the topline struggles to grow," says Fred Crawford, Aflac's CFO. "The good news is that when the growth rate slows, cash flow and capital generation pick up substantially."

Speaking to the growth challenge, Crawford notes that Aflac has roughly 26 million outstanding insurance policies in Japan, about 6% of which lapse each year. The situation is even tighter in the United States: 13 million policies, with 20% to 22% of them lapsing annually. "You have to have one heck of a sales engine to keep pace with that and actually grow," he says.

But why does slow growth stimulate profitability? It's because of the acquisition costs for newly booked

Fred Crawford

policies and the cash reserves that must be set aside in respect of potential future claims under the policies.

Those expenses are recouped from clients' premium payments over several years. When the up-front costs decline and premium revenue from policies booked in previous, higher-growth times is strong, cash piles up.

Aflac is currently generating about $2.5 billion of excess cash flow per year, Crawford notes. About $800 million of that goes toward the company's annual increase in its common stock dividend, which it has been providing to investors for 36 years.

As for the rest, Crawford says his investment strategy is guided by "where we can generate the greatest risk-adjusted long-term returns on that capital."

"Executives have known for a long time that there is a high correlation between strong performance and a diverse workforce."

—Fred Crawford, CFO, Aflac

Buying back company stock is a very low-risk way to deploy capital, the CFO notes. While the absolute return may be relatively modest, the risk-adjusted return is much higher. That makes buybacks a commonly employed investment vehicle.

At the same time, buybacks are "the basis against which other investment alternatives compete," says Crawford, whether they're technology investments, acquisitions, or venture capital bets.

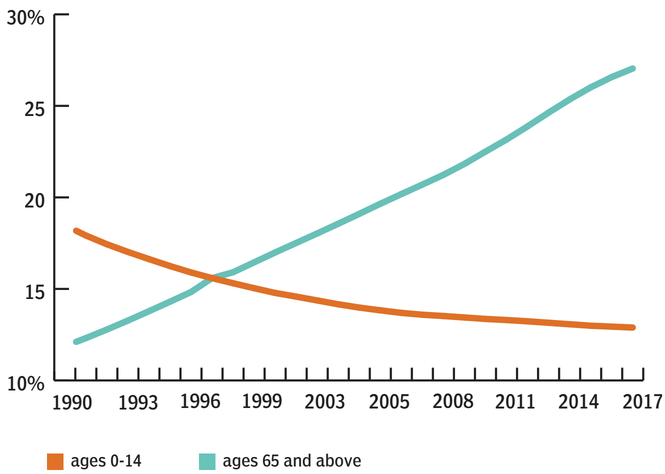
"A share repurchase is a solid, sound investment of excess capital," he says. "But if it's not balanced by investing in growth, your [overall] investment return will not turn out to be what you had hoped. The stock price is not going to grow over the long term just on the back of share repurchases."

Courtesy of Aflac

Japan's Aging Population

The country's rapidly aging population makes growth challenging for Aflac.

Japan's population from 1990-2017 (percent of total)



Source: World Bank

Most (98%) of Aflac's business in the United States is with employers, which offer its supplemental insurance products to employees through their benefits programs.

Conversely, in Japan, the company sells directly to individuals and families. There is a single-payer national health insurance (NHI) program for citizens and permanent residents that don't receive coverage through employers, but it pays for only a portion of members' health-care costs.

That helps make the market golden for Aflac. Approximately 75% of the company's overall business comes from the Asian country. NHI pays for more and more of members' health care needs as they age, but the payouts never reach 100% of expenditures. Most working-age Japanese adults, meanwhile, must pay a significant share of their costs, making that a good market for Aflac, too.

But demographics in the Japanese market are dynamic, even if they always shift in the same direction, given Japan's famously aging population. "The aging population and the [corresponding] shrinkage of the workforce make growth that much more challenging," says Crawford.

He adds, though, that there are some "natural catalysts" for Aflac's business in Japan. For one, while the population is aging, it's very aware of the value proposition of health insurance. Second, the Japanese government is slowly shifting more of the health-care cost burden to the population, widening the gap between what's covered and what's out-of-pocket.

Of course, that's not just a Japanese phenomenon. "Undoubtedly some version of that type of pressure will be faced in the U.S. too, as we look at the affordability of health-care coverage and what employers might take on, or not take on, to fight health-care inflation," Crawford notes. "We'll come in and fill those gaps."

Scattershooting

Crawford touched on some other notable topics:

Aflac's 2018 abandonment of quarterly guidance. The company is now providing only annual guidance.

Aflac's argument against quarterly guidance is its potential to create a short-term mentality among both company management and investors.

"It's not like there's a group of short-term investors that just look for companies that give quarterly guidance," Crawford says. "It's more that it creates a dialogue with investors around the next quarter, which can suck the oxygen out of the room in terms of talking about the company's longer-range strategies."

He added that Aflac has experienced no negative reaction from investors or analysts over its decision to reduce guidance frequency.

The financial value of diversity. "Executives have known for a long time that there is a high correlation between strong performance and a diverse workforce," says Crawford. "If we have 13 million policies in the U.S., we have by definition a very diverse customer population. If we're not diverse, we'll be less able to understand and serve them."

Japan, he notes, is not a particularly diverse society. But one response to the country's shrinking workforce has been an elevation of more women into companies' senior ranks.

"The government realizes that this can support economic development and growth in Japan, and they need to do that any way they can," the CFO says. "This thinking has emanated from the [Prime Minister Shinzo] Abe administration down into the corporate ranks."

Digital transformation. Crawford doesn't like such terms. "If I hear yet another company talking about its digital journey, I think I'm going to scream," he says.

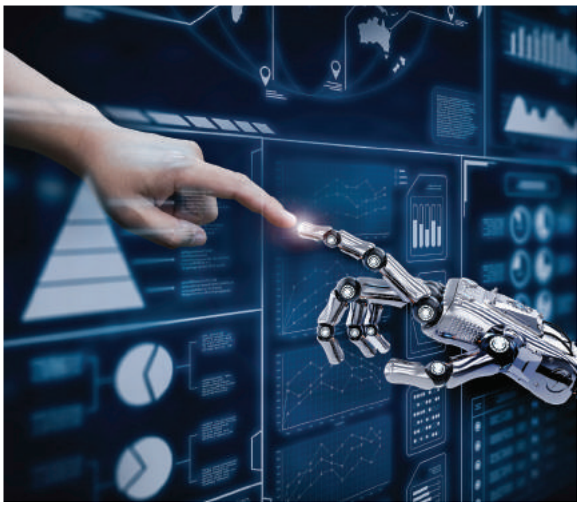
He says he went through a phase where he didn't want to talk to investors about the company's digital efforts until he fully understood them. He eventually gained that knowledge as digital teams created maps detailing each component of a customer's interactions with Aflac, and did the same for interactions agents and brokers.

"In those steps are where you find the pain points," Crawford says. "Digital is not about seeing something and thinking 'it's cool I can do this.' It's about taking something that is painful for [a stakeholder] and shrinking the pain. That's the way to think about digital." CFO

Release the Bots

The new finance chief at RPA firm UiPath, Marie Myers, was an enthusiastic user of robotic software in her previous job as global controller at HP. By David McCann

There are three dominant players in the burgeoning robotic process automation sector, which is increasingly providing potentially game-changing efficiency tools, mostly for large companies. ¶ Blue Prism, the oldest and original market leader, coined the term "robotic automation" in 2012. Automation Anywhere emerged several years ago as its top competitor.



But the youngest member of the triumvirate, UiPath, has lately caught up with the others and is now the fastest-growing. In January, the company hired Marie Myers, one of its early enterprise users and a strong RPA advocate, to be its new CFO.

"I came to this job because I really love RPA," says Myers says, who had been global controller at HP Inc. "I had other offers, but I turned them all down—I didn't want to be the CFO of a hardware company or a plumbing company. Scaling for growth is a big challenge, but I wake up in the morning excited, even though I know it's going to be a long, tough day."

She views RPA as something that will improve the workplace and workers' lives. Part of what's on her mind with regard to that is her three kids.

"After I graduated with my third university degree, I got a job as an analyst, but I worked 14-hour days and did a lot of cutting-and-pasting," she says. "Now, imagine a world in which I could have worked half the hours but done interesting and meaningful work, with all that manual stuff gone from my plate. That could be the life of my kids."

During a recent visit at *CFO*'s New York office, Myers talked about dealing with hyper-growth, UiPath's strategies, emerging trends in the RPA space, and her views on the robotics software market. An edited transcript of the conversation follows.

What's required to scale the company for the kind of growth it's envisioning?
The challenge is getting the team wired for what that requires and then building out the company's operational underbelly. We've already scaled from basically zero; we hit $175 million in annual recurring revenue at the end of 2018 and we see a very fast growth trajectory for 2019 and 2020.

Before you came to UiPath, it was your job to deploy RPA at a company. Your new job probably requires you to have a bigger-picture view of the RPA space. Where are you on that curve?
Well along. I had done RFPs with all three major vendors. Right now, most companies are just scratching the surface on RPA. They're in the proof-of-concept stage, with maybe three or five bots in the organization. Very few have gone to an enterprise scale with bots, where they're either deploying hundreds of them to run parts of the company or providing a [dedicated] bot for each employee.

A bot for each employee? I've only thought of bots as automating various processes, not being deployed on a per-employee basis.
Think about what you do in your day. I'm sure there are manual tasks, whether it's cutting and pasting data from a spreadsheet, or maybe cutting and pasting voice transcripts into documents as text. Or even just sending automated birthday cards or filling out your gym schedule.

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There are only a handful of companies in the world that are thinking very creatively around how RPA can be a key element of their digital transformation. A few are looking at enabling each employee in order to raise their level of digital literacy and understand how to use these digital tools.

I think that shows how broad the market can be. It started with desktop automation many years ago. That was the genesis of the [business process outsourcing] industry, where a lot of labor was moved to lower-cost markets. That has matured into RPA, which replaces a lot of that manual work performed by humans.

Could that particular creative use of bots, deploying them on a per-employee basis, take off and become a major trend?
Absolutely. Just the way touch-screen on cell phones did. Initially, bots weren't seen as enablers. In fact, they were viewed somewhat negatively, as something that would take away people's jobs.

It hasn't been that way in, for example, Japan. People there are more comfortable with bots being part of workflows. There is a more mature perception developing that RPA can really change the way work is done.

I have a bot on my laptop. I hit the run button in the morning and it performs a number of functions. For example, it scans my email, runs some sensitivity analysis, and pops to the top the most important messages. It runs through expense reports that need to be approved. So it helps to prioritize the tasks of my day.

So there are various tasks that bots are programmed to perform automatically and others that you can instruct them to do at a particular point in time?
Exactly. That's the difference between what's called attended and unattended bots.

"Scaling for growth is a big challenge, but I wake up in the morning excited, even though I know it's going to be a long, tough day."
—Marie Myers, CFO, UiPath

Is there a level of reskilling and retraining that's required to make this successful?
Yes. You can't just plug and play. Someone who has been doing a routine job can't just wake up the next morning enabled. But I think most folks in finance have a level of education where they can think about this as an opportunity.

Looking again at Japan, it's a very mature country with a significant shortage of workers. They see RPA as a productivity lever. It's not a unique case, but it's a good one to study because it provides insight into the kind of transformation that can happen.

What do you think the relationship between RPA and AI will be? Will AI absorb RPA? Or is RPA destined to become more AI-like?
I see RPA as a gateway to enabling AI. In the beginning, RPA was kind of bespoke software on people's desktops and laptops. In the past few years, it's come along as an automated platform not only for the development of bots but also for the ability to govern and monitor [automation].

AI is kind of where desktop automation was a decade ago. The models again are bespoke, although they're sitting in the cloud or on servers. You don't necessarily have robustness in terms of inputs, governance, and controls. But RPA can be applied very scalably to managing AI. We're working on exactly that product right now, where you'll be able to bolt AI components onto RPA.

That's important from a finance perspective. You don't want to be relying on AI for elements of your financial processes, cybersecurity, or IT infrastructure without robust governance and controls.

You mentioned earlier that few companies right now view RPA as the linchpin to a broad digital transformation. What is the event or thought process that has to happen to trigger a move toward that broader usage?
Thinking about my own journey, it started when there was significant pressure on results. When there's an operating cost issue on the table and the company needs to think through a massive transformation, some of the traditional tools won't work anymore. What makes RPA attractive for that purpose is that it's fairly easy to implement and adopt at a low cost.

