CFO

JULY 2016 | WWW.CFO.COM

High Hurdles

Why acquirers are stumbling before the finish line

The 2016 Working Capital Scorecard

Index Funds And 401(k) Liability

FEATURES

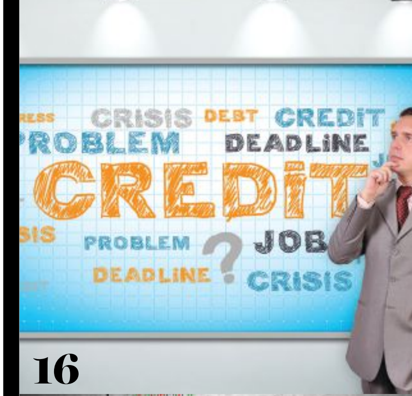
July 2016
Volume 32, No. 6

Cover: Getty Images; clockwise from top left: Getty Images, Thinkstock

CONTENTS

July 2016
Volume 32, No. 6

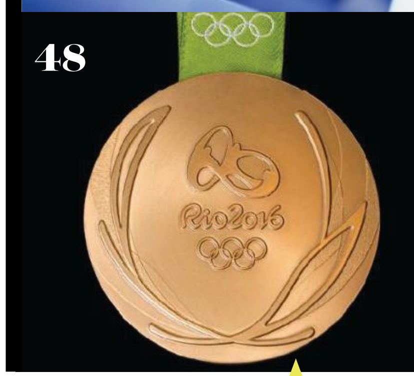
Up Front



16

18

20



48

By the Numbers

Clockwise from top left: Thinkstock (4)

YOU CAN'T BUILD THE BUSINESS OF TOMORROW ON THE NETWORK OF YESTERDAY.

It's no secret: business has changed—in every way, for every business. Modern technologies have brought new opportunities and new challenges, like BYOD and a mobile workforce, that old networks just weren't built for. While demand on these networks has increased exponentially, networking costs have skyrocketed and IT budgets haven't kept pace.

Comcast Business Enterprise Solutions is a new kind of network, built for a new kind of business. With $4.5 billion invested in our national IP backbone and a suite of managed solutions, Comcast Business is committed to designing, building, implementing and managing a communications network customized to the needs of today's large, widely distributed enterprise.

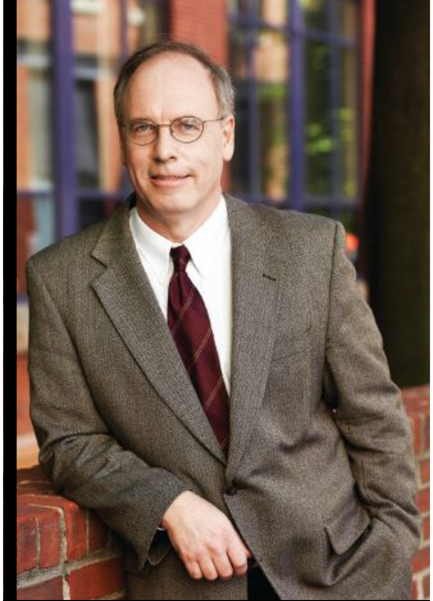
INTRODUCING COMCAST BUSINESS ENTERPRISE SOLUTIONS

COMCAST BUSINESS B4B BUILT FOR BUSINESS™

business.comcast.com/enterprise

FROM THE EDITOR

Let's Scrap A Deal



EDITOR'S PICKS

››At this time last year, merger and acquisition activity in the United States was on pace to set an annual record for the value of deals done, as companies announced megadeal after megadeal. So far 2016 has lagged well behind in both volume and value, as more than $300 billion worth of deals have been withdrawn, dropped, or blocked. As Vincent Ryan reports in our cover story, "The Year of Dealing Dangerously" (page 24), a host of factors have handcuffed mergers, among them weak earnings, a so-so economy, vigilant regulators, greater buyer discipline, and more probing due diligence, particularly regarding a target's information technology.

Still, M&A activity has picked up after the slow start, and the year could see a strong finish, thanks to companies' constant quest for growth, the desire to complement core businesses (or shed noncore ones), and the urge to put cash stockpiles to work, for example. Microsoft described its recent purchase of LinkedIn as a "highly complementary" deal, although CFO Amy Hood said the company would finance the $26 billion transaction through new debt (most of Microsoft's $100 billion in cash is held overseas, and interest rates are still very low).

The ability to raise cash at low rates is a major reason why many large companies aren't focusing on working capital, according to REL. Every year the consultancy surveys the working capital performance of the largest 1,000 U.S. nonfinancial firms, and for several years that performance has been flat. Why should companies bother to wring cash from inventory and receivables management when the cost of borrowing money is so cheap?

In 2015, however, the average cash conversion cycle lengthened significantly. The culprit was the oil and gas industry, which saw revenues and inventory efficiency fall during a year of plummeting prices. In "Over a Barrel" (page 30) we review the state of working capital management and present the annual *CFO*/REL Working Capital Scorecard, which shows the best and worst performers in 27 industries.

Edward Teach
Editor-in-Chief

LEADERSHIP

CFO will have summits for everyone on September 8–9, holding five events in Boston. The subjects are risk management, treasury management, data visualization, the Internet of Things, and FP&A innovation. For more information, go to our summits page at https://theinnovationenterprise.com/summits/calendar.

INVESTOR RELATIONS

Big shareholders that follow passive investment strategies should help insulate a company from activist investors, right? Wrong. To find out why, see Knowledge@Wharton, "Why Passive Investing Increases Corporate Activism," at http://knowledge.wharton.upenn.edu/article/passive-investing-increases-corporate-activism/.

CFO, Vol. 32, No. 6 (ISSN 8756-7113) is published 10 times a year and distributed to qualified chief financial officers by CFO Publishing LLC, 295 Devonshire St., Suite 310, Boston, MA 02110 **(editorial office).** Requests for reprints and permissions should be directed to FosteReprints, (866) 879-9144; E-mail: rhondab@fosterprinting.com; website: www.fostereprints.com. Periodicals postage paid at Boston, MA, and additional mailing offices. **POSTMASTER:** Send address changes to **CFO,** 45 West 45th Street, 12th Floor, New York, NY 10036. ***CFO*** is a registered trademark of CFO Publishing LLC. **SUBSCRIBER SERVICES:** To order a subscription or change your address, write to CFO, 45 West 45th Street, 12th Floor, New York, NY 10036, or call (212) 459-3004; or visit our website at **www.cfo.com/subscribe.** For questions regarding your subscription, please contact subscription@cfo.com. To order back issues, call (212) 459-3004. Back issues are $15 per copy, prepaid, and VISA/MasterCard orders only. Mailing list: We make a portion of our mailing list available to reputable firms.

Kory Addis

Someday, she plans on traveling to the Serengeti.

To make it happen, she's managing her money here, in the dog park with her beagle.

Our mission: inspire your employees to take control of their financial futures and engage with their retirements. This is how we're Thinking Further Ahead.

empower-retirement.com

EMPOWER RETIREMENT™

In **"The Raw Nerve of Materiality"** (June), deputy editor David M. Katz wrote about criticism aimed at the Financial Accounting Standards Board over its decision to adopt a Supreme Court definition of materiality and shed all previous descriptions of the concept it had used.

CFO readers took the opportunity to register their own criticism of FASB. "The general notion [of materiality] has for decades been that something is material if it is likely to affect a [financial statement] user's investment or lending decision," one wrote. **"The Supreme definition is [vague and] useless in that it defines something as material if its effect on the 'mix of information' is 'significant.' "**

Commented another, "Materiality is far too broad a concept to relegate it to a Supreme Court opinion. All the facts and circumstances of the entire entity must be considered before making a judgment on material amounts and matters."

In **"Hot Topic: Climate Change and Insurance"** (April), deputy editor David McCann explored the question of why the pricing of catastrophic property insurance has yet to reflect the impact of climate change, despite a growing conviction among scientists that global warming is responsible for some extreme weather events.

Wrote one reader: "This article is beyond outstanding. We all know and understand the challenges pertaining to climate change as evidenced by our current—and ongoing—storms, floods, and more. The demise and downgrade of numerous insurance providers due to these issues will continue to increase."

THE BUZZ

But, the reader added, "back-door issues are certain to arise. Hidden challenges to business will increase with sophisticated [legalese] contained within the exclusionary clauses of insurance policies and contracts. **It is imperative for corporate CFOs to understand the importance of monitoring these changes.**"

Another reader was less enamored of the article: "Complete BS. More and more companies do *not* believe climate change is real. Their managements simply want to avoid being labeled as climate-change deniers in hopes of preventing bad press, or worse, having a bunch of kooks camp out in front of their headquarters chanting 'boycott, boycott.' **Insurance companies aren't pricing it in because they know man-made climate change is total garbage,** and if they [adjusted] prices without any real statistical support, they'd get dumped."

CFO

PRESIDENT & CEO ▸ Danny Phillips

Editorial

CFO Magazine/cfo.com

EDITOR-IN-CHIEF, *CFO* MAGAZINE
▸ Edward Teach (edteach@cfo.com)

EDITOR-IN-CHIEF, DIGITAL PLATFORMS
▸ Vincent Ryan (vinceryan@cfo.com)

MANAGING EDITOR ▸ Deana Colucci

DEPUTY EDITORS:
▸ David M. Katz (davidkatz@cfo.com)
▸ David McCann (davidmccann@cfo.com)

DIRECTOR OF DESIGN ▸ Jeof Vita

CFO Research/CFO Custom Publishing

EDITORIAL DIRECTOR, RESEARCH
▸ David W. Owens

DIRECTOR, RESEARCH & CUSTOM CONTENT
▸ Chris Schmidt

SENIOR WEBCAST PRODUCER ▸ Joe Fleischer

Advertising Sales/ Product Development

SVP, SALES ▸ Katie Brennan, (646) 277-6476

MARKETING COORDINATOR ▸ Hannah Smith

National Advertising Office

NORTHEAST
▸ Haley Moore, (646) 277-6478; fax: (212) 459-3007
▸ Brian Kleve, (646) 556-7653; fax: (212) 459-3007

MIDATLANTIC/SOUTHEAST
▸ Katie Brennan, (646) 277-6476; fax: (212) 459-3007
▸ Brian Kleve, (646) 556-7653; fax: (212) 459-3007

CENTRAL/CENTRAL MIDATLANTIC
▸ Brian Kleve, (646) 556-7653; fax: (212) 459-3007

MIDWEST, PACIFIC NW
▸ Shelly Schmeling, (312) 932-9392; fax: (212) 459-3007
▸ Brian Kleve, (646) 556-7653; fax: (212) 459-3007

WEST COAST
▸ Judy Hayes, (925) 736-7617
▸ Brian Kleve, (646) 556-7653; fax: (212) 459-3007

CFO Conferences

GLOBAL MARKETING COORDINATOR
▸ Kathryn Wilson, (415) 800-3620

Editorial Offices

295 Devonshire St., Suite 310
Boston, MA 02110
(617) 345-9700

45 West 45th Street, 12th Floor
New York, NY 10036
(212) 459-3004

Subscriber Services

www.cfo.com/subscribe

CFO WELCOMES YOUR LETTERS

Send to: The Editor, *CFO*, 295 Devonshire St., Suite 310, Boston, MA 02110, or e-mail us at: letters@cfo.com. Please include your full name, title, company name, address, and telephone number. Letters are subject to editing for clarity and length.


Introducing
the OHIO of
Everything
SATIN PAINT
O. hio

STATS OF THE MONTH

WORKING IT

5.8M
Number of U.S. job openings, up from 5.4 million one year ago

1.4
Unemployed persons per job opening, down from 6.6 in July 2009

5.1M
Number of hires, up slightly from 5.1 million one year ago

67
Number of U.S. metropolitan areas with an unemployment rate of 3.5% or lower

Source: April 2016 Bureau of Labor Statistics report

Topline

ACCOUNTING

Private Firms Love FASB Breaks on Rate Swaps

But the hedge accounting alternative may also give the biggest private companies an unfair edge on public-company competitors.

Despite worries that privately held giants like Koch Industries and Cargill would gain an unfair advantage over public companies via a simplified hedge accounting alternative for reporting interest-rate swaps, the Financial Accounting Standards Board enacted the measure in 2014.

Thinkstock

Now, with Accounting Standards Update 2014-03 going into effect for quarterly reporting this year, smaller private companies have been welcoming the provision with open arms.

They contend that the standard makes it easier to deal with complexities they can't avoid if they're trying to line up fixed-rate debt. "Most of [my clients] were applying this alternative way before it became available," said an audience member at a private-company town hall meeting hosted by FASB and the Private Company Council (PCC) at Baruch College in June. (Early adoption of the ASU was permitted under the FASB update.) "It's a wonderful alternative."

The woman's private-company clients that had sought fixed-rate financing had entered into interest-rate swaps "based on instruction from the banks. So it wasn't an option for them: they had to enter into [such swaps] in order to get into the financing arrangement."

In the run-up to the FASB update, the PCC had received input that private companies, indeed, often find it hard to borrow at fixed interest rates. To do so, some private companies enter into an interest rate swap to "economically convert their variable rate borrowing to a fixed-rate borrowing," explains a board publication.

FASB Topic 815, however, the standard the ASU updated, requires that a company must record all of its derivative instruments on its balance sheet as either assets or liabilities and measure them at fair value. To curb the income statement volatility of recording a swap at fair value, companies can choose hedge accounting if they meet certain requirements.

"Some private-company stakeholders contend that because of limited resources and/or the difficulty of understanding and applying hedge accounting, many private companies lack the expertise to comply with the requirements to qualify for hedge accounting," according to the FASB publication. Thus, they choose not to apply hedge accounting.

The FASB update, however, makes hedge accounting more appealing by reducing the complexity. "When a private company applies the simplified hedge accounting approach, the income statement charge for interest expense will be similar to the amount that would result if the company had directly entered into a fixed-rate borrowing instead of a variable rate borrowing and an interest rate swap," according to the FASB publication.

The accounting alternative provides another perk for private companies looking to hedge. Under the existing rules, companies had to provide documentation of the hedge's effectiveness at the hedge inception date. But under the simplified hedge accounting approach, to qualify for hedge accounting the private company must complete the same documentation "by the date on which the first annual financial statements are available to be issued after hedge inception," according to the ASU.

FASB project manager Michael Cheng called the relaxing of the contemporaneous documentation provision "the most contentious" part of the update. "That's a huge change from what existing GAAP is," Cheng said.

> **"I really thought that this was a good standard that I would have adopted for public companies as well."**
> **›› Larry Smith, FASB member**

FASB member Larry Smith said that he dissented from voting for the ASU precisely because it differed so much from the current version of GAAP that public companies must follow. "I really thought that this was a good standard that I would have adopted for public companies as well," he said at the gathering.

Concerning contemporaneous documentation, Smith said that he argued that FASB could relax the rules somewhat. But if the reporting requirement was flexible enough that a company could take a full year between the hedge's launch and the date it files its financials, "it [would] enable the company to play around quite a bit," he said.

Another panelist, PCC member Lawrence Weinstock, contended that it's "relevant" for FASB to ease up on the reporting rules for private companies on interest-rate swaps because fewer of them are doing it to structure their debt than for the reason "that this is the only way private companies can get fixed-rate debt."

In response, Smith said, "Let's not lose sight of the fact that Koch Industries and Cargill are both private companies, and they can avail themselves of this." **DAVID M. KATZ**

AIRLINES

An Industry with Sky-High Earnings

After struggling for years to turn a profit, the airline industry has righted itself, according to the International Air Transport Association.

The group revised upward its 2016 forecast, saying airlines would collectively post a net profit of $39.4 billion this year, up from IATA's $36.3 billion forecast in December.

The aggregate net profit margin will be 5.6% on collective revenues of $709 billion. This year is expected to be the fifth consecutive one of improving aggregate industry profits.

"Lower oil prices are certainly helping—though tempered by hedging and exchange rates," IATA's director general and CEO Tony Tyler wrote in the report. "In fact, we are probably nearing the peak of the positive stimulus from lower [oil] prices."

Earnings performance, however, is being bolstered by record load factors, increased ancillary revenues from new value streams, and joint ventures and other forms of cooperation among airlines to improve efficiency.

"It will be only the second year in our history—and the second in a row—in which airlines will make an aggregate return in excess of the cost of capital," Tyler wrote. "After decades of capital destruction, that's a significant achievement."

While investors in the industry have typically seen their capital shrink, this year the group expects the industry to generate a return on invested capital of 9.8%, IATA Economics' chief economist Brian Pearce wrote in the adjoining report. That means for only the second year, the industry will have adequately rewarded equity owners.

On invested capital of almost $600 billion, the industry is forecast to generate $16.2 billion of value for investors this year.

"But it should be clear that $39.4 billion net profit, while exceptional for the airline industry, is really only sufficient to pay investors a 'normal' return for risking their capital," Pearce wrote. "Moreover, high returns have only started to be generated outside North America in the past year and are still not widespread across all regions." **KATIE KUEHNER-HEBERT**

INSURANCE

Securitizing Operational Risks

While Credit Suisse has no immediate plans to expand May's bond offering aimed at covering its exposure to rogue trading, serious accounting errors, cyber attacks, and other operational threats, the bank expects that other financial institutions might be interested in making similar moves.

The bank is also keeping an eye on how the capital markets respond to its largely unprecedented move of securitizing operational risks. To be sure, the bond attracted only enough investment money to provide 220 million Swiss francs (about $222 million) of coverage, a far cry from the 630 million Swiss francs at which the deal had previously been expected to sell.

Issued by Operational Re, a Bermuda-registered special purpose insurance vehicle set up by Credit Suisse, the bond will function as reinsurance on a 270 million Swiss franc insurance policy underwritten by Zurich Insurance.

Apparently tailored to lure wary investors with stringent risk underwriting, the insurance would be triggered only when Credit Suisse's annualized covered losses exceeded 3.5 billion Swiss francs. Further, Credit Suisse would not gain claims payment unless at least 2 of the 23 or 24 covered operational risk events occur. Regulatory fines and reputational risks aren't covered under the Zurich policy.

While more details on the insurance policy were expected from Zurich shortly after the bond was issued, they were delayed by the circumstances of the death of the insurer's former CEO, Martin Senn.

