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TOP CFO PRIORITIES FOR 2018

REMODELING SUPPLY CHAINS

The Price Of Protectionism

Will an "America First" trade policy help or hurt the U.S. economy?

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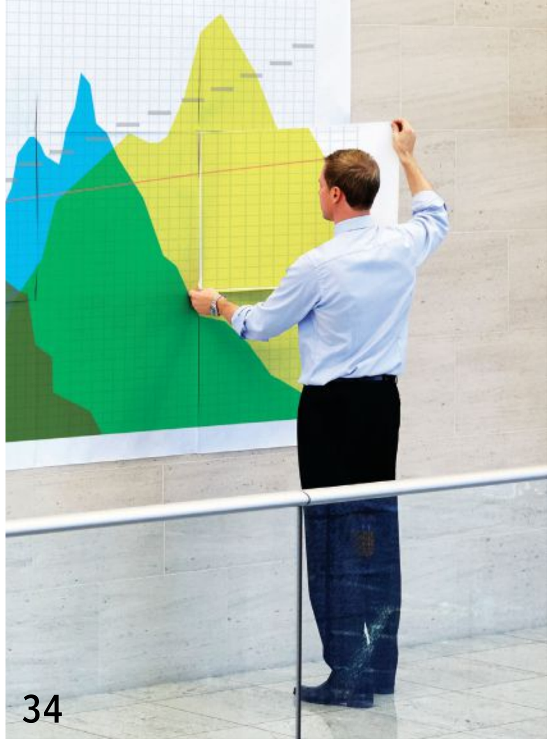
December 2017
Volume 33, No. 10



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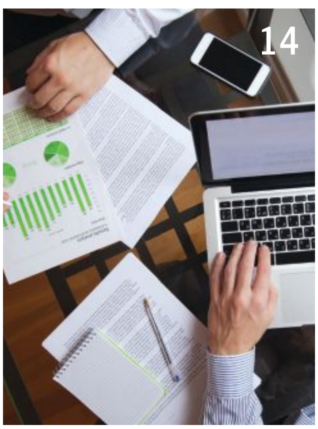

Up Front

By the Numbers

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Beware Tax Cuts

Conspicuous by its absence from our eight-page feature on CFOs' top priorities for 2018 (see "Taking Aim," page 34) is any discussion of the large U.S. corporate tax cut that was speeding through Congress in late November. But if the legislation does pass, CFOs may have reason to worry. ¶ In a recent CFO.com column, Joel Naroff, former chief economist for TD Bank, described why finance chiefs should be careful what they wish for. I am devoting this column to presenting his cogent argument.

"Tax cuts are like sugar highs," Naroff explains. "They get businesses and households running around like crazy, but eventually things come crashing down. Yes, they can raise the level of economic activity in the short term. [But] once the economy accelerates to the new level, how do you grow from there?"

As economics teaches, GDP growth requires businesses to use more workers and "through brute force" expand output, or use workers more efficiently. In the United States, growth of both the labor force and productivity has been lackluster.

The problem with the House and Senate bills, writes Naroff, is that they increase corporate profitability but achieve little else. The corporate tax cut could push growth to 3% or even higher for a period, but "with the labor force and productivity growing so slowly, that pace would exceed the capacity [of the economy] to grow over the longer term," writes Naroff.

Therefore, "to expand output, firms would have to either start hiring unqualified workers or bid workers away from other companies. Either way, labor costs would rise," according to Naroff. "Rising worker compensation may support faster growth, but it would also pressure earnings and raise inflation."

If inflation accelerates, the Federal Reserve will be forced to hike rates faster and higher than currently projected. "That creates the likelihood of bubbles forming," writes Naroff. And what follow bubbles are recessions.

I will add this: A recession is not the result you want from a corporate tax cut. But, if CFOs are smart, they'll devise contingency plans for just such a scenario.

Vincent Ryan
Editor-in-Chief

EDITOR'S PICKS

FINANCE
It's not too early to put the **CFO Rising East Summit** on your 2018 calendar. Taking place March 7–8 in Boston, the event features the CFOs of Voya, Westinghouse Electric, and GameStop. See the full speaker list on the Innovation Enterprise website.

TECHNOLOGY
In **"The Avoidable Mistakes Executives Continue to Make After a Data Breach,"** Bill Bourdon, president of Bateman Group, explores the four sins companies continually commit after a high-profile cyberattack. They include "foot dragging," "poor customer service," "not being transparent," and "failure to accept accountability." Read more on the Harvard Business Review website.

CAREERS
"Managers Aren't Doing Enough to Train Employees for the Future," writes doctor of psychology David W. Ballard. Among the evidence: a recent Rand survey that found more than one-third of U.S. workers did nothing to develop new skills in the past year. The primary cause is a lack of supervisor support, says Ballard. Read more on the Harvard Business Review website.

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Mark Bennington

INBOX

Amid the rampant talk about new technology solutions revolutionizing business models and entire industries, it might be easy to forget that on the ground, implementations often don't go as planned. One example of this is Under Armour's SAP implementation (see page 10).

During the company's recent earnings call, executives blamed a difficult ERP implementation for negatively affecting third-quarter business results. Under Armour's new system is S/4HANA, SAP's in-memory enterprise management business suite. When we wrote about this on CFO.com, some readers offered their own views on getting S/4HANA up and running.

Shaun Snapp of Brightwork Research & Analysis, a specialist in SAP-focused research, wrote, "We have been **sounding the alarm on the immaturity issues with S/4HANA** for some time now. We just completed research into S/4HANA's implementation history that shows a very large discrepancy between what SAP says about S/4HANA and its actual implementations."

Said another reader, an official with an enterprise applications services firm and a specialist in SAP products, "Many companies struggle with smooth transition of their SAP systems to HANA because they fail to assess the HANA readiness of the systems."

He continued, "It is important for organizations to engage with HANA providers in defining the unique SAP HANA roadmap that would best suit their business processes, giving clarity on the system preparedness, time, and cost involved."

In **"Tax Cuts: Be Careful What You Wish For,"** economist Joel Naroff wrote that the main problem with the GOP-proposed cuts is that they will create huge budget deficits. That struck a chord with some readers.

"With mid-term elections coming up in 2018, it's hardly surprising that some politicians are focusing exclusively on short-term measures to ingratiate themselves with their constituents," wrote one. "What politician ever won votes for long-term foresight? And so **the recurring issue of budget deficits is kicked down the road for some future politician to deal with** when it reaches crisis point—and who knows when that will be?"

Chimed in another reader, "A finer affirmation of the current disastrous structure has never been written. The Congress is spending $4 trillion each year. This is not sustainable. With or without the current [tax] revisions, until Congress cuts spending the system will fail."

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STATS OF THE MONTH

$116B
Rise in U.S. household debt, Q3 2017

4.9%
Delinquency rate on outstanding household debt

$1.21T
Total outstanding auto loan debt, $300 billion of which is subprime

$1.4T
Outstanding student loan debt

3.1%
Quarterly increase in credit card balances

Source: New York Federal Reserve Q3 2017 report on household debt and credit

TOPLINE

M&A

Failed M&A Deals Continue to Increase

A massive study of M&A deals over 25 years reveals why announced deals fail to close. By David McCann

The proportion of announced mergers and acquisitions globally that failed to close was up for a third consecutive year in 2016, reaching an eight-year peak. It was the highest level since 2008, the year the financial crisis hit.

At 7.2%, it was the fourth-highest level of failed deal activity in a 25-year period examined in a new study by City University of London's Cass Business School, trailing only 1992, 2008, and 1993. The 2016 deal failure rate was well above the long-term average of 5.7%.

Uncertain political and economic environments—including the election of Donald Trump as U.S. president—were among the factors blamed in interviews with 40 M&A professionals following completion of the research. Given these uncertainties, transaction prices may simply have been too high.

But, considering the cyclical nature of business trends, perhaps as interesting as what caused the high failure rate in 2016 were insights into why deals have gone awry over time and what kinds of deals have been most subject to failure.

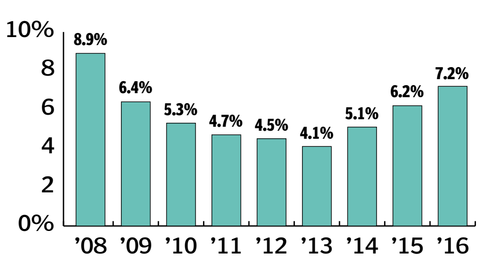
First, there were regional differences in deal failure rates: the highest rate (7.1%) during the 25-year study period was for announced acquisitions in the Asia-Pacific region; the lowest (4%) was in Latin America. The North America rate was 6.4%. By country, China and Australia had the greatest proportion of failures (12.9% and 11.9%, respectively), while Russia and Japan (1.4% and 2.2%) had the lowest.

By industry, failures were most prevalent in the materials and real estate sectors (7.7% and 6.8%) and lowest in the consumer/retail and health-care sectors (4.8% and 5.1%).

By far the starkest differential, though, showed up in the 11.1% failure rate for deals

A Big Year for Deal Failures

The proportion of failed acquisitions is on the upswing, propelled by unrealistically high transaction prices amid uncertain political and economic environments.



Source: Intralinks, City Univeristy of London's Cass Business School

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The presence of a target termination fee, also known as a "break" fee, reduced the average probability of deal failure by almost 12%.

involving public-company targets, triple the 3.7% rate when private companies were targets. Among 30 deal-specific, company-specific, and macro-level financial and nonfinancial factors studied, the 5 most significant for predicting failure were:

1. The absence of a target termination fee (also known as a break fee)—a fee payable by the target to the acquirer if the deal does not close. The presence of such a fee reduced the average probability of deal failure by almost 12%. It's not surprising that targets are more careful about entering into M&A transactions when they might be on the hook for such a payment. However, for deals where the acquirer pays a fee upon walking away, there was no significant influence on the probability of deal failure.

2. The size of parties to the transaction. The greater the target's revenue, the less likely the deal will be completed.

3. Whether a target initially regards an acquirer's bid as hostile or unsolicited. These things happen relatively rarely, but when they happen, a majority of such proposed deals—57.2% and 63.1%, respectively—fail to close.

4. The number of legal advisers retained by acquirers.

5. The number of financial advisers retained by acquirers.

Adding one extra financial adviser reduced the probability of failure by a startling 11.5%. One more legal adviser had an 8.0% effect. "This might seem counterintuitive, given the [possibility] for a large cast ... to get in each other's way," the research report says. However, it adds, many executives argue that such confusion is less likely when advisers are hired for their specific expertise, managed effectively, and incentivized to deliver a deal completion.

Cass conducted the study on behalf of IntraLinks, a provider of software that enables collaboration among parties to M&A deals.

The study covered 78,565 transactions from 1992 through 2016 that involved a change of control of the target company. For each transaction, either its value was at least $50 million, or the revenue of the acquirer or target was at least that amount, in the last fiscal year prior to the deal announcement. CFO

INVESTOR RELATIONS

SEC Chairman Seeks Proxy Inquiry

Jay Clayton will emphasize corporate prerogatives as much as shareholder demands.

Securities and Exchange Commission Chairman Jay Clayton wants to reopen an inquiry into the entire shareholder proxy process, including evaluating the costs and burdens of the proxy system on companies as well as shareholders. "Given the core role of the proxy process in public company governance, I believe the commission should be 'lifting the hood' and taking a hard look at whether the needs of shareholders and companies are being met," Clayton said in remarks at the Practicing Law Institute's annual conference on securities regulation.

Specifically, Clayton is calling on the commission to renew efforts to overhaul the proxy system begun under then-commissioner Mary Schapiro in 2010 with its "proxy plumbing" concept release. The release was called that because its purpose was to look closely at all aspects of the system. "I believe the commission should consider reopening the comment file on the 2010 'proxy plumbing' concept release to solicit updated feedback from market participants about what works and what does not work in our proxy system," Clayton said.

While shareholder proposals can lead to corporate governance changes that align more closely with the long-term interests of Main Street investors, they "also create costs, including out-of-pocket costs and the use of board and management time that otherwise could be devoted to operation of the company itself," according to the commissioner.

Jay Clayton

On the issue of proxy ballot proposals, Clayton seems to want to pay as much attention to corporate prerogatives as he does to shareholder demands. "The shareholder proposal process is not the only piece of this puzzle, but it is a piece worth examining," Clayton added.

The commissioner also said that questions still exist about what level of share ownership should be required to submit shareholder proposals, "as well as whether our current resubmission thresholds are too low."

| DAVID M. KATZ

Courtesy the SEC

TECHNOLOGY

Under Armour Discloses SAP Hiccups

Athletic apparel firm Under Armour is one of SAP's most-touted customers. At a New York event in October, the software giant trotted out an Under Armour enterprise transformation executive to describe the company's journey toward adopting S/4HANA, SAP's in-memory enterprise management business suite.

But, as it turns out, Under Armour's SAP implementation project isn't going so smoothly. On Under Armour's third-quarter earnings call on October 31, Patrik Frisk, the company's president and chief operating officer, said the struggles with the July 1 launch of its integrated ERP business solution "negatively impacted" third-quarter results by causing disruptions in Under Armour's supply chain.

"During this system migration, we have encountered a number of change management issues impacting our workforce and manufacturing partners as they adapt to the new platform and processes," said Frisk. Those issues caused delayed shipments and loss of productivity, he added.

Explaining the problems to an analyst on the conference call, CFO David Bergman said that "the change management [has] been a little tougher than we expected, including working ... with our inventory partners, our vendors, trying to get them up and trained on the system."

Bergman emphasized that the system is now "operating well" and is "stable," but he did say that Under Armour is still working through "the change management and the learnings and the reporting." While those issues won't impact fourth-quarter earnings as much, Bergman said, "they won't be completely gone yet."

Under Armour's SAP install is sizable, involving point-of-sale, warehouse management, inventory control, and merchandising. | VINCENT RYAN

CREDIT

Loan Terms Ease

Aggressive competition from other banks and nonbank lenders is pushing banks to ease business lending standards, according to the Federal Reserve.

The Fed's October survey of senior loan officers found that modest net percentages of banks reported they eased commercial and industrial loan (C&I) terms for firms of all sizes over the previous three months.

For C&I loans to large and middle-market firms, a significant net percentage of banks reportedly decreased spreads of loan rates over their bank's cost of funds. A moderate net share of banks reportedly increased the maximum size of their credit lines, lessened their use of interest-rate floors, and eased loan covenants.

"Among the domestic respondents that reportedly eased their credit policies on C&I loans over the past three months, more aggressive competition from other bank or nonbank lenders was by far the most emphasized reason for easing," the Fed said. "In particular, a majority of banks reported that more aggressive competition was an important reason for easing, with 14 of 29 respondents reporting it as very important, while no other reason queried was cited by more than one bank as being very important."

A moderate net share of domestic banks reported that demand for C&I loans from large and middle-market firms weakened, while demand from small firms was reportedly unchanged on net.

On the commercial real estate side, banks' underwriting standards on most loan categories remained basically unchanged, while demand for CRE loans reportedly weakened. A significant net fraction of banks reported tightening their standards for loans secured by multifamily residential properties.