Aside from scaling, are there any notable challenges or strategies that might be unique to UiPath or to the RPA space?
First of all, I'm dealing with a new category. How do you define it to analysts and investors? What do the KPIs of success look like? There are a set of KPIs for measuring the performance of SaaS companies, but we're not really a SaaS company.

Then there's building the financial acumen—the business telemetry that feels right for the category, without getting too much into predefining what we should do based on what everybody else thinks is right.

You can take a classic business model and apply it to this model, and you might get it wrong. That makes me stay up late at night and think. Try to build a predictive model when you have only two years' worth of history. Is that enough to base a forecast on? How useful is the traditional finance mindset of a three-year plan? CFO

Courtesy of the author

TECHNOLOGY

A 10-Step Plan for Digitally Transforming a Company

In his new book, technology icon Tom Siebel offers a road map for staying relevant during this era of exploding innovation. By David McCann

Most of us have a mental image of technology's development curve as an unbroken and progressively steep incline. ¶ That's not the way Tom Siebel sees it. The billionaire entrepreneur—who famously founded Siebel Systems and built it into the premier customer relationship management vendor in the 1990s before selling the company to Oracle in 2006—sees the curve as more resembling a flight of stairs.

To be sure, Siebel, who recently visited *CFO*'s New York office, comes across as second to no one in his amazement at the degree of technological advancement that's transpired over the past 30 years.

But in his view, the bulk of the transformation has come about in short bursts of innovation, or "punctuations" that often occur in response to an environmental trigger, followed by periods of equilibrium.

"In the technology world, we often think about Moore's Law providing the foundation for constantly increasing change, much like Darwinian evolution's constant accumulation of change. But that's not the way revolutionary evolution works," Siebel writes in his new book, "Digital Transformation: Survive and Thrive in an Era of Mass Extinction," scheduled to be published on July 9 by RosettaBooks.

Recent technological innovation explosions followed the advent of personal computers in the 1980s and the internet in the 1990s. But don't ask Siebel about the dawn of social media, which he says, somewhat hyperbolically, will go down as "the single most destructive event in the history of civilization."

We're amidst an even more profound innovation explosion right now, he contends, pointing to the intersection of elastic cloud computing (think Amazon Web Services, Microsoft Azure, and Google Cloud), big data, artificial intelligence, and the internet of things.

Currently the CEO of C3.ai, which provides a technology stack designed to facilitate digital transformation, Siebel compares the histories of both technological and industrial development to that of living species.

In the time since life developed on Earth, there have been at least four mass extinctions of species, the last occurring 65 million years ago after a meteor slammed into the Yucatan Peninsula. In each case, the extinction event preceded a short period of vigorous, renewed speciation—most notably the Cambrian Explosion about 500 million years ago, when most major animal phyla first appeared in the fossil record—that gave way to a longer period of relative stasis.

Today's corporate world, the book points out, is in the middle of its own mass extinction: 52% of the Fortune 500 companies in 2000 have since been either acquired, merged, or declared bankrupt. Siebel quotes former Cisco Systems CEO John Chambers suggesting upon his 2015 retirement that 40% of businesses would "not exist in a meaningful way" within 10 years.

Amid the demise of so many long-lived corporate icons comes a vast new crop of innovative technologies that are challenging the still-existing companies to give themselves a complete makeover.

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Siebel doesn't hold back when articulating the extent of the change that's at hand. "I think it's as big as, or bigger and more impactful than, the industrial revolution was," he tells *CFO*.

In the book he writes that companies "must recognize when an existing model has run its course, and evolve.... They must build something that will establish a clear existential advantage in order to survive into the new stasis and prosper."

Companies that survive the current punctuation "will completely reinvent the way society, technology, and industry relate to one another," Siebel writes. "The resulting diversity of innovation is likely to be just as extraordinary as aerobic respiration, the Cambrian Explosion, and the human race."

Siebel notes that companies most often embark on a digital transformation effort at the insistence of their CEOs. But not all CFOs are on board, he adds.

"A lot of CEOs are just hanging onto their jobs until they retire in a few years," he tells *CFO*. "It's sad. They're not really interested in what's in the best interest of the shareholders or the best interest of the country."

For those who do care, the book offers a 10-point action plan for CEOs:

1. Marshall the CXO team as the digital transformation engine. A leadership team committed to the digital agenda is "an absolute requirement and a first priority," Siebel writes. But don't take that to mean that the CEO or CMO will suddenly be writing code, he adds. Rather, the leaders must know what opportunities digital transformation can open up and how to differentiate the company's digital efforts from others.

2. Appoint a chief digital officer with authority and budget. This person's primary role is chief evangelist and enabler of the transformation. He or she needs to have, or be able to establish, strong relationships throughout the organization "to help business line leaders transform their processes."

"The coming two decades will bring more information technology innovation than that of the last half century."

—Tom Siebel, CEO, C3.ai

3. Work incrementally to get wins and capture business value. This consists of three simple pieces of advice: (1) Don't get caught up in endless and complicated approaches to unifying data. (2) Build use cases that generate measurable economic benefit first, and solve the IT challenges later. (3) Consider a phased approach to projects, "where you can deliver demonstrable ROI one step at a time, in less than a year."

4. Forge a strategic vision in parallel, and get going. "Map out your industry's full value chain, and then identify steps of this value chain that have been, or that you expect to become, digitized. This will help you understand where your gaps are."

5. Draft a digital transformation roadmap and communicate it to others. Clearly define a future vision for your digital business. "What does your ideal future state look like in terms of your organizational structure, people and leadership, product and services, culture, and adoption of technology? Use this ideal future state to compare against your current state."

6. Pick your partners carefully. "In a digitally transforming world, partners play a bigger role than in the past." Management consultants can help flesh out a company's AI strategy. Software partners can provide the right technology stack to power a digital transformation. Professional services partners can help build advanced AI applications.

7. Focus on economic benefit. "If you can't identify projects for digital transformation that will return significant economic value within one year, keep looking. The market is moving too rapidly."

8. Create a transformative culture of innovation. Even if the CEO has a clear vision of what needs to happen to transform the company, senior management, middle management, and rank-and-file employees must also fully understand it. The right culture rewards collaboration, hard work, and continuous learning.

9. Re-educate the leadership team. "Face the facts. Your organization does not have the skills today to succeed at this effort.... A majority of what you will be told about AI and digital transformation is sheer poppycock delivered by self-proclaimed experts.... You need to be able to distinguish signal from noise."

10. Continually re-educate the workforce. "It is impractical to think about replacing your workforce with a new, qualified team. But you can train them."

Asked to offer advice specifically to CFOs, Siebel sticks to his message. "Pick up a couple books and read them," he says.

Rarely has getting educated been such a high-stakes endeavor, Siebel suggests. The book concludes: "The coming two decades will bring more information technology innovation than that of the last half century.... The great majority of corporations and institutions that fail to seize this moment will become footnotes in history." CFO

Courtesy of Tom Siebel

Agribusiness Bonanza

CFO Mark Patrick discusses the enormous business opportunities available to Syngenta now that it's owned by a big Chinese company. By David McCann and Vincent Ryan

More than one in five people alive today live in China. The country's hundreds of millions of farms, large and small, are chronically strained to produce enough food for the population. ¶ Therein lies the extraordinary opportunity before Syngenta, the large, Switzerland-based agribusiness that state-run chemical company ChemChina acquired in 2017 for $43 billion.

The deal lifted daunting barriers to Syngenta's ability to expand its business in China. The company, which produces seeds and crop-protection chemicals, is a big player in the agriculture field that aims to leverage innovation and technology to vastly—and very profitably—boost the yields of Chinese farmers.

Syngenta, which had been listed on the SIX Swiss Exchange, has gained much well-needed operational flexibility as a privately held subsidiary in the world's second-largest economy. Mark Patrick, a 25-year company veteran, took the CFO reins in September 2016, after the ChemChina acquisition was announced but before it closed.

Patrick sat down with *CFO* editors to discuss a wide range of topics. An edited version of the conversation follows.

How has going private affected what you're doing?
Not a huge amount, except that now we have one shareholder rather than 94 million shareholders. And we have bond investors rather than equity investors, but they want the same financial transparency.

Syngenta is the leading multinational in the crop-protection space in China but it has only a 5% to 6% market share.

We don't have quite the same level of reporting requirements we used to, but day to day there is not a big difference.

What about in terms of numbers you have to send to ChemChina?
There are a few additional requests driven purely by SASAC, the body that runs all the state-owned enterprises in China. But we have SEC filings in the United States and had other requirements for being listed in Switzerland, so we already had pretty comprehensive financial reporting that meets 98% of what China needs.

What does the acquisition require you to do in China from an operational standpoint?
We had invested a lot there already. We have two crop-protection manufacturing sites, and we have a joint venture for our corn seeds business. We need to start scaling up now to ensure that we can service a different market than we were servicing two years ago. That takes a bit of time.

But we have a global business, and what we're seeing in China is not that different from what we saw in Eastern Europe and Latin America a decade or two ago, in terms of establishing more Western-type [farming] practices.

In many cases, farmers are now looking for financial and risk management solutions that they weren't looking for before. It's a source of competitive advantage for us.

ChemChina is already talking about the possibility of an initial public offering for Syngenta. What do you think of that?
It's quite common in China. The transaction agreement that was signed in 2016 said that within five years of the deal's closure they would be looking to IPO a minority stake.

But a couple of things are needed. First, the markets have to be conducive to an IPO. Right now, for example, wouldn't be a particularly good time. Second, we have to demonstrate that

Syngenta

the new Syngenta story is an upgrade from the old Syngenta story and that we're creating incremental value.

What advantages has the acquisition brought to Syngenta's business?
First is China itself. It's a $12 billion market today. We're the leading multinational in the crop-protection space, and we have only a 5% to 6% market share. In seeds, we have less than a 1% market share.

One of President [Xi] Jinping's stated priorities in his 2013 five-year plan was the modernization of agriculture and rural reform. But he needs something or someone to create the momentum to do that. Syngenta is now best placed to establish itself as the leading player in the market. Hopefully, we can go some ways toward helping that modernization along.

China has a basic problem: it has 22% of the world's population and 7% of the world's land. It also has a hugely fragmented market and very unsophisticated farmers. There are 200 million "small holders" who don't have the technology for best-practice protocols, and hence their yields are half what you see in Western countries.

What does that mean for selling into that market of small farmers?
One of the big opportunities in China is Alibaba and [its third-party online payment platform] Alipay, which have e-commerce solutions to reach the small holders in a way that traditional sales reps trudging around the fields couldn't do—there's just too many [potential customers].

There are also huge, state-run farms in China. Now we have an opportunity to partner with them and with Alibaba, where before we couldn't even get through those organizations' front gates. Our CEO, Erik Frywald, met recently with Alibaba's chairman to talk about opportunities for collaboration and partnership.

Courtesy of the author

"Farmers are now looking for financial and risk management solutions that they weren't looking for before."
— Mark Patrick, CFO, Syngenta

What are the ramifications of having one shareholder instead of 94 million?
I'm not running from one quarterly call to the next trying to demonstrate the company's performance. China is comfortable taking a longer perspective. For our industry, given the innovation and the length of time it takes to bring new technologies to market, that's really important for us.

Do they let you plow more of the profits back into the business?
They've been very supportive of our management, whether [we're investing in] M&A or in organic growth through research and development. We did five deals last year. I don't have any complaints about their interaction with us. We weren't quite expecting that.

How closely do you follow the geopolitical machinations between the United States and China?
Very closely. Soybeans have been at the heart of some of the trade disputes. We know the impact that it's had on U.S. farmers, given that commodity prices have suffered substantially. Farm delinquencies here are up quite a bit.

We're hopeful that the disputes will get resolved very soon.

Sometimes lately things in the geopolitical arena seem to be resolved, and then almost in the next moment they're not resolved.
I'm English, and Brexit is a similar mess, even more extreme in some respects. The political situation at the moment is very difficult to navigate. As a CFO, when you haven't got that level of certainty it's very hard to make investment decisions of a material nature. I think we're all struggling with that, irrespective of the sector [we're] in.

How is your U.S. business doing? Farm economics are pretty tough right now.
It was a good year in 2018 for both crop protection and seeds. We gained share in both businesses. But the planning and planting decisions for 2018 were made before much of the current trade uncertainty unfolded. So the 2019 season is a very different kettle of fish, as we're waiting to see how that's going to play out.