While Credit Suisse hasn't had any public cyber-attack losses or had its infrastructure harmed from natural disasters in recent years, the bank has run afoul of regulators for operational miscues. For example, it violated speculative position limits on wheat futures in 2009 and this year settled a charge that it failed to exclude high-frequency traders from its "dark pool" alternative trading system.

Although securitization of insurance risks into the capital markets has been going on at least since the 1990s, most of the activity has involved catastrophic property risks such as hurricanes and earthquakes, according to Paul Schultz, CEO of Aon Securities, a big player in insurance-linked securities.

"Over the past five years, we've been spending a lot more time thinking about other types of risks that can be securitized through a form that the capital markets like," says Schultz, whose firm was not involved in the Credit Suisse deal. A basic principle of insurance-linked securities is that they must provide investors with the opportunity to invest in assets that aren't correlated with traditional equity or fixed-income markets, he says. **D.M.K.**

HEALTH CARE

U.S. Health Care Spending to Fall

The United States is on track to spend $2.6 trillion less on health care between 2014 and 2019, compared with initial projections made right after the 2010 passage of the Affordable Care Act, according to an Urban Institute study released in June.

Declines in spending in those four years on Medicare (-$455 billion), Medicaid (-$1.05 trillion), private health insurance (-$664 billion), and other health spending (-$456 billion) should also be "quite large," the report said.

The health care reform law has contributed to the lower 2015 projections in several ways, the authors wrote. Medicare utilization rates are down; lower payment rates in Medicare may have affected payment rates by commercial insurers negotiating with hospitals and physicians; Medicare policies, such as financial penalties for hospital readmissions, may have spilled over to other payers; and premiums listed on the health insurance exchanges are below expectations because of strong competition, negotiations over provider payment rates, and narrow networks.

But the sluggish economy could be the primary factor in the drop in spending, according to the authors. When the economy rebounds, the reasons for the spending slowdown will be clearer, they said. **K.K.H.**

Thinkstock

MOBILE TECHNOLOGY

App Slowdown Is on the Horizon

Mobile device users installed nearly 156 billion applications worldwide in 2015, but the growth of app installations and direct revenue from them will slow by the end of the decade, according to a new report.

International Data Corp. predicted installations will increase to more than 210 billion in 2020, generating nearly $57 billion in direct (non-advertising) revenue compared with $34.2 billion in 2014.

"While the market will continue to grow throughout the forecast period, IDC expects to see slower growth in both application install volumes and direct revenue over time," the market researcher said in a news release.

The slowdown will largely be driven by market maturation, IDC said, with app install growth declining into the single digits over the second half of the forecast. Volume will still show a five-year compound annual growth rate of 6.3%.

Direct revenue from mobile apps is also expected to experience slower growth by the end of the forecast period, although the five-year CAGR will remain in the double digits at 10.6%.

"While they provide a convenient measure of the mobile app economy and its beneficiaries, we caution that preoccupation with download/install volumes and associated direct revenue may miss the thrust of changes in the mobile marketplace," John Jackson, an IDC vice president, said.

"Facebook and Google continue to dominate mobile ad spending thanks to the scale and sophistication of their network effects, [while] Facebook's moves to incorporate news and other interests into its experience will likely pull traffic and install volumes away from [discrete] apps," he added.

According to IDC, Apple's App Store "ecosystem" captured nearly 58% of global direct app revenue in 2015, an increase of 36% year over year, but its share of install volume was only 15%, down nearly 8%.

"The sheer volume of Android-based devices in use ensures a greater overall number of installs through Google Play, which captured about 60% of install volume and nearly 36% of direct revenue in 2015," IDC said, adding that Apple is expected to continue outperforming Google Play in terms of revenue generation. **MATTHEW HELLER**

BANKING

Bank Profits Show First Drop in Two Years

The net income of U.S. banks dipped for the first time in two years in the first quarter of 2016, but strong loan and operating revenue growth provided some cause for optimism.

In its Quarterly Banking Profile, the Federal Deposit Insurance Corp. said federally insured commercial banks and savings institutions reported aggregate net income of $39.1 billion in the first quarter of 2016, down $765 million (1.9%) from a year earlier.

The decline in earnings was largely attributable to a $4.2 billion increase in loan-loss provisions and a $2.2 billion decline in noninterest income. Lenders to the energy sector, in particular, have been facing rising levels of troubled loans.

But on the more positive side, loan balances increased 1.1% in the first quarter, bringing balance growth over the past 12 months to 6.9%, the highest rate since 2008. Net operating revenue grew 2.7% to $172.9 billion year over year.

"The mixed first quarter results reflect an evolving economic environment," FDIC Chairman Martin Gruenberg said in a news release, noting that "a prolonged period of low interest rates has narrowed margins and caused some institutions to reach for yield."

Overall, net interest margins in the first quarter remained low by historical standards at an average of about 3.1%, although community banks averaged nearly 3.6%. Net income for community banks was up 7.4% and revenue rose 6.9%.

Gruenberg cautioned that community banks were more exposed to interest rate risk and that the effects of the oil price slump could spread to those institutions, especially in the regions that benefited most from the boom.

The number of past due loan payments by commercial and industrial borrowers increased 65%, to $9.3 billion, in the quarter. **M.H.**

Thinkstock

IPOs

Bankers Forecast IPO Rebound

Capital markets executives at leading U.S. investment banks expect the IPO market to improve in the second half of 2016 but remain well below last year's pace.

BDO USA said in its 2016 IPO Halftime Report that 34% of bankers are predicting the pace of U.S. IPO activity will increase during the second half of the year, while 18% forecast a decline and 47% anticipate IPO activity will remain at the same level as the first half of the year.

Overall, capital markets executives foresee a 5% increase in the number of U.S. IPOs during the second half of the year. But even at that rate, the number of offerings would be the lowest for a full year since 2009.

Respondents also predict offerings will raise $15 billion in total IPO proceeds on U.S. exchanges in 2016, the lowest amount since 2003.

"Although the U.S. IPO market began to show signs of life in May, almost doubling the number of offerings priced during the first four months of the year, it remains well behind the pace of 2015 and the average for the past decade," Paula Hamric, director in the capital markets practice of BDO USA, said in a news release.

In May, IPOs had their busiest week since July 2015, with the $1 billion offering by US Foods raising hopes that the new-issue market is warming up after a protracted freeze.

In the BDO survey, executives cited stock market volatility (41%) during the initial weeks of the year and the availability of private funding at attractive valuations (23%) as the main causes of the big drop in IPOs this year.

As possible drivers of an IPO revival, 30% cited the need for a sustained stock market rally and 23% pointed to the need for better pricings and improved returns from new offerings.

"The overarching theme is an aversion to the risk associated with making an offering in increasingly discerning public markets versus the certainty of private funding or a sale," Hamric commented. "Until these alternatives become less attractive and IPO performance improves, growth in offering activity is likely to be minimal."

The BDO poll is a national telephone survey of 100 capital markets executives. **M.H.**

AUDITING

Staggered Boards Affect Audit Committees

Audit committees at companies with a staggered board structure are not responsive to low shareholder approval, making them less effective than their counterparts at firms that do not stagger board elections, according to a new study.

In staggered (or classified) votes, only a third of board seats are typically up for election each year, with members being elected for three-year terms. The practice has become less popular in recent years amid criticism that it encourages management entrenchment to the detriment of shareholders' interests.

The study, published in the journal *Auditing*, may add fuel to the critics' fire, finding that the adverse effects of a staggered board may extend to the board audit committee.

While nonstaggered boards, the study says, respond to shareholder disapproval by improving the composition of audit committees, increasing the frequency of meetings, and enhancing the quality of financial reporting, staggered panels do not.

To assess the effectiveness of audit committees, the study's authors—Ronen Gal-Or and Udi Hoitash of Northeastern University and Rani Hoitash of Bentley University—analyzed more than 18,000 board elections over a seven-year period and other data.

The results showed, among other things, that low shareholder approval is associated with an average increase in audit-committee meetings from 8.35 a year to 12.05. "Staggered directors that have lower incentive to appease shareholders will be less likely to increase meetings," the study said.

In addition, low approval of boards at nonstaggered companies was found to lead in the two years post-election to a significant drop in noncash accounting items that are often associated with earnings manipulation. **M.H.**

Thinkstock

Cincinnati Bell
connecting what matters

$150,000,000
Senior Secured Credit Facility
Joint Lead Arranger and Bookrunner

May 2016

SpecialtyCare
partners for life

$165,000,000
Senior Secured Credit Facilities
Joint Lead Arranger and Bookrunner

April 2016

Tower Hill Insurance

$125,000,000
Senior Secured Credit Facilities
Joint Lead Arranger and Bookrunner

April 2016

FIVE GUYS

$260,000,000
Senior Secured Credit Facilities
Joint Lead Arranger and Bookrunner

March 2016

TSC TRACTOR SUPPLY CO
TractorSupply.com

$700,000,000
Senior Unsecured Credit Facilities
Joint Lead Arranger and Bookrunner

February 2016

cpsi

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

January 2016

We created Regions Securities® to provide small- to large-cap companies high-quality service and advice from talented, relationship-oriented bankers. That means your business gets our dedicated "A Team" every time. Our capital markets experience and deep resources enable you to receive creative, customized solutions tailored to meet your company's strategic and financial objectives. From capital raising in the debt and equity markets to mergers and acquisitions advice, our bankers can set things in motion for your company. It's time you got the attention you deserve.

Terry Katon | Executive Managing Director
terry.katon@regions.com

REGIONS
SECURITIES

Corporate Banking | Capital Markets & Advisory Services | Comprehensive Financing Solutions | Industry Expertise

Recognize Credit Losses Sooner, FASB Says

The big change is being referred to as "Day 1 loss" reporting.

By David M. Katz

In June, addressing an issue that arose in the early days of the financial crisis, the Financial Accounting Standards Board released an Accounting Standards Update (ASU) "requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations," according to a FASB press release.

Departing from the current "incurred loss model," which critics say substantially delayed reporting of credit losses, the new current expected credit loss model "is taking away the threshold to booking your reserves, and as a result, your reserve gets booked on day one," says FASB member R. Harold Schroeder. "That is the big notable change that people are referring to as the 'Day 1 loss.'"

Another purpose of the standard is to help investors "better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio," according to the press release. "These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements."

Under the incurred loss accounting methodology, banks, insurance companies, and other corporations holding debt and securities at cost must put off the recognition of credit losses until they judge that it's "probable" that a loss has been incurred. In practice, that has meant that a company must be as much as 80% confident that a loss has occurred, according to Schroeder.

That threshold is considered very high. In the period right before the economic crisis starting in 2008, many banks found it hard to assign such a high likelihood to the probability that each loss in their entire loan pool would actually occur. But they and their investors had expectations that hard times were coming.

At the same time, following the incurred loss model, the banks' auditors advised financial officers that they shouldn't book incremental losses—much less entire pools of them—because they weren't "probable" yet. The incurred loss model has thus been widely characterized as producing a situation of "too little and too late": By estimating too few losses in current financial statements, companies will have nothing in reserve when the losses actually do occur.

Allaying Frustration

The ASU seeks to allay "significant frustration on the part of both bankers and investors," Schroeder says. "The frustration for bankers was that they could see problems in their portfolios that current accounting rules did not allow them to adjust to and book additional reserves for the expected losses that were embedded in their portfolios."

For their part, investors were frustrated because they could see the mismatch between the accounting and the actual economics of the banks' arrangements. That forced investors to develop their own estimates using external data "that they could use as a rough proxy for losses that they could expect to see in the future," Schroeder adds.

That proxy tends to be the product of "a very time-consuming process that results in a more imprecise number than you would like as an investor. But investors are more willing to accept an imprecise number if it's closer to what they believe will be true, than a highly precise, inaccurate number," according to Schroeder, a former investment executive himself.

"There was frustration on the part of bankers and investors, and this standard will do a lot to relieve that frustration," he says.

While the discussion of the anticipated effects of the new standard has mainly focused on banks, "I hope it's going to improve financial reporting [more broadly] by giving a more current look at what entities expect to have in the way of credit losses on their financial assets," says Jonathan Howard, a partner in the national office accounting services unit of Deloitte & Touche, who acknowledged that he hadn't had time yet to read the

Thinkstock

entire 285-page ASU.

Howard thinks that the standard could have a big effect on the balance sheets of holders of large amounts of real estate receivables, especially with the issuance of the new FASB leasing standard. The standard requires lessees to put the financial results of their operating leases on their balance sheets.

To be sure, FASB members defined the scope of the standard by the accounting issues covered, rather than by industry. The new standard applies to all corporate investments that are carried at cost rather than at fair value, "whether they're loans or debt securities or net investments in leases or receivables," notes Schroeder.

Asked which industries could be most affected, he replies that "the financing divisions of industrial companies would have to think about this. Technology companies that have taken excess cash and invested in bond portfolios if they're carrying them at something other than fair value" are also likely to be covered, he adds.

Effective Dates

At the same time, the standard is "going to take some significant time and effort for entities to transition into this new standard, which is why we have an effective date that's delayed all the way to 2020," Deloitte's Howard says.

The credit losses update will take effect for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. For public companies that are not SEC filers, the ASU will take effect for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. For all other organizations, the ASU will take effect for fiscal years beginning after December 15, 2020, and for interim periods within fiscal years beginning after December 15, 2021.

The standard update had its origins in 2008, when FASB and the International Accounting Standards Board set up a Financial Crisis Advisory Group "to advise the Boards on improvements in financial reporting in response to the financial crisis. The FCAG recommended exploring more forward-looking alternatives to the incurred loss methodology," according to a FASB publication.

The ASU was passed by a 5-2 vote by the board, with Lawrence Smith and James Kroeker dissenting. CFO

Big Banks Friendlier to Small Borrowers

Large banks approved almost one in four small-business loan applications in May, a new high.

Large banks approved loans to small businesses at a record pace in May, while alternative lenders' approval rates continued to decline, according to a new survey. Still, institutional and alternative lenders continue to have the highest approval rates for small borrowers.

In its latest monthly review of small-business loan applications, online marketplace Biz2Credit found that approval rates at banks with $10 billion or more in assets rose one tenth of a percent to a new all-time index high of 23.2%.

Big banks approved 6% more funding requests on average from a year earlier—the seventh time in the last nine months that they increased approval rates.

"Big banks have demonstrated their commitment to small-business lending over the last two years with investments in automation that have resulted in higher profit margins," Biz2Credit chief executive Rohit Arora said in a news release.

Approval rates at institutional lenders rebounded from their first drop in over two years. The one-tenth of a percent gain to 62.8% matched an all-time index high.

But alternative lenders took yet another hit in May, approving 60% of small-business loan requests on average. Over the past two and a half years, the sector's approval rate has dropped significantly from 67.3% in December 2013.

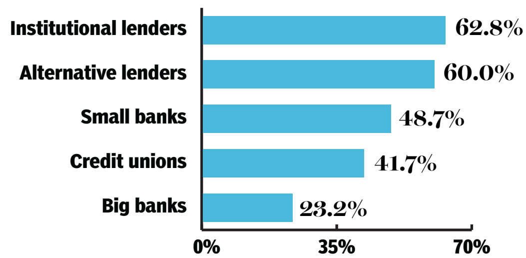
In other sectors, loan approval rates dropped at small banks to 48.7% in May 2016, matching a two-and-a-half-year low and the fourth decline in the last five months.

Credit unions continued their long decline in loan approval rates, granting a new all-time index low of 41.7% in May, down two tenths of a percent from April. Approval rates have declined at credit unions every month in the past year.

"As big players such as J.P. Morgan and Wells Fargo expand in small business lending, it continues to negatively impact small banks," Arora said. "When lenders invest in technology, small-business owners can now receive funding in a matter of days. This has led to higher quality borrowers gravitating to the larger financial institutions." KATIE KUEHNER-HEBERT

Getting to Yes

Small-business loan approval rates in May 2016



Source: Biz2Credit Small Business Lending Index

It's Time to Consider A Carve-Out

With the appetite for IPOs at a low ebb, carve-outs offer an alternative path to boosting shareholder value and firming up the balance sheet. By Levi Preston

The current volatile markets are challenging CFOs to craft strategies during 2016 that will improve balance sheet health and deliver shareholder value even in an uncertain operating environment. ¶ Currently, the "go public" option lacks appeal for many companies. The number of initial public offerings filed in the United States through mid-June was less than half the total for the same period a year ago, according to IPO Monitor. So, this may be the year finance chiefs might want to consider carve-outs as an alternative strategy.

A carve-out is a corporate reorganization that creates a new subsidiary where one did not exist, intentionally structuring it to function as a self-operating entity. The parent company may create the subsidiary with the intent either to sell it or to retain an equity stake and management control. A carve-out also can be a pathway to pursuing an IPO for the new entity by issuing shares in it to current or new investors.

Importantly, carve-outs offer companies a promising way to maximize shareholder value and show investors they have a clear strategy to strengthen the balance sheet while achieving operating efficiencies.

Identifying Candidates

To assess the viability of a carve-out strategy, start by identifying the best candidates. Optimal carve-out candidates often fall into one of two categories:

• Market share candidate. If an asset or business line of a consolidated entity has a large share of its targeted market but is a relatively small (less than 10%) piece of the parent company, it can be an attractive target for a carve-out. Pursuing this type of candidate likely would create minimal ripple effects for the consolidated entity.

• Noncore subsidiary. In many mergers, acquisitions, or other business combinations, the final consolidated entity will have absorbed one or more locations or business lines that don't fit with its long-term strategy. These are ideal carve-out candidates within the first 12 months after the transaction.

Noncore assets and lines of business may also emerge without the catalyst of a business combination. The noncore assets may be performing poorly or not be aligned with management's vision for the future. In these cases, carve-outs present a source of liquidity while making the parent a more cohesive entity.

Evaluating Complexity

Once you identify a candidate, it is important to perform an internal diagnostic to analyze the asset and determine the complexity of the carve-out.

In assessing complexity, a key question to consider is how autonomously the carve-out operates from people, processes, and systems perspectives. The degree of complexity relates directly to the cost of execution.