Banks also reported that standards for all categories of residential real estate lending either eased or remained basically unchanged. Specifically, a moderate net share of banks reported easing underwriting standards for mortgages that are eligible to be securitized by government-sponsored enterprises. | MATTHEW HELLER

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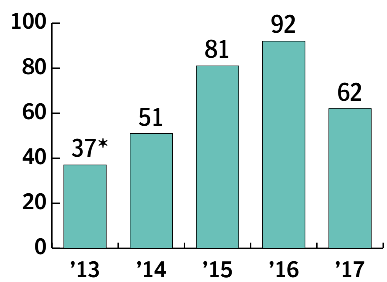
REGULATION

Enforcement Actions Fall

The Securities and Exchange Commission filed 62 enforcement actions against public companies and their subsidiaries in the government's 2017 fiscal year, a 33% decrease from a year earlier. The cause of the drop was a paltry 17 cases filed in the second half of the year (April 1 to September 30), a period when the number of SEC actions usually increases.

Easing Up?

SEC enforcement actions against public companies slowed significantly in 2017 from a year earlier.



*Count based on the year the SEC initiated the action

Source: Securities Enforcement Empirical Database

Total monetary settlements against public company defendants also fell from the first half of fiscal 2017 to the second half, declining to $196 million from $1 billion.

The data, published in mid-November, are taken from the Securities Enforcement Empirical Database (SEED), a collaboration of New York University's Pollack Center for Law & Business and Cornerstone Research.

The report did not give a reason for the drop in SEC cases, other than to say it corresponds to a change in leadership at the SEC. New SEC Chair Jay Clayton was confirmed by the Senate in May. In criticizing Clayton's pro-industry leanings, Democrats have called him "one of the most loyal guardians of Wall Street."

The number of defendants cooperating with the SEC was also down in the second half of fiscal 2017, with only 32% cooperating (versus 63% in the first half).

In other findings from the SEED report:

- "Issuer reporting and disclosure" continued to be the most frequent type of allegation against public-company defendants, accounting for 39% of enforcement actions.
- There were 10 actions involving violations of the Foreign Corrupt Practices Act in fiscal year 2017, but only two after February. The report attributed this fall to the departure of Kara Novaco Brockmeyer, chief of the enforcement division's FCPA unit since 2011.
- Allegations against investment advisers or investment companies were the most frequent type of enforcement action in the second half. This is consistent with Clayton's intent to focus more on investment professionals, the report said. | V.R.

Floyd Mayweather

REGULATION

SEC Warns Celebrities

The stars of entertainment, sport, and social media who are endorsing digital coin offerings may be violating U.S. securities laws, the Securities and Exchange Commission said in an October warning about the increasingly popular funding mechanism.

Boxer Floyd Mayweather, actor Jamie Foxx, and socialite Paris Hilton are among the celebrities who have helped fuel the boom in initial coin offerings (ICOs) or "token sales," which have raised more than $3.2 billion this year, a 3,000% jump from last year's total. But according to the SEC, celebrity endorsements may be unlawful if digital coins are considered securities and the celebrity does not "disclose the nature, scope, and amount of compensation received in exchange for the promotion."

"A failure to disclose this information is a violation of the anti-touting provisions of the federal securities laws," the SEC's enforcement division and office of compliance inspections and examinations said in a joint statement. "Persons making these endorsements may also be liable for potential violations of the anti-fraud provisions of the federal securities laws, for participating in an unregistered offer and sale of securities, and for acting as unregistered brokers."

Mayweather and popular rapper DJ Khaled both endorsed the Centra ICO, which raised more than $30 million from investors around the world. The SEC encouraged investors to research potential investments rather than rely on paid endorsements. | M.H.

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FRAUD

Ex-American Realty CFO Gets Jail

Former American Realty Capital Properties CFO Brian Block has been sentenced to 18 months in prison for his role in an accounting fraud that overstated a key metric used to evaluate the REIT's financial performance.

U.S. District Court Judge J. Paul Oetken said Block "participated in a scheme to inflate the value of the company" by "brazenly" making up numbers to ensure American Realty's AFFO (adjusted funds from operations) per share for the second quarter of 2014 was consistent with its publicly announced guidance and to conceal accounting errors in a previous report.

The fraud resulted in overstating AFFO for fiscal 2014 by about $13 million and inflated AFFO per share by about 5%.

"It's a serious set of crimes," Oetken said at Block's sentencing hearing in early November. "I'm not exactly sure why he did it," he added. "What is clear is he knew better … and should have known better."

Prosecutors had sought a sentence of at least seven years but Oetken cited mitigating factors, including Block's lack of a prior criminal history and "personal history" as a good father and friend. "It is unbelievable to me today that I am here," Block told the judge. The conviction is "so at odds [with my character]," he added.

American Realty disclosed the fraud in October 2014, saying it had asked Block and chief accounting officer Lisa Pavelka McAlister to resign after determining that the company overstated AFFO.

Block had been CFO of American Realty since its inception in December 2010. According to the government, Block, McAlister, and others learned in early 2014 that the method of calculating AFFO contained an error but continued to use the incorrect calculation. McAlister, who pleaded guilty to related charges, has yet to be sentenced. | **M.H.**

TECHNOLOGY

Losing Ground To Cyber Criminals

In the battle between organizations and cyber criminals, the bad guys are winning. The financial consequences of hacks have again shot up by 23% this year, equaling the increase seen in 2016.

Ponemon Institute conducted a benchmark study of 254 organizations, all with more than 1,000 "enterprise seats," or direct connections to the entity's network and enterprise systems. The results underscore the reality that cyber crime is a pervasive nemesis, far beyond the occasional mega-hacks—against Equifax, Target, Yahoo—that make big news.

The studied organizations suffered an average of 130 successful breaches (up from 102 reported in a similar study last year), resulting in a collective average cost hit of $11.7 million. U.S. companies reported the highest average annual cost, $21 million, while Australian firms had the lowest, $5.4 million.

Both the number of successful breaches and the dollar costs were annualized; the study looked at a 4-week period for each participant and extrapolated the results to a 52-week period. The measured costs included:

- The direct expense for accomplishing given activities;
- Indirect costs, such as the amount of time, effort, and other resources (other than cash) spent; and
- The cost of lost business opportunities as a consequence of diminished reputation after an incident.

The study report, which was co-developed by Accenture, broke down the cost components in several ways. For example, it measured the relative impact of various negative consequences of breaches. Information loss accounted for 43% of the total; next came business disruption (33%), revenue loss (21%), and equipment damage (3%). The study also looked at internal spending on breach response, the biggest portion of which was "outlays related to breach detection," at 35%. A third categorization looked at the different cost types, the largest of which was "production losses," at 31%.

Besides the United States and Australia, participating organizations were based in France, Germany, Italy, Japan, and the United Kingdom. | **D.M.**

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How Risky Are New Revenue Recognition Rules?

Significant risks are inherent in the judgment calls that the new rules will demand. By Kyla Curley and Mark Giese

The effective date of the new revenue recognition guidance is, at long last, here. At some point after that, we'll begin to see whether the new standard's principles-based methodology is working as intended. ¶ As companies work through the challenges of implementing the new guidance, those making revenue recognition decisions cannot put themselves in the proverbial shoes of investors, regulators, auditors, and anyone else relying on their financial statements. Nonetheless, there are some actions decision-makers can take to mitigate the risks associated with greater reliance upon judgment.

Judgment Calls Arise

Elements of judgment reside in each step of the new standard's five-step process, including:

Step 1: Identify the contract(s) with customers. The collectability of consideration in a transaction is a concept that requires judgment in both the current and new guidance. Under the new guidance, collectability will be addressed in the determination of whether a contract exists, rather than whether revenue can be recognized. Of course, the concept of collectability is not new. However, the judgments used to assess it will now be necessary at the outset of the revenue recognition process.

Step 2: Identify the performance obligations within the contract(s). Identification of performance obligations will be less restrictive under the new guidance and, therefore, contracts may have fewer performance obligations to be accounted for separately. The determination of these performance obligations will also require increased application of judgment.

Step 3: Determine the transaction price. The transaction price under the contract(s) involves a number of judgments, including consideration of variable and noncash factors. Under the new guidance, entities will determine variable consideration by estimating either the "expected" value or the most likely amount in a range of possible amounts. As variable consideration will be based on an estimate, the timing of revenue recognition may be accelerated upon implementation of the new standard as compared with the more formulaic recognition of multiple elements over time, as currently required.

Step 4: Allocate the transaction price to the performance obligations in the contract. To allocate an appropriate amount of consideration to each performance obligation, an entity will now determine the stand-alone price at the outset for the goods or services. As stand-alone selling prices can be calculated or estimated in numerous ways that may require significant judgment, revenue recognition may be accelerated under the new guidance, particularly when compared with the current allocation methods.

Step 5: Recognize revenue when (or as) a performance obligation is satisfied. Under the current guidance, the percentage-of-completion method is generally used when recognizing revenue for contracts. Under the new rules, revenue is recognized when, or as, control of the asset is transferred to the customer. The determination of when control is transferred is often a matter of judgment, and will require consideration of when obligations are satisfied.

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Best Practice Mitigation

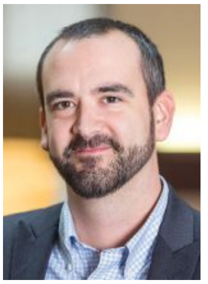
Revenue recognition decisions are often subject to scrutiny and challenge in hindsight. That may require a company to scramble to find contemporaneous documentation that supports a reported accounting conclusion for unusual transactions or when the facts and circumstances are ambiguous or nuanced.

Difficulties supporting prior accounting conclusions with contemporaneous documentation may incur more time and expense for companies, as well as cast a shadow of doubt on those prior decisions. As the saying goes, "if you didn't document it, you didn't do it."

With heightened judgment around revenue recognition, the universe of decisions that an entity may need to later justify greatly escalates. However, a finance team that documents thoroughly, in a timely manner, the rationale for all key subjective decisions, including the "who," "what," "why," and "how" buttressed against the accounting guidance, will be better positioned to justify judgment calls.

Proper documentation in support of judgment-based accounting decisions will also aid in situations in which customer contracts differ greatly, and will help assess whether the principles and judgments applied in each instance are consistent across those contracts.

Kyla Curley



Mark Giese

Using assessments of collectability as an example, the underlying facts and circumstances with each customer—credit risks, contractual rights of return, etc.—will vary. By documenting the decisions, especially those with more convoluted fact sets, an organization is better able to judge whether it is consistently applying the correct principles. That is especially helpful for organizations that experience high turnover in finance and sales functions, as new employees will need to rely on and understand the subjective decisions made by predecessors.

Documenting conclusions is certainly not a new concept, but it deserves reconsideration in light of the updated standards. Proactive efforts can go a long way toward avoiding or substantially reducing future costs to defend accounting conclusions against scrutiny by regulators.

Further, having an effective system of internal controls that includes a consistent approach to tackling revenue recognition judgment, such as maintaining key accounting conclusion memos, will facilitate greater transparency. Even if an auditor or regulator doesn't agree with the ultimate conclusions, organizations will be better positioned to demonstrate a good-faith effort. CFO

Kyla Curley is a managing director and Mark Giese a manager with StoneTurn, a forensic accounting, corporate compliance, and expert services firm.

FASB Member Calls Standard "Transformative"

The new rule will turn a diverse set of industry standards into one framework.

Issuing the Financial Accounting Standard Board's revenue recognition rule, which takes effect this month, is perhaps the board's most "transformative" action in the last decade, according to outgoing FASB member Marc Siegel.

The rule "may or may not have significant outcomes on the revenue of a company," acknowledged Siegel, who will depart FASB in June 2018 after 10 years with the board. But the standard is "transformative" in moving reporting of the top line of the income statement from a diverse group of industry standards to "one framework [for] how to think about revenue," he said.

"It's very important to have a new framework to think about revenue items in a world where new industries are coming up every year or two," said Siegel. "We can't be doing very specific revenue guidance for each new or altered industry."

Siegel, speaking at the FEI financial reporting conference, explained that it had been important for FASB to work with the International Accounting Standards Board to issue a converged revenue recognition standard, as well as one based on a unified framework. That was because both standards had shortcomings.

"We had lots of sector-specific standards. The IASB didn't," said Siegel. "They had too little guidance on revenue recognition, where we, in effect, had too much."

Nevertheless, the framework hasn't eliminated every kink in the process of

Top, courtesy the authors; bottom, Thinkstock reporting revenue, according to Marsha Hunt, who joined FASB on July 1, 2017.

There's "a source of actual tension" between companies and their auditors in the implementation, said Hunt, formerly corporate controller of Cummins. Issuers sometimes feel that auditors are slowing down the process of complying with the standard. In some ways the companies want the decisions earlier than some in the system are prepared to give them, she said.

To be fair, Hunt acknowledged, the auditors are not only responsible for giving an opinion on the revenue number that appears on a company's income statement, they also have to be comfortable that the company has adequate controls over the implementation of the standard. | DAVID M. KATZ

Estimates Change at Record Pace

A change in pension accounting is responsible for many of the revised assumptions.

The number of changes in accounting estimates by SEC-registered entities in 2016 was the greatest since 2000, the first year for which Audit Analytics analyzed all annual and quarterly SEC filings.

There were 820 such changes last year, up from 628 in 2015, the auditing research firm reports. The long-run average is about 550 changed estimates per year.

The surge was largely driven by changes to pension accounting estimates. There were 210 of those in 2016, compared with just 24 a year earlier. At least partly responsible for the increase in such estimates was a fast-accelerating trend of companies switching to the "spot-rate" method of calculating the present value of future pension obligations.

The trend was sparked by AT&T, which disclosed the change in early 2014. Within two years, several dozen companies followed suit. Historically, pension-related changes have accounted for only 4% of changed accounting estimates.

Pension-plan sponsors have traditionally determined a discount rate for performing the calculation using a weighted average of 30-year Treasuries. Under the spot-rate method, plan sponsors use individual spot rates derived from a high-quality corporate bond yield curve and match them with separate expected pension-plan cash flows for each future year, rather than a single weighted average.

The spot-rate method is thought to provide a more precise measurement, but it can also boost a company's financial results, at least in the short term. Indeed, Audit Analytics suggests, changes to accounting estimates in general may be evidence of "earnings management."

Over time, the ratio of changed accounting estimates that have caused a positive impact on income to those that have exerted a negative effect has been about 1.3 to 1, according to the Audit Analytics data. "This suggests perhaps that management is more likely to make a change in an accounting estimate if it is expected to benefit income," writes John Pakaluk of Audit Analytics. Last year, that positive-impact-to-negative-impact ratio was about 1.6 to 1, the highest in the 17 years for which the research firm has tracked such changes.

Accounting estimates are notoriously difficult to audit. "Some of the more complex figures require judgments about future events," Pakaluk explains. "For example, a certain number of accounts receivable will not be collected, but neither the actual bad accounts nor the specific number of them is known. Therefore, some model is used to estimate the number of doubtful accounts (essentially, invoices that won't ever get paid)."

Depreciation of assets, provisions for legal contingencies, hedging, and derivative valuations all require estimates, which always are based partly on assumptions, he notes.

For the sake of comparability between periods, under ASC 250-10-45-19 such assumptions are expected to remain the same unless a good reason arises to change them. When these assumptions are changed, they must be disclosed if they are material.

| DAVID McCANN

Reworking Assumptions

Among the almost 10,000 revisions to accounting estimates that Audit Analytics has analyzed for the past 17 years, these are the most common types.

Estimate Category	% of Total
Depreciation, amortization, and depletion	22%
Percentage of completion and contract revenue recognition	12%
Restructuring reserves	10%
Income taxes, including valuation allowance	7%
Contingencies and commitments, including litigation	6%

Source: Audit Analytics

Understanding the Tech Target

Consider the following questions before embarking on the acquisition of a technology company. By Decker Walker and Jens Kengelbach

Traditional companies and tech firms have plenty of differences. Business models, cultures, metrics, compensation schemes, and ways of working are just a few. The match between a large, often bureaucratic corporation in a traditional industry and a nimble, fast-moving startup often appears ill-conceived. Yet, in 2016, more than 8,800 tech firms found new owners or major investors, approximately 70% of which were outside the tech sector.

