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26 Cover Story
Human Capital’s Big Reveal
Disclosing vital data about a company’s workforce will soon be the norm. Will U.S. businesses fall in line?
By David McCann

34 Easy Money?
Private capital providers are fighting to finance middle market firms. But finance chiefs should proceed with caution.
By Russ Banham

40 Special Report: Mergers & Acquisitions
Buyers Beware
Acquirers play a risky game if they cut corners on due diligence.
By Tam Harbert
Up Front

4 | FROM THE EDITOR
6 | INBOX
8 | TOPLINE: Time to scrap annual impairment testing? | CFOs can handle the COO role, too | CFOs stay cautious on cash holdings | U.S. trade policy fails | Financial app buyers stuck in the present | and more

16 | HEALTH BENEFITS
What Are the Top Health Benefits Priorities for 2020?
Here’s what health plan sponsors should be thinking about this contract season.
By Dorian Smith

18 | BUDGETING
The Zero-Based Mindset
Starting from a “zero base” is not only a budgeting technique—it can reshape the customer portfolio.
By Kris Timmermans and Chris Roark

20 | WORKPLACE ISSUES
10 Steps to Effective Finance Meetings
Here’s a playbook for making meetings work the right way.
By Mitchell York

22 | STRATEGY
Effective Capital Allocation
A disciplined, rigorous approach to making investment decisions is the key to winning superior returns.
By Glenn Schiffman

24 | CAPITAL MARKETS
Navigating Reference Rate Reform
With Libor’s days numbered, companies should start transitioning immediately to new reference rates.
By Ramona Dzinkowski

By the Numbers

44 | BUSINESS OUTLOOK
Duke University/CFO Survey Results

IMMIGRATION: THE ANSWER TO THE TALENT GAP?
U.S. finance chiefs are strongly in favor of more accommodative immigration policies, even as they prepare for a potential recession.
By Lauren Muskett

46 | FIELD NOTES
Perspectives from CFO Research

LEAD PERFORMER
CFOs aim to break out of their traditional roles to boost enterprise performance.
By Chris Schmidt

48 | THE QUIZ
Back to School
Can you score 100% on this finance test? No cheating!
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Let’s face it: some business executives consider corporate finance a backwater. Much of the work is unsexy: Yes, you might have a day ringing the bell at the New York Stock Exchange, or shaking hands on a billion-dollar merger, but they are rare. CFO work is more often about tasks like optimizing back office systems, devising new ways to forecast cash flow, and translating the new lease accounting rules. Right?

Fortunately, we are living in very interesting times. All the substantive changes going on in the economy, politics, technology, and the capitalist system itself are going to push finance chiefs beyond their comfort zones. In that vein, here are three things you should be thinking about as summer vacation memories fade and the leaves start to change color.

**The Economy.** No one is predicting that central banks’ monetary easing will produce a burst of economic growth in the United States or anywhere else. Can your organization withstand a global economic slowdown? Does your company have a plan to do so? Will your balance sheet survive a U.S. recession that may arrive as early as 2020?

**Technology.** Digital transformation is a big job for finance departments. But just take one subset of it: adopting artificial intelligence (AI) tools. How well do you understand artificial intelligence and what it can do for your company now? How will your team go about developing AI use cases? Does your company have experts that can tell which products offer genuine artificial intelligence capabilities and which are just promoted that way?

**Corporate Purpose.** America’s CEOs finally came out and said it: Businesses must work for the benefit of all stakeholders, including customers, employees, suppliers, and the communities in which they operate. No publicly held company is going to throw out shareholder primacy, but from now on there may be pressure to pay more than lip service to those other constituencies. Will your management team and board of directors embrace this change or hide from it? How can this new paradigm be incorporated into enterprise decision-making? What are the reputational risks of ignoring these other stakeholders?

Welcome back.

Vincent Ryan
Editor-in-Chief
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In response to “The Hard Part of Boosting Liquidity” (June/July), this year’s edition of our Working Capital Scorecard, Steven McLendon, the CEO of Balanced Inventory, enthused, “Excellent report! We commend you for addressing the key obstacle to boosting liquidity—inventory investment—and how to make real headway companies must gain control by viewing inventory in terms of Days Inventory Outstanding.”