Decisions on what to plant and which technology to invest in are predicated on what the commodity price is going to be when farmers harvest and sell. Some of them have taken protection by hedging forward.

Are you able to project where the U.S. market will go over the long term?
U.S. farmers are the most sophisticated on the planet and [they] yearn for innovation. They continue to drive yield and quality like nowhere else in the world. We don't see that changing materially. It's ingrained in the U.S. farming culture.

Now, Mother Nature seems to be always a step ahead, whether you're talking about weed resistance, insects, disease, or the vagaries of weather. So companies like ours have to continue to innovate so that farmers can deal with whatever Mother Nature throws at them.

For example, we now have products in our portfolio that are drought-resistant and can tolerate heat stress. Now, our lead times for new technology aren't 6 to 12 months. They're more like 8, 10, or 12 years. So we've been working at this for some time. CFO

Capturing Sales Synergies

Too often companies focus on cost synergies but fail to examine revenue synergies and the benefits of an improved "commercial engine." By Bulend Corbacioglu and Kevin Mulloy

An acquisition, especially a major acquisition, provides an ability to not only combine existing capabilities but to reset and adjust the key commercial elements that drive the business's economics. Understanding the value-creation potential that is available in any acquisition is critical to winning bids without experiencing the "winner's curse."

Value creation comes from three areas: cost synergies, revenue synergies, and an improved commercial engine. Too often companies focus deeply on the first of the three and neglect the others.

Cost synergies, such as from operations, procurement, back-office, and IT, are typically viewed as "hard" numbers and included in analyses. Revenue synergies, from cross-sell and up-sell and the impact of an improved commercial engine, can be significant. However, many times they are relegated to the "icing on the cake" category and not included in the core analysis. We believe that this is often because companies lack experience or confidence in conducting this kind of analysis. This information can be known and can be a competitive weapon if done well.

Sizing the Synergies

Assessing potential economic improvements requires detailed commercial analysis and planning. This analysis generally needs to cover a number of areas:

1. The customer decision-making dynamics of the products and services to be assessed. The decision-making unit (DMU, the team of individuals participating in a buyer decision process) and the decision-making process (DMP, how the buyer makes choices) of the related offerings can be aligned and compared. Ideally, there should be some connection so that relationships and strategic positioning of both organizations can be leveraged to accelerate adoption.

2. The customer value-creation potential. The best cross-sell and up-sell opportunities come from situations where the customers realize an important value-creation effect. Too often acquirers look primarily at their own value creation and fail to deliver a compelling advantage to the customer. Yet, they are surprised when they fall short of their targets or expectations.

3. The risks or disincentives that may exist for customers. Too often acquirers fail to consider that besides the positive incentives for customers, there could be disincentives or risks that customers will have concerns over (e.g., the combined business may be viewed as "too many eggs in one basket" when customers are looking for multiple sources).

4. The repositioned combined offerings. This includes the combined products and services, the brands, and the messaging to the market based on customer and market perceptions of the legacy organizations, as well as the potential integrated value proposition.

5. A refresh of pricing approaches and tools. This includes things like quote generation and template RFP responses, as well as the rules of engagement that reinforce the message (e.g., dual brands with differentiated value proposition) and drive margin.

6. Reimagining the product/service roadmap. In the long term, a roadmap needs to be developed for new product and service innovation that leverages the companies' complementary capabilities.

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Bulend Corbacioglu

Kevin Mulloy

Value creation comes from three areas: cost synergies, revenue synergies, and an improved commercial engine.

Capturing Benefits

The efforts to understand and capture the new benefits start before the deal closes and should continue throughout the post-merger integration phase.

Prior to deal close

1. Complete initial customer and market research. This work goes beyond the typical diligence work focused on customer economics, concentration, satisfaction, and retention. It should include key DMU/DMP dynamics for major segments, the initial view of overall value creation potential, the potential end customer value-creation levers, and the potential end customer risks and disincentives.

2. Develop initial cross-sell and up-sell plans. These should be realistic plans and based on specific initiatives with the required support.

3. Develop initial combined entity go-to-market plan. This should be the high-level plan that provides direction (and will be confirmed and fully detailed post-close when the full leadership team can be brought into the process).

After deal close, short term (first 30-60 days)

1. Develop and launch immediate market messaging. Given the elevated risk of confusing the market with the messaging, it is imperative to quickly align the messaging based on the combined value proposition (i.e. "what's in it for the customers and partners") and roll out the necessary tools to convey the message (e.g., website, brochures, other collateral, case studies).

2. Develop and launch immediate communication plans. Similarly, immediately launching a clear communications plan for customers, channels, and the sales team consistent with the market message will help mitigate competitors' attempts to poach.

3. Finalize the integrated go-to-market model and the cross-sell and up-sell plans. This is a key element to both setting the targets and defining the go-to-market model to deliver on those targets. It provides the customer segment coverage and ensures the necessary coordination and interactions required for cross-sell and up-sell, like organizational structure linkages and specialized support roles.

4. Communicate the immediate integrated core product and pricing. Although this may be adjusted with further work, providing a clear post-close picture is important.

5. Assign specific cross-sell and up-sell targets to the sales force. These targets will signal intent and commitment to achieving cross-sell and up-sell. They will also help create early successes to both motivate the team internally and to showcase the combined value proposition.

6. Institute an attractive cross-sell and up-sell compensation incentive/spiff. This will help jump-start the cross-sell and up-sell sales motion. Again, these plans will signal commitment while also driving behaviors. Similar to any other adjustment to incentive compensation, the organization has to ensure the plan drives the right behaviors by also checking how it would have impacted the last few years' compensation.

Post-close, long term (60-120 days)

1. Improve integrated frontline sales management. Too often, integration efforts focus mostly on the field sales personnel and territories; of higher value is the thoughtful integration and improvement of the sales management function.

2. Complete detailed customer segment and value driver work as needed. Both legacy businesses might have market analytics in place, but these need to be reviewed from the combined business' perspective. They should be updated as needed to derive the necessary actions.

3. Finalize the repositioning of the combined offerings. The repositioning should include products and services, the brands, and the messaging to the market. It should be based on customer and market perceptions of the legacy organizations and the potential integrated value proposition.

When undertaken correctly, a better understanding of the potential in revenue synergies and an improved commercial engine will allow a company to bid more effectively and create more post-merger value. The understanding translates into captured value if the organization executes the post-merger integration process effectively. CFO

Bulend Corbacioglu is managing director, Germany, of Blue Ridge Partners. Bulend has been helping serial acquirers build value through acquisition and integration activities for 20 years. Kevin Mulloy is Blue Ridge's managing director, U.S., with a focus on innovation and technology management.

Insurance Alternative Rises

Unlike traditional insurance, "parametric" coverage pays out after a triggering event, regardless of actual losses. By Lynn Freehill-Maye

Most insurance payouts compensate for direct losses—and only after what can be a long claims process. But finance executives should know the ins and outs of a growing market segment that is structured differently: parametric insurance. Parametric coverage pays when a certain objective triggering event occurs, regardless of the actual losses suffered.

That's different, of course, than traditional indemnity insurance.

For example, if a hotel's occupancy rate ("the index") drops below 20% ("the trigger"), an automatic payout is generated no matter the cause—a storm, war, wildfire, earthquake, or terrorist attack. Parametric insurance does not cover the actual event loss, but rather the approximate loss.

While parametric (or index-based) insurance has been around for awhile, global insurance giants are promoting new parametric offerings. Swiss Re, for example, is automatically paying Hong Kong business clients if a certain-level typhoon warning is issued; Singaporean retailers if too much pollution haze hangs in the air; and European shipping companies if river levels fall below a certain depth.

Likewise, Axa covers French vineyards if frost hits within an agreed upon calendar window and U.S. car dealerships if hail of a certain size is recorded. The insurer also just inked a deal with a Chilean forestry company that pays out if wildfires hit a certain percentage of the company's land (as measured by a satellite).

Clarity is a major part of parametric's appeal to businesses, says Paul Ramiz, a director for innovation and solutions at Aon. There are no long claims investigations or waiting while a loss is confirmed, and presumably fewer disputes. Aon began selling weather-related parametric coverage in 2012 and added non-weather-related parametric products last year.

"The claim is paid out efficiently, cleanly, and quickly," says Ramiz. "There are fewer people in the [processing] chain. The quickest claim has been paid in a week."

Building a Market

The catastrophe bond market, which developed in the mid-to-late 1990s, showed the appetite for alternative risk transfer mechanisms. Swiss Re, for example, offered major California earthquake coverage in 1997, but considering the massive payouts it might have been on the hook for, it transferred some of the risk to the capital markets.

Meanwhile, developing markets, such as the Caribbean and Latin America, have long featured coverage with specific triggers, says David Eckles, professor in the risk management and insurance program at the University of Georgia's Terry College of Business. But those have often been in micro-insurance, which protects low-income people, and where the size of the loss might not necessarily merit a claims investigation.

Appetite for corporate-scale parametric coverage has been building in highly developed markets such as the United States, Europe, and Australia.

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“What if, what if, what if—have you really thought out all the what-ifs? You need a well-designed trigger—otherwise it’s calculated to give rise to disputes.”

—Nigel Brook, partner, Clyde & Co.

In an age of global complexity and in which risk management departments are getting better at managing pure financial exposures, parametric triggers look appealing. Businesses can be devastated financially without necessarily suffering physical damage. Losses can occur even if the underlying asset is not within the insured’s control. And parametric coverage can fill the protection gaps from deductibles or from perils that are excluded in indemnity insurance contracts.

In developing markets, more trustworthy data is making parametric coverage viable now, says Karina Whalley, business development manager for Axa’s global parametrics group. High-quality government satellites can track happenings on the ground even in geographic locations where reliable information arbiters weren’t previously present—and the data is freely available.

“We’re seeing better and better satellites being launched, both temporally and spatially. The granularity has really improved,” Whalley says. “That has propelled the market forward.”

What to Consider

CFOs like parametric payouts because they can smooth out quarterly profits and losses, says Christian Wertli, head of innovative risk solutions at Swiss Re. Coverage also helps assure a risk-minded board that a company’s executives are prepared for a range of harmful possibilities.

When looking to buy parametric coverage, however, finance executives should bear in mind that they’re weighing the certainty of payout against the “basis risk”—the potential mismatch between the policy’s parameters and the underlying risk exposure. A vineyard’s wine grapes could be destroyed even though the thermometer does not hit the designated low temperature range.

“It’s a great policy for peace of mind in that you know whether you’ll get paid [in the event of a loss], but there’s also quite a bit of uncertainty as to whether the trigger will line up with your actual losses,” Eckles says.

Parametric payouts are easier without the usual claims adjusters, legal disputes, or complex business-interruption calculations involved. But since most parametric contracts are bespoke, the real work is done upfront in arriving at (and properly measuring) a business’ appropriate trigger, says Nigel Brook, partner in the global law firm Clyde & Co.

Brook was a co-author of the firm’s 2018 report on parametric and inclusive insurance. The report cited a policy issued to the East African nation of Malawi. The policy covering drought was not immediately triggered even though there was widespread crop failure. Later investigations revealed that farmers in Malawi had switched to a different crop with a shorter growing cycle. When this data was put into the model, it created a more accurate estimate of the drought-affected population, and a payout was triggered.

“The whole industry is still evolving, and obviously the better the data gets and the more computer power we have, the more creative Swiss Re can get with solutions.”

—Christian Wertli, head of innovative risk solutions, Swiss Re Corporate Solutions

“What if, what if, what if—have you really thought out all the what-ifs? You need a well-designed trigger—otherwise it’s calculated to give rise to disputes,” Brook says. “And then also make sure you have dealt with all the contingencies that could arise that could undermine the contract, such as faulty sensors or [an incorrect] data source.”

In Progress

More and more policies with parametric triggers are turning up. The question is whether they’ll become mainstream. At present, only a few companies offer parametric coverage directly to individuals. An organization called JumpStart promises to pay residents a fast, flat, no-deductible sum if their area is hit by an earthquake, whether that money is used to repair a damaged home or if the insured just wants to relocate.

Insurers like Swiss Re are bullish on the entire market. In addition to its corporate coverage in nearly a dozen countries, the company just launched fully automated parametric plans for smaller clients.