The more obvious costs to execute a carve-out include the expected deal preparation items, including sell-side document preparation, engaging outside counsel, new audit requirements, and data-room management.

Additional, valuable insights to inform your decision-making can be gathered by asking the following questions about complexity and cost:

• Is there already functional leadership in place, or will the carve-out require an interim management team?

• How reliant is the business line on a consolidated shared services center for back-office operations?

• Does the business line have sophisticated financial reporting resources to dedicate to the transaction that can move at deal speed?

• How many disparate systems warehouse the transactional data of the carve-out business?

• How commingled is the transactional data with that of other divisions that won't be carved out?

• Does the carve-out candidate share customers and/or vendors with other divisions?

• How many legal entities house the material contracts of the carved-out entity?

Thinkstock

• How many employees and executives will be severed from the parent entity?

• Are there international regulatory impacts that have not been previously considered?

• Does the carved-out entity have easily identifiable segments?

Exit Considerations

If the internal diagnostic determines that the benefits of pursuing a carve-out exceed the associated costs, there are at least four traditional approaches to a successful exit. The consolidated entity can spin off the carved-out entity to current investors and maintain operating control, market it to competitors or private sponsors, prepare it for an IPO, or pursue those various options simultaneously to see which direction proves to be most compelling.

While these tracks share some common due diligence interests, the various exit options have differing needs for information that can be difficult to satisfy simultaneously. Pursuing multiple tracks requires a dedicated finance team that can respond quickly to a wide variety of questions and produce the necessary reporting documents at deal speed.

To ensure the deal remains on track, maintain a central conduit and consistent bridge among the multiple iterations of the information that potential buyers or investors will want to review (such as confidential information memorandums, pro forma results, audited historical financial statements, and publicly filed management's discussion and analysis).

Ultimately, you'll go a long way toward ensuring a successful carve-out by proactively identifying the best candidate, evaluating the complexity of a deal, and thinking through exit considerations. This process could lead to a transaction that supports your company's strategy while also offering liquidity through this alternative to an outright IPO or some other form of M&A. CFO

Levi Preston consults with many middle-market companies as a principal with Riveron Consulting.

Too Many Hats?

Research suggests the challenges of the CFO's job have grown too great for one person to handle.

Has the role of CFO expanded so much that even well-rounded finance executives can struggle in the job? The question arises from a recent survey of 769 finance leaders around the world by EY, in which more than half of respondents said they are unable to focus enough on strategic priorities because of time spent on operations, compliance, controls, and costs (see chart).

Under Pressure

Reasons CFOs can't focus on strategic priorities

Amount of time spent on compliance, controls, and costs	56%
Can't delegate responsibilities due to lack of necessary skills within the finance team	52%
Increasing operational responsibilities	51%
Current finance function doesn't have the right mix of capabilities to meet the demands of future strategic priorities	47%

Source: EY survey of 769 finance leaders around the world

"It's become a job that may be too big for any one individual to do well," says EY principal Tony Klimas, "given all the responsibilities and the incredible contrast between the day-to-day controllership functions and the very long term, strategic, executive functions." Indeed, in a separate EY survey of more than 1,000 finance leaders, 48% said they have to comply with more than 10 sets of regulatory reporting standards.

"People are struggling, and they're also fatigued at this point," says Klimas. "They've been through a lot. In the 1990s they put in ERPs. Then they prepared for Y2K. The dot-com bubble burst, and then came a period of [heightened regulatory activity], followed by the worst recession in 80 years. And it's not going to end. The complexity of the job will continue to accelerate. The CFO's job is to figure out how to deal with that."

So how does one deal with that? "You'd better know your strengths and weaknesses, and you'd better put people in key roles who complement you," Klimas says.

That's easier said than done, given that the talent pool in companies' middle-management ranks is thinner than it used to be. One reason for that is demographic: baby boomers are retiring, Generation X is less populous than its predecessor, and millennials for the most part are not ready to step up.

For Klimas' part, though, a bigger factor in the dearth of talent is the way companies have organized their finance operations. "With today's operating models, there are offshore centers of excellence, and lots of pieces of the finance function are outsourced," he says. "So, the career path for a young finance or accounting person to come up through the ranks is not as clean [as it used to be]. A lot of CFOs are feeling the impact of that now." **DAVID McCANN**

Productive Idea: A Five-Hour Workday?

A small San Diego company is growing fast and finding ways to work so efficiently that employees get every afternoon off. By David McCann

It's been just over 100 years since Henry Ford ignited a labor revolution—and throttled up his company's productivity—by, in part, introducing the eight-hour workday to his some 14,000 employees. ¶ Now, a much smaller enterprise is borrowing a page from that history and cutting the workday's length even more. ¶ About one year ago, during a year in which Tower Paddle Boards made the Inc. 500 list of the fastest-growing companies in America, it implemented a workday of just five hours. Think that's a joke? It's not. The company's CEO and founder, Stephan Aarstol, states unequivocally that it's been a productivity booster. He's even written a book about the policy, *The Five-Hour Workday: Live Differently, Unlock Productivity, and Find Happiness*, a self-published effort.

The short day is also, of course, a recruiting and retention tool. Furthermore, it underscores Tower's purpose, which is to build itself into a major beach lifestyle brand. But there's a more world-view business principle behind the short-day policy.

"Everybody intrinsically understands the idea that if you put constraints on [spending] money, you'll get better results," says Aarstol. "What people don't realize is that you should put a constraint on time as well."

The common workday of eight or nine hours "trains the work force to be lazy," he says. "Time is like a sponge. If you have eight hours to do something, you take eight hours. But if you tell people to get the same amount of work done in five hours, they start working at a faster pace and find creative solutions to stuff."

"Very few people have stopped and asked what a knowledge worker's day should look like," says Aarstol.

Aarstol famously appeared on the ABC reality show "Shark Tank" in 2012. Billionaire entrepreneur Mark Cuban agreed to give him $150,000 that the company needed to pay off a loan, in exchange for a 30% equity stake—despite Aarstol losing his train of thought and freezing up for an agonizing minute-plus during his presentation on the show.

The year before that, Tower had generated $260,000 in sales. Five years later, annual sales are expected to reach almost $10 million in 2016. That compares with $7.2 million last year, so the short workday doesn't seem to be getting in the way of growth.

Meanwhile, there is a catch to this story. Tower Paddle Boards has just 11 employees. Three of them manage shipping from a warehouse and staff a small retail storefront. The rest are not even involved with the paddleboard business, instead focused purely on developing new beach-themed business lines.

There is also a working factory that's used only to produce prototypes of paddle boards, while the manufacture of the company's actual products is outsourced overseas.

But Aarstol insists that the way he went about implementing the five-hour workday offers lessons even for large companies. He initially told his workers that it was a three-month, "summer hours" experiment. The message was: "This summer you're going to have your afternoons off, but in exchange for that I want you to figure out how to do what you do in just five hours."

He says, "Any company could find a benefit from doing that. You're going to find a lot of solutions in that three months for how people can work faster."

There is no lunch hour at Tower Paddle Boards, which means there's also no "after-lunch coma," Aarstol says. The employees at the warehouse and store work from 9:30 a.m. to 2:30 p.m., while the others, who work at a separate headquarters site, are in from 8 a.m. to 1 p.m. "They're not actually working all that much less," he says. "It's just a bit more of a compressed day."

Much of the improved efficiency has been enabled through the use of inexpensive, cloud-based software tools, Aarstol says. That relates to

Thinkstock

some of the thinking behind the short-day policy.

"I consider everyone in the company a knowledge worker," the CEO says. "Everyone selects and uses software systems, designs and optimizes their business unit and their workspace, and optimizes the tools they use to do things efficiently. No one has a 'manager' above them that designs systems which they then just implement. Everyone has to get creative, find solutions, and push certain metrics."

Importantly, Aarstol adds, there is no logic behind applying the same-length workday to knowledge workers as Henry Ford applied to factory workers in 1914.

"We're going through a transition of tools for knowledge workers that was very similar to the transition of tools for the industrial revolution that made factory workers 10 times as productive as they were before," he observes. "All of a sudden your ability to get stuff done gets easier and easier."

But, he continues, "The eight-hour workday is sacred. Very few people have stopped and asked, with a blank slate, what a knowledge worker's day should be like, how could it work better, how should you manage people's energy?"

Aarstol says that at companies where he's worked, there were always people who were able to be several times more productive than everyone else was. His recruitment philosophy is to find and attract such people for all company positions. "It's a renegotiation with them: I'm only going to take a few hours of your day, because I know you can run circles around other people. And then you can do consulting on the side, or have a bigger life, or whatever."

Many companies today go the opposite way, he points out, exerting pressure on their increasingly productive work forces to boost productivity even further by working more than 40 hours a week, and in some cases substantially more.

"Time is like a sponge. If you have eight hours to do something, you take eight hours."
›› Stephan Aarstol, CEO and founder, Tower Paddle Boards

"This is recreating the robber-baron class," he says. "Companies are hugely profitable, wages are stagnant, and they're even laying people off and telling those remaining that they're lucky to have a job."

Aarstol acknowledges that no one at Tower Paddle Boards is forced to leave work after five hours. Indeed, some employees were initially uncomfortable with the new schedule, and even now, when there's a new project they occasionally put in more hours voluntarily.

But, the entrepreneur adds, sometimes he'll make a point of leaving the office at 1 p.m. for two weeks at a time "because I want everyone to know that it's OK." CFO

U.S. Doubles Overtime Threshold

The Obama administration says its new overtime rule will strengthen the middle class.

The Obama administration has announced new regulations that will extend overtime pay to 4.2 million workers, saying the move would stimulate economic growth by strengthening the middle class.

The rule unveiled in May doubles the salary threshold for time-and-a-half overtime eligibility from $455 a week to $913 a week, or from $23,660 to $47,476 for a full-year worker. The threshold will be automatically updated every three years, beginning January 1, 2020.

Overtime eligibility was last updated in 2004 and now covers just 7% of full-time salaried workers, administration officials said. The higher threshold, which will take effect December 1, will increase that ratio to 35% and boost workers' pay by an estimated $12 billion over the next 10 years.

"This is a step in the right direction to strengthen and secure the middle class by raising Americans' wages," President Barack Obama said in an email message. "When workers have more income, they spend it—often at businesses in their local community—and that helps grow the economy for everyone."

The administration noted that employers could mitigate the effect of the rule by, among other things, raising salaries above the new threshold or limiting hours to 40 per week.

But critics said the measure would undermine the morale of salaried employees by requiring them to account for every hour of their workdays.

"These rules are a career killer. With the stroke of a pen, the Labor Department is demoting millions of workers," David French, a senior vice president for the National Retail Federation, said in a statement.

The White House initially proposed a $50,440 standard but lowered it to appease critics. ◗ **KATIE KUEHNER-HEBERT**

Give Data Assets Their Due

Don't wait to assess a target's data assets until after the deal closes. Here's what you need to find out during due diligence. By Craig Callé

Companies working on a merger or acquisition pore over a seemingly endless amount of material to determine the transaction's suitability. Ironically, one of the most important assets for most companies, data, gets relatively little attention in the process. ¶ Developing a comprehensive understanding of a target's data and information assets usually results in a transaction with substantially lower risk—especially cybersecurity risk—and creates vast opportunities for value creation.

Here are seven questions you should address when you conduct your next M&A due diligence to determine the extent to which the target operates in a data-centric manner.

1. Can you show me your data map? You might think this a fairly simple request, but few organizations can produce a good data map, which is essentially an inventory of data and information assets revealing where they are located. It's no wonder that the state of cybersecurity is so poor. If you can't locate these assets, how can you possibly protect them or, for that matter, create the most value from them?

Even the National Association of Corporate Directors' Cyber-Risk Oversight Handbook warns directors to make sure management has a data map. Creating and sustaining one is not a small undertaking for the disorganized organization, but it can and should be done.

2. What portion of your data is sensitive? If the organization has not adequately mapped its data, it cannot accurately measure the portion deemed to be sensitive. An assessment of what is considered to be sensitive data is an essential exercise. Did Sony consider all the snarky emails about its celebrity clients to be "sensitive" or "crown jewels" and therefore worthy of special protection? Probably not. Data and information assets are balkanized across an organization. They can be on paper, in data centers, on laptops and other mobile devices, in the cloud, and elsewhere. There are compelling technologies and processes available today to classify these assets.

3. Which cloud-based services are used, and how risky are they? Lots of companies work hard to protect their computer networks. They build hard domes, fortified by firewalls and other forms of protection, to keep bad things out.

Yet, more than a third of business-critical applications were in the cloud by 2014, according to research by Ponemon Institute on behalf of Netskope. And the shift from the use of traditional, on-premises, licensed software to software-as-a-service (SaaS) applications like Salesforce.com is accelerating.

Companies' visibility over the use of cloud-based services by employees and contractors today is very low, and that is a source of staggering security risk. There are more than 16,000 SaaS apps floating around out there, and fewer than 10% of them are enterprise-ready, according to a new report from Netskope.

Millennials are especially inclined to pull down an app without first seeking permission from IT. Many SaaS apps are downright scary from a security standpoint. Fortunately, there are ways to discover, analyze, and control the use of cloud-based services, but few companies so far have taken advantage of the enabling technologies.

4. What is the target's level of cyber-hygiene, and that of its vendors with network access? The data breach experienced by Target Corp. highlights the notion that an organization's security is only as strong as its weakest vendor's ability to secure the corporation's data. Every organization should know what it looks like from a hacker's perspective so it can immediately address its shortcomings.

There are services available that create a level of understanding that goes far beyond the traditional vendor risk management methodologies such as questionnaires and penetration tests. We are entering an age of cyber transparency, where organizations carry cyber-risk ratings that are similar

Thinkstock

in nature to the credit-risk ratings by Moody's and Standard & Poor's.

How will your acquisition target compete in a world where poor cyber-hygiene can cost business?

5. What data analytics tools do you use, and who is using them? We are now in the golden age of data analytics, and the target's level of sophistication is a function of the tools its people use to turn data into insights that generate revenue and shareholder value.

Is the CFO's financial planning and analysis team just forecasting the next quarter, or are they shoulder-to-shoulder with business unit leadership, helping them mine vast amounts of structured and unstructured data at their fingertips?

Maybe the business units are simply taking matters into their own hands and using data analytics tools on their own. Inventory the tools in use and you will get an indication of the extent to which the culture is data-driven and the value that you can create once you own the place.

6. How much of the target's data is simply ROT? Studies indicate that more than two-thirds of a typical organization's data is redundant, obsolete, or trivial (ROT). This data can be in the form of old operational log files, data stored by departed employees, outdated drafts, or copies of once-important documents that are no longer needed.

When was the last time you obeyed your organization's records retention policy, assuming it even has one? Yet there is a compelling case for reducing ROT data.

Storage comes in many forms, from tapes to flash memory, and, contrary to popular belief, it's not cheap. Organizations that are good at content management are much better able to find and protect data that isn't ROT. You can get into related issues like data quality while you're at it. You should know where your target is located on its journey toward information governance maturity.

7. What data would be valuable to third parties, and how much could you sell it for? You may want to buy a company for lots of reasons, and you may never want to sell any of the target's data to someone else. However, the analysis involved in answering this question will yield remarkable insights that you probably had not considered. The target's data is often overlooked as a motivation for an acquisition, but it can generate tremendous value in the right hands, with the right tools and skills.

There is a tendency in M&A deals to treat data as just an IT issue that can get dealt with after the transaction closes, during the integration process. However, data is an asset of enterprise-wide consequence, representing considerable risk and reward. Make your transaction successful by treating data as a critical asset. CFO

Craig Callé is the CEO of Source Callé, a consulting firm that helps organizations mitigate risk and create value by treating data as a critical asset. He is a former CFO of several private equity-backed companies.

IT Budgets Barely Increasing

Organizations with IT budgets of less than $5 million are feeling the pinch most.

Slowing corporate revenues mean only small increases in company IT budgets this year, according to Computer Economics' annual IT Spending and Staffing Benchmarks study for 2016/2017.

The Irvine, Calif., firm's survey of more than 200 IT executives in the United States and Canada showed that IT operational spending will increase only 2% this year, the least since the start of the spending recovery in 2012.

Smaller organizations with IT budgets of less than $5 million are feeling the pinch the most, as they're planning, on average, a mere 1.7% increase. Large and midsize organizations on average are increasing IT operational budgets by 2.9% and 2.7%, respectively.