Tech startups often have specific reasons for selling to a nontech buyer. Those reasons go well beyond the financial aspects of the transaction. In our experience, acquirers that make the effort to understand what the target's management team is looking for and how it sees the fit with the new parent gain a big leg up in making acquisitions work. Considering the following questions before embarking on a tech transaction can help set expectations and smooth the M&A process and post-deal transition.

1. Why do so many tech companies sell to buyers from other sectors? Money is one reason, of course. Founders and their backers often want to cash in, and in many instances, nontech buyers are often the ones that are willing to write the biggest checks. But multiple other factors come into play as well.

Industry veterans provide access to existing products and services that the technology firm would find hard to build out on its own. Established companies from outside the tech sector can provide access to new markets through their core product lines. Cruise Automation, for example, was able to deploy its autonomous-driving technology overnight through General Motors' global vehicle base rather than retrofitting cars one by one.

Buyers from other industries also give targets access to an established customer base, enabling the target to leapfrog previous sales targets. When Walmart acquired Jet.com, for example, Jet.com gained access to the fast-growing e-commerce marketplace run by the world's biggest brick-and-mortar retailer and added muscle to compete with Internet retail giants.

Nontech partners provide the trust and brand recognition of an established major industry player. This enhances the target's visibility and reputation as a reliable business platform. For instance, brand recognition for the app mytaxi rose with the first investment by Daimler in 2013, and today, mytaxi is the world's most successful taxi intermediary, with more than 10 million downloads.

2. What do tech companies expect in the M&A process? Agreeing on a deal can be complicated by the different perspectives that buyers and startups bring to the negotiating table. Often, the acquirer will ask hundreds of questions about the target's business plan, with a strong focus on scaling up operations or boosting bottom-line profitability measures. Usually, the target company is much more interested in talking about top-line growth, new-customer acquisition cost, and customer churn rates.

Management presentations and expert sessions often leave both sides wondering if they are headed for a difficult future. A frequent issue is when the acquiring company's M&A team has a limited understanding of the tech firm's technical architecture, hardware, or software and how it can be integrated into the industrial player's products and services.

Acquirers that are not tech companies can advance the process by showing an early understanding of the target's technology, business model, and success factors. This is especially important in a competitive auction situation. The buyers should not rely on price alone; they need to win over the

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Decker Walker

target's management team with a compelling case for synergy.

Open and candid discussions about potential culture clashes and how to solve them can help. Acquirers also have to clearly outline their cooperation and integration model for the target as part of the wider company.

3. What do tech firms expect after the closing? Tech deals frequently founder because of misunderstanding over post-merger integration and how the target will operate once the deal closes. Target company management teams typically expect a high degree of continuing entrepreneurial freedom, which is vital for top-talent acquisition and retention. These expectations often include maintaining the target's standalone P&L and having the ability to financially motivate key decision makers in ways that do not fit into typical corporate compensation schemes.

Jens Kengelbach

Targets also look for their new parents to make decisions fast, often much faster than allowed by the lengthy decision-making processes that result from corporate policies and politics. Successful acquirers often establish separate governance procedures for their tech acquisitions.

Moreover, tech companies expect ready access to the acquirer's product base and distribution network in order to achieve early, tangible win-win results. One big reason for failed technology acquisitions, in our experience, occurs when the acquirer treats the target's technology as a pilot or as a fig leaf for the acquirer's tech agenda, rather than as a means of strengthening its core business. CFO

Decker Walker is North America leader of the M&A practice of The Boston Consulting Group. Jens Kengelbach is global head of M&A, and leader of the BCG Transaction Center. Georg Keienburg and Timo Schmid contributed to this article.

M&A Retention Bonuses Pay Off

Financial incentives for key employees are having a big impact.

Large companies engage in M&A not only to grow and enter new markets, but also to bring in new talent. For example, a company intent on becoming more digital may acquire one that has the talent to drive that transformation. In such cases, offering key employees of the acquired company financial incentives to stay on is a popular strategy—and an increasingly successful one.

Willis Towers Watson surveyed 244 companies in the Americas, Asia, and Europe with at least 500 employees—1,000 employees for U.S. companies. Each participant had completed an acquisition or merger within the past two years and had used retention agreements in conjunction with at least one such transaction.

The study found that 79% of such acquirers retained at least 80% of employees that received retention agreements through a designated retention period, lasting a median of 18 months after deal closings for senior leaders and 12 months for other employees. In a similar study in 2014, only 68% of acquirers were as successful.

"Companies today are smarter about how to construct a compelling agreement," Willis Towers Watson's report says. "They are more selective about the number and type of retention award participants and more strategic about how to use agreements."

Indeed, despite the increasing success of the agreements, this year the median retention budget is less than 1% of transaction cost, the study finds, a plunge from 1.9% in 2014. The report continues, "Acquirers are moving away from the broad strokes of providing retention agreements based on factors such as organizational levels and moving toward a more focused look at individuals who are critical to delivering deal value."

Topping the list of factors that companies take into account when deciding who will be offered an agreement is "employees below executive level with key skills in the context of the transaction." Notably, high-retention companies (those with a success rate of at least 80%) are more likely to consider non-executive employees than are other companies, and the gap is significant: 61% to 47%, respectively.

Status as high-potential or high-performance talent fell in importance substantially since the 2014 survey, dwindling from 45% and 39%, respectively, to 25% and 22%. The focus instead is on those with key skills or senior leadership roles. | DAVID McCANN

Top, courtesy the authors; bottom, Thinkstock

TECHNOLOGY

Government Must Step Up Cyber Defenses

The president's cyber adviser thinks defense systems are five years behind the hackers. By David M. Katz

Rudolph Giuliani, President Donald Trump's informal cybersecurity adviser, told a cyber risk conference in New York City in October that the administration has a long way to go before it can safely protect U.S. corporations, as well as the civilian side of the federal government, against hackers. Speaking at the Cyber Risk Insights Conference, the 2008 U.S. presidential candidate and former New York City mayor said that "there's a lot of work the government has to do, this administration has to do, in getting the government up to a level of security where [we] can be comfortable."

In January 2017, Giuliani was tapped by then president-elect Trump to form a public-private task force with the assignment of producing a cybersecurity plan for the administration within three months. Although no task force report has yet surfaced, on May 11 the president issued an executive order on "Strengthening the Cybersecurity of Federal Networks and Critical Infrastructure." The executive order called on federal government agencies to complete cyber risk management reports, also within three months.

Asked by a participant at the conference, which was held by Advisen, a risk management data firm, what the administration's cybersecurity position was, Giuliani answered that the administration has two functions. "One is to improve the defense for [government data], and the second is to share that information [with the private sector] to the extent that it can," he said, and then, correcting himself, added, "not so much information, but techniques."

The federal government "has an enormous amount of sensitive material and is as open to attack as any other sector," he said.

Noting that "there's so much overlap between the private sector and the government," Giuliani explained that the public-private council can benefit government cybersecurity as well as that of the private sector, "because a lot of the research and development [of cybersecurity] applications is occurring in the private sector."

At the same time, "the government defenses have not been all that good," he said, referring to the 2015 hack of the U.S. Office of Personnel Management, which exposed potentially sensitive information connected to about 22.1 million people. "You have a sense from the OPM hack that the civilian side of the government wasn't protected in the same way that the military side of the government was protected," said Giuliani, who is chief of the cybersecurity, privacy, and crisis management practice at law firm Greenberg Traurig.

For its part, private sector cyber-defense technology is lagging perilously behind the tech abilities of potential hackers. "The defense is trailing the offense by 5 years, maybe," Giuliani said. "It's only in the last 10 to 15 years that we have really concentrated on this and made it a subject of great analysis. So, it's going to take us a while to develop."

Asked if cyber exposures are, in fact, an insurable risk, Giuliani said, "Right now, it's sure hard. An insurable risk is a risk you can quantify." Earlier, Giuliani said that "the problem for the insurance industry is very, very dramatic" because for insurers to be able to underwrite risks, they have to be able to measure them. To be able to do

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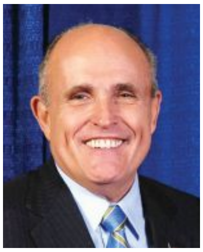
that, however, the risk has to entail historical accuracy and future predictability. "Right now, you can't measure this risk because it's—believe it or not—too new," he said.

Acknowledging that cyber risks are pervasive and systemic, Giuliani contended that "we don't have enough experience of legal liability and damages." While there have been cases involving cyber liability, "we haven't had enough so that we can have a clear picture of what is reasonably predictable."

One conference attendee disagreed with Giuliani's dire assessment of cyber coverage. Concerning the former New York mayor's contention that because cyber risk lacks history, cyber insurance can't be adequately provided to corporations, Eric Jones, global manager for business risk consulting at property insurer FM Global, said: "That's not exactly true. It depends on what kind of cyber risk you're talking about, what perspective you're buying it from."



The federal government "has an enormous amount of sensitive material and is as open to attack as any other sector."

—Rudolph Giuliani, former New York mayor

Jones said, however, that he could agree with Giuliani's point if he were referring to insurers that try to underwrite cyber risks on the basis of the historical data contained in actuarial tables. But it's possible to underwrite the risk company by company, "from the ground up," rather than via aggregate statistics, the consultant said. "So cyber isn't really different than any other perils," Jones added. CFO

Enemy Targets

World War II strategy offers insights into how nation-states are hacking into U.S. companies.

To say that the planning of the D-Day invasion by U.S., British, and other Allied forces was a complex endeavor would be an understatement. A U.S. army pamphlet on the Normandy invasion sketches the results of the planning succinctly: "A great invasion force stood off the Normandy coast of France as dawn broke on 6 June 1944: 9 battleships, 23 cruisers, 104 destroyers, and 71 large landing craft of various descriptions as well as troop transports, mine sweepers, and merchantmen—in all, nearly 5,000 ships of every type, the largest armada ever assembled." Look at a vintage map of the operation, and you'll see arrows swooping, overlapping, and curling through various points of vulnerability, starting with the beaches of Northern France.

To attempt to map the threat posed today by cyberattacks against the United States and its allies by hackers deployed by enemy nations in the same way the Allied leaders mapped the D-Day invasion might seem illogical. After all, today's attacks aren't on actual places but in cyberspace, and the weapons involve software rather than physical ammunition.

But to Reid Sawyer, a long-time veteran of military intelligence and now a senior vice president in charge of cyber risks at JLT Specialty Insurance Services, the interconnectedness of the U.S. economy and its vast number of potential hacking vulnerabilities might make a similar kind of mapping effort quite useful these days.

That's because massive, concerted cyberattacks on companies—attacks seemingly driven by enemy nations—increasingly resemble D-Day–like campaigns, Sawyer explained at a recent cyber risk conference. He noted that he and some colleagues have begun to subscribe to what he calls "the campaign theory of espionage" as a way of understanding such attacks. "When we think of these massive [hacking] organizations, we can picture these big sweeping arrows toward Utah beach in Normandy."

Like the Allied generals, the heads of these criminal organizations plot out soft targets in vast supply chains and joint ventures and similar extended intercompany links, according to Sawyer. "This is really happening all the time," he said of such cyber warfare approaches, in which enemy strategists are continually searching for entry points.

Haris Shawl, a cyber threat intelligence manager at PwC, said: "If you have intellectual property that's important to your assets, it's the people that you do business with that the nation-states are going to get to."

Both speakers cautioned executives working for small or mid-size enterprises against thinking that state-sponsored cyber attacks can't affect their companies. "The problem is that small companies are involved with innovation and are therefore a target," especially smaller tech companies linked to the IT systems of larger corporations, according to Sawyer. | D.M.K.

Top, Wikipedia; bottom, Thinkstock

What Auditors Are Looking for This Year

Big changes in business, the economy, technology, and regulations point to an assortment of red flags for auditors. By Robert Rostan

Across virtually every sector of the economy, corporations face unprecedented changes in the business environment, driven by global economic trends, technological developments, and regulatory initiatives, among other forces. Ultimately, the impact of these changes will be evident in companies' operational and financial performances. But there is another area that will be affected by the forces of change: the annual audit, as auditors must take these dynamic forces into account in assessing a company's risk exposures and controls.

Based on my experience as a CPA and CFO, as well as an instructor in financial statement analysis and accounting, I see several emerging red flags that will be major issues for auditors—and thus for CFOs and audit committees—during the 2017–2018 audit cycle. Specifically, there are eight significant audit issues that are worthy of attention by finance executives and audit committees.

Trend Dependent

A number of the emerging audit red flags arise from prevailing global economic and business trends, especially the disruptive (and to some extent unanticipated) impact of technology.

Cybersecurity threats. The Equifax data breach, along with the news that the Securities and Exchange Commission's EDGAR system was hacked, are the most recent dramatic reminders of the cybersecurity threats that plague businesses with great regularity. While cybersecurity breaches pose a threat to risk management and business continuity, they also create an audit challenge: since 2011 the SEC has required public companies to disclose cybersecurity risks and incidents. It is important for companies to be able to demonstrate to their auditors that they have robust plans to respond to (and quickly recover from) a cyber-threat.

Retail-sector turmoil. The retail industry has experienced enormous disruption due to the success of Amazon and other e-commerce firms.

Auditors will be carefully scrutinizing not only retail companies but any business with exposure to retail (such as real estate owners and operators, lenders, suppliers to retailers, transportation providers, and insurers). They will have to assess whether companies have properly accounted for the impact of store closures or nonpayment of obligations from retailers.

Municipal exposure. The dire fiscal condition of many states impacts municipalities, most of which are reliant on state funding, and effects the status of projects or facilities funded by states.

From an audit perspective, any company that does business with states, municipalities, or even private enterprises that receive public funds will need to reflect this exposure in its audited financial statements.

Revenue recognition. Public companies must adopt new revenue-recognition standards for reporting periods beginning after December 15, 2017, as a result of Accounting Standards Codification (ASC) 606.

ASC 606 will change the top line for many organizations. Auditors will pay close attention to whether the future impact of ASC 606 has been properly disclosed under the requirements of SEC Staff Accounting Bulletin No. 74. Auditors will also assess whether a company's methodology is reasonable and will challenge controls related to this new GAAP.

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Hanging Around

The following audit red flags have been of concern for some time, but are receiving continued or renewed attention. For example, these matters rank among the most frequent subjects of SEC comment letters to public companies.

Non-GAAP metrics. The SEC has continued to focus on companies' use of non-GAAP measures, such as "adjusted earnings" or "adjusted earnings per share." While companies may supplement GAAP financial reporting with non-GAAP measures to provide investors or other stakeholders with additional insight, the SEC remains concerned that non-GAAP measures may be emphasized at the expense of the GAAP presentation. Thus, companies must have procedures to ensure clear and accurate disclosure of non-GAAP measures, proper reconciliation to GAAP, and consistency in the use of non-GAAP measures from year to year.

Segment reporting. Another evergreen issue in audits is segment reporting, which is required for publicly held entities. The SEC wants to ensure that companies provide visibility and transparency with respect to the financial results and positions of their operating units. Thus, auditors will be seeking to determine whether a company's segment reporting truly reflects the way its chief operating decision-makers actually run the business, assess performance, and allocate resources.

The treatment of foreign subsidiaries of U.S. companies for income-tax purposes has become a hot-button issue.