“The whole industry is still evolving, and obviously the better the data gets and the more computer power we have, the more creative Swiss Re can get with solutions," Wertli says. “We’ll definitely see more in this area.” CFO

Lynn Freehill-Maye is a business and sustainability writer whose work has appeared in The New York Times, The Washington Post, *and* The Wall Street Journal.

Courtesy of the authors

How to Blow the Whistle to the SEC

Becoming a whistleblower requires planning. Here are some points to think about before filing a tip.

Want to blow the whistle on your company and receive a fat monetary award from the Securities and Exchange Commission for reporting a securities law violation?

Since the SEC Office of the Whistleblower announced its first payout in 2012, it has issued 29 of them exceeding $1 million. What's more, in the government's fiscal year 2018, the SEC issued awards totaling $168 million to 13 individuals, more than in all previous years combined. While the SEC has proposed recently that it impose a cap on awards, providing a tip can still be lucrative (besides, of course, being the right thing to do).

The following are some points to think about before taking the plunge. They're are based on Katz, Marshall & Banks' "SEC Whistleblower Practice Guide." The guide was written by attorneys Lisa Banks and David Marshall.

You have to voluntarily provide the information, and the information has to be original.

"Voluntarily" means the information about misconduct has to be provided before the whistleblower receives a request, inquiry, or demand for it from the SEC, or in connection with an investigation, inspection, or examination by the Public Company Accounting Oversight Board or by Congress or other federal authority.

To qualify as "original information" that will support a claim for an award, the whistleblower's tip must consist of information that is derived from the person's "independent knowledge" or "independent analysis." The SEC can't already know about it from some other source, in other words, and it can't be "exclusively derived" from allegations made in certain judicial or administrative hearings, government reports, audits, or the media unless the whistleblower is the original source, say Banks and Marshall.

Some employees are not eligible for awards.

Employees in certain roles, such as attorneys, compliance personnel, auditors, and corporate officers, can participate in the SEC's whistleblower reward program only under certain circumstances, say Banks and Marshall.

For example, a corporate officer who learns of the information in connection with the company's processes for identifying and addressing unlawful conduct is generally not eligible.

However, these persons can be eligible if the would-be whistleblower "reasonably believes" that disclosure to the SEC is needed to prevent "substantial injury" to the entity or investors, or that the organization "is acting in a way that would impede an investigation of the violations."

Consider reporting internally first ...

The SEC rules make clear that the main purpose of the whistleblower program is to encourage individuals to provide high-quality tips directly.

However, there are provisions that incentivize whistleblowers to use internal corporate compliance programs. For example, the SEC affords whistleblower status to an individual as of the date he or she reports the information internally (as long as the employer then provides the same information to the SEC within 120 days).

... But beware of the risks.

While reporting internally first might mean a larger award, the whistleblower could be subject to retaliation from his or her employer. The Sarbanes-Oxley and Dodd-Frank acts do provide legal protections against retaliation, however. In addition, the SEC Whistleblower Program has expanded protections for employees in recent years. The SEC has already won three successful enforcement actions involving companies that retaliated against employees who reported securities violations.

The SEC has also "taken aim" at employer-imposed agreements that might impede the flow of information from employees, say Banks and Marshall. "The agreements are often signed as a condition of employment or of receiving severance payments."

Make the case compelling.

A tip has to lead to a successful enforcement action to garner an award. An individual must file a Tip, Complaint, or Referral (TCR) form (available on the SEC website). The form can be submitted either online or by mailing or faxing it.

The SEC emphasizes that the information must be compelling. "It is important that the first read of a whistleblower tip provides SEC staff with a sound understanding of the alleged violations and, to the extent possible, how to investigate and prove them," say Banks and Marshall. | VINCENT RYAN

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IN BLOCKCHAIN THEY TRUST

The technology's transparency and immutability allow competitors to share data and industries to build credibility with consumers.

BY RUSS BANHAM

Getty Images

Someday, you may use

an app at a supermarket to scan the beef sirloin you plan to buy for dinner, discovering the cow's life journey. Another app will assure that the pair of handmade Gucci loafers you just bought are authentic. These apps will be connected over the internet to blockchain platforms, each one a digital ecosystem created for a specific industry. And they're not distant dreams of tech entrepreneurs—these apps are already in development.

A year ago, the *CFO*/Duke University Business Outlook Survey found that 78% of U.S. finance chiefs said they didn't know whether or how blockchain would affect their company. Only 3% claimed to even understand it. But many organizations apparently did their homework since then and warmed to the technology's potential. In Deloitte's 2019 Global Blockchain Survey (of a more general set of senior executives), more than half (53%) said blockchain had become a critical priority for their organizations; four in 10 said they were willing to invest $5 million or more in blockchain initiatives in the next year.

What has been the catalyst? Companies eager to drive down operating costs, certainly. The other, somewhat surprising, impetus is the lack of trust—between industry competitors, suppliers and customers, and even the manufacturer and the consumer.

Traceable and Accurate

Farther back, five years ago, blockchain meant bitcoin, the cryptocurrency whose founding depended on a trading platform in which currency data was confirmable and immutable. Bitcoin's star has faded. But blockchain has wider value as a network to exchange data and transact via "smart contracts." These contracts trigger based on prearranged terms and conditions. Smart contracts can automate highly manual and semi-manual transactional processes to cut operating expenses and reduce points of friction with customers.

At its most basic, blockchain is a digital ledger that records transactions among a network's participants and distributes them to members in real time. Every 10 minutes, a transaction is verified as factual and then permanently time-stamped and stored in a "block" similar to a page in a ledger. Once a block of transactions is complete, it is linked to the preceding block to create a chain of records.

Since the data entries provide a secure audit trail, network members are assured the ledgers are beyond reproach (although some, like *MIT Technology Review*, claim blockchains are hackable). "Blockchain's initial wave of business transformation is the creation of single sources of truth," says Jamie Solomon, a managing director for North America at Accenture.

The technology lets distrustful parties come to an agreement without relying on intermediaries. In blockchain-fueled networks, companies can share accurate and verifiable data with each other and with suppliers. Not all data—just information that is of mutual benefit. "Industries have now passed the stage where they want to apply blockchain because it's cool," says Paul Brody, global blockchain leader at Ernst & Young. "There is now widespread [recognition] that blockchain lends itself to solving real business problems."

Taking Steps

One of those problems is overcoming consumer skepticism of companies that claim to sell "ethical" goods. Blockchain, it turns out, offers an uncontestable way to trace a product's lifecycle. That capability impelled Lukas Pünder, finance chief of handmade shoe brand CANO, to investigate developing a blockchain for the fashion apparel industry.

"We wanted consumers to be able to trace every step in the manufacture of each pair of our shoes—from the origin of the raw materials to the craftspeople in Mexico who use traditional braiding methods," says Pünder.

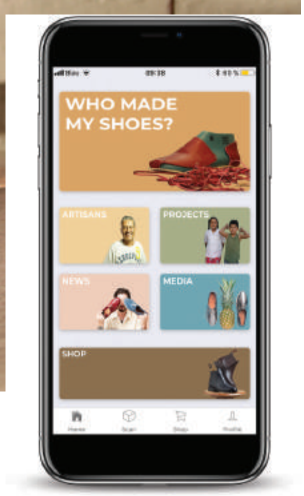
Pünder leveraged Oracle's blockchain technology to create a digital ecosystem for CANO. Customers interested in their purchase's provenance can use an app on their smartphones to scan a near-field communications chip embedded in the shoes or apparel. The two-year-old company's complete summer collection will be equipped with the transparency technology.

For the winter collection, to be launched in September, CANO products will use a pilot solution for the entire industry called Retraced. Retraced offers more in-depth information about a product and has a more sophisticated design. Other fashion brands that will be equipped for the Retraced transparency solution include European makers John W. Shoes, Afew Store, and Jyoti-Fair Works. Additional brands will be onboarded after a test phase. With Retraced, about 50,000 to 100,000 products will be tracked this year.

Trust in a company's sustainable practices are important, Pünder says. In an industry rocked by allegations of unsafe working conditions and low wages, the apps let consumers know that they're not purchasing

"Ten percent of all fashion items are faulty. Now you can identify exactly which company in the supply chain is responsible."

—Lukas Pünder, CFO, CANO



CANO uses blockchain to track each step of its manufacturing process. Customers can then use an app to scan an embedded tag on the product and learn its history.

products from unscrupulous sellers. “By leveraging transparency as a core value, a company can achieve desirable brand differentiation,” Pünder says.

Companies like CANO can also discern which suppliers are producing shoddy work, generating lower quality products that customers tend to return. “Ten percent of all fashion items are faulty. Now you can identify exactly which company in the supply chain is responsible,” Pünder says.

Pruning Processes

In what other industry is trust an issue? Insurance. “Policies and claims involve multiple parties, complicated agreements, complex logic, different intermediaries, and many verification points, making them ripe for blockchain,” says EY’s Brody.

More than 30 large global insurers, reinsurers, and insurance brokers joined in 2018 to create a blockchain consortium, The Institutes RiskStream Collaborative.

“There’s great value in members sharing their data for mutual benefit, but the problem in the past has been an immense lack of trust between these entities,” says Christopher McDaniel, Risk Stream president.

The consortium is developing Canopy, a blockchain that connects the industry in a data-sharing network. An example of its proposed use is the car insurance claims process. At present, if two drivers, each insured by a different company, are in a minor collision, they jot down their driver’s license and car registration information. Each policyholder then calls his or her insurance agent to relay the other party’s information.

Once notified, the insurers start the drawn-out claims administration process, manually preparing a “First Notice of Loss.” A claims adjuster is tasked with gauging the extent of the damage and relative fault for the accident. This process entails numerous and lengthy back-and-forth phone calls and emails between the insurers. They eventually agree on who pays.

“Once you remove the inefficiencies across companies in an industry, all sorts of innovative concepts bubble up, to the benefit of all parties in the blockchain network.”

—Christopher McDaniel, president, RiskStream

In the future, with Canopy, each policyholder would have an app provided by their insurer. The drivers would upload a QR code reader and scan each other’s codes. The information would flow to Canopy in real time, giving the insurers the ability to simultaneously verify the drivers’ identifying information. The blockhain platform would trigger a First Notice of Loss without the involvement of agents.

By sharing their policyholder data in Canopy, the two insurers’ processing cycle times would shorten. Agents would be able to devote more time to managing client risks instead of processing information. “You need people to process claims and underwrite policies,” says Matt Lehman, managing director in the insurance practice of Accenture, a solutions provider to RiskStream. “That’s a lot of trapped value.”

Both the proof of insurance and First Notice of Loss capabilities will be technically ready and available to network members in July, but then carriers have to embed them into their own mobile applications, which will take longer.

A TECHNOLOGY IN PROGRESS

Executives still have doubts about whether blockchain’s promises will be realized.

Among enterprises, blockchain adoption is still the road less traveled. Deloitte’s 2019 Global Blockchain Survey, conducted in February and March, reveals that while most senior executives across 12 countries call blockchain a top-five priority, only 23% have initiated a blockchain deployment. And more than 43% think blockchain is overhyped.

There is also still much uncertainty over the technology. Lack of employee skills and understanding, unclear return on investment, and too few compelling use cases are causing some executives to keep blockchain at arm’s length, according to the survey.

Still, overall sentiments about blockchain are positive. For example, almost 9 in 10 (87%) of senior executives strongly or somewhat agree that “blockchain will enable new business functionalities and revenue streams in my industry,” and almost the same number strongly or somewhat agree that “blockchain technology is broadly scalable and will eventually achieve mainstream adoption.”

Deloitte says finance chiefs and other members of management should be asking the following questions:

- How are blockchain-enabled processes changing the way my sector does business?
- How can blockchain reshape my industry? What are my long-term objectives and strategies?
- Does blockchain create the potential for new market ecosystems, and what role should I play?
- Where are my biggest blockchain blind spots?

Concludes Deloitte: “Even those who may have looked askance at the technology in the past appear to be viewing blockchain with a new sense of possibility.” | **VINCENT RYAN**

Further down the line in Canopy's development, as the vehicle accident information flows to the blockchain platform, it could set off a series of smart contracts to member tow truck firms, car repair shops, rental car agencies, and law enforcement.

The next stage in Canopy's development calls for members to share data in the interest of developing new products. RiskStream's McDaniel provides the example of a group of electric bicycles reinsured at a micro-transactional level.