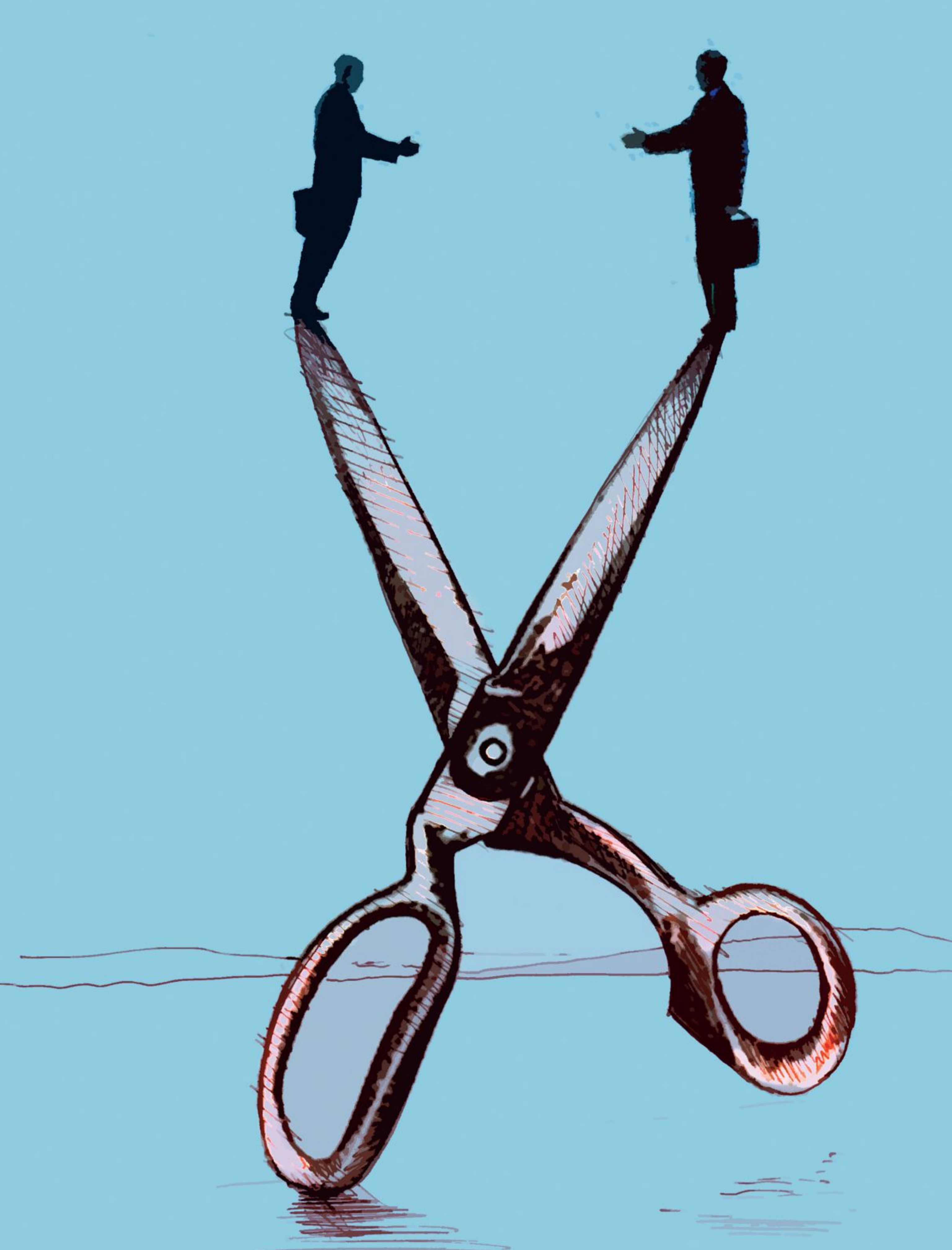
"We're hoping that small organizations are not the canary in the coal mine," Computer Economics president Frank Scavo said in a press release. "A lot will depend on whether economic conditions strengthen or weaken in the second half of 2016."

The number of IT executives hoping that the C-suite will let them increase their budgets is slightly higher than the number anticipating a budget reduction as the year progresses, resulting in a net 1% positive indicator for that trend. That compares with the minus 4 percentage points recorded in 2015 and the minus 15 percentage points at the start of the recovery period.

"IT executives feel a fair amount of certainty around their spending plans," the firm said. "While spending growth has slowed, there is no sense of panic."

Spending this year is being directed toward new investments in business applications, security, and cloud technology. As more applications move into the cloud, IT capital spending on data-center infrastructure on average will be flat for the third year. CFO

KATIE KUEHNER-HEBERT



The Year Of Dealing Dangerously

Antitrust actions, buyer cautiousness, and longer due diligence phases have all contributed to a slowdown in mergers and acquisitions.

BY VINCENT RYAN

Would a rational person have made a $62 billion bid to buy Monsanto, the genetically modified seeds company, in the current climate for acquisitions?

Werner Baumann, former finance chief of aspirin maker Bayer AG and now the company's chief executive, did in May. Cue the criticism: Monsanto has called the $62 billion offer "incomplete and financially inadequate." The deal, which would be the largest thus far in 2016, faces a host of regulatory challenges, as it consolidates power over the farming supply chain. "Arrogant empire building," an analyst called it. And Monsanto protesters, who regularly take to the streets, are highly motivated to stop the transaction, including in Bayer's home country of Germany, where the public is generally opposed to GM crops.

Amid the hubbub, Baumann told a German magazine, "Our planned takeover of Monsanto will be a marathon rather than a sprint." That statement, more than any other, typifies the task of getting a large acquisition to the finish line in 2016.

Getty Images

More than $300 billion worth of deals involving at least one U.S. company have been squashed, withdrawn, or dropped after a government lawsuit this year (see table, page 27). That's about three months' worth of U.S. merger and acquisition deal activity by this year's pacing. The cost of not completing a transaction can be steep: Halliburton paid a $3.5 billion break-up fee to Baker Hughes after the Justice Department sued to block their $28 billion merger.

Due to some government wins in high-profile proposed mergers, "the risk profile is up for companies," says Jon Dubrow, a partner at McDermott Will & Emery. "I don't

"If the government has felt it needed to litigate in order to protect competition, it has been willing to do so."

›› Jon Dubrow, partner at McDermott Will & Emery

think there's been much of a change in the government's [antitrust] standards, but companies have brought some pretty aggressive transactions before them," he says. "If the government has felt it needed to litigate in order to protect competition, it has been willing to do so."

Government challenges and other factors, including a dislocation in the first-quarter debt markets, have also ratcheted up deal risk. The result? M&A volumes and aggregate deal values have plummeted: at the end of April, the dollar value of deals in 2016 was down 30% and the number of deals was off 11% from a year ago, according to FactSet.

North America had been on a great run, with four quarters of 10% or more year-over-year deal growth in 2015, "but what we are starting to see is the effects of a not overly strong global economy and weak U.S. earnings," says Matt

Merger Slowdown

U.S. deal volume and value have plummeted in 2016.

	January	February	March	April
Aggregate deal value	$103 bill.	$102.2 bill.	$91 bill.	$127 bill.
No. of deals	1,062	951	957	901
% change YoY value	-21.2%	-19.1%	-55.7%	-10.2%
% change YoY no. of deals	-5.7%	-9%	-14.2%	-17.4%

Source: FactSet

Porzio, vice president of strategy of Intralinks, a virtual data room provider. "Then you layer on the natural M&A cycle—a lot of the good ideas have been done, and valuations are extremely high."

The Intralinks Deal Flow Predictor, an independently verified forecast of M&A activity, shows that in Q3 2016 North America M&A announcements will be down 9% year over year (Intralinks measures the activity in its data rooms to generate the forecast). Porzio calls it a more "normalized, sustainable" level of M&A activity after the trillions' worth of takeovers last year.

Will mergers and acquisitions be as few and far between as Intralinks predicts? Some experts say conditions are still ripe for plenty of takeovers, buyouts, and tie-ups.

"There is a supportive shareholder investor base for corporates to go out and do deals," says Stephen Wilkinson, global head of M&A at law firm Herbert Smith Freehills. "Shareholders aren't as they were five years following the crash, clamoring for their money back. They are struggling to know what to do with it if they do get it back, so they are supportive of companies making sensible acquisitions and divesting noncore businesses to focus on their core assets."

Globally, there are more regulators than ever. As a result, "companies have had to tread on eggshells when they put cross-border deals together."

›› Stephen Wilkinson, global head of M&A, Herbert Smith Freehills

A LACK OF TRUST

It won't be easy for potential buyers like Bayer, however. Regulators are taking a magnifying glass to mergers that in any way could reduce competition. U.S. government agencies are trying to get bigger budgets because the number of large, complicated deals is up significantly. In the government's fiscal year 2015, companies proposed 67 mergers worth more than $10 billion, double the volume of 2014, according to congressional testimony from Bill Baer, U.S. assistant attorney general for antitrust.

"More resources would make the agencies a bit more aggressive, because if you're resource limited, you're just throwing your people at the biggest problems," says Dubrow of McDermott Will & Emery. "But if you have more people, some of things on the margins that get a pass might get a longer look."

Globally, there are more regulators than ever, notes Wilkinson. As a result, "companies have had to tread on eggshells when they put cross-border deals together," he says.

The European Competition Commissioner, for example, in April blocked CK Hutchison Holdings from buying O2 UK from Spain's Telefonica.

Attorneys agree that in both Europe and the United States the stance on antitrust issues has not changed. But there is one element of U.S. antitrust laws that has been tripping up more deals of late, says Dubrow, and it involves the issue of "price discrimination."

The Federal Trade Commission has succeeded in getting entire deals thrown out based on anticompetitive effects in only a small subset of the buyers' and sellers' overlapping sales channels. So, for example, the Staples–Office Depot merger, blocked by a federal judge in May, was shown to be harmful because it lessened competition in the "sales of office products to very large corporate customers," just one of either company's distribution methods.

"This can make a deal harder to get through—you can have a transaction that doesn't create issues for the vast bulk of customers, but if there is a group of customers that are uniquely impacted by a transaction, that can result in the overall deal being challenged, and courts are agreeing with the government in some of those cases," says Dubrow.

"It might be counterintuitive to people in the C-suite, but if you can't fix it, that little issue can hang up your whole deal," he says.

While the government has challenged only a handful of high-profile deals in court, the unknown factor is whether there is an effect "on companies not trying something, not going forward with a deal if there is a risk it won't past muster with antitrust authorities," says David Gibbons, global head of the corporate practice at Hogan Lovells.

DEEPER DILIGENCE

Besides increased government scrutiny of deals here and abroad, the very nature of how deals are done is changing, with strategic buyers in particular. "Strategic buyers have more discipline now," says Chris Nemeth, co-leader of M&A services at Crowe Horwath. They've woken up to the fact that they have to "integrate and run and grow" the target businesses. "Running through the financials, coming up with a price, and papering the deal is not enough anymore; when you're buying a company you are paying a premium, so you have to do something with it," says Nemeth.

The due diligence process used to be a financial and legal

The Federal Trade Commission killed the Staples-Office Depot merger because it lessened competition. Small issues that don't affect "the vast bulk of customers... can result in the overall deal being challenged," says Dubrow.

Photos courtesy of the companies

Failure to Complete

A sampling of deals whose end came in 2016.

Proposed Merger	Reason for Termination	Proposed Value
Pfizer–Allergan	Terminated after change to U.S. tax inversion rules	$160 billion
Halliburton–Baker Hughes	Terminated after Justice Department sued to block deal	$28 billion
Staples–Office Depot	Called off after a federal court rejected merger on antitrust grounds	$6.3 billion
CF Industries–OCI NV	Called off due to new U.S. rules on tax inversions	$8 billion
McCormick–Premier Foods	Offer withdrawn	$2.1 billion
Honeywell–United Technologies	Bid dropped after United Tech rejected offer	$90 billion
Canadian Pacific Railway–Norfolk Southern	Bid dropped after target objected to deal	$30 billion
Anbang Insurance–Starwood Hotels & Resorts	Offer withdrawn due to "market considerations"	$14 billion

Source: FactSet

exercise, but now clients are taking a more multi-functional approach, says Nemeth, asking Crowe Horwath to provide due diligence around the target's information technology, human resources, and operations.

Porzio of Intralinks doesn't see deals dying in the diligence phase currently, but he says there are more deals that are taking longer in the process.

"When I was a banker you could get through diligence and sell a company if you could get people to agree on the numbers and the culture fit, and management answered a few questions," Porzio says. "Now all of a sudden a guy like a chief information security officer has a pretty vocal seat at the table. Some of these deals, especially involving companies that handle consumer data or operate in the health care industry, are slowing down so management can get comfortable that they are not buying a time bomb."

In one midmarket deal Porzio witnessed, the companies reached a sales purchase agreement only to have the CISO of the acquirer "put the brakes on and say he was not comfortable that the target's level of cybersecurity was at the buyer's level. He told the board that he needed to go in and do an assessment and hire a consultancy to do an audit, as well as buy cyber-insurance if the deal did move forward."

Boards of directors and other stakeholders also contin-

WHERE THE BIG DEALS ARE

Large combinations are fewer and farther between in 2016.

Last year's record-setting M&A market was driven by a proliferation of megadeals, those valued north of $10 billion. While regulators and the market have scuppered many mergers and acquisitions so far in 2016, plenty of large deals have been attempted.

In one of the largest, **Johnson Controls bought Tyco International** for $29.4 billion in January. (FactSet provided the values for the deals discussed here.) The combined firm will maintain Tyco's Irish legal domicile, but will be 56% owned by Johnson Controls' shareholders. Despite the tax-inversion component, experts predict the merger will pass regulatory muster.

In mid-June, **Microsoft gobbled up LinkedIn** in a $26.2 billion, all-cash deal. Microsoft hopes to tie together LinkedIn's platform with its Microsoft Office product set, expanding the market for both.

Apollo Global Management acquired home security giant ADT in a leveraged buyout and merged ADT with Protection 1, in a deal valued at $12.3 billion. ADT was spun off from fire safety and security systems maker Tyco in 2012.

In an all-cash deal, **Sherwin Williams acquired rival paint maker Valspar** for $10.8 billion. The deal will give Sherwin-Williams a platform to grow in Asia-Pacific and EMEA, and the combined company would have pro forma 2015 revenue of $15.6 billion and 58,000 employees.

Abbott Laboratories bought St. Jude Medical for $25 billion in one of the year's biggest deals. With combined annual sales of approximately $8.7 billion, Abbott's cardiovascular business and St. Jude Medical will hold the number one or two positions in many cardiovascular device markets.

There have been several smaller but still substantial transactions so far in 2016. For example, **U.S.-based IHS agreed to acquire Markit** for $6.2 billion in a combination of business data providers. Markit provides pricing and reference data to the securities industry; HIS' business units include Jane's Defence Weekly and technology industry research firm iSuppli. The deal was the largest in a string of acquisitions for IHS, which included purchases of Oil Price Information Service and Carproof, a Canada-based vehicle data provider.

Dominion Resources, the owner of Virginia's largest utility, **bought Utah natural gas provider Questar** in a transaction valued at $6 billion. Dominion inherits Questar's 1 million residential and commercial customers and will assume about $1.6 billion of the company's debt.

Finally, **Chinese aviation and shipping conglomerate HNA Group is buying electronics distributor Ingram Micro** for about $6 billion, one of a string of overseas deals by Chinese companies thus far in 2016. **V.R.**

In one deal the companies reached a purchase agreement, says Porzio, only to have the acquirer's CISO "put the brakes on and say he was not comfortable with the target's level of cybersecurity."

›› **Matt Porzio, VP of Strategy, Intralinks**

ue to ask of a lot of questions of management around doing deals, says Neil Dhar, U.S. capital markets leader at PwC. "We see a lot of buyers doing commercial due diligence—market sizing and growth potential," he says. In addition, "in relation to the promises the buyer is making to Wall Street around synergies and value capture, there is a lot of emphasis on building robust processes so that management can track and communicate the progress to key stakeholders."

Facilitating all that, of course, is the ability to dig into businesses through data analysis tools, Dhar says. "Buyers are able to do much more comprehensive reviews of businesses—profitability metrics, market sizing, comparison to peers."

And, perhaps counterintuitively, the deeper due diligence is not only happening with very large deals. "In some ways the big deals are more structured," explains Nemeth. "In the middle market so much of the target's story isn't really captured in the org chart—who really has the key relationships? Who makes the decisions? What does success really hinge on? It's not easy for a buyer to figure that out."

FEEDING THE FIRE

If there's anything that does pour some fuel on M&A deal making in the second half of 2016, it will be the pressures faced by executive management.

Despite the relatively slow start to 2016, the conditions for M&A are still favorable, say experts. "There's this overwhelming inexorable hunger for growth both driven internally by executives trying to hit their bonus numbers, but also externally in terms of shareholders," says Crowe Horwath's Nemeth. "And the increase in activist shareholders really lights a fire under the seats of a lot of these deal people."

One behavior that activism tends to drive is the habit of management and boards to continually ask whether they are the best owners of a given business, says Dhar of PwC. "Companies are being actively vigilant around portfolio optimization—there's more emphasis on, are we holding the right sets of businesses?" he says.

What that does is put more individual assets on the selling block. "We will also see big megadeals close and certain assets will fall from the tree as [companies] combine, for regulatory purposes or noncore purposes," says Dhar. "Private equity will look to purchase those businesses." Some of those assets will be small, however, as will be the assets that older companies acquire to protect their markets from disruptive technology upstarts.

The other pressure faced by companies is just to earn a decent return on their capital. Says Drew Spitzer, a managing director at Harris Williams: "We have a very low interest-rate environment and very attractive financing terms, cash on strategic [buyers'] balance sheets, and slower organic earnings growth. ... Buyers are making a decision that deploying the cash in the value and fashion that they are has a better return on investment than the alternatives."

Finally, at this point, neither the market for financings nor the price of assets looks to be deterring acquirers.

"Leverage multiples are probably not where they were at their peak, but they are not far off," says Spitzer. "The actual rates you are paying for financing a leveraged buyout are higher than there were at this time last year, but they've tightened significantly since the March time frame."

On the price issue, the median premium paid for U.S. acquisitions was 33.8% from February through April, according to FactSet. Bayer's initial offer to Monsanto represented a 37% premium. By comparison, median premiums hit nearly 50% in the third quarter of 2015.

"Companies are being actively vigilant around portfolio optimization—there's more emphasis on, are we holding the right sets of businesses?"