Income taxes and foreign subsidiaries. The treatment of foreign subsidiaries of U.S. companies for income tax purposes has become a hot-button issue. From an audit standpoint, it is not simply a matter of whether a business may be sheltering income in overseas subsidiaries, although that is certainly a significant matter. Auditors also will want to gauge the implications of foreign income on a company's liquidity position—that is, whether a business would have the ability to repatriate cash to cover obligations and what the tax impact would be.

Enhancing the MD&A. The management discussion and analysis in companies' annual reports is often rudimentary, and the analysis can be lacking in depth. Rather than "boilerplate" disclosures, companies should make a meaningful attempt to provide transparency in the MD&A—describing the performance of the business in layman's terms and providing in-depth analysis, especially in terms of sensitivity to interest rates, economic policies, customer behavior, and other factors.

Clearly, this is a starter list of audit red flags, and each sector will have its own industry-specific critical issues. The larger point is to think beyond the "usual suspects" of financial-statement and operational issues and to anticipate and prepare for emerging matters of concern to auditors.

Robert Rostan is CFO of Training The Street, a financial-education firm.

PCAOB Probes Help

Companies raise more capital after a PCAOB inspection.

Audit firm inspections by the Public Company Accounting Oversight Board increase companies' ability to raise capital, according to a study. Companies audited by PCAOB-inspected auditors "raise significantly more external capital following the disclosure of their auditors' PCAOB inspection reports," writes Nemit Shroff, the author of the study and an associate professor of accounting at the MIT Sloan School of Management.

Shroff also finds evidence that companies often change their capital-raising behavior and spending following inspection report disclosure, contingent on the report's content. Companies respond to a clean report, for example, "by issuing additional external capital amounting to 0.5% of their assets and increasing capital expenditures by 0.3% of their assets," according to the paper.

"This study shows that the PCAOB adds significant value to the financial reporting process," said Shroff. "It opens up the black box of auditing, which benefits both investors and companies."

In an attempt to eliminate the possible complicating effects of U.S. securities regulation on audit-inspection data, as well as other possibly irrelevant effects, Shroff limited his data sample to 35 non–U.S. countries and to probes done under the PCAOB's international inspection program.

The Sarbanes-Oxley Act of 2002, which established the PCAOB, requires the board to inspect the auditing procedures of auditors opining on the financials of Securities and Exchange Commission–registered companies, including non–U.S. auditors of non–U.S. companies cross-listed on a U.S. stock exchange. Such audit firms are subject to PCAOB inspections "in the same manner and to the same extent" as U.S.–based audit firms, according to Sarbox. | DAVID M. KATZ

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RISK MANAGEMENT

Wildfires, Hurricanes Teach Risk Reduction

Companies can leverage their involvement in infrastructure development to raise resiliency standards. By Erik R. Peterson

The Northern California wildfires. Harvey. Irma. Maria. We shudder at the thought of the devastation these natural disasters have inflicted. And such high-cost disasters aren't just happening in the United States. In Mexico, strong earthquakes have left hundreds of people dead. Across South Asia, more than 1,200 people were killed and millions more displaced in severe monsoons in August 2017.

The rate of natural disasters worldwide has more than quadrupled since 1970 to around 400 per year, at a pace and price that scientists predict will continue to mount. The World Bank estimates that, each year, natural disasters cost about $327 billion in asset losses and an even more dramatic $520 billion in lost consumption.

A report by the Centre for Research on the Epidemiology of Disasters (CRED) and the UN Office for Disaster Risk Reduction (UNISDR) notes that the greatest number of natural disasters globally between 1995 and 2015 occurred in the United States, China, and India—the three most populous countries in the world (representing more than 40% of the world's population) and three of the largest economies globally (representing more than 40% of the global economy).

Further, rising sea levels threaten 60% of the world's economic assets. In a hyper-connected world, such losses have spillover effects on virtually every large organization. A disaster in one corner of the world can have critical implications for a business in another.

To illustrate the consequences of this ripple effect, consider the fact that Hurricane Harvey brought more than 60% of U.S. ethylene production to a screeching halt. The petrochemical is a cornerstone of the multi-trillion-dollar global chemical industry, accounting for about 40% of global chemical sales. Industrial and commercial manufacturers alike depend on ethylene derivatives for products as diverse as car parts, antifreeze, baby diapers, PVC pipes, and vinyl. The number of companies affected by this disruption is too big to count.

The time is therefore ripe for businesses to consider going all-in to help tackle these disasters. While governments and interest groups continue to duke it out over how much or how little influence climate change will have over future natural disasters, businesses ought to be engaging more substantively in advance planning and preparation initiatives.

They should employ tactics now to help build resilience and operational continuity in those communities where they operate, actively respond when disasters do occur, and examine ways in which contingency planning might mitigate the destruction caused by future events.

For starters, the private sector can leverage its involvement in infrastructure development through public-private partnerships and major investment projects to raise resiliency standards. Indeed, the private sector is responsible for 75% of investment in infrastructure, according to the UN Office for Disaster Risk Reduction. That experience gives private-sector infrastructure developers the knowledge and ability to work with governments to develop building codes for critical infrastructure like roads, bridges, and dams to withstand future natural disasters.

Better infrastructure will not only

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build community resilience, but also reduce disruptions in future business operations. The amount of time it takes for a city or region to recover from a disaster is a crucial consideration for firms weighing the relative risks and exposures of an investment.

Yet, paradoxically, some of the world's fastest-growing economies where global businesses have a keen interest—Indonesia, Thailand, and Bangladesh, for example—are more at risk of disruptions from natural disasters. That's because the safety regulations and infrastructure of those nations haven't kept pace with growth rates of population density in disaster-prone urban areas. This situation underscores the important role businesses play in contributing to resilience in high-growth markets that are vulnerable to disasters.

Another powerful way corporations can help strengthen community resiliency is to promote relief efforts. The UN's Sendai Framework for Disaster Risk Reduction 2015–2030 recognizes this important function. Although it acknowledges that national governments have a primary role in disaster risk reduction and response, the private sector has taken this responsibility seriously. A United Nations–led network of private-sector entities dedicated to upholding the Sendai Framework, called ARISE, includes an impressive list of global companies, including some of the world's largest multinationals.

Some corporations demonstrated leadership in their response efforts in the wake of recent disasters. During the hurricanes in September, for example, companies like Bass Pro Shops, Walgreens, and Home Depot offered supplies for immediate relief efforts.

TeleTech provided technology support and staff for a massive fundraising effort. PetSmart provided resources to support local animal rescues. And several Silicon Valley firms mobilized users across their platforms to coordinate response efforts. For instance, Airbnb encouraged hosts to open their homes to evacuees, Uber and Lyft offered free rides to shelters, and Tesla unlocked battery capacity in its vehicles to aid evacuees.

The World Bank estimates that, each year, natural disasters cost about $327 billion in asset losses and an even more dramatic $520 billion in lost consumption.

Exercising Foresight

Another way in which the private sector can improve disaster mitigation and response is through effective supply chain management. In this respect, engaging in foresight exercises such as disaster simulations and contingency planning is crucial.

These planning exercises are useful when they're done at the company level. But they also provide further opportunities for public-private partnership by engaging all relevant stakeholders in simulations and other parts of the contingency planning process.

The difficult and ongoing relief efforts in Puerto Rico certainly highlight the perils of damaged infrastructure in providing necessary goods and services to affected populations. But they also provide a case study of what can go well when businesses use contingency planning to mitigate supply chain disruptions that stem from natural disasters.

Pharmaceutical giants Bristol-Myers Squibb and Baxter have said that proper contingency planning ahead of the storm helped to keep supplies stocked or, when appropriate, moved off the island. Because of their proactivity, product inventory hasn't led to shortages for their customers in the same way so many others have been affected. These efforts have helped these companies maintain business operations while also improving public health.

Obviously, no business leader can prevent a natural disaster. But every business leader can, and should, make bolder commitments to mitigating risk through a combination of infrastructure investments, contingency planning, and providing expertise to support responses.

The benefits will ripple across the value chain of economic assets, employees, suppliers, distributers, customers, and the rest of the global supply chain, and build agility in responding to disrupted market conditions. As headlines on natural disasters come and go, so too will the sense of urgency to implement risk-reduction strategies. But anticipating and planning for the future disasters will be a permanently positive fixture for the continuity of a business's operations and its bottom line. CFO

Erik R. Peterson is a partner at A.T. Kearney, a management consulting firm.

Editor's Choice

SOLAR PROTECTIONISM

In the latest episode in a trade battle pitting solar-panel makers against installation companies and users, the U.S. moved to curb imports. The U.S. International Trade Commission recommended that import tariffs of up to 35% be imposed on solar cells, which convert sunlight into electricity, and 30% on solar modules, or sets of cells.

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HUMAN CAPITAL

Learning Lessons From Wells Fargo

How companies can avoid negative fallout from sales incentive compensation programs. By Steve Giusti

It's already been more than a year since the fake-accounts scandal at Wells Fargo came to light. The matter not only led to the removal of the company's CEO and other top executives, but also left a trail of lawsuits and a significantly damaged brand in its wake. Yet, despite the massive public embarrassment and heavy penalties it caused, the lessons of this debacle have yet to permeate many organizations.

While some observers pointed a knowing finger at a sales incentive compensation process run amok, the financial institution's model should not shoulder the blame. It performed exactly as it was designed, driving associates to cross-sell at least eight accounts per customer. It was culture, not compensation, that was to blame.

Be it the CEO who was publicly noted as coming up with the idea of "Eight is Great," or an overly aggressive head of community banking, somewhere along the line there was a systemic cultural breakdown. It was so dramatic that leaders apparently encouraged employees to secretly open 3.5 million unauthorized bank and credit-card accounts in order to meet sales quotas.

Sales compensation is often a discipline that falls somewhere between sales, human resources, and finance. But recent events, as well as the new ASC 606/IFRS 15 revenue recognition standard that includes new commission expense accounting rules, should move it to the top of a CFO's awareness list. Not only is sales compensation one of the biggest line items in many budgets, but there are potential pitfalls that can cause material harm.

So how can you ensure that doesn't happen under your watch? Start by asking a couple of tough questions.

1. "Does our plan establish realistic goals?" Sales compensation plans drive behavior. A well-designed plan supports key business goals, helps drive sales-rep performance, and increases forecasting accuracy.

But if a plan establishes overly lofty goals tied to outlandish reward structures, it can encourage widespread bad behavior. Again, it's all about cultural breakdown. It's fine for an organization to establish aggressive goals, but its compensation plans must align with both corporate values and the industry at large. And all of that starts by asking what behavior the organization hopes to drive and engineering the sales plan from there.

To achieve this, make sure to involve a wide variety of people from multiple disciplines in developing a plan. Don't do it in a vacuum. Finance, human resources, legal, and sales performance management experts should all be at the table. That way, if a top executive suggests quadrupling new customer sales by overinflating plans, it is more likely someone will call "time out" to consider the true implications.

2. "Is our plan transparent enough?" Some companies devise sales incentive compensation plans in back rooms or even on the back of the CEO's cocktail napkin. Then they institute bad plans across the organization—a recipe for disaster.

For a plan to be truly effective, finance and sales executives must not only agree to what's in it but also have real-time visibility into how reps are tracking to it. How is the plan performing? Who is making their numbers and who isn't? What's the standard devia-

Flickr

tion? Having this information gives sales leadership and reps the context they need to do a better job and compete more effectively.

At the same time, providing full transparency into how people are performing serves as a check on questionable or bad behavior. For example, one rule of thumb says a business should expect about 60% to 70% of sales reps to perform at or above quota. Had Wells Fargo been transparent about performance, I'm guessing someone would have questioned why so many sales reps were meeting the new goals.

But equally as important is having the right checks and balances in place and having someone analyzing the outcomes. There should have been a "look-back" at all new accounts created to see if they were truly active, how many had been quickly closed, and whether the customer was seeing any real value.

"If a plan establishes overly lofty goals tied to outlandish reward structures, it can encourage widespread bad behavior."
—Steve Giusti, corporate controller, Xactly

After all, are you paying a sales-team member to close a deal or to establish and maintain a long-term relationship with a customer? CFO

Steve Giusti is corporate controller and a vice president at Xactly, a provider of cloud-based incentive compensation solutions.

How to Protect Unvested Pay

Don't stand idle if your employer tries to make you forfeit unvested deferred or equity compensation.

Many CFOs have employment agreements that provide for severance and/or notice pay if they are terminated without cause or if they leave with good reason. But such agreements and related deferred or equity plans do not necessarily protect unvested deferred or equity compensation.

Fortunately, as the recent Massachusetts case, *Suzuki v. Abiomed, Inc.*, illustrates, the implied covenant of good faith and fair dealing may be used to protect an executive's unvested performance-based equity awards and, by extension, other performance-based deferred compensation.

In *Suzuki*, a vice president of a health-care technology company alleged that his termination was undertaken in bad faith to deprive him of compensation due for his past labor. Specifically, the executive said that he was terminated: (1) after performing much of the work necessary to achieve the business objectives to which the vesting of his equity was tied; and (2) because he refused to agree to a mid-contract reduction in the compensation to which he was entitled under his existing employment agreement.

The company alleged that it was within its rights because, under the agreement, it had the right to terminate without cause.

Brian MacDonough

The company further argued that the performance-based contingencies to which the equity grant was tied had not occurred prior to termination and, in fact, did not occur until 15 months after the termination. The *Suzuki* court found that both of the company's arguments were unpersuasive.

In denying the company's motion to dismiss, the court distinguished between performance-based vesting and time-based vesting. It held that, "while [the executive]'s actual realization of any value of the shares promised him in [his employment agreement] could only take place in the future, those shares served as a 'continuing inducement' for work towards" the performance measures, "and they functioned as a part of [his] 'day-to-day compensation' for work performed."