"A primary insurer of electric bicycles could cluster them across different geographies, creating a portfolio of risks that would be traded in an open market," he says. "Different reinsurers would assume portions of the primary insurer's risks in real time, automated through prearranged smart contracts."

"Once you remove the inefficiencies across companies in an industry, all sorts of innovative concepts bubble up, to the benefit of all parties in the blockchain network," McDaniel adds.

Sean Ringsted, chief digital officer at the large global insurer Chubb (a member of Canopy), cites the value of Canopy's ongoing work for policyholders. "By improving our operating efficiencies, eliminating duplicative, redundant data flows and questions about where the data comes from and is it accurate, our customers benefit from much easier and less time-consuming claims processes, not to mention more innovative risk-transfer products," he says.

Farm to Table

Livestock agriculture is another industry experimenting with blockchain. "There's a growing segment of direct-to-consumer brands that retail only organic, free range, grass-fed, responsibly raised, and naturally sustainable lamb, beef, chicken, and pork of the highest quality from small farmers," says Leslie Moore, owner of Farmer Girl Meats, an e-commerce farm-to-table business based in Princeton, Kansas. "The challenge has been proving everything I just said to consumers."

Moore, a third-generation farmer raised on her family's grass-fed beef farm in Kansas, left in the 1990s for business school and later a job in branding at a large manufacturer. She returned to the farm with an idea for building a platform that would track relevant data on the farm's meat products.

Truth and transparency are lacking in today's meat industry, she says. "Ambiguous language in [U.S. Department of Agriculture] regulations allow imported beef from Paraguay, New Zealand, and Australia to be labeled as 'Product of the USA,'" says Moore.

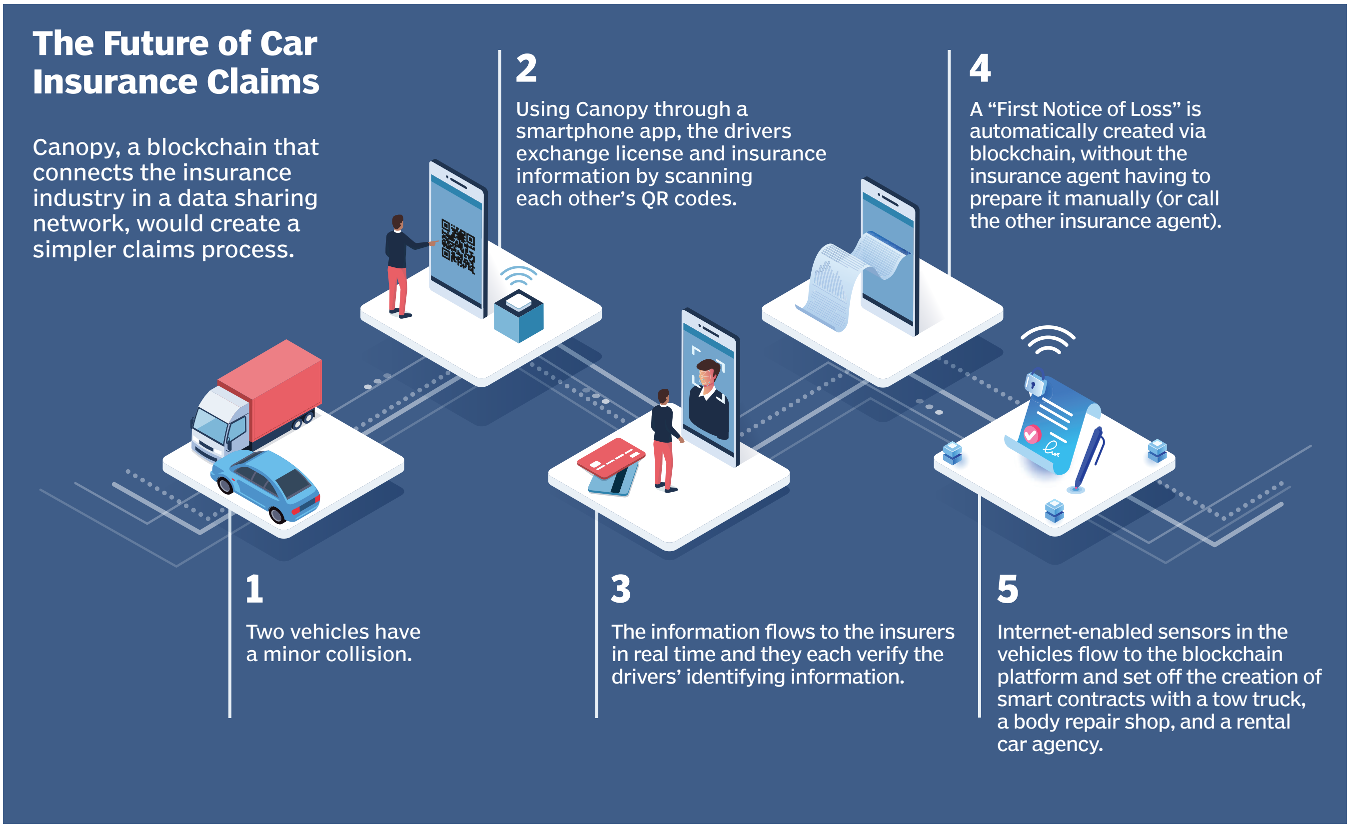
The imported grass-fed beef is shipped in what are called primal cuts (the main areas of the animal, which include the loin, rib, round, flank, chuck, sirloin, and brisket). It goes directly to USDA-approved facilities in the United States. The meat is inspected and cut into packaged goods destined for grocery store shelves nationwide.

"An animal born, raised, and harvested in a foreign country can be marketed to consumers as a product of the United States; its true origin is unknown to the buyer," Moore claims.

Through a partnership with Silicon Valley blockchain startup Citizens Reserve, Moore hopes to alter the paradigm for small livestock producers. The app provides traceability from the birth of an animal to the steak or pork chop on a plate, she says. "Everything that animal encounters over its lifespan becomes part of its story."

This includes what a cow or pig is fed each day, what kinds of fertilizers or pesticides the farm may use, and whether an animal has been treated with antibiotics, making it no longer antibiotic-free. "That classification results in a lower markup, but if the buyer could see that the medicine was used only topically and not ingested, it could alter economic outcomes for the farmer," says Moore.

Leslie Moore, owner of Farmer Girl Meats, is working with blockchain startup Citizens Reserve to create an app that will track an animal's lifespan from "land-to-plate."



The blockchain platform would give each package of meat a unique digital identity providing "farm-to-plate" lifecycle information so consumers can make more educated buying decisions.

Thane Tokerud, financial controller of Citizens Reserve, says the major benefit of the ecosystem it is developing, called Impact Ranching, is providing traceability.

Farmers and other vendors on the platform could view distribution outlets eager to sell meats from farms that can literally prove their sustainable practices through the use of blockchain, Tokerud explains. Specialty meats have up to a 20% markup, so the additional distribution opportunities can equate to significantly higher margins.

Another advantage, which may not get the promotion the others do, is in product recalls. Regulators and distributors could quickly ascertain the origin of meat sitting on grocery store shelves and pull it if necessary. Walmart and its Sam's Club division, for example, are planning to implement blockchain technology this year to get real-time, end-to-end traceability of leafy green products.

Impact Ranching, which goes live in 2020 and will have many agricultural industry collaborators, also may obviate farmers' reliance on the costly third-party certifications required by the USDA. "Since the data in the ecosystem is verifiable and immutable, the information theoretically would allow farmers to self-regulate, reducing the time-consuming bureaucracy they presently confront," Tokerud says.

"The information theoretically would allow farmers to self-regulate, reducing the time-consuming bureaucracy they presently confront."

—Thane Tokerud, Financial Controller, Citizens Reserve

Accenture's Lehman sees a similar benefit for insurers. "Regulation in insurance is complicated, given 50 different states with disparate rules and complex filings," he says. "If you can create specific real-time views for regulators in Canopy, where they get to see accurate, immutable, and standardized data they know is factual, it will remove a layer of bureaucracy."

That's a big ask of regulators—blockchain technology will first have to earn the government's imprimatur. That may take awhile, because the applications are still somewhere immature. It's also unclear how fast or if these industry solutions will produce a return on investment for companies. But industries are pushing forward, confident of blockchain's potential to bring business partners together and build credibility with consumers. CFO

Russ Banham is a Pulitzer-nominated financial journalist and best-selling author.

Breaking The Budget

Quickly obsolete numbers, endless revisions, "gaming" of bonus targets—traditional budgeting is a poor guide to strategic decision-making.

| BY STEVE PLAYER, PAIGE LEAVITT, AND RACHELE COLLINS |

Getty Images

Despite the constantly churning mechanisms of business, the traditional budgeting process has changed little since the 1920s. An organization can spend months creating a blueprint for the next year and then expend even more effort to stay on that defined path—regardless of whether the initial assumptions were correct. This inefficient process creates static numbers that quickly become obsolete. They also do little to support strategic decision-making.

And there are plenty of other major flaws of the century-old approach:

- Even with spreadsheets and analytics, finance professionals are stuck with a laborious process of back-and-forth negotiation between varying assumptions and expectations.
- Organizations are married for a year to negotiated targets, adding little value to planning in a rapidly changing world.
- An overemphasis on "making the numbers" takes away focus from strategic initiatives and can be counterproductive in allocating assets.
- In-house financial analysts are sidetracked by having to collect and validate data, rather than having the bandwidth to generate the analysis needed to plan alternative action.
- The traditional budget becomes a negotiation game where reaching bonus targets becomes more important than optimizing outcomes.

Organizations clearly need a better model. Like a ship, an organization's structure, capacity, ability to produce value, and even speed and location are the result of thousands of past decisions. Planning is the process of assessing the ship's position and capabilities against where it is trying to go. Plans cannot be based on where the ship went last year; they need to be forward-looking.

No captain or crew can perfectly predict what will happen. They can, however, track the ship's progress in pursuit of specific targets, while adjusting when off course and increasing speed when on the right track.

ALTERNATE APPROACHES

There are a number of viable budgeting methods that address the traditional process's weak spots.

Rolling Forward. Traditionally, organizations set targets to indicate where the organization wants to go. Forecasts then indicate what is likely to happen based on the organization's current configuration and change initiatives. The two views do not always align.

Using a rolling horizon can help to continuously monitor an organization's course for a consistent time period. Static budgeting typically forecasts to a wall (i.e., only to the fiscal year-end). Doing so focuses attention on meeting targets set before the year began. The problem? Managers quickly learn to negotiate low targets.

Rolling forecasts use a consistent horizon (five quarters out, say) to provide visibility and time to address new realities. Visibility shifts from "making this year's budget" and bonus targets to long-term concerns, including outperforming the competition and reaching strategic goals.

Rolling forecasts also help organizations consider the full impact of spending decisions and actions. Organizations with large-volume businesses, predictable trends, and access to large customer data sets tend to benefit the most from using a rolling forecast.

Driver-Based. Some organizations choose to combine a rolling horizon with a driver-based forecast. Instead of being based on opinions and past performance, driver-based forecasts zero in on key environmental and operational factors. They employ logic diagrams to represent causal and quantifiable relationships between underlying drivers and their effects on the overall business. (For example, a logic-diagram can map out the whole process that occurs from identifying the potential customer universe to total sales leads, sales calls, and eventual gross sales.) That gives management a deeper understanding of cause-and-effect relationships.

The greatest advantage of using a driver-based forecast is identifying the handful of key drivers that will make everything else flow.

Driver-based models look for mathematical relationships, such as between sales targets and units already sold. (For example, what is the issued sales leads to sales calls ratio? The sales calls to unit sales ratio?) The value of each individual driver can be identified by past performance, benchmarks, and marketplace indicators. The more relationships tracked in a logic diagram, the more that can be predicted and the more lead time an organization has to act.

The greatest advantage of using a driver-based forecast is identifying the handful of key drivers that will make everything else flow. Organizations benefit most from driver-based forecasts when they understand systems thinking and their businesses well enough to develop predictive logic diagrams. Organizations using activity-based cost management, in particular, are excellent candidates because of their experience mapping process activities and drivers.

BREAKING THE BUDGET

One Step Beyond. Organizations that have success with driver-based rolling forecasts may be ready to completely dispense with tradition. A more adaptive approach, "beyond budgeting," revamps the entire financial and performance management process. Instead of focusing on meeting budgeting goals, an organization concentrates on tracking internal and external drivers of performance on a rolling horizon and dynamically adapting plans and allocating resources.