›› **Neil Dhar, U.S. capital markets leader, PwC**

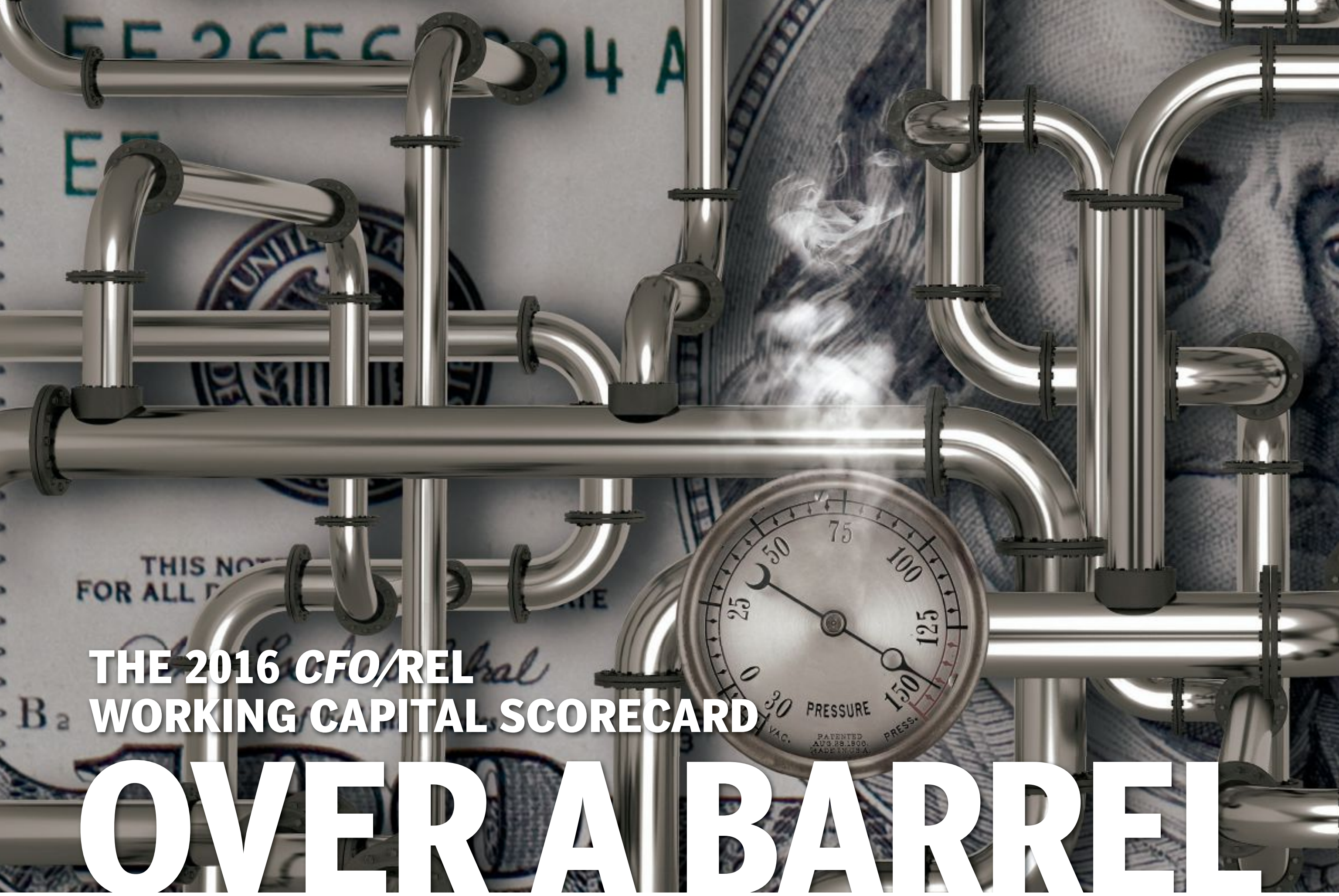
"EBITDA multiples are still pricey in a historical context, but they are [smaller] than they were a year ago," says Rich Jeanneret, Americas vice chair at EY. "And with capital inexpensive, you can drive a pretty good return with the current cost of capital. Buyers and sellers are more in alignment than they were."

Where does that leave the second-half forecast? "We will not see the level of volume from last year," says Dhar, "but especially if there is a financing market, I think you will continue to see deals go on at a steady click."

For sellers, it's still a good time to be out in the market, says Intralinks' Porzio. "Companies are not forgoing inorganic M&A growth strategies, and some are doubling down as others shy away," he says. For rational C-suite executives and boards, M&A may be more arduous than ever, but it's still a viable option. CFO

VINCENT RYAN IS EDITOR-IN-CHIEF, DIGITAL CONTENT, AT *CFO*.

Photos courtesy of the companies



THE 2016 *CFO*/REL WORKING CAPITAL SCORECARD

OVER A BARREL

Thanks to the slumping oil and gas industry, the working capital performance of America's largest companies is at its worst level in years. BY EDWARD TEACH

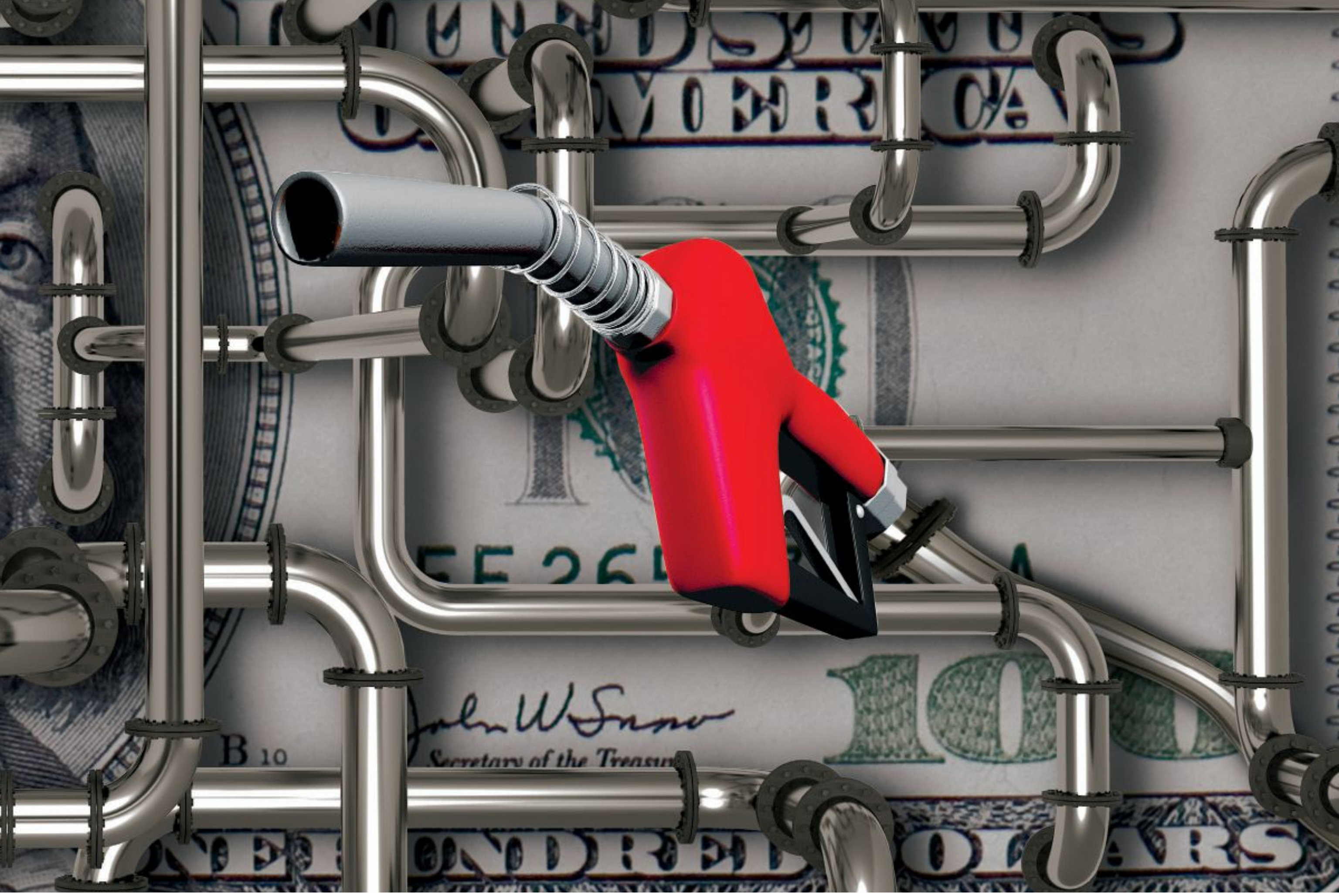
Working capital performance among America's largest companies took a turn for the worse in 2015. After three years of stability, the cash conversion cycle—the amount of time that cash is tied up in working capital—increased by 7% (2.4 days) for the 1,000 large nonfinancial companies recently surveyed by REL, a working capital consultancy and division of the Hackett Group. At the end of 2015 the cycle stood at 35.6 days, the highest level since before the financial crisis.

But all is not as dismal as it may seem. One very large industry—oil and gas, which accounts for 9.9% of the revenues of the companies in REL's survey—drove the poor performance, owing to the spectacular fall in oil prices since the summer of 2014. When oil and gas companies are excluded from the results, the cash conversion cycle actually improved in 2015, falling by 0.1 day.

That's hardly reason to cheer, though. Companies still prefer to raise cash in part by issuing debt at low interest rates, rather than by improving working capital efficiency, says REL. Debt for the top firms increased by 9.3% ($413 billion) in 2015, while cash on hand ($977 billion) is at its highest level since 2008, according to Craig Bailey, a senior director at REL. Following the end of the recession, the largest companies have increased their collective debt six years in a row, by a total of 58%.

Meanwhile, the cash conversion cycle shortened at 457 companies, lengthened at 543. Also, the overall working capital turnover ratio (revenue divided by net working capital), which indicates how effectively companies use working capital to generate sales, deteriorated. Companies earned 5.1 cents less revenue per dollar of working capital

Getty Images



spent in 2015, compared with 2014.

And the total working capital improvement opportunity—defined as the amount of cash that could be freed up if all the companies in REL's survey performed at the level of the top quartile in their industries—remained at $1 trillion. Even if everyone is above average only in Lake Wobegon, the enormous sum reflects the level of inefficiency in working capital management among U.S. companies.

What's more, REL's research indicates that even when companies do focus on working capital improvement, their attention spans are short—three years or less for most, based on cash conversion cycles.

Inventory Ills

Of the three pieces of working capital opportunity, the largest is inventory, at $421 billion in 2015. Days inventory outstanding drove the increase in the cash conversion cycle, rising 10.3%, from 44.5 days to 49.1 days. But when oil and gas is excluded from the results, DIO rose just 3.7% in 2015, continuing a slight upward trend since the end of the recession.

Bailey notes that inventories were flat at many firms and actually decreased by 2% overall. But the cost of goods fell by 7.4% for the top companies, as revenue declined by 5.3%, again driven by oil and gas. That caused days inventory outstanding to rise, as cost of goods sold is the denominator in the DIO formula (see "How Working Capital Works," page 33).

In the oil and gas industry, DIO soared more than 50%, from 17 days to 26 days. Inventories declined by 6%, but cost of goods decreased 13%, as falling oil prices spurred the industry to reduce costs. Days inventory outstanding also rose substantially (16%) among the 10 industrial conglomerates in REL's survey, led by Icahn Enterprises, whose DIO jumped 56%, from 42 to 66 days. Yet Icahn remained one of the best performers in the sector, measured by its relatively short cash conversion cycle.

Other factors affected inventories in 2015, says Bailey. One was the West Coast port strike at the beginning of the year, which resulted in supply chain backlogs at many companies. Another source of inventory inefficiency was the continuing trend of multinationals moving sourcing from China to even lower cost countries, where suppliers lack the sophistication of their Chinese counterparts, and where infrastructure and transportation issues create longer lead times.

The challenge for these multinationals, says Bailey, is to strip out inventory buffers by better integrating their supply chains—adopting new technology, working more closely with suppliers, and sharing data about forecasts and expected demand. "We've seen organizations not only share better information with suppliers, but also share risk as well—entering into certain stocking agreements with local suppliers, for example," he says.

Stretching Payables

The second-largest source of working capital opportunity, accounts payable ($334 billion), showed improvement last year. Days payable outstanding increased 5%, from 47.7 days to 50.1 days.

Indeed, DPO performance has trended upward during the past eight years, by a total of almost 10 days, says Shawn Townsend, a director at REL. By contrast, DIO has deteriorated by about the same amount during the same period, while days sales outstanding has remained essentially flat since 2008.

There are good reasons for the varied results. For starters, inventory is far more complex to manage than the other two components of working capital, while collections efforts must stop short at creating customer disruptions, points out Derrick Steiner, an REL director. "Typically, management feels more comfortable addressing the payables side," he says. "They have more direct influence over it, and companies have the internal ability to improve and adopt DPO best practices."

In fact, large companies have been extending their supplier payment terms. Net 60 days is currently standard for North American companies, says Townsend, but a number of large companies have taken advantage of their market position and leverage to extend their payment terms to 90 days and even 120 days, he says.

Stretching payments so far (or squeezing suppliers, as detractors would say) raises the risk of destabilizing the supply chain, notes Townsend. To forestall this, some companies are extending payment terms in conjunction with a supply chain finance program, which enables suppliers to sell their receivables before maturity to a designated bank at a discount based partly on the seller's credit strength.

Supply chain finance has been growing in popularity since the financial crisis, says Townsend. Large banks have traditionally dominated the market, but a number of fintech companies, such as Taulia, Kyriba, and PrimeRevenue, have entered the space with technology platforms and, in some cases, financing.

Receivables Stability

The smallest component of working capital opportunity is accounts receivable, amounting to $316 billion. Days sales outstanding remained basically unchanged in 2015, rising by 0.4 day to 36.7 days. Receivables performance has been essentially flat since 2009, a pattern that persists even when individual industries are considered, says Ben Michael, a director at REL.

What accounts for the stability? "Some of the mechanisms for improving performance are in your own hands," answers Michael. "Payment terms obviously impact the performance of receivables, but you can influence collections directly through the robustness of your internal procedures."

Net 30 days continues to be the standard customer payment terms among the largest companies, according to REL. Whatever the duration, setting and enforcing standard terms is key to improving receivables performance, says Todd Glassmaker, an REL director. Doing so should involve, on one hand, close collaboration between finance and sales; and on the other, working with customers to understand and resolve any billing issues or other concerns they may have.

"Really understand the difference between your DSO and payment terms, or what we refer to as 'the best possible DSO,'" says Glassmaker. "Know what the gap is between actual performance and the target to shoot for." To hit that target, adds Michael, "you need to have the whole

PERFORMANCE PAYOFF

How top working capital performers compare with median performance

- On **days sales outstanding**, the first quartile companies in the 2016 REL Working Capital Survey outperformed the median by 42% (25.1 days versus 43.5 days for the median). The difference is equal to $50.3 million of cash flow per $1 billion of sales.
- On **days payables outstanding**, the first quartile outperformed the median by 45% (59.1 days versus 40.9 days), equal to $49.9 million of cash flow per $1 billion of sales.
- On **days inventory outstanding**, the first quartile outperformed the median by 53% (25.5 days versus 54.7 days), equal to $80.0 million of cash flow per $1 billion of sales. (Note: For this metric, part of the difference between the top quartile and the median could be the result of comparing service companies and industrial ones.)
- On the **cash conversion cycle**, the first quartile outperformed the median by 115% (-8.5 days versus 57.2 days), equal to $180.2 million of cash flow per $1 billion of sales.

Source: 2016 REL Working Capital Survey

organization, from sales and operations to credit and collections, pointing in the same way, with everyone understanding the impact of their particular actions."

Keeping Score

Drawing from REL's latest working capital survey of the 1,000 largest U.S.-based companies (excluding the financial sector), the 2016 *CFO*/REL Working Capital Scorecard on the following pages shows the best and worst companies in working capital management in 27 industries. Companies are ranked by their cash conversion cycles; to learn how CCC is calculated, see "How Working Capital Works."

The survey calculates working capital performance based on the latest publicly available data, as sourced from FactSet/FactSet Fundamentals. In order to provide comparable analysis, REL has made adjustments to the data to reflect the impact of off-balance-sheet arrangements and financing revenue and receivables. CFO

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

HOW WORKING CAPITAL WORKS

Days sales outstanding (DSO): AR/(total revenue/365)

Year-end trade receivables net of allowance for doubtful accounts, divided by one day of revenue.

A decrease in DSO represents an improvement, an increase a deterioration.

Days inventory outstanding (DIO): Inventory/(total COGS/365)

Year-end inventory, divided by one day of cost of goods sold (COGS).

A decrease is an improvement, an increase a deterioration.

Days payables outstanding (DPO): AP/(total COGS/365)

Year-end trade payables divided by one day of COGS.

An increase in DPO is an improvement, a decrease a deterioration. For purposes of the survey, payables exclude accrued expenses.

Cash conversion cycle (CCC): DSO + DIO - DPO

Number of days for each indicator added up for the assets part of the balance sheet and subtracted for the liabilities.

The lower the number of days, the better.

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

Companies are classified according to the FactSet industry classification system, using data sourced from FactSet. For purposes of the survey and presenting the results, certain industries have been grouped together.