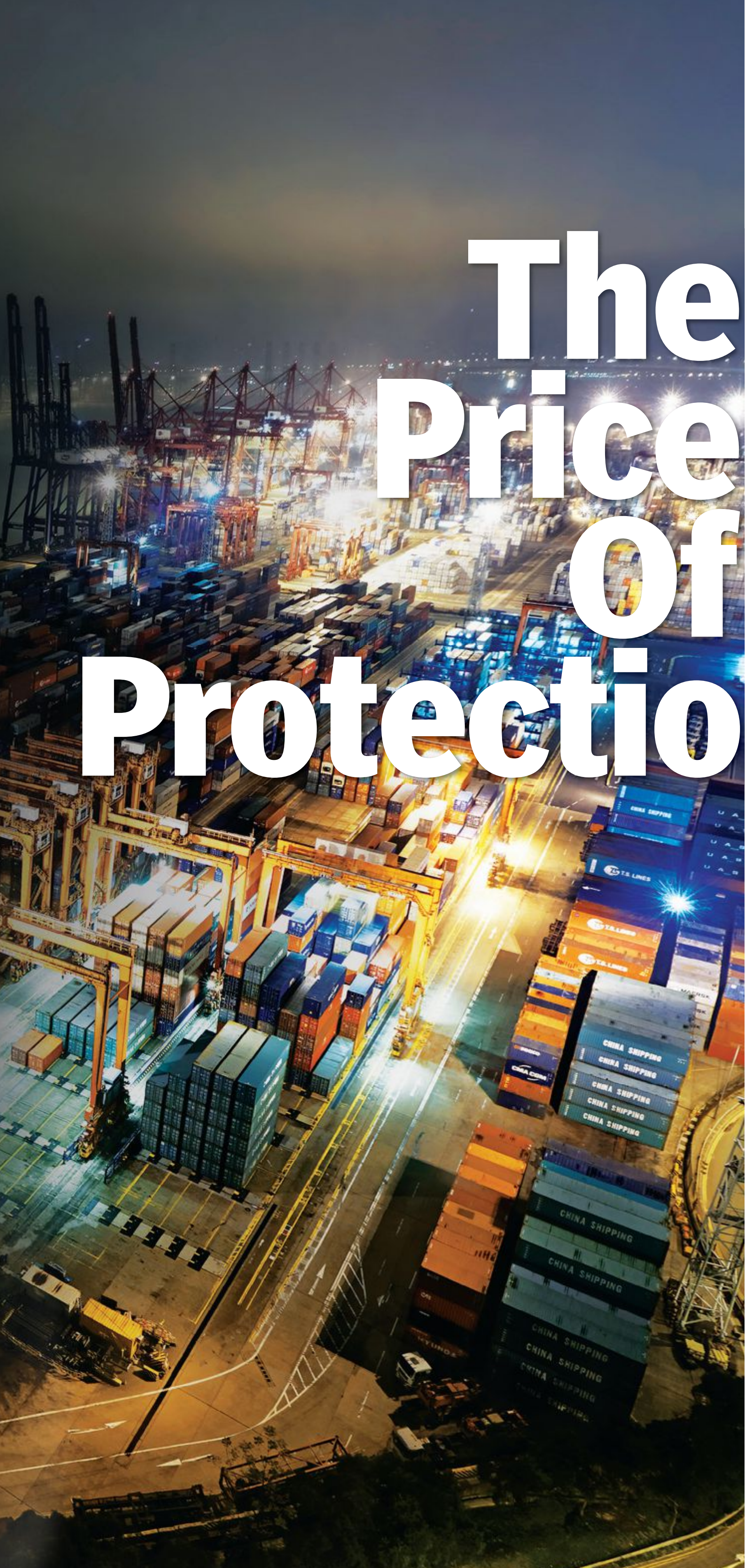
It is important to remember that all employment is contractual in nature. The covenant of good faith and fair dealing has been applied to executive employment agreements, even in situations where the employment is terminable at-will. The covenant protects against one party robbing the other of the fruits of the contract.

Nancy Shilepsky

The bottom line is that, first and foremost, and whenever possible, CFOs should negotiate (or renegotiate) for protection of deferred and equity compensation upon termination, such as for accelerated vesting of grants and extended exercise of options.

Brian MacDonough practices employment law at law firm Sherin and Lodgen. Nancy Shilepsky is chair of the firm's employment department.

Courtesy the authors



The Price Of Protectionism

To defend domestic steel and other industries, President Trump is ready to slap tariffs on some foreign producers. But has he weighed the potential costs to the wider economy?

By Russ Banham

When it comes to trade protectionism, Isaac Newton's third law of motion is instructive: "For every action, there is an equal and opposite reaction."

President Donald Trump's repeated calls for stiff tariffs and quotas against Chinese, South Korean, and other foreign companies that are allegedly dumping their products on U.S. shores sounds all the right patriotic notes. Until, that is, as history shows, foreign countries retaliate in kind.

Powered by the appeal of his "America First" platform, the president has waved the flag to promote the idea of protecting a number of industries against predatory foreign competition. He has also suggested withdrawing the United States from the North American Free Trade Agreement, much like he earlier pulled out of the fledgling Trans-Pacific Partnership.

Getty Images

The Price of Protectionism

Trump is far from the first president to vigorously support strong U.S. trade policies. Barack Obama and George W. Bush slapped high tariffs on Chinese tires and foreign steel imports, respectively. The difference is Trump's jingoistic rhetoric—a "win-at-all-costs" attitude that assumes other countries will cower and capitulate. His stance also seems to ignore the reality of multinationals' reliance on global markets.

If the president deems it necessary to dissolve free-trade agreements and set tariffs on some large industries, it will mark a significant break with the country's past. "Since the Great Depression, we've had a gradual policy shift from the protectionist trade policies of the Smoot-Hawley tariff toward freer trade that eventually culminated in the World Trade Organization," says Doug Irwin, a professor of economics at Dartmouth College. "We'd be going backward in time."

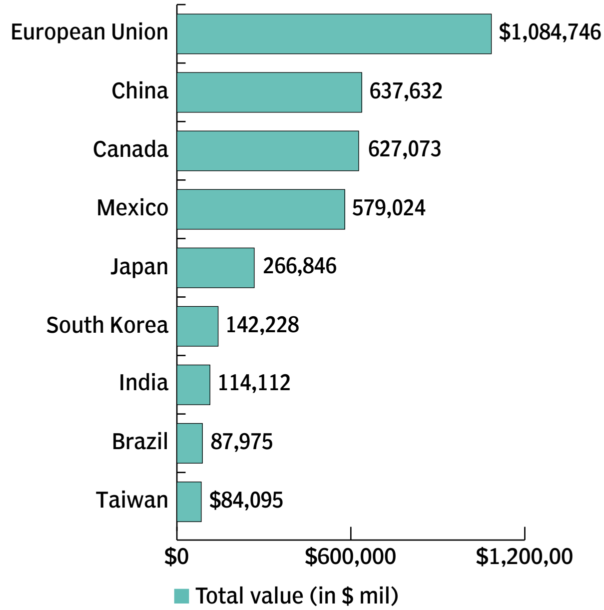
The moves might also cause prices on many goods to jump, forcing consumers to rein in spending. The drop in spending, theoretically, would slow the economy and lower corporate revenues and profits.

Although all that is a ways from happening, the next few months are a critical juncture: The White House will be deciding whether to actually impose penalties recommended by the U.S. International Trade Commission (ITC) on some foreign competitors. Says Scott Linicome, an international trade attorney and adjunct scholar at the Cato Institute: "We're at the cliff's edge."

Allies in Commerce

The European Union, Canada, China, and Mexico were not only large importers into the United States in 2016, they were also valuable markets for U.S. merchandise and services.

Top two-way trading partners for the United States*



*merchandise and private services, exports plus imports
Source: U.S. Department of Commerce

Turning Up the Heat

With its America First rhetoric, the Trump administration seems to be ignoring history. American trade protectionism has regularly failed to help the industries and workers that the government was trying to protect, says Linicome. "The trade protectionism the president favors increases the prospect of retaliation by foreign countries, harming import-dependent U.S. companies," he explains.

Domestically, someone must pay the piper when tariffs are imposed on importers. For example, the overall economic cost of U.S. trade protections against steel imports from the 1990s to the early 2000s was close to $2.7 billion, in Linicome's estimates. Since U.S. steel-consuming industries employed between 40 and 60 workers for every single steelworker, the jobs preserved in the steel industry were vastly outnumbered by job losses in the industries using steel. The harsh protectionist measures were challenged by the World Trade Organization and removed in 2003.

In other words, what's good for one industry is not always good for the wider economy. A current case in point is the U.S. solar industry.

Two bankrupt solar panel manufacturers, SolarWorld Americas and Suniva, have petitioned the federal government to impose tariffs on Chinese-made solar panels. They allege that Chinese companies are dumping their products on U.S. soil—that is, selling the goods below their actual cost in order to steal market share. The U.S. manufacturers have requested a minimum import tariff of 32 cents per watt for solar modules and 25 cents per watt for solar cells. That's just a few cents less than the current per-watt costs, so it's a significant levy. The petitioners are also seeking a minimum price on panels of 74 cents a watt, nearly double their current cost.

The ITC, a quasi-federal agency that determines the impact of imports on domestic industries, weighed in on the subject in September 2017. Its four current members unanimously concurred that Chinese solar panel imports

"Chinese solar makers are not flooding the U.S. market by dumping products at unfair prices—they're meeting American demand for solar."

—Abby Hopper, president, Solar Energy Industries Association

Courtesy Solar Energy Industries Association

Continual Gap

After climbing to $745 billion last year, the U.S. merchandise trade deficit actually shrank in 2016, but so did the total value of merchandise exports.

U.S. merchandise trade with the world, 2014–2016, in $ billions

Total exports	2014	2015	2016
Total exports	$1,621	$1,503	$1,454
General imports	$2,356	$2,248	$2,189
Trade balance	-$735	-$745	-$735

Source: U.S. Department of Commerce

had caused “serious injury” to domestic producers. In mid-November, the ITC presented its tariff recommendations to President Trump, who has until January 12, 2018, to decide whether to impose the levies.

More than two dozen U.S. solar manufacturers have gone belly up since 2012, so there’s a good chance the president will take some action in the name of domestic producers. But most of the solar industry opposes government intervention, which would drive up consumer prices for solar energy, causing the volume of solar installations in the United States to plummet.

“Chinese solar makers are not flooding the U.S. market by dumping products at unfair prices—they’re meeting American demand for solar,” asserts Abby Hopper, president and CEO of the Solar Energy Industries Association. “The petitioners went bankrupt of their own account.”

Hopper maintains “the vast majority” of U.S. solar companies are thriving, growing revenues 98% in 2016. Those companies are projected to triple in size over the next five years. “If the [petitioners] get what they want, it will double the price of solar, which will reduce demand by more than half,” Hooper says, and could result in 88,000 lost jobs. An entire industry, economists claim, would lose traction at a time when the build-out of solar infrastructure is in its nascent stages.

Splish Splash

President Trump also is considering imposing tariffs in a more mature market: washing machines. In a petition filed by appliance maker Whirlpool, the ITC unanimously agreed that two South Korean washing machine manufacturers—Samsung and LG Electronics—were causing “serious injury” to Whirlpool. In early December, the ITC will decide what specific tariffs or quotas it thinks should be implemented.

In both the solar and the washing machine cases, the ITC reviewed the petitioners’ claims through the lens of Section 201 of the Trade Act of 1974. This “safeguard” law offers broader protections to U.S. companies than the 1930s-era antidumping and countervailing duty laws.

Whirlpool declined requests for an interview, but in published reports the company insists Samsung and LG have an unfair advantage. A more level playing field would help the company sell more washing machines, resulting in the hiring of an additional 1,300 employees, Whirlpool says. The South Korean manufacturers have demurred, attributing Whirlpool’s declining sales to its washing machines’ inferior design and a shift in consumer preferences.

There is some truth to this argument. “Whirlpool has lagged behind in terms of meshing the Internet of Things (IoT) with its products, whereas Samsung and LG have excelled in this space,” says Robert Hartwig, an associate professor of finance at the University of South Carolina.

If Whirlpool is not meeting demand for Internet-equipped products, that’s a problem. Many consumers, particularly those in the tech-savvy millennial generation buying their first residence, are “looking for smart kitchen appliances and other products that integrate with the rest of their homes,” Hartwig says.

Whirlpool’s attestation that it won’t be able to hire more employees without trade protection is likely true, but that doesn’t mean overall U.S. employment will suffer. Both Samsung and LG have announced plans to build factories in the United States that would more than make up for Whirlpool’s hiring loss.

“It’s hard to take Whirlpool’s claim [that] it’s a victim,”

“Just because [Whirlpool] used to dominate the domestic market doesn’t mean they deserve to continue to dominate.”

—Laurence Kotlikoff, professor of economics, Boston University

says Laurence Kotlikoff, professor of economics at Boston University. “Just because it used to dominate the domestic market doesn't mean it deserves to continue to dominate. With that kind of logic, we should slap stiff tariffs on foreign agricultural products because half the country used to be employed in the agricultural industry and only 2% are employed in it today.”

Hartwig contrasts Whirlpool’s claims with longstanding arguments made by the U.S. steel industry about foreign competitors. “It’s difficult to see how in the kitchen appliance space—where consumers spend quite a bit of time in their purchasing decisions—foreign companies are dumping products,” he says. “These are differentiated products, not cheap undifferentiated steel from China.”

If the president imposes a tough levy on LG and Samsung,

Courtesy Boston University

many consumers will end up paying more for a washing machine they prefer over one made by Whirlpool. Or they just might stick with the one already in the laundry room.

Steel Trap

Steel makers, perhaps more than any industry, are confident that the president's tough talk on the subject of cheap steel imports will result in tariffs. "Steel is a big problem; we're like a dumping ground, okay?" Trump told reporters traveling aboard Air Force One in July 2017. "[Other countries are] dumping steel and destroying our steel industry. They've been doing it for decades and I'm stopping it. There are two ways, quotas and tariffs. Maybe I'll do both."

During the 2016 presidential campaign, Trump frequently insisted that China had dumped steel in the U.S. market. On more than one occasion, he called the alleged dumping a national security issue. As always with President Trump, it's hard to separate bluster from real plans. However, Nucor's CEO John Ferriola told *Bloomberg* in September that Trump had personally assured him of his determination to impose steep levies on steel imports. Nucor, the largest domestic steel producer, declined requests for an interview.

Under Trump's directive, the Department of Commerce has investigated the national security dimensions of steel imports under the rarely used Section 232 of the Trade Expansion Act of 1962. According to Linicome, the rule

The Price of Protectionism

permits the president to impose protectionist measures that fall outside permissible global trade rules, effectively constituting a unilateral trade action.

"Were this to happen, it would be an abrupt departure from previous Republican and Democratic administrations," says Linicome, author of a detailed Cato Institute policy analysis, "The Long History of America's Protectionist Failures," demonstrating the failure of American protectionism from the late 1880s to the present.

Does the U.S. steel industry need trade protection? "Big steel companies like to complain that cheap foreign steel is the problem, when the real problem is small domestic minimills using scrap metal to make steel," says Dartmouth's Irwin. The mills mostly produce carbon steel used in automobile manufacturing, construction, and consumer products. "These mills are close to their customers and are more nimble and efficient," Irwin says.

Steel imports aren't taking away the industry's market share, he asserts. "You could stop all the imports you want, and the big steel firms would still face tough competition."

If the president imposes stiff trade protections on steel imports, economists expect a reprisal by China and any other countries caught in the squeeze. "When you move in

High-Flying Maneuvers

The U.S. Commerce Department takes action over Canada's subsidies to jet maker Bombardier.

The big question for some is not the likelihood of tariffs, but how high the levies will be. In this regard, the decision by the U.S. International Trade Commission (ITC) to impose preliminary antisubsidy duties on Canadian aircraft manufacturer Bombardier may be illuminating.

Here's the backstory: Rival American manufacturer Boeing accused the Canadian government of unfairly subsidizing Bombardier's C Series jets, dumping the aircraft at a price well below production costs. Canada is accused of offering billions of dollars in loans, equity infusions, grants, and tax credits to Bombardier.

The U.S. Commerce Department retaliated with a stiff 219.63% countervailing duty on the jets. The duties are subject to the ITC's re-

view, hence their "preliminary" status. The ITC is expected to provide its recommendations in early 2018.

The size of the duty took many economists by surprise. In effect, it would triple the cost of C Series aircraft sold in the United States. In a statement, Bombardier called the proposed duty "absurd."

Meanwhile, *Newsweek* reported that Boeing has received substantial government subsidies: $457 million in federal grants, $13 billion in state and local subsidies, and nearly $64 billion in federal loans and loan guarantees. That makes Boeing's complaint that Canada is unfairly subsidizing the C Series jets seem hypocritical.

As Dean Baker, co-director of the Center for Economic and Policy Research, puts it, "You can't define protectionism as the things you don't like." | **R.B.**

Courtesy Bombardier

the direction of unilateral protectionism via Section 232, the likelihood of countermeasures restricting American companies' businesses in affected foreign nations increases," Linicome says.