LT Apparel Group redesigned its forecast process well enough to ditch the annual budget.

This approach is ideal for organizations wishing to replace a centralized budget approval process with a self-regulating and decentralized approach. The elimination of bureaucratic rituals can lead to (1) faster responses when drivers change and (2) a collective shift in focus to investing in long-term goals.

First Principles

"Beyond budgeting" completely dispenses with traditional budgeting activities, but it also requires discipline.

1. **Values.** Bind people to a common cause, not a central budget.
2. **Governance.** Govern through shared values and sound judgment, not detailed rules.
3. **Transparency**. Rather than restricting and controlling information, ensure everyone has a realistic picture of the organization's financial standing and strategic priorities.
4. **Teams.** Organize a seamless network of accountable teams, not centralized functions.
5. **Trust.** Trust teams to regulate and improve their performance; don't micromanage them.
6. **Accountability.** Base accountability on broader strategic goals, not budget assumptions.
7. **Goals.** Set ambitious medium-term goals, not short-term fixed targets.
8. **Rewards.** Base rewards on how performance supports strategic goals, not on fixed targets.
9. **Planning.** Make planning a continuous and inclusive process, not a top-down annual event.
10. **Coordination.** Coordinate through rolling forecasts, not annual budgets.
11. **Resources.** Make resources available just in time. Avoid simply resourcing fixed amounts.
12. **Controls.** Base controls on fast, frequent feedback, not on budget variances.

Source: "The Leader's Dilemma: How to Build an Empowered and Adaptive Organization Without Losing Control" (Jossey-Bass, 2011)

Beyond budgeting, however, requires leadership that has moved beyond a command-and-control mindset to instead empower all levels of decision makers. It also requires transparency and trust. Finally, it does not work for organizations still struggling to align operations on shared values and goals. (See the sidebar, "First Principles," below.)

IN REAL LIFE

New York–based LT Apparel Group, a privately held supplier of clothing brands such as Adidas, Carhartt, and French Toast, redesigned its budgeting process and used technology to streamline forecasting.

Before 2014, LT Apparel's forecasting process occurred semiannually, largely due to the amount of time it took to produce a budget with spreadsheet models shared from multiple locations. The process sometimes took five months to complete, including dealing with consolidation issues and system crashes. As a result, sometimes actuals arrived before forecasts were finalized.

LT Apparel found it a challenge to overcome the ineffectiveness and inaccuracies laden in its semiannual approach. The apparel industry operates on long lead times. Using overseas manufacturers means it sometimes takes 18 months for products to go from concept to the consumer. The organization needed a more reliable, long-term forecast to better plan for fluctuations in commodity pricing and labor rates, and ultimately to invest its available cash flow.

LT Apparel redesigned its forecast process with the following features:

- **Rolling horizon**—The new process involves monthly forecasts to facilitate asset allocation. The forecasting team sets the forecast for 30 months out and then keeps that horizon rolling. Most months require only small changes to the forecast. Material updates are aligned with the individual brand's production and selling calendars. As the forecast is updated, the model leverages 24 months of historical data.
- **Driver-based**—The forecast is automatically fed with variable cost structures, new-hire assumptions, and fixed expenses based on historical data. The forecasting team focuses on a small number of key drivers, such as sales projections and distribution costs, with many tied to seasonal rolling averages.
- **Decentralized accountability**—Process owners are responsible for providing critical information on key drivers. For example, a wholesale planning department provides the

Photo courtesy of LT Apparel Group

variables related to sales, margin, and inventory. The logistics team then develops the distribution volume metrics and related costs. These inputs feed the forecast model.
- **System analytics capabilities**—A cloud-based enterprise performance management (EPM) system provides a single source of truth and a modeling component to build and report on the rolling forecast.

The new EPM software was fully implemented by December 2015, and all planning templates were integrated by June 2016. By the end of 2016, LT Apparel had eliminated the annual budget. The retailer has seen improvements in process accountability and financial projection accuracy, and the new forecast provides the information necessary to plan cash reserves and capital investments.

ALL IN

Minnesota-based Park Nicollet Health Services replaced its traditional budgeting process with a beyond budgeting approach. The provider of primary care clinics, urgent care centers, and pharmacies was formed out of a 1990s merger. Through the early 2000s, it had trouble yielding a positive operating result. The process for developing its budget required the finance and accounting function to combine 240 budgets and then produce a number estimating the scale of the loss.

Management would then return those budgets to operational managers to "try again," because the estimated loss was too big. Requiring two such passes, the budgeting process would take up to seven months to complete. Board approval would come very late in the new year.

Because the existing process didn't work, the organization shifted to a focus on targets, unbiased forecasts, and action plans to address forecast and target gaps. The goal was to be forward-thinking rather than always justifying performance based on a budget made months ago.

As a first step, finance examined its processes and mapped its value streams. Looking at the scale of dysfunction in its traditional budgeting approach, it completely eliminated it. Instead, the organization decided to:

• Base goals on maximizing performance potential;

• Base evaluation and rewards on relative improvement with hindsight;

• Make planning a continuous process with forecasts set on a rolling horizon of six quarters;

• Provide resources in response to need and market opportunities;

• Coordinate company activities according to prevailing customer demand; and

• Set base controls on effective governance and performance indicators.

Instead of focusing on setting budget needs and justifying variances, employees now have the bandwidth to focus on Lean management. And instead of judging employees on their capacity to meet the budget, evaluations focus on improvement in process performance. Annual bonuses are based on relative financial performance instead of the budget, and the organization now bases goals on profit potential.

Park Nicollet Health Services operates without an annual budgeting cycle; instead, it makes planning a continuous process.

Finance and accounting measures performance based on costs for year-end service and units per full-time employee. Instead of comparing actual performance to a budget, the function compares actual performance with the previous quarter and—since Minnesota health care has a lot of seasonality—the same quarter last year.

Park Nicollet's effort has eliminated waste, empowered employees to make thoughtful decisions, and focused the finance and accounting function and the larger organization on work that matters. Although mergers have occurred since its budgeting transformation, Park Nicollet continues to operate without an annual budgeting cycle.

The process for developing the budget required the finance and accounting function to combine 240 budgets and then produce a number estimating the scale of the loss.

Moving beyond a traditional budgeting approach requires persistence to ensure a truly adaptive process doesn't devolve into an exercise in budgeting revisions. The ultimate goal in planning should be to dynamically adjust resource allocations as needed to reach strategic goals. The point is not to make numbers hit a magic target but instead to allocate resources and act wisely. CFO

Steve Player is a senior research fellow working with APQC's financial management research team. He is the co-author of "Future Ready: How to Master Business Forecasting." Paige Leavitt is a writer and editor focused on process and performance improvement in business and education. As principal research lead, Rachele Collins, Ph.D., is responsible for APQC's best practices research in financial management.

Photo courtesy of Park Nicollet Health Services

SPECIAL REPORT Working Capital Scorecard

The Hard Part of Boosting Liquidity

With payables stretched to the limit, wringing more cash out of working capital will be a challenge. **By Vincent Ryan**

What CFO doesn't want working capital to generate cash rather than consume it? To not have to answer pesky analyst questions about lower quarterly cash levels? To not have to draw on a line of credit because customers are paying on time?

No, CFOs would rather be confident that the accounts receivables and payables departments are operating optimally. But that requires attention to detail, and few organizations can focus on this core area consistently.

The 2019 *CFO*/The Hackett Group Working Capital Scorecard shows that the largest 1,000 U.S. companies remain efficient users of working capital. But, as in most years, they could be doing better, especially at managing inventories.

The 1,000 companies (benchmarked every year the past decade) didn't perform poorly in 2018. Total net working capital dropped as a percentage of revenue last year despite robust sales, and the average cash conversion cycle (roughly, the time it takes to turn resources into cash) fell to 34.8 days from 35.5 the prior year. To boot, operating cash flow rose 17%.

However, the needle barely moved on the key working capital metrics, and one, days payables outstanding, actually worsened. Why does that matter? These companies' balance sheets may not be as resilient as they think.

While profitability and sales rose in 2018 for the 1,000 U.S. companies in the scorecard, cash on hand fell 9% from 2017. And many of them are significantly leveraged—they had an average debt of 47% of revenue, up from 35% in 2008. The gap between debt and cash levels is much wider today compared with the period prior to the Great Recession, points out Gerhardt Urbasch, a senior director at The Hackett Group.

More ominously, many experts see some external sources of cash from the past two years drying up. The Trump tax cuts and greater incentives to repatriate foreign cash put less pressure on working capital efficiency, but now their effect is dwindling, Urbasch says. Meanwhile, tariff tit-for-tat is driving up the costs of imports and raw materials, eating into profit margins when costs can't be passed on to customers.

All that could put a new emphasis on cash flow. In addition, some companies face internal challenges. For example, DowDuPont, in the midst of a complex spinoff transaction, is spending cash on separating out three enti-

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ties' IT systems. To combat that, the chemical giant is "actively working" on days sales outstanding, days payables outstanding, and days inventory outstanding, said Howard Ungerleider, the company's CFO, at a May conference. Every day of efficiency DowDuPont finds in these working capital areas generates $100 million of additional cash flow, Ungerleider said.

The Easy Part

For the last 10 years, getting better at managing working capital has been largely about fixing only one leg of a three-legged stool: days payables outstanding. Working capital benchmarks

"The easiest component of working capital to improve is DPO [days payables outstanding], because large companies tend to have leverage there."

—Shawn Townsend, director, The Hackett Group

have remained respectable because large companies have extended payment terms with suppliers. That has elevated their cash levels.

The scorecard companies gradually went from paying their suppliers in about 45 days in 2009 to about 56 days (almost two full months) in 2017. But the rubber band stretches only so far. Supply chain finance programs ensured that suppliers' own liquidity didn't suffer; now, it appears, resistance from suppliers has kept customers from lengthening terms any farther.

While average days payables outstanding (DPO) has risen by 38% since 2008, in 2018 average DPO actually fell (worsened). On average, the 1,000 companies paid their suppliers almost two days faster (in 54.8 days, compared with 56.4 the prior year). A majority (53%) of the 1,000 companies saw this DPO deterioration.

Of course, not all companies have reached the zenith of optimizing payables. The top-quartile performers in the Working Capital Scorecard had an astonishing average DPO of 64.7 days. However, median performers had an average DPO of just 45.3 days.

Columbus McKinnon, for example, a provider of electric hoists and crane components, improved its DPO by 6 days in the first quarter of 2019. That helped push down working capital as a percentage of sales by 70 basis points. Management thinks the company still has an opportunity to delay payments even longer.

The average large company, though, has done as much as it can to stretch terms and gain efficiencies from its procure-to-pay processes, say The Hackett Group's consultants. For most of them, 2019 will be quite a different animal.

"The easiest component of working capital to improve is DPO, because large companies tend to have leverage there," says Shawn Townsend, director at The Hackett Group. Once an organization exhausts that avenue, however, it has to move on to another leg of the stool: receivables, inventory, or both.

Tightening Up

Those are much more difficult areas from which to wring cash.

With companies lengthening payment terms the past decade, tightening up on receivables has been tough. For 2018, the scorecard's 1,000 companies improved receivables performance (days sales outstanding, or DSO) by eight-tenths of a day in 2018 (to 38.5), largely due to increases in revenue. (The DSO equation is accounts receiv-

Sales Into Cash

Days sales outstanding varied widely by industry last year.

- **42** Computer hardware
- **35** Beverages
- **21** Motor vehicles
- **14** Airlines
- **30** Oil & gas
- **18** Food & staples retail
- **54** Automotive parts
- **23** Hotels & restaurants
- **52** Chemicals

Source: The *CFO*/Hackett Group 2019 Working Capital Scorecard

Mixed Results

26.7
Number of days it took top-quartile performers to collect on receivables (vs. 46.7 days for median performers)

-9%
Change in cash on hand (year over year) for the 1,000 companies at the end of 2018

$5.5 trillion
Total debt load, up 5% from 2017

17%
Rise in days inventory outstanding the last 10 years

54.8
Average number of days it took to pay suppliers (DPO) in 2018

Source: The *CFO*/Hackett Group 2019 Working Capital Scorecard

Photo courtesy of the company

Moving the Needle

Cash conversion got faster for the scorecard's 1,000 U.S. companies, but only marginally.

Collection of receivables was slightly faster.