The 2016 *CFO*/REL Working Capital Scorecard

Best in Industry
Worst in Industry

	CCC 2015	CCC 1-yr. % change	CCC 2014	DSO 2015	DSO 1-yr. % change	DSO 2014	DIO 2015	DIO 1-yr. % change	DIO 2014	DPO 2015	DPO 1-yr. % change	DPO 2014
Aerospace & Defense												
Northrop Grumman	34	9%	31	44	3%	43	17	12%	15	27	1%	27
ManTech Intl.	42	53%	27	72	13%	64	NM	NM	NM	30	-18%	37
Aerojet Rocketdyne	50	-8%	54	37	-7%	39	39	-32%	58	26	-39%	43
BE Aerospace	235	14%	205	47	17%	41	258	10%	234	71	2%	70
Rockwell Collins	263	7%	247	72	-5%	76	260	4%	249	69	-11%	78
KLX	443	1%	436	60	-9%	66	431	3%	419	49	0%	49
Median	**108**	**1%**	**106**	**65**	**3%**	**64**	**97**	**4%**	**94**	**36**	**-5%**	**38**
Airlines												
Virgin America	-25	-576%	-13	2	-5%	2	NM	NM	NM	27	79%	15
SkyWest	-14	-58%	-9	7	-22%	9	22	14%	19	44	16%	38
Delta Air Lines	-10	-1664%	-1	18	-13%	21	10	-7%	10	38	19%	32
Allegiant Travel	9	41%	6	4	-4%	5	8	0%	8	4	-44%	6
Alaska Air Group	12	-27%	17	14	-22%	18	6	-4%	6	7	11%	6
Republic Airways	34	41%	24	21	283%	5	23	-17%	27	10	11%	9
Median	**(1)**	**-186%**	**1**	**10**	**9%**	**9**	**9**	**13%**	**8**	**14**	**25%**	**16**
Automotive Parts & Aftermarket												
Tower Intl.	-3	-304%	2	47	15%	41	16	7%	15	66	22%	54
Visteon	15	-49%	29	59	-10%	66	28	-8%	30	72	8%	67
Cooper-Standard	15	-27%	21	50	17%	42	21	-11%	23	55	24%	45
Federal-Mogul	94	6%	88	68	-5%	71	81	9%	74	54	-4%	57
LKQ	126	1%	125	30	-8%	33	131	2%	128	35	-3%	36
Clarcor	137	-2%	140	64	-14%	74	107	5%	102	34	-6%	36
Median	**34**	**18%**	**29**	**49**	**6%**	**46**	**41**	**17%**	**35**	**55**	**1%**	**55**

NM = not meaningful, because the results moved from positive to negative, or vice-versa. Results shown are for fiscal years. Medians shown are for the full industry. Based on financial statements of the 1,000 largest U.S. public companies (excluding the financial sector), as reported by FactSet / FactSet Fundamentals. Source: REL

Best in Industry
Worst in Industry

	CCC 2015	CCC 1-yr. % change	CCC 2014	DSO 2015	DSO 1-yr. % change	DSO 2014	DIO 2015	DIO 1-yr. % change	DIO 2014	DPO 2015	DPO 1-yr. % change	DPO 2014
Beverages												
Molson Coors Brewing	-27	-50%	-18	43	-6%	46	38	3%	37	109	7%	102
PepsiCo	-8	-222%	6	32	0%	32	38	-6%	40	78	18%	66
Coca-Cola Bottling	14	-17%	16	34	8%	31	25	-6%	26	45	9%	41
Coca-Cola Enterprises	50	-4%	52	71	2%	70	29	4%	27	50	11%	45
Monster Beverage	68	19%	57	64	54%	42	54	-7%	58	50	18%	42
Constellation Brands	194	-8%	211	41	13%	36	200	-4%	208	46	43%	32
Median	**29**	**-19%**	**36**	**37**	**4%**	**36**	**38**	**-2%**	**39**	**50**	**12%**	**45**
Building Products												
A. O. Smith	22	-18%	27	72	-2%	74	55	5%	53	106	6%	100
Masco	39	6%	36	44	-2%	45	53	5%	50	58	-1%	58
NCI Building Systems	43	4%	41	39	7%	36	49	10%	44	45	13%	40
Griffon	89	5%	85	58	-13%	68	80	12%	72	49	-9%	54
Watsco	102	0%	102	40	0%	40	79	-4%	83	17	-20%	21
BMC Stock	108	138%	45	75	111%	36	74	102%	36	41	53%	27
Median	**63**	**11%**	**57**	**44**	**3%**	**43**	**70**	**18%**	**59**	**48**	**4%**	**46**
Chemicals												
Westlake Chemical	-2	-127%	6	19	60%	12	3	-1%	3	23	188%	8
Calumet Specialty Products	25	-7%	27	18	-14%	21	43	18%	36	35	19%	30
Sherwin-Williams	27	-27%	37	36	-3%	37	67	2%	66	76	15%	66
Sensient Technologies	194	-3%	199	62	7%	58	172	-5%	181	40	1%	40
Monsanto	202	10%	185	40	-14%	46	213	7%	200	51	-17%	62
FMC	278	25%	222	206	15%	179	145	27%	114	73	3%	71
Median	**79**	**1%**	**78**	**51**	**-1%**	**52**	**72**	**8%**	**67**	**45**	**0%**	**45**
Computer Hardware & Peripherals												
Lexmark Intl.	-12	-42%	-8	45	9%	41	49	9%	45	106	12%	95
HP	2	-32%	3	48	5%	45	31	9%	29	77	8%	71
Brocade Communications Systems	6	-10%	6	38	2%	37	23	5%	22	55	5%	52
Super Micro Computer	95	17%	81	59	12%	53	102	9%	93	66	2%	65
Fortinet	126	3%	122	94	7%	88	120	-1%	121	88	1%	87
Netgear	131	13%	117	82	13%	72	87	2%	85	37	-9%	40
Median	**46**	**-6%**	**49**	**59**	**13%**	**52**	**50**	**-1%**	**50**	**66**	**-3%**	**68**
Consumer Durables												
Select Comfort	-6	69%	-21	9	40%	6	76	59%	48	91	22%	75
Whirlpool	5	-6%	5	44	-13%	51	58	-8%	63	97	-11%	108
Tempur Sealy Intl.	31	-32%	45	44	-7%	47	39	-11%	44	53	14%	46
Taylor Morrison Home	471	4%	452	15	-60%	37	479	10%	435	23	10%	21
TRI Pointe Group	492	-18%	602	5	134%	2	500	-19%	618	13	-31%	19
William Lyon Homes	660	-7%	707	6	-40%	10	685	-5%	723	31	16%	27
Median	**118**	**-6%**	**125**	**28**	**-32%**	**41**	**113**	**9%**	**104**	**38**	**-11%**	**42**
Containers & Packaging												
Crown	-1	-117%	7	31	-9%	34	62	-3%	64	95	3%	92
Ball	0	-99%	17	34	2%	34	51	-6%	54	85	20%	71
Owens-Illinois	17	-23%	22	33	13%	30	80	8%	74	96	18%	81
Packaging Corp. of America	74	7%	69	40	0%	40	59	2%	58	26	-10%	29
WestRock	82	58%	52	54	31%	41	84	64%	51	56	38%	40
AptarGroup	105	8%	98	62	8%	57	72	11%	65	28	15%	24
Median	**43**	**7%**	**40**	**40**	**-2%**	**41**	**58**	**4%**	**55**	**52**	**7%**	**48**
Electronic Equip., Instruments & Components												
Jabil Circuit	3	218%	1	30	7%	28	58	12%	51	84	8%	78
Ingram Micro	22	-31%	32	48	0%	48	31	-9%	35	58	13%	51
Tech Data	22	7%	21	41	12%	37	31	13%	27	50	15%	43
Keysight Technologies	138	-2%	141	51	14%	44	153	3%	148	65	27%	51
Bruker	205	-3%	212	53	-11%	59	183	1%	181	31	8%	29
National Instruments	267	18%	226	66	10%	60	277	10%	252	76	-11%	85
Median	**82**	**11%**	**74**	**58**	**1%**	**58**	**79**	**6%**	**74**	**60**	**1%**	**59**
Energy Services & Equipment												
Patterson-UTI Energy	22	42%	16	42	-44%	76	4	-22%	6	25	-63%	66
Rowan	27	-59%	67	68	-36%	105	NM	NM	NM	40	6%	38
Seacor	32	7%	30	55	-12%	62	12	32%	9	35	-16%	42
Oil States Intl.	182	33%	137	111	11%	100	99	41%	70	27	-17%	33
Forum Energy Technologies	221	28%	173	51	-19%	63	208	38%	151	38	-10%	42
National Oilwell Varco	242	16%	208	103	-4%	107	160	23%	130	21	-27%	29
Median	**86**	**-9%**	**95**	**67**	**-13%**	**77**	**56**	**5%**	**53**	**31**	**-27%**	**42**

NM = not meaningful, because the results moved from positive to negative, or vice-versa.
Results shown are for fiscal years. Medians shown are for the full industry. Based on financial statements of the 1,000 largest U.S. public companies (excluding the financial sector), as reported by FactSet / FactSet Fundamentals. Source: REL

Best in Industry
Worst in Industry

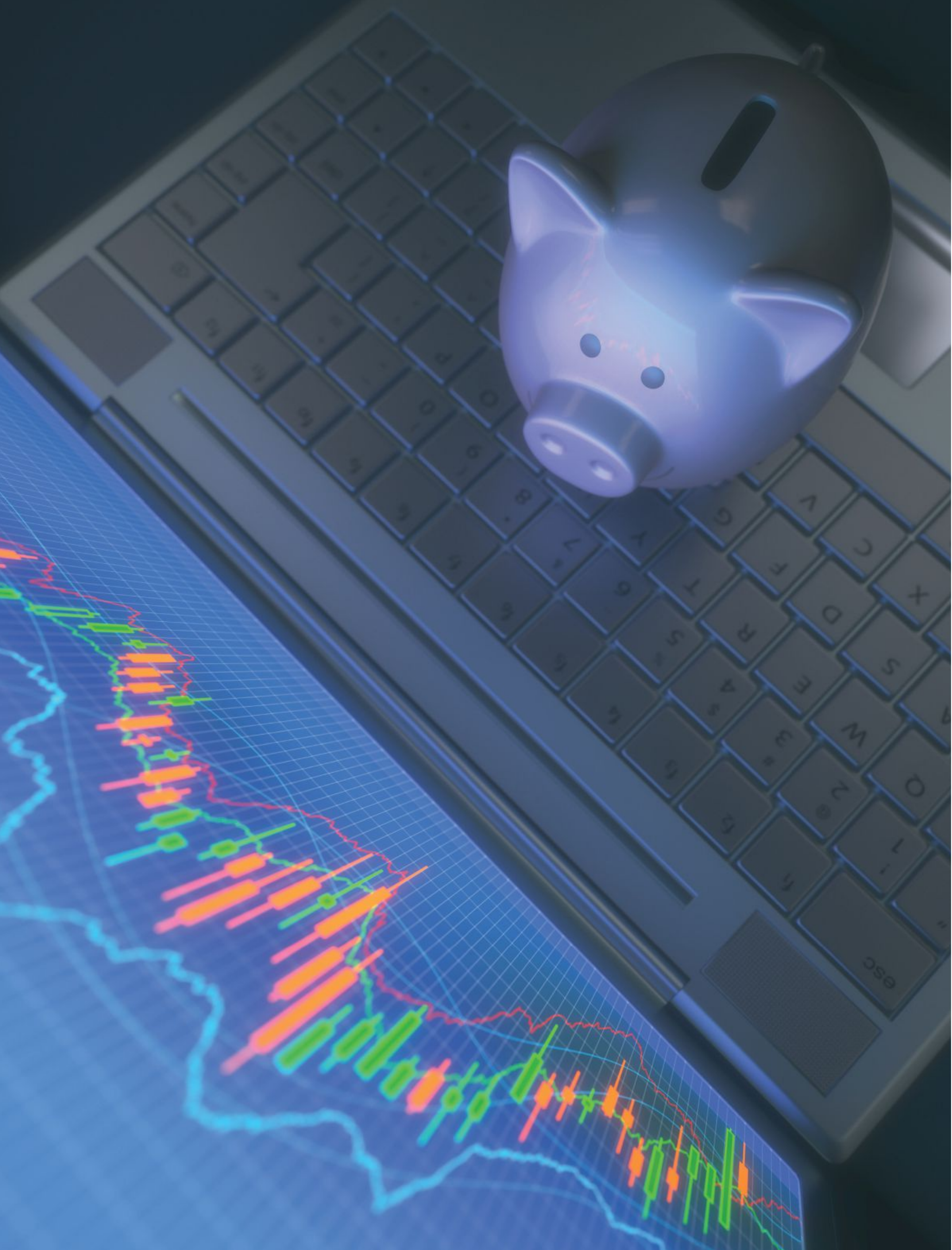
	CCC			DSO			DIO			DPO		
	2015	1-yr. % change	2014	2015	1-yr. % change	2014	2015	1-yr. % change	2014	2015	1-yr. % change	2014
Engineering & Construction												
Fluor	24	-5%	26	52	0%	52	NM	NM	NM	28	6%	26
Granite Construction	41	4%	39	59	9%	55	10	-21%	13	29	1%	28
Matrix Service	41	-8%	44	78	-3%	80	1	-18%	1	37	1%	37
Aegion	81	-10%	90	90	-9%	99	17	-21%	22	26	-14%	31
Tutor Perini	100	-5%	105	176	-2%	179	NM	NM	NM	76	2%	74
Dycom Industries	101	3%	98	106	5%	101	11	-8%	12	16	5%	16
Median	**55**	**-6%**	**59**	**81**	**-4%**	**84**	**9**	**-14%**	**10**	**29**	**-3%**	**30**
Food												
Mondelez	-15	-280%	9	32	-20%	41	55	-11%	61	102	10%	93
Kellogg	2	-90%	16	31	14%	27	56	0%	56	86	28%	67
WhiteWave Foods	10	49%	7	24	19%	20	41	12%	36	55	10%	50
Ingredion	69	7%	65	44	3%	42	63	6%	59	37	2%	37
TreeHouse Foods	79	-12%	90	23	-20%	29	85	-11%	96	29	-16%	35
McCormick	83	-12%	94	39	-9%	42	106	-2%	108	61	9%	56
Median	**49**	**24%**	**39**	**28**	**3%**	**27**	**51**	**2%**	**50**	**29**	**-16%**	**35**
Food & Staples Retail												
Costco Wholesale	2	-11%	2	2	0%	2	33	3%	32	33	3%	32
PriceSmart	5	322%	1	1	10%	1	42	6%	40	38	-4%	40
Sprouts Farmers Markets	6	-10%	6	1	17%	1	24	-5%	25	19	-2%	20
Chefs' Warehouse	56	-9%	61	43	1%	42	44	-1%	44	31	21%	25
Sears	73	31%	56	6	21%	5	98	30%	75	31	25%	25
GNC	112	9%	102	20	6%	19	127	17%	108	35	41%	25
Median	**15**	**-17%**	**18**	**6**	**15%**	**5**	**41**	**3%**	**40**	**29**	**15%**	**26**
General & Specialty Retail												
AutoZone	-26	18%	-32	9	15%	8	272	2%	267	307	0%	307
CST Brands	-1	-1117%	0	3	-20%	4	8	16%	7	12	15%	11
Murphy USA	2	-6%	2	4	32%	3	5	16%	4	7	33%	5
Restoration Hardware	160	13%	141	5	-3%	5	205	14%	179	49	16%	43
Conn's	220	8%	204	168	7%	158	91	-8%	98	39	-26%	53
Tiffany	504	-8%	551	18	9%	17	570	1%	562	84	200%	28
Median	**62**	**-6%**	**66**	**7**	**-1%**	**7**	**81**	**4%**	**79**	**40**	**2%**	**39**
Household & Personal Care												
Procter & Gamble	-6	-147%	12	23	-20%	29	57	-14%	66	86	4%	82
Avon Products	3	-83%	15	26	13%	23	98	8%	91	122	23%	99
Coty	13	16%	11	57	6%	53	127	-5%	134	171	-3%	176
Central Garden & Pet	126	3%	122	46	4%	44	109	2%	107	29	-1%	29
Estee Lauder	164	-20%	204	40	-13%	46	261	-2%	267	136	26%	108
Nu Skin Enterprises	212	-21%	267	6	13%	5	232	-21%	292	25	-16%	30
Median	**28**	**-28%**	**38**	**33**	**-8%**	**36**	**106**	**17%**	**91**	**85**	**3%**	**82**
Industrial Conglomerates												
Berkshire Hathaway	-7	81%	-36	40	-2%	41	29	11%	26	76	-26%	103
Honeywell Intl.	57	0%	57	75	6%	71	68	9%	63	86	13%	76
Icahn Enterprises	63	47%	43	38	20%	32	66	56%	42	41	33%	31
3M	97	3%	95	50	3%	49	91	1%	90	44	0%	44
General Electric	126	97%	64	81	42%	57	114	29%	89	70	-15%	82
Textron	144	10%	131	28	5%	27	155	11%	140	40	11%	36
Median	**76**	**14%**	**66**	**66**	**20%**	**55**	**73**	**8%**	**67**	**57**	**3%**	**55**
Machinery												
Navistar Intl.	8	-8%	9	15	-17%	19	49	-5%	52	57	-9%	62
Paccar	11	-2%	11	14	-17%	17	19	-13%	22	23	-19%	28
Shiloh Industries	26	-42%	45	64	-10%	71	21	-50%	43	59	-14%	69
Nordson	162	9%	149	81	9%	75	116	5%	110	35	-2%	36
Graco	167	14%	147	61	-1%	62	132	18%	112	27	-4%	28
Joy Global	214	5%	204	93	-9%	102	166	4%	159	45	-20%	57
Median	**86**	**8%**	**79**	**55**	**0%**	**55**	**76**	**5%**	**73**	**45**	**-1%**	**46**
Medical Specialities & Services												
Cerner	-58	-14%	-51	85	18%	72	11	-47%	21	154	7%	144
Express Scripts	-19	-15%	-17	24	11%	22	8	-5%	9	52	10%	47
Quest Diagnostics	28	-18%	33	44	-4%	46	7	-24%	9	23	9%	21
St. Jude Medical	254	3%	247	81	3%	79	221	7%	208	49	22%	40
Cooper	268	8%	249	57	-2%	59	292	7%	274	81	-3%	84
Zimmer Biomet	552	28%	432	88	24%	71	532	26%	421	67	12%	60
Median	**122**	**2%**	**120**	**59**	**3%**	**58**	**116**	**-3%**	**119**	**47**	**17%**	**41**

NM = not meaningful, because the results moved from positive to negative, or vice-versa. Results shown are for fiscal years. Medians shown are for the full industry. Based on financial statements of the 1,000 largest U.S. public companies (excluding the financial sector), as reported by FactSet / FactSet Fundamentals. Source: REL