In addition, the United States already has numerous restrictions placed on foreign steel. Of the 373 trade barriers the country had in place at the end of 2016, Linicome says, more than half (191) involved foreign steel. "We don't need higher tariffs or quotas on steel imports," he insists. "Go that route and it will simply result in higher prices for American industries reliant on steel, which is a lot of industries."

Irwin concurs: "A lot of steel users are saying, 'Wait a second—if you help these guys [like Nucor], you're just going to hurt us. Where's the fairness in that?'"

Shining Bright

The solar industry says a tariff on Chinese solar panels would severely hurt end-user demand.

$84 billion*

The solar industry's contribution to U.S. gross domestic product

260,077

Number of solar industry workers in the United States

39%

Share of electricity-generating capacity attributed to solar

19%

Drop in solar prices over the last 12 months

* All data as of year-end 2016
Sources: Solar Energy Industries Association, The Solar Foundation

Open for Business?

Such "wait a second" instances aren't confined to steel imports. If the Trump administration exits NAFTA, Midwest farmers and U.S. automotive suppliers that export to Mexico will incur tariffs that, for the most part, do not exist today. "There's always a tradeoff in the politics of trade," says Darmouth's Irwin, author of the book, "Clashing Over Commerce: A History of Trade Policy."

Ironically, Trump's proposal to rewrite NAFTA in the country's favor has little support from domestic business leaders. The U.S. Chamber of Commerce has promised to send an army of lobbyists to Capitol Hill to persuade Congress to preserve the agreement. Another group, the Trade Leadership Coalition, in November began airing pro-NAFTA advertisements in nine states that Trump won in 2016. The U.S. and other NAFTA members recently held the fifth of seven scheduled rounds of talks about the 23-year-old treaty. Unfortunately, Congress does not have the power to save the treaty.

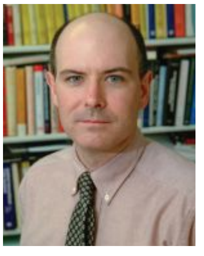
The White House also has a lot of power when it comes to trade fights. The ITC is considered a fair broker when it comes to examining trade issues and executing the law, but the larger geopolitical dimensions of the commission's recommendations must be weighed by a sitting president. Given Trump's staunch nationalism, geopolitics is likely to be a secondary concern in his tariff determinations.

If Trump rules in favor of unilateral trade protections and sky-high tariffs, other industries looking for market-share fortifications will come knocking on the ITC's door. "Many past presidents were unsympathetic to domestic industry and turned down the ITC's proposals for relief," says Irwin. "Now we have an administration that is inviting these petitions, sending a message to other industries that 'We're open for business.'"

So, what's the solution? "Instead of taking protectionist measures, government and industry need to develop policies to help workers prepare for disruption and quickly adjust to it afterwards," says Linicome.

Another suggestion is to let the WTO perform its key functions as a forum for trade negotiations and adjudicating trade disputes. The organization defuses political tensions and comes up with "reasonable ways of deciding if a country's trade policies are in conformance with agreements or violate them," says Irwin.

The Trump administration has hinted at ignoring or leaving the WTO, the organization through which 164 countries, including China, have agreed they want to resolve trade disputes. A U.S. departure could cause other countries to follow suit and leave a proven system in tatters.



"You could stop all the imports you want, and the big steel firms would still face tough competition."

—Doug Irwin, professor of economics, Dartmouth College

"If we kick aside the WTO, the future of the United States as a global competitor is in jeopardy," Hartwig says. "There is no way the country can go it alone in a political, social, or economic context."

Yet Trump seems determined to move the nation toward bilateral trade deals that favor the United States. Or worse. Many domestic producers would love steep tariffs slapped on goods imported from other countries, Kotlikoff says, but that would be unwise. The U.S. economy is currently 16% of the world economy and, he contends, headed to 5% by the end of the century. "This is not the time to seek unfair advantage over global competitors," he says. CFO

Russ Banham is a veteran financial journalist and author and a longtime contributor to CFO.

Courtesy Dartmouth College

Taking Aim

Six CFOs from diverse industries reveal their top business objectives for 2018.

Next year promises to be an exciting (and, possibly, very critical) year for many companies. Interest rates may finally head higher, workers may be tougher to find, valuations pricier, and consumer spending more robust. Or, as CFOs know all too well, none of that may happen. Unforeseeable events and market conditions will intervene, as they always do. Excessive leverage may finally get the better of the credit markets. An asset bubble could pop. Or populist politics could cause a Western nation's economy to seize.

But, overall, despite the risks, it is a good time to be a chief financial officer. A potential corporate tax cut in the United States could boost many companies'

Getty Images

bottom lines. Technology will continue to slowly enable greater productivity in the finance department. And federal regulators may loosen some of the red tape that businesses think is choking growth.

Overall, it looks like, finance chiefs will have an abundance of "levers" they can pull to influence business outcomes next year. But which ones will they use? The choice is highly dependent, of course, on the businesses they run. But it is also dependent, in part, on the swirl of macroeconomic factors mentioned above. In 2008, for example, hardly any CFO of a financial institution would have stated "market share growth through aggressive M&A" as their number one goal for that year.

What do CFOs have at the top of their to-do lists for 2018? What are their primary missions? To find out, we interviewed the finance chiefs of six mid-size to large U.S. organizations. Their choices, which are probably shared by many organizations, reflect the kind of year we are headed into: one full of promise for many sectors, but also one heavy with uncertainty.

The following stories describe the top priorities for the CFOs of companies in a diverse set of industries: retail, freight logistics, recreational equipment, computer peripherals, chemicals, and real estate. On the surface, to a layperson, their goals might sound simple, but fellow CFOs know the following six objectives are anything but easy to execute on, and achieve, in any year.

The profiles were written by deputy editors David M. Katz and David McCann, and editor-in-chief Vincent Ryan.

Survive Disruption

Asked to characterize how he sees 2018 playing out, Scott Settersten, the CFO of retailer Ulta Beauty, uses the words "dynamic" and "exciting." But Settersten chooses more measured terms to describe the essence of his job in the forthcoming year: "It's a question of being able to balance the growth levers of the business versus the core of keeping the lights on."

Both descriptions are true. On the one hand, Settersten will be closely watching the dynamic and disruptive effects of Amazon's powerful online strategy, which emphasizes ever-shrinking product delivery times, lower overhead, and tightening margins. "Retail is just going through this crazy cycle ... with the Amazon effect" and Walmart's effort to keep up by growing its online presence, he says.

Ulta, whose stores offer cosmetics, fragrances, skincare, haircare, and salon styling tools, is trying to maintain a foothold in online merchandising even as it seeks to expand its core bricks-and-mortar business. Settersten continues to focus on the company's investment in what he calls "normal growth drivers"—building new stores, developing the company's loyalty programs, and offering seasonal discounts. But "there are also a lot of other things that are churning in the background," he says. Those include new investments in artificial intelligence, web applications, and digitalization.

"It's a question of being able to balance the growth levers of the business versus the core of keeping the lights on."

—Scott Settersten, CFO, Ulta Beauty

"The question is ... what [technologies] work best for our particular business model," Settersten says. "There are a lot of [technologies] you can invest in—take chances on, place bets on—but you need to be as sure as you can be of what really might benefit your customers in the long-term."

A more immediate focus will be maintaining the company's sales and profit growth. During the first six months of its 2017 fiscal year, Ulta's net sales increased about 22% and its net income surged 33%.

To keep the company growing at that pace, Ulta needs to continue expanding its number of stores and their total square footage, as well as getting customers to stroll into them. Therefore, a prime concern of Settersten's in 2018 will

Holding On

Ulta Beauty is still expanding, but other U.S. retailers are at risk of defaulting on their debt obligations.

U.S. retailers on Fitch Ratings' "Bonds of Concern" list*

Sears
Claire's Stores
Guitar Center
Nine West
Bon-Ton Stores
David's Bridal
Fresh Market
Bi-Lo
99 Cents Only Stores

*inclusion on the list indicates they have a significant risk of default over the next 12 months

Source: Fitch Ratings

Courtesy Ulta Beauty

be the real estate market. Adding to the 1,010 or so stores Ulta had at the end of August 2017, the company is committed to opening one hundred each year until it reaches between 1,400 and 1,700 total.

During a conference presentation in December 2016, Settersten told investors that "real estate is one of our core competencies." Although the company hasn't typically built many of its stores in malls—the higher per-square-foot costs can be a deterrent—the finance chief is seriously looking at "a lot of mall opportunities people are presenting to us."

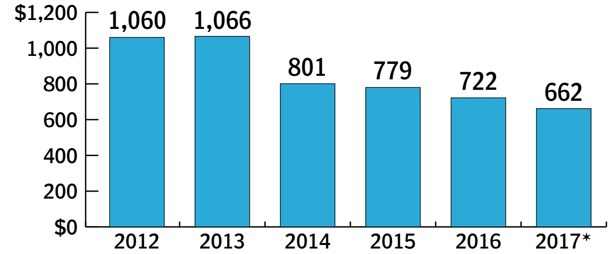
In deciding on whether to set up a store in a mall—or any other location, for that matter —the cost per space is a big part of the calculation. But the financial health and competitiveness of other tenants in the mall is also crucial, especially "how Amazon may impact them and the traffic flow in those centers over the long-term," Settersten says.

With the changes triggered by online commerce that are sweeping through retail, "we don't want to be left [in a mall] by ourselves" the finance chief adds. "Even though we do a good job driving our own traffic, we need to have the combined strength of multiple retailers in one." | **DAVID M. KATZ**

Offloading Debt

After being close to bankruptcy, freight logistics firm YRC Worldwide has cut its long-term debt by 37% in six years.

in $ millions



*as of September 30, 2017; all other years as of December 31
Source: S&P Capital IQ

Raise Prices

Freight logistics provider YRC Worldwide has experienced increased volume for its 14,000-truck fleet over the past few quarters and is expecting more of the same for 2018. And after some paydowns, the company's outstanding debt is below $1 billion. Welcome trends? Sure, considering that the company is six years into an epic turnaround effort and has been at the brink of bankruptcy several times. But they're not the needle-movers YRC is looking for.

From a financial standpoint, what the $4.7 billion shipper wants most in 2018 is to continue boosting its yield through price increases. It also aims to achieve a satisfactory resolution to collective bargaining negotiations with its union, says CFO Stephanie Fisher. And the outlook is good for both of those outcomes, she adds.

"Price goes straight to the bottom line, whereas with volume you have to add labor to make it work."

—Stephanie Fisher, CFO, YRC Worldwide

The company's yield was up in 2017, and capacity constraints throughout the trucking industry indicate that 2018 may be even more fruitful. A years-long driver shortage is forecast to get worse, although that's not a bad thing if a trucking company wants to raise prices, because it essentially functions as a limit on supply. Also, new safety devices that record truckers' hours of service, mandated by Congress to be installed in commercial trucks by December 18, 2017, may force out smaller shippers that rely on drivers working long shifts.

"Our focus in 2018 is going to be on price, which always outweighs volume, because price goes straight to the bottom line, whereas with volume you have to add labor to make it work," says Fisher. As part of the effort, YRC will look to cull volume from unprofitable shipping lines. "It doesn't make sense to deliver freight we're not making money on, especially when there's a driver shortage," she notes. Fisher adds that "customers will have no choice but to accept price increases, because our competitors are doing the same thing."

On the collective bargaining front, YRC is in a holding pattern. The company's agreement with the International Brotherhood of Teamsters expires in March 2019, but for

Courtesy YRC Worldwide (2)

all practical purposes there's little Fisher can do to prepare until she's able to assess the results of labor negotiations by key competitors.

"The good news for us is that we have a better relationship with the IBT leadership than we've had in a long time," Fisher says. "The union's new freight director came into the position earlier this year, and we've had more meetings with him than we'd had in the previous three or four years."

The IBT freight director worked with YRC to establish, for the first time, wage differentials for union members based on regional costs of living, the CFO notes. He also cooperated with YRC to address operational changes related to December's opening of eight new distribution centers, which YRC expects will dramatically reduce shipment bottlenecks.

Crucial to the company in 2018 are the investments it's making in "revenue equipment"—tractors and trailers—and software that optimizes the routes drivers take to pick up and deliver freight. They offer greater bang for the buck than debt paydowns, despite heavy interest payments on the loans. "Someone at our investor conference asked us, 'If someone gave you $500 million, what would you do with it?' We immediately said we'd invest in revenue equipment," says Fisher. | **DAVID McCANN**

Drive a 'Culture of Data'

Consider a large, global company that allows its business units to run their own affairs without an eye toward consistency in operations or branding. There is no long-term strategy in place and e-commerce is an afterthought. Little effort is expended on capturing data, let alone analyzing and making decisions based on it. Unsurprisingly, this company isn't growing.

That's a snapshot of Specialized Bicycle Components, a maker and distributor of bikes and related products, as it existed roughly three years ago. That was around the time Nik Rupp joined the company as global controller, following 11 years in various divisional finance roles at Nike. Things have changed at Specialized in the interim, especially in the structure of the 43-year-old company, which currently has about 1,600 employees and $1.2 billion in annual sales.

Specialized Bicycle is creating a dedicated data team to leverage information from point-of-sale, website visits, and retailer inventory.

"Financial planning... by its nature doesn't think bigger about all that can really be done with data."

—Nik Rupp, CFO, Specialized Bicycle Components

"We've put in place true regions, true regional leadership, new functional leadership, and within the last 12 months, for the first time, a long-term strategic plan," says Rupp, who moved up to the CFO chair in March 2016. "This year, we're finally back on track with growth."

The strategic plan, largely focused on leveraging data to build a robust e-commerce operation, will dominate the finance chief's agenda for 2018. In November, the company launched an e-commerce platform, including a new website. Rupp will be aiming to maximize the platform's value. However, a number of elements, like the ability to order a bike online and pick it up at a Specialized dealer location, are not yet built.

Concurrently, Rupp is overseeing the creation of a dedicated data team that will be looking not just at financial data, but point-of-sale data, data from website visits, retailer inventory data, and other information. But the goal is not data analysis per se.

"What I'm trying to put in place is not just a tier of folks embedded within financial planning to do additional reporting on what's going on with e-commerce," says Rupp. "I'm building a separate structure that sits outside financial planning, so as to drive a culture of data and an understanding of that throughout the organization."

That, he says, is "subtly different even from what we had at Nike, which looked at a lot of data within traditional planning functions. That, I think, limited the scope of the [analyses]. Financial planning looks at certain fixed elements and by its nature doesn't think bigger about all that can really be done with data."

Courtesy Specialized Bicycle Components (2)

The strategy has generated some early wins that, while relatively modest, provide a taste of what could be accomplished as the effort matures. For example, Specialized had been paying Google more than $1 million a year for search-engine-optimization services without really knowing if it was getting its money's worth. The data team took a close look and figured out that the company could get the same reach and impact for much less.

While leaders at the company's Morgan Hill, Calif., headquarters are on board with the need for the data initiatives, convincing some of the regional leaders has been more of a challenge, according to Rupp. "Most of those individuals have owned a traditional distribution or retail business, and they don't necessarily see the value in it," he says. "But I've been sending some of the data-team members to work with those leaders, and they're starting to see the impact on generating new ideas and understanding not just the traditional finance data but what's happening in the broader marketplace." | **D.M.**

Execute Crisply

What more can DuPont performance chemicals spinoff Chemours accomplish in 2018? Since its spin in July 2015, the $5.9 billion revenue company has already raised capital through asset sales, cut net debt, and delivered on 60% of the cost savings it proposed to stakeholders. The company's shares marched up steadily in 2017, reaching a price-to-earnings ratio of 34.4 in November.