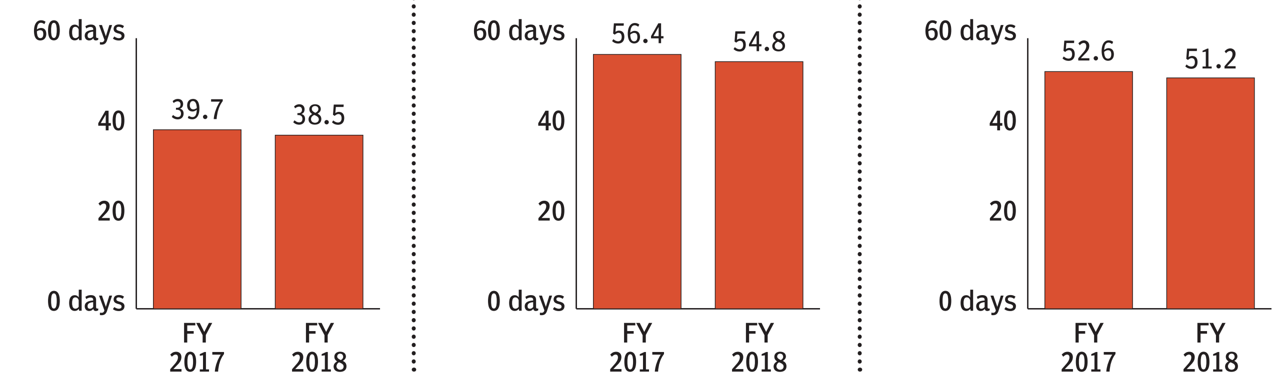
Days sales outstanding

Payment terms, after years of stretching, shortened.

Days payables outstanding

Progress was finally made on cutting back excess inventories.

Days inventory outstanding



Source: The *CFO*/Hackett Group 2019 Working Capital Scorecard

ables at year-end divided by one day of revenue.) Nearly 600 of the scorecard companies saw DSO improvements in 2018. But as a group they have pushed DSO to under 36 days only twice in 10 years, and among scorecard companies DSO is still near its all-time high.

One of the obstacles is the lag in adopting the latest technologies. Companies are struggling with applying them on the receivables side of the cash conversion cycle, says Todd Glassmaker, a director at The Hackett Group. The end-to-end solutions that are available for payables just aren't ready yet for AR teams. "There are a host of technologies in play but they're a still a bit immature—it's also a customer-facing solution, so there is a lot more complexity," Glassmaker notes.

While companies have leveraged older technology to evaluate customer creditworthiness and prioritize account collections, as well as to automate some collections messaging, they are still figuring out how artificial intelligence and robotic process automation can improve receivables performance.

There are other reasons why lowering DSO may be difficult. As with DPO, the top-quartile performers are bumping up against the natural limits. They posted an average DSO of 26.7 days in 2018, which seemingly would be pretty difficult to improve upon in most industries. "That is probably right up against best possible, given the nature of standard payment terms," says Craig Bailey, an associate principal at The Hackett Group.

In addition, large companies are unlikely to revert back to paying suppliers in 45 days (like they did a decade ago) and lose their working capital cash cushion.

Instead of sitting on their hands while awaiting better tools, though, many receivables departments will need to work on (1) tightening up internal billing processes and (2) building cash awareness among sales and collection teams, Glassmaker says. In collections, that means giving agents visibility into how they impact corporate targets and, in sales, introducing a working capital element into sales teams' compensation.

Stock Answers

To make real headway on lowering the cash that working capital ties up, organizations will to have to look in a forbidding place: days inventory out-

"There are a host of technologies in play but they're a still a bit immature—it's also a customer-facing solution, so there is a lot more complexity."

—Todd Glassmaker, The Hackett Group

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standing (DIO). DIO among the 1,000 companies fell slightly, to 51.2 days in 2018. That was down from 52.6 in 2017, and the first drop since 2011. But inventory levels still increased 7.4% for the year, and DIO performance was merely adequate—the average DIO among the 1,000 companies was at its second highest point since 2009.

For many reasons, inventory levels are the most difficult nut to crack in the working capital realm. Economic and industry trends have been working against the notion that holding fewer days' worth of inventory is a best practice.

The perennially low interest rate environment has made it less painful for companies to carry excess inventory. In addition, some see a competitive advantage in having higher minimum or safety inventory levels due to the complexity of global supply chains.

Inside organizations, finance just hasn't been able to put the screws to the inventory operations side. What's been missing is a "burning platform" for the discussion of cutting back on inventory levels, says Bailey. While finance may wish to optimize inventory on a cash-flow basis, manufacturing or operations managers tend to look at costs. In the cash vs. cost trade-off, cash has been losing—in other words, optimizing cash in inventory management has not been a priority.

"From a cost perspective it may make sense for a manufacturer to have very large production runs, but from a cash perspective that might not be the right thing to do, because it's increasing average inventory," Bailey explains.

"We still have opportunities both in... making the right product available at the right time in the right location, and reducing quite significantly days inventories on hand."

—Luca Zaramella, CFO, Mondelez

More organizations are beginning to focus on tackling inflated and excess inventory levels, says Bailey. So much so that The Hackett Group's experts expect 2019 to be an inflection point.

For example, beverage maker Mondelez maintains that it is best-in-class with its low cash conversion cycle. In a late May earnings call, CFO Luca Zaramella said the company tracks payment terms closely and uses advanced receivables and collections management. But its biggest opportunity going forward is inventory management.

"We still have opportunities both in ... making the right product available at the right time in the right location, and reducing quite significantly days inventories on hand," Zaramella said.

Helen of Troy Limited, a marketer of brand-name housewares, is also targeting inventory levels. "We have a lot of improvement we can make in just getting our forecasting and demand planning into a good place where we don't need to have safety stocks and those types of things that we've held in the past," Brian Grass, Helen of Troy's finance chief, told investors in May.

Helen of Troy is also trying to consolidate suppliers. Grass said having fewer, more strategic partners that it can use to shorten cycle times and lead times could have "a multiplier effect, along with the demand planning, to get the inventory balances down."

Lower inventories will be a blessing for any organization if global growth slows and demand from consumers and businesses wanes. The smartest companies will be preparing for it. Some of Hackett's clients, for example, are paying down debt with the cash they generate through better working capital management. They plan to continue doing that even if the direction of U.S. interest rates later this year is down rather than up.

For most companies, finding that cash won't come easily, since for many payables are already optimized. They'll have to look in other areas to make any headway in cutting working capital bloat. CFO

How Working Capital Works

Days sales outstanding (DSO): AR/(total revenue/365)
Year-end trade receivables net of allowance for doubtful accounts, divided by one day of revenue.

Days inventory outstanding (DIO): Inventory/(total COGS/365)
Year-end inventory, divided by one day of cost of goods sold (COGS).

Days payables outstanding (DPO): AP/(total COGS/365)
Year-end trade payables divided by one day of COGS.

Cash conversion cycle (CCC): DSO + DIO – DPO
Number of days for each indicator added up for the assets part of the balance sheet and subtracted for the liabilities.

Note: Some companies use revenue instead of cost of goods sold when calculating DPO and DIO. The Hackett Group's methodology uses COGS across the payables and inventory categories to reflect an accurate output.

Photo courtesy of the company

CFOs Revise Recession Projections

Finance chiefs still think an economic downturn is coming, but not until the second half of 2020, finds the latest Duke/*CFO* survey. By Lauren Muskett

CFOs are pushing out the timing of their recession predictions, according to the first-quarter Duke University/*CFO* Global Business Outlook Survey. About two-thirds of U.S. CFOs (67%) now believe the United States economy will be in recession by the third quarter of 2020, and 84% think it will happen by the first quarter of 2021.

That's much later than the timing CFOs gave in December 2018, when almost half (49%) of them said they thought the U.S. economy would enter a period of contraction by the end of 2019. In this new survey, which ended April 5, only 38% think a recession will arrive by the first quarter of 2020.

"A majority of CFOs believe that the U.S. will be in recession within about 16 months," said John Graham, a finance professor at Duke's Fuqua School of Business and director of the survey. "While the start date of the recession has been pushed back relative to what we heard last quarter, there is a consensus that a downturn is approaching."

The first-quarter survey, which garnered 469 respondents in North America, puts CFOs' projections closer to those of many U.S. economists. However, the two groups are not fully in sync. A National Association of Business Economics survey in February found that 75% of member economists expect a recession by the end of 2021, with only 42% saying a recession will happen in 2020.

Regardless, both economists and CFOs seem to agree that a 2019 recession is off the table. Indeed, Goldman Sachs economists recently proclaimed that the odds of a recession over the next four quarters are only a touch over 10%.

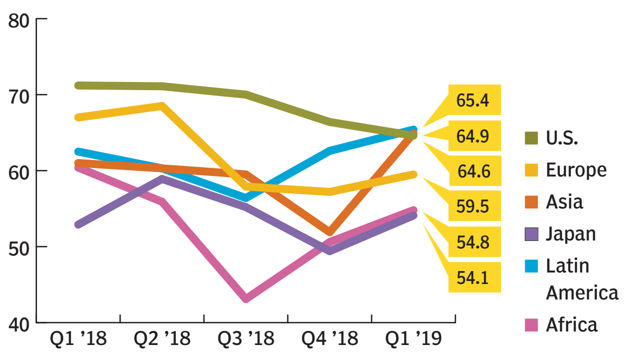
Which economic variables will provide an accurate indication of a coming slowdown? Almost half (47%) of CFOs considered GDP growth to be one of the top three indicators. Consumer spending (39%), commodity prices (31%), and interest rates (29%) were also named as popular gauges of an imminent downturn.

The survey's U.S. CFO optimism index, historically an accurate predictor of future hiring and overall GDP growth, dropped to 65.4 in the first quarter, down one point from last quarter and five points from September 2018. A year ago, the U.S. CFO optimism index was near a record high, at 71.2. It has averaged 60 on a 100-point scale for the past 20 years, but dipped into the 40s during the last recession.

CFO optimism globally rebounded in the first quarter. On a scale of 0 to 100, optimism among CFOs in Europe rose two points, to 59.5. Asia climbed sharply to 64.6. Overall optimism among CFOs across Latin America rose to 64.9, boosted by optimism in Brazil.

Economic Optimism Continues to Fall in U.S.; Rebounds Globally

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



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

Outlook for 2019

Supporting the notion that an economic downturn is more than a year off, CFOs maintained their projections for 12-month increases in capital spending (5%), hiring (2%), and wages (3%).

And why not? U.S. respondents' level of optimism about their own companies' performance the next 12 months hit 70.4 for the first quarter, up from 68.5 at the end of 2018. Their "best guess" for 2019 real revenue growth was a median 14%, with a 1-in-10 chance it would be as high as 22%.

Some of that revenue growth will be fueled by continued access to a salubrious credit market. The Federal Reserve's decision not to hike rates so far in 2019 may have a big impact on corporate investment and overall financial health. Respondents estimated that their long-term borrowing rates would increase only slightly by the end of the year, to a mean of 5.2% from a current 4.8%, or 200 to 250 basis points above three-month LIBOR. About 51% of finance executives surveyed said the level of interest rates is “important” or “very important” in choosing the amount of debt for their company.

The level of interest rates affects companies’ capital structure policies for varying reasons. One respondent pointed out that “higher interest costs require more sales to cover debt service at a time when revenues may be more difficult to find.” Another offered, “we don’t want to incur high interest rates that will knock our debt coverage ratio outside of industry standards.” And a third said low-cost debt drove higher leverage and share buybacks, but still enabled “adequate balance sheet flexibility.”

Which metrics do firms use to calculate the optimal amount of debt? Debt-to-EBITDA was cited by 38% of respondents as their number-one metric, 16% chose debt-to-assets, and 12% selected interest coverage.

About one-fifth of respondents recently changed the target range for the amount of leverage their company is willing to take on. About 29% of those increasing leverage indicated they would use the surplus funds for general needs. Another 28% indicated the money was for specific investments. In the answers to open-ended questions, many indicated the change in debt level was due to an acquisition; new projects requiring initial capital investments; market expansion or new products; or equipment maintenance and modernization.