Best in Industry
Worst in Industry

	CCC 2015	CCC 1-yr. % change	CCC 2014	DSO 2015	DSO 1-yr. % change	DSO 2014	DIO 2015	DIO 1-yr. % change	DIO 2014	DPO 2015	DPO 1-yr. % change	DPO 2014
Metals & Mining												
Consol Energy	-16	72%	-57	29	7%	27	25	27%	20	71	-32%	105
Peabody Energy	13	-52%	27	15	-51%	31	25	-7%	26	27	-11%	30
SunCoke Energy	20	-26%	27	13	-30%	19	41	-6%	43	33	-4%	34
Newmont Mining	113	14%	99	12	-48%	24	133	24%	107	33	3%	32
Materion	117	-1%	118	35	-5%	37	96	0%	97	15	-4%	15
Allegheny Technologies	133	-7%	143	39	-25%	52	133	-9%	146	40	-28%	55
Median	**53**	**4%**	**51**	**22**	**-26%**	**30**	**62**	**5%**	**59**	**24**	**-18%**	**29**
Office Equipment, Services & Supplies												
Pitney Bowes	-10	-67%	-6	47	18%	40	23	12%	21	80	20%	66
Deluxe	-3	64%	-8	27	9%	25	27	2%	27	57	-3%	59
Republic Services	3	-59%	7	39	0%	39	3	11%	2	38	12%	34
Knoll	66	23%	54	39	-3%	40	77	-2%	78	49	-24%	64
Tetra Tech	102	-2%	103	142	-3%	146	NM	NM	NM	40	-5%	42
Acco Brands	109	-4%	114	89	-2%	91	74	-1%	74	53	4%	52
Median	**29**	**-3%**	**30**	**47**	**2%**	**46**	**27**	**2%**	**27**	**49**	**-6%**	**52**
Oil & Gas												
Murphy Oil	-463	13%	-529	72	19%	60	65	-7%	70	600	-9%	660
Noble Energy	-295	39%	-484	2	-89%	22	34	-6%	36	331	-39%	542
Anadarko Petroleum	-245	20%	-307	25	1%	25	22	-6%	23	292	-18%	356
Cimarex Energy	48	54%	31	57	-9%	62	38	-33%	57	47	-47%	88
Par Pacific	55	44%	38	12	-9%	13	48	66%	29	5	32%	4
Apache	63	528%	-15	72	23%	58	101	-2%	103	109	-38%	176
Median	**2**	**20%**	**1**	**34**	**12%**	**31**	**22**	**29%**	**17**	**48**	**8%**	**45**
Pharmaceuticals												
Bristol-Myers Squibb	45	195%	-48	86	25%	69	145	-26%	196	186	-40%	312
Catalent	76	0%	76	74	-8%	81	47	0%	47	45	-12%	51
Johnson & Johnson	84	30%	64	56	3%	54	165	5%	157	136	-7%	146
Eli Lilly	277	23%	226	64	7%	60	348	24%	281	135	17%	116
Zoetis	344	11%	311	72	-4%	75	340	11%	305	68	-1%	69
United Therapeutics	794	184%	280	48	4%	46	822	215%	261	76	178%	27
Median	**127**	**-6%**	**135**	**68**	**3%**	**66**	**210**	**-12%**	**239**	**124**	**22%**	**102**
Semiconductors & Semiconductor Equipment												
Amkor Technology	29	-26%	39	67	22%	55	45	13%	40	83	49%	55
Synopsys	52	132%	22	63	9%	58	NM	NM	NM	11	-69%	36
Skyworks Solutions	55	-24%	72	60	19%	51	63	-25%	84	69	10%	62
Lam Research	163	12%	145	76	20%	64	128	9%	117	41	15%	35
Mentor Graphics	173	-5%	182	152	-5%	160	62	23%	50	42	47%	28
KLA-Tencor	246	8%	228	79	23%	64	200	3%	195	34	9%	31
Median	**125**	**3%**	**121**	**49**	**-3%**	**51**	**125**	**7%**	**117**	**51**	**10%**	**46**
Telecommunications Equipment												
Apple	-66	-4%	-63	27	-24%	35	7	-11%	7	99	-6%	105
EchoStar	20	8%	18	54	20%	45	14	25%	11	48	27%	38
Qualcomm	36	616%	5	28	-14%	33	61	10%	56	53	-36%	84
CommScope	102	16%	88	80	37%	58	68	19%	57	46	68%	28
Trimble Navigation	119	0%	119	58	5%	55	99	-3%	103	38	-1%	38
Harris	135	78%	76	84	103%	41	119	64%	73	68	79%	38
Median	**67**	**67%**	**40**	**55**	**20%**	**45**	**61**	**7%**	**57**	**57**	**19%**	**48**
Textiles, Apparel & Footwear												
Steven Madden	20	35%	15	11	-25%	15	41	5%	39	32	-18%	39
Guess?	76	-1%	76	40	8%	37	84	6%	80	48	20%	40
V.F.	91	8%	84	37	2%	36	94	5%	90	40	-4%	42
Columbia Sportswear	132	16%	114	58	-2%	60	136	11%	123	63	-9%	68
Under Armour	148	32%	112	40	21%	33	145	12%	130	37	-27%	51
Hanesbrands	164	10%	149	43	-6%	46	193	12%	173	71	2%	70
Median	**98**	**-3%**	**101**	**40**	**9%**	**36**	**131**	**6%**	**123**	**48**	**-6%**	**51**
Utilities												
ITC	-282	-30%	-216	36	1%	36	83	-18%	101	401	14%	353
NextEra Energy	-15	-142%	36	41	6%	39	56	0%	56	112	91%	59
Alliant Energy	-11	54%	-24	19	110%	9	38	5%	36	68	-1%	69
Dynegy	79	123%	35	40	9%	37	76	109%	36	37	-2%	38
One Gas	86	15%	75	51	-22%	66	91	33%	68	56	-5%	59
Dominion Resources	107	36%	79	38	-13%	44	148	40%	106	80	11%	72
Median	**29**	**5%**	**28**	**40**	**4%**	**39**	**42**	**5%**	**40**	**54**	**-4%**	**57**

NM = not meaningful, because the results moved from positive to negative, or vice-versa.
Results shown are for fiscal years. Medians shown are for the full industry. Based on financial statements of the 1,000 largest U.S. public companies (excluding the financial sector), as reported by FactSet / FactSet Fundamentals. Source: REL



Passive Aggression

Why plan sponsors that switch to passive investment vehicles could run afoul of ERISA. By David McCann

For 401(k) plan sponsors, the risk of being sued is seemingly on the rise. Over the past year, plan participants have filed class actions against companies like Verizon Communications, Intel, Chevron, and BB&T over high fees or poor performance. Not surprisingly, some plan sponsors are switching from active funds to index funds and other passive investment vehicles, which generally offer low fees and bring higher returns than many active funds.

According to a 2015 study of 254 plan sponsors by Aon Hewitt, 36% said they were "moderately" or "very" likely to switch some or all of their actively managed funds to index funds in 2016. That would accelerate a trend that's been unfolding for years. At the close of Q1 2016, 49% of assets in target-date funds within 401(k) plans were passively managed, according to Mercer's quarterly TDF survey. That's particularly notable considering that TDFs are drawing the bulk of new inflows into 401(k) plans. Among employees hired within the previous two years, 59% of their balances were invested in TDFs at the end of 2014, the most recent year studied by the Employee Benefit Research Institute.

But if plan sponsors are moving to passive investments primarily to forestall litigation, they could be courting more lawsuits, experts warn. That's because if participants' best interests are not the top motivation for shifting investment strategies, sponsors may not be properly exercising their fiduciary duties.

The Employee Retirement Income Security Act of 1974 (ERISA) requires that plan fiduciaries *solely* take into account the best interests of participants and beneficiaries when making decisions about retirement plans (except decisions such as whether to have a plan or cancel an existing one).

But it appears that more often than not, fiduciaries don't adhere to the rule. In a recent survey of 410 large 401(k) plan sponsors, 57% told Cerulli Associates that the primary reason they decided to offer passively managed investment options was to "alleviate threat of lawsuits/fiduciary concerns." Similarly, 55.3% of respondents identified "fiduciary liability and fear of lawsuits" as a very important factor when making decisions regarding 401(k) plans.

"Someone who has a clear view of what their fiduciary obligations are can't respond to a survey saying they're making decisions in a fiduciary capacity to protect themselves or their company from liability," says Jamie Fleckner, a partner with law firm Goodwin Procter.

Jessica Sclafani, associate director of Cerulli's retirement practice, agrees, adding: "There's an increased interest in passive investing because plan sponsors mistakenly believe it mitigates their fiduciary exposure. Nothing in ERISA says you are protected by offering passive investments."

A History of Litigation

That's not to say plan sponsors don't have legitimate legal concerns. In the 15 years since the implosion of Enron decimated its employees' retirement accounts, which were heavy with Enron stock, plan participants have brought hundreds of lawsuits against sponsors of large retirement plans.

For many years, most such cases were against companies that either offered company stock, which performed poorly, as the only investment option in the plan, or that were alleged in one way or another to have misled or coerced plan participants into buying company stock, following which the stock lost value.

Around 2007, cases began appearing that charged plan sponsors with lack of prudent plan management by selecting funds carrying higher administrative fees than other comparable options. Just in the past two years, and increasingly so recently, the number of such suits has spiked, and the mix of suits "has tilted more toward the fee suits," says Fleckner.

That's happening for a couple of reasons, Fleckner notes. For one, the Supreme Court last year ruled in a case against utility Edison International that after a fund is selected, a fiduciary has

Thinkstock

an ongoing duty to monitor plan investments in it, including fees. Previously, courts threw out many fee cases involving investment options that had been available in plans for longer than the six-year statute of limitations for damages claims that is stipulated in federal law.

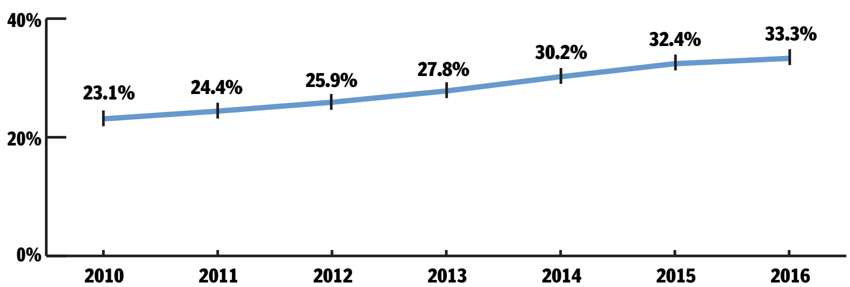
For another, some high-profile fee lawsuits have been settled for big money. For example, in 2015, Lockheed Martin and Boeing settled such cases for $62 million and $57 million, respectively. That has pushed plaintiffs' attorneys to more aggressively target large plans. Fleckner says the trend is disturbing, and not just because it's causing plan sponsors to base plan decisions on inappropriate motivations.

"Litigation is not an efficient way to regulate an industry," Fleckner says. "Each case is very idiosyncratic to particular facts, particular evidence, and maybe to the parties, the lawyers, and the judges."

On the other hand, there likely would be many more fee suits, specifically targeting smaller plans, if the economics of such cases were attractive to plaintiffs' attorneys. Charles Massimo, CEO of CJM Wealth Management, says fiduciaries at the vast majority of 401(k) plans that the firm reviews are in breach of their responsibilities under ERISA.

The most common issue, Massimo says, is related to which "share classes" a plan's funds are in. Essentially, share classes are multiple versions of the same fund, the only difference being the administrative fees, which are highest for individual investors and lowest for large institutional ones. "Most fiduciaries don't realize there can be seven different share classes for a fund," Massimo says. "The majority of plans we see have funds in more expensive share classes when they're eligible for a lower-cost share class."

Going Passive
Total net assets in passively managed U.S. ETFs and mutual funds*



*As a percentage of all investments in such funds, both actively and passively managed
Data as of year-end except 2016 (May 31)
Source: Morningstar

Focus on Costs
In most cases, plan sponsors are not replacing actively managed funds with passive ones. Rather, they're adding a "sleeve" of passive funds to the lineup to provide a low-cost, index-based investment choice in each major asset

GOOD ADVICE: MONITOR ADVISERS

Fiduciary liability is also at the core of a new Department of Labor rule. Slated to take effect in April 2017, the rule is aimed at eliminating conflicts of interest for financial advisers to small retirement plans (those with less than $50 million in assets), individual participants of all plans, and IRA owners.

That's mostly good news for the employer sponsors of small plans, which may not have sufficient financial wherewithal to make sound decisions regarding the plans. But executives responsible for overseeing these plans shouldn't just sit back and relax; rather, they should reevaluate their agreements with their advisers, experts say. And there are implications for large plan sponsors as well.

The DoL's conflict of interest rule requires, with limited exceptions, that any person or entity that renders financial advice to small plans, plan members, or IRA owners, and receives fees or commissions for doing so, must act as a fiduciary in that capacity. That means their advice must be in the best interests of such parties.

Many external advisers to plans already commit in their contracts with their clients to act as fiduciaries. Some don't, though, particularly those who advise small plans.

A commonplace scenario that the rule targets: a plan participant, upon termination of employment, opts to roll over the balance in his or her 401(k) plan to an IRA. The participant goes to the plan's recordkeeper to inquire about doing so, and the recordkeeper recommends its own proprietary IRA, or that of a provider from which it receives fees or commissions, even if those options would not be in the participant's best interest.

"If someone has hundreds of thousands of dollars in an account that gets shaved by 100 basis points instead of 50 basis points, that could really affect the person's quality of life, for perhaps the next 30 years," says Joseph Adams, a partner with McDermott Will & Emery.

While the new DoL rule applies to third-party advice given to plans with less than $50 million in assets, it also applies to advice rendered to participants of plans of any size. And plan sponsors "don't want

class category, as well as an actively managed option in each category, says Liana Magner, leader of U.S. direct contribution investment for Mercer Investments.

Some are taking the more radical approach, though. "We are seeing many plan sponsors eliminating all active management," says Josh Cohen, managing director and head of institutional defined contribution at Russell Investments. "And in many cases, they are moving to the lowest cost possible."

Bradford Campbell, an of-counsel attorney with Drinker Biddle & Reath, points out that ERISA doesn't require plan sponsors to pick the lowest-cost options. It requires them merely to ensure that fees be "reasonable."

"However, the [specter of potential lawsuits] has definitely influenced how plan committees have been looking at investments and made them focus more on costs," says Campbell, who served as assistant secretary of labor for employee benefits during the second George W. Bush administration.

"If they pick the lowest cost," Campbell continues, "they view it as reducing their litigation risk, even though it isn't necessarily the case that a lowest-cost fund is the most prudent one. An investment committee might actually think that a mix of active and passive investments is best, but do they really want to defend the extra cost of litigation? So they just decide to offer a diversified suite of passive investments."

"It isn't necessarily the case that a lowest-cost fund is the most prudent one."

›› Bradford Campbell, former assistant secretary of labor

He suggests, though, that a literal interpretation of "acting solely in participants' interests" may not be necessary in practical terms. What matters more, from an enforcement standpoint, is a written record of motivations for decisions.

If the notes of a plan committee meeting say, "Because we are afraid of litigation, we will dump all of our active funds," that could well be viewed as a violation of ERISA, Campbell says. But if the notes say, "We've concluded that fees are an important part of this decision, and on balance we've decided that our participants will be better served by lower-cost investments," it would be difficult for regulators to demonstrate that it was an imprudent decision, according to Campbell.

Still, Magner cautions plan sponsors that even with passive investment options, there are important decisions to be made for which plan fiduciaries can be held accountable.

"You're still on the hook for making sure you're in the best vehicle for your asset base," she says. "And there are passive strategies out there that have revenue sharing built into them and have higher fees than we would like to see." CFO

DAVID McCANN IS A DEPUTY EDITOR AT *CFO*.

to see their employees' pockets picked on their way out," Adams says. The concern is less for those rolling over their balance to a new employer's retirement plan, which will have fiduciaries in place to protect its new employee's interests.

While the new rule specifically regulates the actions of third-party advisers, plan sponsors have a fiduciary responsibility to monitor whether advisers are in compliance.

The Sponsor's Responsibility

Given the new rule, Adams says, plan sponsors should investigate whether its recordkeeper has a list of recommended IRA providers, and if so, what financial arrangements are in place with those providers.

Companies also should at this time evaluate all of their relationships with plan providers and consultants, says Greg Marsh, executive vice president and corporate retirement plan consultant at Bridgehaven Financial Advisors. They should ask: Are you acting in a fiduciary capacity? Are the proper agreements in place regarding that?

That's because, most observers agree, it may prove difficult for the DoL to effectively police the rule.

To be sure, there are a number of ways a noncompliant adviser could be found out. For example, the department will do random audits and inspections, or a plan participant could complain to the DoL.

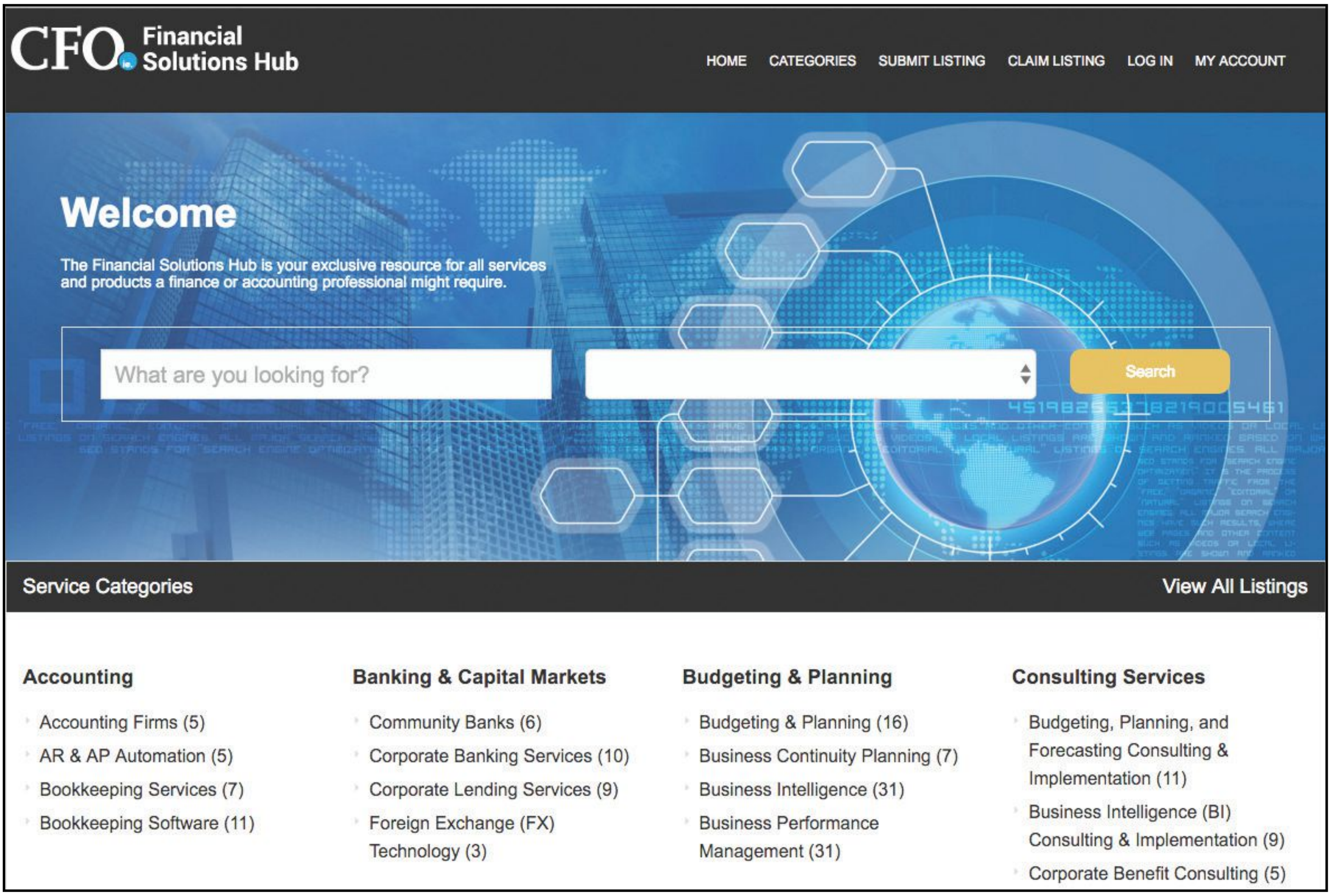
"But, could you also be operating out of compliance for the next 10 years and it goes completely undetected? Absolutely," says Marsh. Adams, though, says that the DoL likely will "carefully pick the right case to make a good enforcement example."