For Chemours CFO Mark Newman, the priorities in 2018 will be execution and dialing up the company's performance. Part of that will be improving the regular operating and business reviews with the company's three unit presidents, keeping them focused on adjusted EBITDA, free cash flow, and return on invested capital.

"We have moved [on] from an organization that wants to get every fact and figure before making a decision."

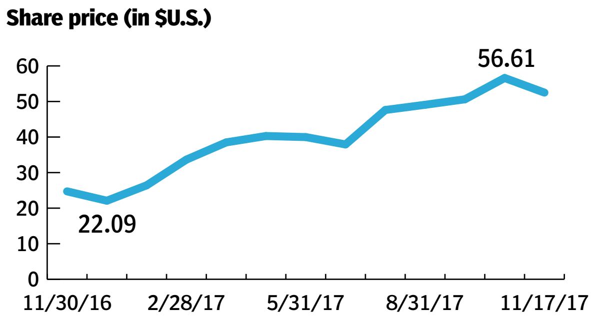
—Mark Newman, CFO, Chemours

Not that growth isn't a priority, too—the company's businesses are what Newman calls "highly investable," and Chemours is forecasting greater capital expenditures in them over the next couple of years. But inside the organization, Chemours is still throwing off the shackles of the highly matrixed, bureaucratic DuPont. Instead of relying on numerous corporate staffs to interact with operations, Newman and other top management are forcing decision-making down to the business units and driving individual accountability, a keystone of the company's transformation.

"We have moved [on] from an organization that wants to get every fact and figure before making a decision," Newman says. "We want not only crisp execution but also timely decision-making. There has been a huge emphasis on the need for speed."

High Performance

The shares of DuPont spinoff Chemours have easily outpaced the S&P 500 in the past year.



Source: TD Ameritrade

Related to the idea of casting off the skin of the old DuPont is driving broader employee engagement in 2018. "One of the things that has surprised us is the level to which all employees can bring forth ideas," says Newman. Chemours has established a framework to post employee ideas on a centralized platform, so they can be exposed and vetted and, if they have merit, executed quickly. "Now that we have the infrastructure in place, our next goal is getting more ideas through the pipelines," Newman says.

Transformation is also underway in the finance department. Chemours has moved off of a legacy consolidation management reporting system. It is also changing its service delivery model to include some business process outsourcing. And Newman is trying to "refresh" the retained organization so that it is much more focused on high-value decision-support activities and less on transaction processing.

Newman has big ambitions for finance: he wants nothing less than a "top quartile" finance organization in terms of efficiency and overhead costs: "one of, if not the best" finance functions in chemicals, he says.

Courtesy Chemours

The finance and operations teams already have made great strides when it comes to cash flow. Chemours has cut its cash conversion cycle significantly, after, among other steps, making a concerted effort to determine what level of materials and finished goods the company really needs to stockpile in order to support customers.

"Today our business unit leaders understand that when we talk about capital invested, it's not just the fixed assets; it's also working capital," Newman says.

The markets for titanium technologies, fluoroproducts, and chemical solutions are headed for growth in 2018. Chemours is also slated to take out an additional $150 million in costs. On paper, the company looks to enjoy a profitable 2018—as long as it executes. | **VINCENT RYAN**

Increase Margins

There can be little doubt that the housing market has remained red hot, with September marking the 67th straight month of year-over-year price gains. Yet while people looking to sell their homes might be able to claim high prices for them, they also could find themselves in a bind. Once they sell their homes, they might have trouble buying new ones to live in. Numbers from the National Association of Retailers tell that story, too: by the end of September, total housing inventory had fallen year-over-year for 28 consecutive months.

To Kathleen Philips, the CFO of Zillow Group, a web and mobile nexus for homebuyers and renters fueled by ads sold to real estate agents, those numbers are important ones to consider as she looks for ways to fatten her company's margins for 2018.

Commenting on what she considers the "historically low" number of houses on the market, Philips says "it's challenging for buyers to find homes, and it's challenging for agents because they often have to go with their clients into an offer situation [with the home they are selling] before the client can actually purchase a [new] home."

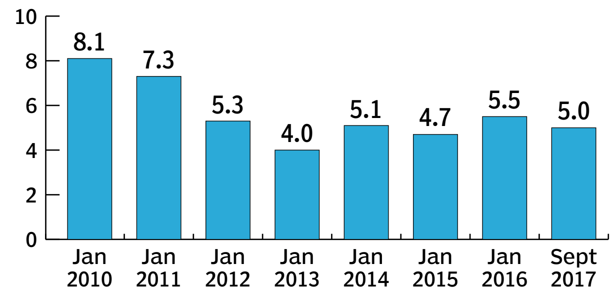
Asked how those challenges will affect Zillow, Philips doesn't hesitate. "We view it as an opportunity," she says. One facet of the opportunity is that new features on its websites will tighten "the agent-buyer partnership as they try to make a purchase in the hot market."

By doing that, Zillow could boost agent membership in its "Premier Agent" ad sponsorship program, which brought in about 70% of the company's $282 million in third-quarter revenue. One example of a tech innovation that the company hopes could boost ad sales is the "My Agent" feature it launched this year.

Hunting for Houses

Zillow Group considers the "historically low" number of houses on the market in the U.S. an opportunity for its real estate websites.

Months of supply of houses in the United States



Source: U.S. Bureau of the Census

After a potential buyer makes frequent visits to a premier agent's website, Zillow automatically replaces a list of agents with a contact box that features only that agent. "This two-way contact module," said CEO Spencer Rascoff on the company's third quarter earnings call in November, "will help agents convert more leads into transactions by keeping that agent in front of the consumer throughout their search."

In her quest to widen Zillow's 2018 margins, Philips will also be looking at R&D investments aimed at luring traffic to the company's web and mobile platforms. "One of the things we are testing right now is an instant-access platform where a potential home seller can connect with a real estate agent and talk to that agent about listing their home," the finance chief notes.

Another major potential outlay on the CFO's mind is sales force growth. "During 2017, we were a little conservative with the expansion of our sales force, so as we move into 2018 we're evaluating [spending more on it]," Philips says.

Besides focusing on possible R&D and headcount in-

"During 2017, we were a little conservative with the expansion of our sales force, so as we move into 2018 we're evaluating [spending more on it]."

—Kathleen Philips, CFO, Zillow Group

Courtesy Zillow Group

creases in 2018, Philips will contemplate ways to build upon the company's $100 million advertising spend in 2017. But a CFO's focus can't only be on spending. True to form, the finance chief points out that, along with mulling future outlays, she and her colleagues will "think about how we're going to pay for all of that." | D.M.K.

Invest for Growth

If Vincent Pilette, CFO of Logitech, has a mantra, it is "spend less, grow faster." But a ruthless cost-cutter Pilette is not. Along with Logitech CEO Darrell Bracken, Pillette has spent five years restoring the computer device maker's credibility, improving its cost structure, and trimming its product portfolio. That's all in service of delivering sustainable top-line growth in its five big markets: gaming, video collaboration, music, smart home, and creativity & productivity.

But it's what enables that growth that is the real priority in 2018: a focus on expanding what Pilette and the leadership team call "pure margin," the margin before reinvestment. In a company with no outstanding debt, that gross profit is continually plowed back into the business to create a virtuous circle of growth.

Logitech, a $2.2 billion revenue company, aims long-term to deliver non-GAAP gross margins in the range of 35% to 37% and raise non-GAAP operating margins toward the high-end of its target of 10% to 12%. To expand margins, Logitech has "a broad set of levers, all the way from pricing to product costs across [a] diversified portfolio," Pilette says.

Higher margins allow Logitech to invest in its five core capabilities—engineering, design, operations, go-to-market, and marketing. Reinvestment in any year can consist of things like "expanding the sales force to capture the large growth opportunities in video collaboration [webcams, headsets, meeting room solutions], redesigning the retail presence to drive incremental growth in PC peripherals, or training point-of-sales staff to better understand the products," says Pilette.

Of course, funds go to products that are well-positioned in growing markets and where market share can be gained. Logitech also invests to "build up adjacent categories" or acquire "where it makes sense," says Pilette. In its last two quarters, Logitech bought Jaybird (audio devices) and ASTRO Gaming (gaming headsets).

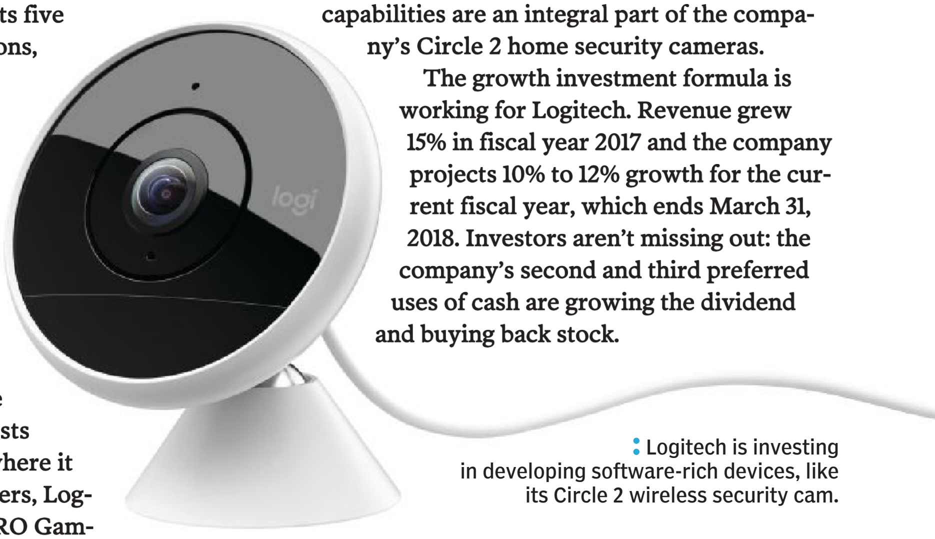
As with any tech company, margin goals are enabled by automation. Previous information technology investments enabled the company to lower costs in finance, operations, and other functions. Going into 2018, though, the investments will be about "adjusting [Logitech's] processes and tools to continue to make better decisions and improve performance," Pilette says.

"So long as our margins are within our targeted range, we believe the best use of our capital is to reinvest in our capabilities."
—Vincent Pilette, CFO, Logitech

For example, recent improvements to the channel revenue management module of the company's Oracle12 business suite give management quick and accurate information on contribution margin by customer account. Because growth is so important to Logitech, another aim for automation is to "create flexible processes that can scale to absorb business growth without increasing the infrastructure operating costs," according to Pilette.

Technology is also enabling research and development of software-rich Logitech devices, like the FLOW-enabled PC mice and keyboards that can be connected across multiple devices. Likewise, machine learning and data analytics capabilities are an integral part of the company's Circle 2 home security cameras.

The growth investment formula is working for Logitech. Revenue grew 15% in fiscal year 2017 and the company projects 10% to 12% growth for the current fiscal year, which ends March 31, 2018. Investors aren't missing out: the company's second and third preferred uses of cash are growing the dividend and buying back stock.



Logitech is investing in developing software-rich devices, like its Circle 2 wireless security cam.

But Logitech is clear about its first priority: "So long as our margins are within our targeted range, we believe the best use of our capital is to reinvest in our capabilities," says Pilette. | V.R.

Courtesy Logitech

Breaking Out

Shedding an obsession with costs, supply chains embrace new operating models and high-quality service. By David McCann

Since the notion of supply chain management emerged in the 1800s, the focus has been on transporting parts, materials, and finished goods from point to point at the lowest cost. Companies are still trying hard to do that today, of course. But increasingly, other objectives are taking priority. ¶ In particular, companies are using various digital technologies that, among other effects, eliminate certain supply chain activities and players. These steps may reduce costs, but their underlying purpose is to facilitate the creation of new business models based on other motivations, such as leveraging contemporary consumer buying preferences.

As a domino effect, such macro changes are pressuring business-to-business suppliers to refine their own business models. In so doing, one eye may be trained on taking advantage of the altered environment, the other on plain survival. At the same time, some companies are taking a hard turn toward using quality as a competitive weapon. That can result in lowered costs but it also can mean actually adding costs to achieve the improvements.

"Cost is not the hottest topic in supply chain today," says Matthew Lekstutis, supply chain consulting lead for Tata Consultancy Services. "Instead, you see many new kinds of supply-chain models."

Even where squeezing costs out of the supply chain remains a key goal, there's less effort devoted to it. That's because it's becoming more difficult to do, notes Rick Pay, principal of supply chain consulting firm R. Pay Co. Today, an increasing portion of supply-chain activity is accomplished under multiyear contracts with software-as-a-service vendors, third-party logistics firms, and other service providers. "That turns them into fixed costs over the life of the contract," Pay says. "Companies negotiate the terms up front, of course, but once they sign, they're locked."

Any Way You Want It

One of the most impactful changes for supply chains stems from retail's broad, ongoing shift to omnichannel distribution. "Omnichannel" means companies provide customers with multiple ways to purchase and receive products. The trend has resulted in vastly increased direct-to-customer shipments, which carry exponentially higher costs than sending pallets of products to stores.

Even in companies where squeezing costs out of the supply chain remains the top goal, there's less effort devoted to it.

Nike is among a number of companies building online infrastructure that allows consumers to design their own products. In Nike's case, customers select options from menus of shoe fit, color, style, and performance characteristics. "It's called customization of scale," says Lekstutis. "It changes the entire economics of the supply chain."

The direct-to-consumer trend is not cost conscious—it's driving a surge in product returns, imposing additional costs for repackaging, repairing, storing, reselling, and perhaps discarding returned items. "Many consumers are buying online with the idea that if the item doesn't fit or isn't the right color, they can just return it," notes Pay.

But while it may seem impossibly inefficient to essentially create a different product for each customer, that's only the case if a company tries to do it within its existing manufacturing and supply-chain structure, according to Lekstutis.

Nike and other companies are supporting the direct-to-consumer model through the use of "additive manufacturing," otherwise known as 3D printing. Manufacturers and wholesale distributors are considering or actually starting to install banks of printers in factories and warehouses to print products or parts on demand. "3D

Thinkstock

printing is a disruptive digital technology that enables significantly shorter lead times," Lekstutis says.

Additive manufacturing mitigates some of the increased costs imposed by omnichannel distribution, by reducing shipments from factories to distribution centers and lowering inventory-management costs. If 3D printing of products were to achieve a critical mass, Pay observes, "the way companies would manage their inventory is that they wouldn't have any."

And manufacturing quality wouldn't necessarily suffer, especially if 3D printing technology continues to improve. Already, many 3D-printed parts are at least as accurate as machined ones, according to Pay.

Doing It Better

On the quality front, the fact that purchasing departments are creating more-detailed requests for proposals (RFPs) is telling, according to Bryan Eaves, a partner at Sourcing Business Solutions, a provider of supply chain process-improvement services.

A company looking for a logistics provider to handle customer returns is now interested in more than just cost, Eaves says. It will typically ask more questions related to quality: How will the vendor get products fixed before they go back to customers? What kinds of innovative ideas has the service provider generated to improve quality?

Breaking with a longtime norm, companies are trying to position supply-chain quality as a differentiator, says Patrick Van den Bossche, a partner and board member of management consulting firm A.T. Kearney. Van den Bossche says he's working with several companies that are heavily promoting their delivery speed, visibility into their supply chains, and proactive risk management.

"In every industry there's a role for a company that's the early mover and one that's the cost champion," he says. "Now companies are emerging that want to be seen as the high-quality, low-risk option." That orientation has been triggered in large part by all the supply disruptions in recent years, including tsunamis, hurricanes, and West Coast port strikes, Van den Bossche explains.