47%

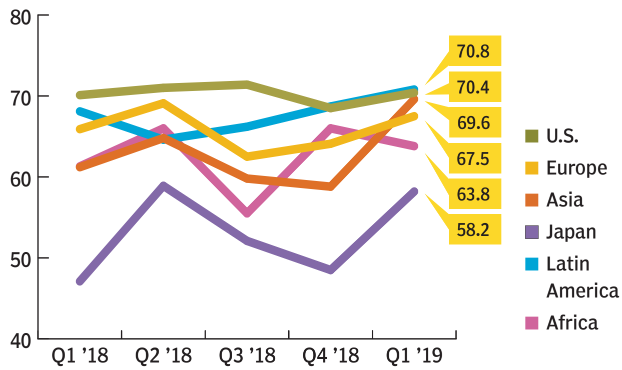
of CFOs consider GDP growth to be one of the top indicators of a coming slowdown, followed by consumer spending, commodity prices, and interest rates

The debt sources these CFOs planned to tap in 2019 included lines of credit (40%), bank loans (33%), the bond market (12%), and non-bank loans (10%). (In comparison, less than 10% planned to issue some kind of equity).

The term on bank loans was four to five years for almost half (46%) of respondents, while new non-bank loans most often came with terms of two to three years. More than half (54%) said their new bond issues would have a term in the range of six to 10 years.

Company Confidence Rises Slightly in U.S; Jumps in Asia

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



*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. The survey concluded April 5, 2019, and generated responses from more than 1,500 CFOs, including 469 from North America, 145 from Asia, 261 from Europe, 590 from Latin America, and 42 from Africa.

Decisions on Debt

While low interest rates have made issuing debt attractve thte last decade, finance chiefs still make decisions about leverage using other yardsticks. Capital structure is most often affected by finance executives’ desire to maintain financial flexibility, according to this quarter’s survey respondents. Why is financial flexibility so important? About six in 10 (62%) chose “ability to avoid financial distress during an economic downturn.” More than half (58%) said it was to be able to quickly pursue investment opportunities, and 42% said it was to “preserve unused line of credit capacity.”

Other companies were driven to access credit because of the volatility of their earnings and cash flows (54% considered this important or very important) or insufficient internal funds (55%). Very few CFOs (19%) said the tax deductibility of debt was an important factor in the amount of debt on they held on their balance sheets.

With the increase in rates, are any organizations planning to deleverage in 2019? About four-in-10 executives (44%) indicated their organizations would not be retiring any debt this year. Others are. Almost one in three (31%) said they would be doing so, but only as debt matures. Less than one-fifth (17%) said they would be retiring debt before it matures. Of those retiring debt, 31% said they would be replacing it with a similar amount of new debt.

The first quarter Duke/*CFO* survey, concluded April 5, generated responses from more than 1,500 CFOs. CFO

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FIELD NOTES

Perspectives from CFO Research

The Disappearing DB Pension Plan

The use of defined benefit pension plans continues to decline as sponsors look to de-risk pension strategies. By Chris Schmidt

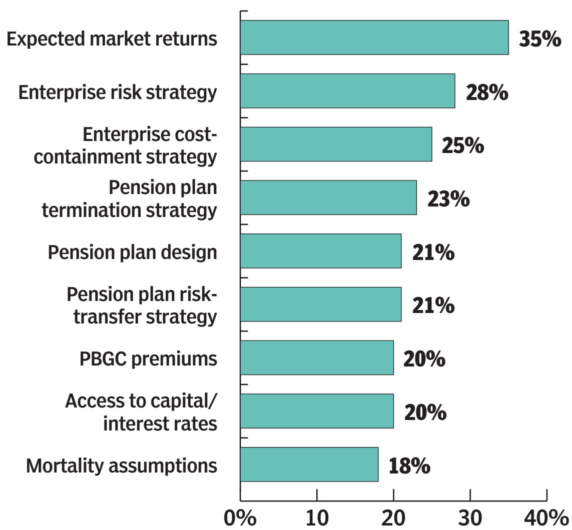
Governing a defined benefit (DB) pension plan and its investment strategy has always been challenging. Over the past decade it's also become increasingly complex, not to mention costly, spurring many plan sponsors to reevaluate their pension plan approaches.

A new survey of 155 U.S. senior finance executives conducted by CFO Research, in collaboration with Mercer, found that 77% of those DB plan sponsors expect to change how their plan is managed over the next two years. That was up from 60% the last time the survey was conducted in 2017. (Mercer and CFO Research have been conducting a DB risk management survey on a biennial basis since 2011.) Meanwhile, 63% conceded their organizations were struggling to find the time and expertise to fully meet their obligations relating to oversight of their DB plan investment strategy.

Historically high equity prices are causing some plan sponsors to question whether the stock market is due for a downturn that will impact pension strategy. In fact, 35% of respondents identified expected market returns as the factor most likely to prompt them to modify their pension funding policies and practices over the next two years. (See Figure 1.)

FIGURE 1

What changes do you believe are most likely to cause your organization to modify its pension funding policies and practices over the next two years?



Multiple responses allowed

De-Risking Paths

Many employers have spent much of past two decades looking for ways to dial down the risks presented by their DB plans. They aim both to minimize the plan's impact on their organization's financial statements and to relieve management of duties that take their focus away from core business activities. For some, the "nuclear option" is increasingly popular. The survey found that 71% of plan sponsors were considering terminating their plans over the next 10 years, up from 59% in 2017 and 47% in 2015.

Broadly speaking, those intent on de-risking have three levers to pull: funding strategy, investment strategy, and risk-transfer strategy. Which are they using?

Funding strategy. The Pension Benefit Guarantee Corporation (PBGC) insurance premiums remain a key driver of pension funding strategies for many employers. Improving a plan's funded level can reduce its PBGC premiums. In the 2019 Mercer/CFO survey, 85% of survey respondents said they recently increased contributions to reduce the future cost of PBGC premiums or were considering doing so, up from 73% in 2017 and 57% in 2015.

Other recent increases in contributions were motivated by the Tax Cut and Jobs Act of 2017, which not only lowered taxes but also raised the cost of financing pensions (for taxable corporations). Seven in 10 respondents said their organizations made a contribution beyond the minimum as a direct result of changes in corporate tax law. They included 29% that made a significant additional contribution.

Investment strategy. Strategies such as dynamic de-risking appeal to some plan sponsors because they may obviate the need to come up with additional cash for their plans. In dynamic de-risking, the sponsor maps out a "glide path" that specifies how a plan's asset allocation strategy will change as its funded status improves. The goal is to have assets and liabilities tightly matched once the plan reaches its maximum funding level. Doing so makes it easier to maintain the plan going forward or terminate it, if that is the desired outcome. In the 2019 survey, just slightly more than half of respondents said their organizations had a dynamic de-risking strategy in place, and 34% said they were considering one.

Other investment-related risk-management strategies are available. For example, 37% of respondents said their organizations recently increased allocations to fixed-income investments, 30% adjusted the duration of their fixed-income investments to hedge plan liabilities, 28% made greater use of derivatives to hedge interest-rate risk, and 23% made greater use of options or related methods to manage tail risk. (See Figure 2.)

Risk-transfer strategy. One of the most straightforward approaches for moving pension risk from the plan sponsor to another party (or to the employee) involves offering plan participants a lump sum in exchange for their standard pension benefit. In the 2019 survey, 57% of senior finance executives (compared with 33% in 2017) said their organizations have amended their plans to make a permanent lump-sum feature available when employees retire or are otherwise terminated. And 40% said they have offered at least one window during which certain participants could get a lump-sum payment.

Greater enthusiasm for this method is evident—76% of sponsors that have offered a one-time lump-sum payment to some or all plan participants said their organizations were satisfied or very satisfied with the outcome.

Another risk-transfer option is to offload retiree obligations to an insurer through the purchase of an annuity. Many plan sponsors assumed that annuity purchases were too expensive to make economic sense. That's still a common perception; in the latest survey, 39% of respondents said they think an annuity buyout for retirees would be expensive (e.g., 110% to 115% of the pension benefit obligation held) or very expensive (greater than 115% of the PBO).

71%

of DB plan sponsors are considering terminating their plans over the next 10 years

Despite that prejudice, more plan sponsors may be warming to the idea. The proportion of surveyed organizations that have completed or were considering an annuity purchase for some or all retiree obligations remained flat over 2017 (55%). A greater proportion (70%) said they're likely to transfer some or all of their retiree obligation from their DB plan through the purchase of an annuity in this year or next. That's up from 56% that were planning to do so two years ago.

The End State

Every defined benefit plan in the U.S. is facing one of three end-states: sustainability, hibernation, or termination. Right now, termination appears to be the most popular option.

Regardless of the ultimate goal, plan sponsors will need to pay attention to data, transaction costs, and plan management.

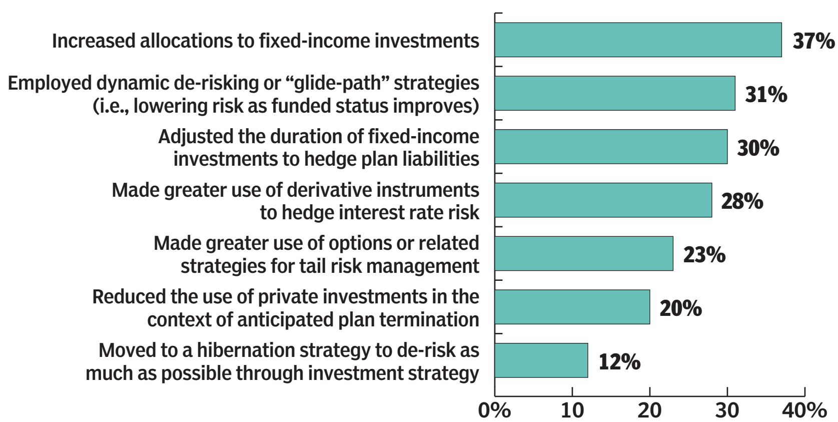
Data. Right now, plan sponsors are highly confident in their plan data. Nearly all (95%) of the survey respondents said their plan's data was either pristine (meaning they would be able to execute a plan termination immediately) or in good shape (meaning they would be able to execute a termination in a matter of weeks). That was up from 85% in 2017.

Transaction Costs. Many plan sponsors (65%) believed that buying annuities to cash out plan participants was expensive. In practice, this may not be the case. Sponsors contemplating an annuity purchase should be planning now for what the actual costs may be, and exploring alternative payment strategies that may make de-risking via an annuity more attractive.

Plan Management. A majority of plan sponsors have already consolidated their service providers to some degree, allowing for more streamlined plan management. Currently, 62% of sponsors use a single provider for all DB services or use the same provider for at least two DB services. CFO

FIGURE 2

Has your organization implemented any of the following investment-related actions for managing risk in its DB plan?



Multiple responses allowed

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THE QUIZ

Tee Time

With the United States Open golf championship in mid-June and the warm summer weather driving recreational golfers out to play, it's a peak season for the U.S. golf industry. Consumer spending on greens fees, golf equipment and apparel, golf tourism, and more combine with the industry's diverse supply needs to create a vibrant economic engine. See how much you know about the business side of this popular sport.

1 What was golf's estimated impact on the U.S. economy, in dollars, in 2016 (the year studied in the most recent U.S. Golf Industry Report)?

A. $25 billion
B. $84 billion
C. $52 billion
D. $114 billion

2 How big was the U.S. market for golf clubs and balls in 2018?

A. $1.9 billion
B. $4.3 billion
C. $2.7 billion
D. $6.5 billion

3 In which state did the legislature propose in April 2019 to dramatically increase taxes on golf courses?

A. California
B. Florida
C. New York
D. Texas

4 As of May 30, 2019, what was the market cap of Acushnet Holdings, the largest pure-play U.S. golf company?

A. $1.8 billion
B. $3.8 billion
C. $4.5 billion
D. $2.4 billion

5 What was the approximate ratio of U.S. golf course openings to closures in 2018?

A. 1:1
B. 2:9
C. 1:16
D. 3:1

6 How many jobs did the U.S. golf industry support in 2016?

A. 1.3 million
B. 900,000
C. 650,000
D. 1.9 million

7 How much money did PGA Tour events generate for charitable causes in 2018?

A. $85 million
B. $190 million
C. $245 million
D. $330 million

8 How many Americans played golf in 2018?

A. 33.5 million
B. 18.8 million
C. 12.5 million
D. 27.4 million

Sources: National Golf Foundation, U.S. Golf Industry Report (by a coalition of golf's governing bodies and partners), PGA Tour, *Golf* magazine, SEC.gov

Answers: 1-B; 2-C; 3-C; 4-A; 5-C; 6-D; 7-B; 8-A

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