Either way, much of the "enforcement" effectively may be accomplished by private litigation. "Unfortunately, that is a likely outcome of this rule and a valid criticism of it," says attorney Bradford Campbell of Drinker Biddle & Reath.

Campbell notes that while advisers will have to make disclosures, exactly what's required to be disclosed is subject to some interpretation. And they will have to implement policies and procedures related to conflicts of interest, but it's inherently a judgment call as to whether any particular ones will be effective.

"As a result of those built-in ambiguities," Campbell says, "it's going to be a field day for the plaintiffs' bar to bring lawsuits against financial institutions—and potentially against plans, with plaintiffs asserting that a plan sponsor played a role in enabling the financial institution to do the things they say were wrong." **D.M.**

Introducing the CFO Financial Solutions Hub



The Financial Solutions Hub is your exclusive resource for all services and products a finance or accounting professional might require.

Visit www.financialsolutionshub.com

CFO ie.

The Business Of Politics

Second-quarter results from the Duke/*CFO* Business Outlook Survey reflect political uncertainty.

By Chris Schmidt

Political uncertainty is altering the spending plans of U.S. companies, according to the latest Duke University/*CFO* Magazine Global Business Outlook survey. Worried by the upcoming presidential election and continuing Washington dysfunction, nearly half of U.S. firms (47%) are pulling back on hiring or spending.

Despite the political uncertainty, however, the survey's Optimism Index for the U.S. economy remained steady in the second quarter. Financial executives rated the U.S. outlook at 59.4 (on a 0–100 scale), virtually unchanged from the previous quarter and approximately equal to the long-run average. Top concerns remain economic uncertainty, the difficulty of finding qualified employees, regulatory requirements, and the cost of benefits.

POLITICAL RISK TO THE ECONOMY

In this pre–Brexit vote survey, nearly 8 in 10 (79%) U.S. executives believe that the United States economy faces moderate (34%) to large (45%) political risk. Political risk to the economy was found to be lower in Europe (64% reported moderate or large risk for their individual countries) and Asia (69% reported moderate or large risk in their countries). Executives in both Africa and Latin America saw much higher political risks from their countries' economies, with 90% of respondents in Latin America, and 93% of respondents in Africa, reporting moderate or large risk.

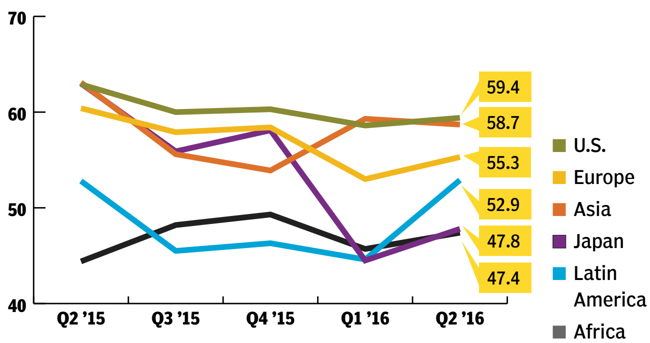
The greatest sources of U.S. political risk stem from the upcoming elections, Washington dysfunction, proposed regulations, and proposals to hike the minimum wage. (See chart, opposite page.) At a point in the U.S. presidential election cycle when gross uncertainty typically begins to diminish, the unique circumstances affecting both the Democratic and Republican tickets have enabled substantial uncertainty to persist, and even grow, both within and across party lines. This unique election cycle has also further applied the brakes to a legislative agenda that had heretofore shown scant forward motion. And CFOs are always

79%

Percentage of U.S. finance executives who believe that the U.S. economy faces moderate-to-large political risk

Globally, economic optimism holds steady

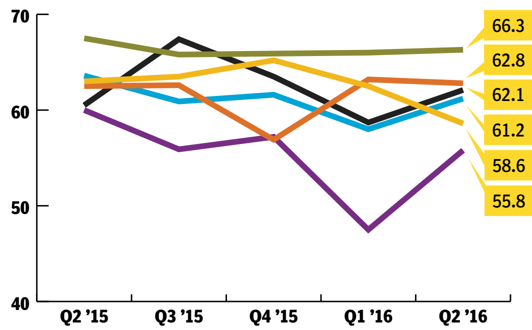
Finance executives rate their optimism about their domestic or regional economy*



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

Company optimism rebounds, except in Europe

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



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

Source for all charts: Duke University/CFO Magazine Global Business Outlook Survey of finance and corporate executives. Responses for the current quarter include 626 from the U.S., 153 from Asia (outside of Japan), 32 from Japan, 130 from Europe, 135 from Latin America (including Mexico), and 113 from Africa.

wary of new government regulations (including changes to the minimum wage), fearing the business disruption, increased costs, and competitive disadvantages that can accompany new regulations.

Faced with this political uncertainty, the executives responding to the survey indicated that they are delaying or scaling back business spending plans until the risk dissipates. Specifically, they say that political uncertainty has led their firms to be more cautious with spending, making acquisitions, and hiring; each was cited by more than one-third of respondents.

OUTSIDE LOOKING IN

Nearly 4 in 10 (38%) U.S. executives believe that foreign companies are wary about doing business with American companies due to U.S. political risks. This perception may be overly pessimistic—only about half as many executives outside of the United States agree that U.S. political risk is causing their firms to be wary of dealing with American firms. This perception by U.S. executives, relative to their counterparts around the globe, may be contributing to the survey's finding that U.S. capital spending will increase by only 1% over the next year, a level that trails the expected inflation rate.

Other countries' willingness to do business with U.S. companies is also directly related to the topic of international trade negotiations and deals, which are a focal point of both U.S. political campaigning and legislative debate. A majority (54%) of U.S. executives think cross-country trade deals are good for the U.S. economy; this is lower than the approximately two-thirds of executives outside the country that favor such alliances. In sum, U.S. executives have a relatively dim view of dealings outside of their own country, compared with other countries' eagerness to do business with them.

AROUND THE WORLD

Elsewhere in the world, economic optimism in Europe increased to 55.3 (on the 100-point scale) this quarter, up from 53 last quarter.

Top European concerns include economic uncertainty, regulatory requirements, government policies, weak demand, and employee morale. With 64% of European executives rating the political risk to their own countries' economies as moderate or large, more than 6 in 10 (62%) companies are holding off on spending or hiring in response.

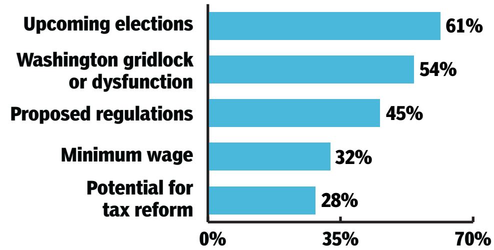
Asian optimism (excluding Japan) averaged 58.7 out of 100 this quarter, not much lower than the 59.3 registered last quarter. In Japan, however, economic optimism made a modest recovery to 47.8, following last quarter's dive to 44.5.

Top concerns across Asia include economic uncertainty, weak demand, currency risk, government policies, and difficulty attracting and retaining qualified employees. With more than half (55%) of Asian executives rating political risk to their economies as moderate or large, an equal number (54%) of Asian companies are holding off on spending or hiring in response.

African optimism inched up from 45.7 to 47.4 this quarter, but African executives are worried about economic uncertainty, currency risk, government policies, limited access to capital, inflation, and difficulty hiring skilled workers. With 93% of African executives rating political risk to their economies as moderate or large (the highest in the world), 7 in 10 (72%) companies also are being cautious about spending or hiring in response.

Latin American economic optimism leapt upward to 52.9 from last quarter's 44.6, as political uncertainties preceding the last survey have been settled in at least some of the countries in the region.

Which political uncertainties are the source of your caution?



Optimism increased in Brazil, Chile, and Ecuador into the mid-40s, and remained much stronger in Mexico (65) and Peru (68.1).

BREXIT BLOWUP

Lastly, European finance leaders were asked about the referendum in the United Kingdom on whether Britain should leave the European Union, the so-called "Brexit." *(The survey closed on June 3; the referendum was held on June 23—Ed.)* European finance executives assigned a 42% likelihood of the Brexit being approved, ultimately doing a better job of predicting the decision to exit the EU than UK betting shops did.

When asked their opinion of a Brexit, strong majorities of European respondents believe that a Brexit would threaten the European Union (77%) and would lead to similar referendums in other EU countries (78%).

Strong majorities of European respondents also believe that the UK remaining in the EU is good for UK businesses (76%) as well as for other European businesses (78%).

Given the surprising outcome of the Brexit vote, these opinions effectively foreshadow a volatile and changing economic future for the UK, EU, and global economy. CFO

Enabling "Eureka!"

A CFO Research survey tests the process and technology path to "instant insight." By Chris Schmidt

CFOs around the world increasingly recognize that the standards for their finance functions' responsiveness and credibility are being raised, and that yesterday's processes and solutions will no longer be able to deliver information that provides a competitive advantage.

To regain this advantage, leading-edge finance chiefs are acting to make sure that the financial planning processes and systems of tomorrow will deliver "instant insight"—based on highly credible data that enables corporate teammates to act confidently, decisively, and correctly.

The clear desire for instant insight was a key finding of a recent global CFO Research survey of more than 300 senior finance executives from companies with more than $500 million in annual revenue. The survey, sponsored by SAP, sought finance executives' insights into how well the current systems and processes their companies use for financial planning and analysis (FP&A) are able to support management's need to keep up with an accelerating flow of information.

So, what will the finance function of the future need to look like as it adapts to the pace of decision making in a fast-changing, global business environment?

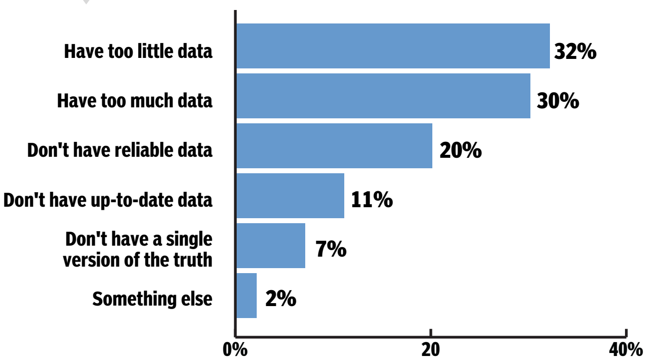
PLANNING IN THE MOMENT

Instant insight allows managers across an enterprise to dynamically plan in the moment—that is, to develop instantaneous responses to business changes using up-to-the-minute data sets of any size at any time. Nearly all survey respondents (94%) agree that, over the next two years, the ability to dynamically plan "in the moment" will become much more important for their companies in allowing them to react to a fast-changing business landscape. In addition, almost all respondents (93%) expect that, in this environment, their finance functions will feel increased pressure to provide managers with instant access to financial information.

For a CFO and a finance team, delivering in-the-moment insights first requires processes and systems that seamlessly access all the data, quickly, with total confidence that data is complete and correct. Without this certainty, the swelling flow of information seen in many organizations poses the danger of overwhelming historical decision-making processes and overloading information systems.

FIGURE 1

The greatest risk to our effective and timely use of FP&A is...



Percentage of respondents
Note: Percentages may not add to 100% due to rounding.

94%
Percentage of finance executives who agree that the ability to plan "in the moment" will become more important over the next two years.

In the survey, a director of finance for a large U.S. manufacturer highlights the challenge at hand: "We have lots of high-quality data being managed in silos in the different functional areas. This data is supported by good logistics and financial systems. However, all this data was telling us different stories depending on its origin (sales, logistics, finance...). We lacked a single story of what was happening."

DELIVERING WHAT'S USEFUL

The survey also confirmed that business managers are increasingly reliant on their companies' finance functions for the most current and credible financial data, as well as the most insightful financial analysis. In the survey, finance executives describe a future environment in which they are required to work more closely with other managers to provide analysis that is based on the most current and the most credible financial data. Nearly 9 out of 10 respondents (89%) say that, over the next two years, they expect pressure will increase to boost the confidence of decision makers in the credibility of the data they use for decision making.

Interestingly, respondents are split between having too little data (32%) and having too much (30%). (See Figure 1.) In addition, respondents indicate that, to some degree, they find themselves sacrificing data quality in order to share financial analysis with managers more quickly. More than 6 out of 10 respondents (63%) say that the need to get financial analysis into management's hands quickly means that the data is not as accurate or reliable as it could be.

Respondents also recognize that there must be a commitment to improving the manner in which instant insights are shared. One way to share data with functions across the business is through visualization tools. Most respondents (87%) expect that their finance functions will be called on to provide insightful and interactive visualizations of financial information.

MOVING PAST MANUAL

One of the biggest obstacles finance leaders say their functions are grappling with is the amount of manual intervention required by their current systems. The more time finance professionals spend in making sure that data generated by different information systems matches up and is credible, the less time they have for working with business managers to provide high-value financial analysis.

As the controller of a large U.S. company in the transportation industry explains, "[The lack of an automated] financial planning and analysis tool means manual, time-consuming processes to produce budgets, trends, and forecasts." With manual processes comes the need to devote more finance resources to transactional and compliance activities, leaving fewer resources available for higher-value analysis. Finance leaders most often identify the increasing complexity and volume of reporting and compliance requirements (32%) and the day-to-day requirements for transactional activities (31%) as the biggest hurdles to making strategic contributions.

Other respondents report that one of their biggest obstacles is that the information tools they are using simply are not up to the task. Many see their current financial planning systems falling short of the demands they expect will be placed on them: nearly 9 in 10 respondents (87%) believe that the processes and systems they currently use for FP&A will require substantial improvements in order to support the need to dynamically plan in the moment.

Another factor weighing down finance's ability to deliver timely and accurate data is the data migration process. Respondents recognize that they could improve both data quality and the finance function's responsiveness by reducing the need for migrating financial data from one system to another. So, for example, nearly three-quarters of finance executives (74%) say that improving the ability to share data seamlessly between ERP and financial planning systems would also provide greater assurance that planning data conforms to actual data. The implication is that, with more-integrated systems, finance could spend less time on manual tasks and validating data, and more time analyzing the data to contribute business insights.

FIGURE 2

An improved ability to share data seamlessly between our ERP and financial planning systems would make a substantial improvement in...

Increased collaboration among users of the systems	76%
Greater flexibility in and customization of financial analysis	75%
Increased responsiveness to fast-changing business conditions	72%
Improved ability to develop a single version of the truth	70%

Percentage of respondents
Multiple responses allowed.

INTEGRATION IS KEY

Respondents are optimistic that integrating ERP and FP&A systems can clear many of the communication and analysis roadblocks that prevent instant insight from being realized. More than three-quarters of respondents (76%) view close integration between systems as a way to increase collaboration among users.

An equal number (75%) view close integration between systems as a means of improving the usefulness of financial data by allowing greater flexibility in and customization of financial analysis. Other benefits include boosting responsiveness to rapidly evolving business conditions (72%) and improving the ability to develop a "single version of the truth" (70%). (See Figure 2.)

In sum, the survey confirmed that making wider and more effective use of financial data in a fast-changing environment is capturing more and more of the CFO's attention. While it appears that the path to achieving instant insight will require finance to focus substantial attention on this goal, at least the path appears reasonably well marked. CFO

THE QUIZ

Summer Spectacle

On August 5, the Summer Olympic Games will open in Rio de Janeiro. Thought to cost as much as $20 billion to stage, the quadrennial event takes place amid Brazil's worst recession since the 1930s, the impeachment of Brazilian president Dilma Rousseff, and the threat of the mosquito-borne Zika virus. Test your knowledge of the 2016 Olympics by taking our quiz.

1. Known as "the Miami of Rio," this neighborhood in Rio de Janeiro is the location of the Olympic Park:

   A. Barra da Tijuca
   B. Copacabana
   C. Maracaña
   D. Ipanema

2. The yellow cat-like mascot of the Games is named after a Bossa Nova musician who co-wrote "The Girl from Ipanema." What is the mascot's name?

   A. Vinicius
   B. Astrud
   C. Antônio
   D. Opie

3. In addition to Rio de Janeiro, five cities will host Olympic soccer games. Which of the cities below will *not* host soccer?

   A. Brasilia
   B. Recife
   C. São Paulo
   D. Belo Horizonte

4. These two sports are returning to the Olympics for the first time since the early 20th century. Name the sports:

   A. Golf
   B. Ultimate Frisbee
   C. Rugby
   D. Mall walking

5. To be held from September 7 to September 18, Rio's Summer Paralympic Games will be the biggest ever. How many athletes are expected to compete?

   A. 1,350
   B. 2,350
   C. 3,350
   D. 4,350

6. According to a recent study, the average cost overrun (in real terms) of Olympics held from 1960 to 2012 was:

   A. 82%
   B. 101%
   C. 147%
   D. 179%

7. How many Olympic Games experienced no cost overruns between 1960 and 2012?

   A. 0
   B. 1
   C. 2
   D. 3

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

Sources: www.rio2016.com; *New York Times*; Bent Flyvbjerg and Allison Stewart, "Olympic Proportions: Cost and Cost Overrun at the Olympics 1960-2012," working paper (Saïd Business School, University of Oxford, 2012)

www.rio2016.com