Courtesy Rick Pay

"If you want to tap into some leading-edge thinking in business, supply chain is really where it's happening."
—Rick Pay, consultant

To enhance delivery speed, companies are switching from reliance on electronic data interchange to cloud-based application programming interfaces for accepting and processing many orders. That reduces processing time from hours to minutes, he says.

For boosting supply-chain visibility, suppliers are using a new generation of cellular-based shipment tracking technology featuring improved battery life. The most advanced tracking systems transmit real-time information on a shipment's location as well as factors that could affect product quality like temperature, humidity, vibration, shock, air pressure, and light.

Such changes allow a supplier to demonstrate confidence in its distribution network by, for example, contractually agreeing to larger penalties for breaching service terms.

"If a supplier can guarantee it will always provide customers with the raw materials they need, no matter what, that's a pretty powerful commercial advantage," says Van den Bossche. "That's quite exciting for supply chain professionals, because they've typically been stuck on cost."

Existential Threats

Many companies, of course, both manage their own supply chains and play a role in the supply chains of other companies. In the latter context, strategies are increasingly about how to survive and thrive in an environment where virtual marketplaces are displacing physical ones.

The ripple effects from the business models of Alibaba and Amazon can weaken traditional suppliers or eliminate them, and often those suppliers aren't replaced. Now, both Internet retail giants are working to build technology-enhanced package-delivery services that promise to undercut long-entrenched market leaders Fedex and UPS. Uber and Lyft are cutting heavily into the businesses of other transportation providers and their suppliers. And, in many markets, Airbnb is besieging the businesses of lodging providers.

"If technology exists that may make a company's role within a supply chain obsolete, then that company needs to look at the collective 'cradle-to-grave' activities that go into the procurement, development, and final sale of any particular product or service," says supply chain consultant Alex Calderone. "It needs to figure out where there may be opportunity to make up for anticipated losses in market share that could stem from emerging technologies and changing business models.

"Where the company positions itself within a supply chain is going to be far more important that how it manages the costs of its own supply chain," Calderone continues. Moreover, it's clear that the era of new technologies and business models disrupting supply chains is only beginning.

For example, says Calderone, the expected wide-scale deployment of autonomous cars means that auto manufacturers will develop self-driving fleets that allow them to "sell" the same car thousands of times by providing a type of on-demand taxi service (which may itself threaten Uber and Lyft).

Infrequent, high-priced transactions (auto purchases) will be replaced by soaring volumes of low-priced transactions. That means consumers' demand for car ownership will decline. Companies that supply auto manufacturers with metal and other materials face a dire future unless they find ways to disrupt their own business models.

Other industries that could become collateral damage, according to a recent CNBC report, include insurance and auto repair, as accidents decline; commercial parking, as driverless fleets remain on the road most of the time; and urban real estate, as easier commuting shifts residences to suburban areas.

Lasso Your Data

The need to keep pace with changing markets poses a significant quandary for many companies. IT analyst firm Gartner coined the term "bimodal capability," referring to a company's ability to tend to its existing business while exploring opportunities centered on leveraging new technologies.

But while Gartner has presented bimodal capability as a golden fleece of sorts, the need to stay on target regarding current goals while also getting ready to withstand—or trigger—industry disruption is a significant quandary for some companies.

To establish the type of bimodal supply chain envisioned by Gartner, a company first must recognize that industry disruption is imminent, says Tata's Lekstutis. Next, it should create an environment that prioritizes capturing data on a ubiquitous basis across the business. That should pave the way to begin using that information to define all of the business's product characteristics, bills of materials, transportation modes and lanes, lead times, quality specifications, and network, supplier, and customer characteristics. "It sounds daunting, but most of the data exists—it just needs to be connected," Lekstutis says.

The next task, he adds, is cleansing the data to avoid things like inconsistency. For example, a company almost surely will use different numbers to refer to products or parts than some of its customers or suppliers do. A similar problem could arise from freight carriers having different tracking numbers for parts or products. Global standards body GS1 is developing data standards designed to overcome some of those issues, Lekstutis notes.

Such activities can drive robust value from a supply chain, value that enables no less than a reinvention of a company. "If you want to tap into some leading-edge thinking in business, supply chain is really where it's happening," says Pay. CFO

Tech Tweaks

An industrial distributor automates inventory and order handling.

Like many companies, Lawson Products, an industrial distributor of maintenance and repair products, operates its own supply chain and is a part of other companies' supply chains. In both cases, technology makes a big difference.

Lawson, a $275 million Nasdaq-listed company, sells things like nuts, bolts, fasteners, and chemical products. At customers' production sites, Lawson maintains a supply of its products that customers use regularly enough that they would risk production shutdowns if they ran out.

Lawson sales reps scan the product bins with a Motorola device to determine how much product a customer has on hand. The device interacts with custom software that automatically generates an order. "The rep doesn't have to manually input anything or do anything other than scan the bin and transmit the order," says CFO Ron Knutson. "It's a seamless process."

Ron Knutson, CFO, Lawson Products

At its warehouses, Lawson uses a type of scanning technology called CubiScan, provided by software firm Quantronix. Lawson scans all of its products—it currently has 55,000 SKUs—to record their dimensions and weight. Then, as orders come in, the software selects and sends to the packing line the appropriate shipping box to accommodate the size, shape, and weight of items included in the order. "This is fairly new technology, and if CFOs aren't using it, they should be," says Knutson. "It avoids a lot of labor cost."

The company recently began cutting additional labor costs through a process known as cross-docking, which Knutson says has been growing prevalent at distribution centers. Cross-docking is a system by which high-demand products are shipped out almost immediately after their arrival without ever being stored. "It limits the number of times we touch the inventory," the CFO says. "How much you save depends on how much you can cross-dock, which might be only 5% to 10% of your inventory. But that's the way distribution companies drive earnings, by taking out nickels and dimes." | D.M.

Courtesy Lawson Products

To DB or Not DB?

Sponsors seek to tackle the rising costs and onerous administrative burdens of defined-benefit pension plans. By Chris Schmidt

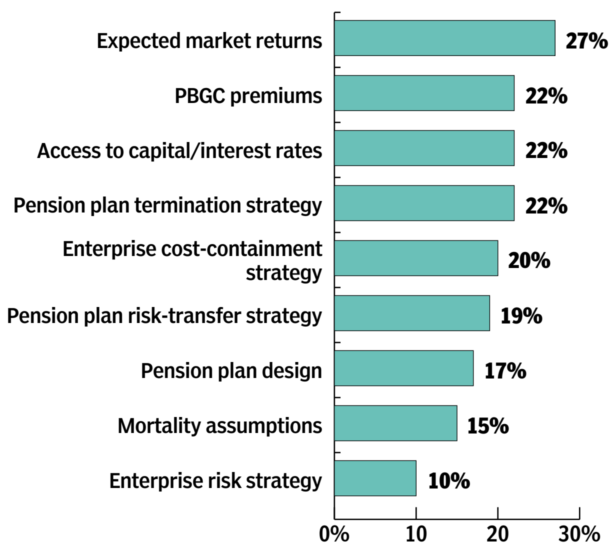
Like it or not, CFOs frequently find themselves cast in the role of pension managers, dealing with a host of economic, regulatory, and environmental factors outside of their control. Faced with these variables, what decisions are finance chiefs making about their pension plans to manage risk and meet the financial needs of employees and retirees?

Funding choices are near the top of the list. For companies with defined-benefit (DB) pension plans, it's an opportune time to retire funding shortfalls to avoid increases in costs. An increase in discount rates and positive equity markets raised the aggregate funding level of pension plans sponsored by S&P 1500 companies by 1%, to 83% funded status, according to Mercer numbers for September 2017.

But in a recent survey of 175 senior finance executives in the United States (conducted biennially by CFO Research in collaboration with Mercer), sponsors are not just relying on the math for help. Nearly three-quarters of respondents to the survey said they were either considering increasing their pension contributions (33%) or had already done so (40%), to reduce the premiums they pay to the Pension Benefit Guaranty Corporation (PBGC).

FIGURE 1

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



Note: Multiple responses allowed

Steadily increasing levies imposed by the PBGC on unfunded, unvested benefits are a big motivator. Among respondents, 22% ranked PBGC premiums as most likely to cause their companies to modify their pension funding policies and practices over the next two years—second only to "expected market returns" (27%). (See Figure 1.) The benefit of bringing up funding levels is so great that more than one in five companies (22%) that are prefunding plans are borrowing to do so—an increase over prior years.

The prospect of lower federal corporate taxes also has survey respondents considering prefunding their DB plans in 2017 to a greater extent than they have in past years (42%) or contributing beyond the minimum amount they did in 2016 (35%). Overall, companies are funding their plans at higher levels than in 2015, the time of the last survey.

Closing Time?

In concert with the push to fund plans, many sponsors are weighing freeing themselves—partially or fully—of the obligation. DB plans remain active and intact in some industries, in some cases owing to a strong union presence. A majority of survey respondents (58%) reported having DB plans that were open and accruing benefits for all eligible employees.

But the number of open traditional pension plans offered by employers has been on the decline for years. A significant chunk of surveyed sponsors, 42%, said that their DB plans were either closed to new employees or in some stage of being frozen. Nearly half of respondents whose plans were open and accruing benefits for all eligible employees said that it was either "very likely" (27%) or "likely" (19%) that they would close their DB plans to new hires in the next two years. Slightly more than one-third of those respondents, 35%, planned to go further—closing their DB plans and freezing accruals for all employees.

For sponsors, developing a pension exit strategy involves designing a step-by-step process that requires changing asset allocations to lower risk as frozen plans move closer to termination. Plan sponsors also want to avoid volatility in their financial statements, which is why more than 8 in 10 respondents said they either have a "dynamic de-risking strategy in place" (42%) or "are currently considering one"

(40%). Common de-risking maneuvers include employing liability-driven investment strategies, offering lump-sum payouts, and purchasing annuities.

Among survey respondents using a dynamic de-risking strategy, a strong majority of those who either increased their DB plan's allocation to fixed-income investments or adjusted the duration of fixed-income investments as a hedge against liabilities were satisfied with their actions (91% and 86%, respectively). More than half of all respondents (53%) said they were likely to increase their allocation of fixed-income investments in the next two years, almost the same proportion who said it was likely that they would adjust the duration of their fixed-income investments to match liabilities (50%).

77%

Defined-benefit plan sponsors who either voluntarily prefunded their plan in 2016 or are considering voluntary prefunding in 2017

Transferring the Risk

Successfully terminating a defined-benefit plan isn't merely the outcome of a big decision; it's the culmination of a carefully planned transition. Once a DB plan is frozen, its power to attract and retain workers is diminished. For the sponsor, it becomes a legacy obligation that weighs heavily on the balance sheet.

The careful question of whether, and when, to terminate it requires considering several factors: the cost of maintaining it (including PBGC premiums), the degree to which it is funded, and the price of purchasing an annuity to settle plan-related liabilities.

Why do it now? Besides the PBGC premium hikes, the proposed regulations updating mortality tables, scheduled to go into effect in 2018, will for most sponsors increase DB plan contribution budgets. That gives sponsors an incentive to, among other options, make lump-sum offers to former employees sooner rather than later. By making the offer, companies hope to transfer some pension liabilities off their books to plan participants.

Nearly 75% of survey respondents said they have already offered lump-sum payments to certain participants since 2012—up from 59% two years ago. Almost 90% say they were satisfied with the result of offering those one-time payments. And more than 50% considered it likely that their companies would take some form of lump-sum risk-transfer action in the next couple of years—for many of those sponsors, this will be the second or third lump-sum offer they have made.

A significant number of sponsors surveyed have gone the other route—implementing an annuity buyout for some pension participants. In that kind of transaction, an insurer assumes responsibility for the sponsor's retirement liabilities. Among survey respondents, more than half (55%) had either completed such an annuity buyout or were considering it. The vast majority of those buyouts, 81%, have been aimed at all retirees.

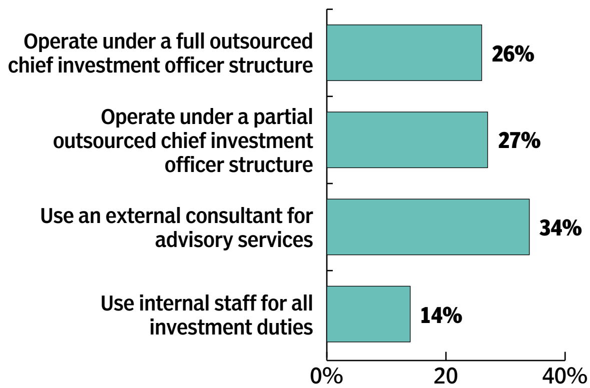
As survey respondents made clear, monitoring the many moving parts of a pension plan—from interest rates to mortality tables to equity markets—isn't simple. Among survey respondents, 55% said they agreed that they "struggle to find the time and expertise required to fully meet [their] obligations related to overseeing the investment strategy of [their] organization's pension plan."

This stress that such planning puts on the time and expertise of internal staff has led more and more plan sponsors to delegate the execution of their investment strategies to outside experts. Ideally, such a service provider offers know-how, not only about investment strategies but also compliance concerns and other aspects of fiduciary oversight. More than half of survey respondents said their pension governance operates under an outsourced chief investment officer structure, with equal proportions doing so either "partly" (27%) or "fully" (26%). (See Figure 2.)

While outsourcing won't suit every sponsor, it is evidence that the hard and "soft" costs of DB pension plans require a hard look from CFOs. The market performance so favorable to plan funding over the last two years won't last forever. CFO

FIGURE 2

Which best describes your current defined-benefit investment governance structure with respect to advisers?



Note: Percentages may not add to 100 due to rounding.

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THE QUIZ

Here at Last

This month, the converged standard on revenue recognition from the Financial Accounting Standards Board and the International Accounting Standards Board finally takes effect for publicly held companies. The standard, called ASC 606 in the United States and IFRS 15 elsewhere, will be a headache for many issuers. How much do you know about ASC 606?

1 Following their converged guidance on recognizing revenue in contracts with customers, how much time did FASB and the IASB allow companies to adopt the standards?

A. 1.5 years
B. 2 years
C. 3.5 years
D. 4 years

2 For privately held companies, the standards take effect for reporting periods beginning after what date?

A. December 31, 2017
B. December 31, 2018
C. December 15, 2019
D. December 15, 2018

3 ASC 606 strengthens disclosure requirements, focusing on three key areas. Which of these is not included?

A. Contracts with customers
B. Contracts with vendors
C. Significant judgments
D. Assets recorded for the costs to obtain or fulfill a contract

4 Which industry, according to experts, will be most affected by ASC 606?

A. Telecommunications
B. Transportation
C. Technology
D. Consumer goods

5 There is a five-step process for recognizing revenue under ASC 606. Which of these is not one of the steps?

A. Identify the customer contract, its performance obligations, and the transaction price
B. Allocate the transaction price
C. Recognize revenue
D. Issue a new customer contract

6 ASC 606 allows for two different transition methods: the modified-retrospective method and the full-retrospective method. The latter requires which of these:

A. Recasting all prior years' data on comparative financial statements
B. Additional GAAP disclosures
C. Evaluating revenue under ASC 605
D. An adjustment to beginning retained earnings in the year of initial application

7 Since September 2016, how many times have the revenue-recognition rule changes been mentioned in earnings-call transcripts?

A. 131
B. 313
C. 249
D. 185

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

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