He continued, “While many try to reduce the risk of stock-outs by building up inventories, this strategy is not sustainable as variations in demand/supply and long lead times continue to grow. **We routinely see companies holding two to three times the inventory required** to effectively meet demand.”

“Fresh Evidence of Auditor Bias Emerges” (CFO.com, Aug. 12) told of an academic study concluding that companies penalize auditors who opine that there are material weaknesses in their clients’ internal controls. After rendering such opinions auditors are replaced at a greater-than-average rate, and **auditors therefore are reluctant to honestly report on internal controls material weaknesses (ICMW)**, the study found.

“No company wants to be called out for ICMW or the new Critical Audit Matters,” one audience member wrote. “That being said, I, as a C-suite person, find it hard to believe that the management/board of a company is not already aware of such. Rather than correct the issue, it’s ‘shoot the messenger.’ And too, the accounting firms need to better communicate with the board, explaining why they have a concern.”

In response to “Five Ways CFOs Can Use AI—Today” (CFO.com, July 3), by EY’s Nigel Duffy, a reader pointed out that few people think about how **AI will not just predict demand, but also create it**.

“AI will not only predict what products my customers will buy, it will also predict what products I (should) design,” he wrote. “The speed of disruption will accelerate in ways we can’t imagine. There will be an Uber or Airbnb shakeup in every industry.”

He added, “Today AI can identify where embezzlement has occurred. Imagine when it predicts who will commit it and when. **AI is not over-hyped, it’s just not fully realized—yet.**”

“Facebook Hit with Record $5B Fine over Privacy Breaches” (CFO.com, July 24) spurred a musing about fair play: “Who gets the $5 billion? My privacy was breached. How much will I get?”
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FASB lays out the case for rethinking the approach to goodwill accounting. By Vincent Ryan

As far back as the spring of 2016, the Financial Accounting Standards Board told CFO that it planned to take another look at goodwill accounting for public companies. At the time, FASB had issued a proposal to change the guidance for goodwill impairment, which later was adopted.

The next step for FASB was to consider whether to permit or require the amortization of goodwill. “Advocates of allowing companies to amortize the recognition of goodwill in the years following a merger argue that it would free companies of a burden that has no limits,” we wrote three years ago.

That burden, of course, is having to perform annual impairment tests, often requiring hiring outside valuation experts to determine the fair market value of acquired reporting units. As CFO pointed out, “Annual goodwill analysis and reporting never ends for a company after it has acquired another entity. If companies were able to amortize goodwill, then at some point it would vanish from their books.”

Fast forward to July 9, 2019. FASB issued an Invitation to Comment (ITC) seeking input from preparers and investors on the accounting for certain identifiable intangible assets acquired in a business combination and on the subsequent accounting for goodwill. Comments are due October 7.

ITCs are published, explains supervising project manager Joy Sy, when the board is not leaning one way or another on an issue. And indeed, the answer to the question of whether annual goodwill impairment testing actually is a burden is not clear-cut.

Before getting a reprieve from FASB, private companies said they struggled with the cost and complexities of the testing. But when FASB has asked public companies about it, “we have heard very split views,” says Sy. “Some very large issuers say they don’t have to dedicate a lot of resources [to goodwill] impairment testing and indicate they would still perform the test if FASB didn’t require it.”

Financial statement users don’t agree on the current approach, either.

According to the ITC, the current impairment model can confirm the existence of an underperforming acquisition. In addition, impairment charges can be “a mechanism for holding management accountable for poor capital allocation decisions.”
But some investors don’t think impairment testing provides meaningful financial information. Why? According to the ITC:

- Goodwill impairments are non-recurring charges often removed from investors’ analyses or eliminated through a non-GAAP metric.
- Impairments to goodwill are confirmatory, at best, after observing other information, including other elements of financial statements such as cash flows.
- Impairment charges are generally a lagging indicator of the external and internal economic factors that give rise to goodwill impairment.

As an alternative, the amortization model would assign a useful life to goodwill and amortize it on a straight-line basis. That useful life could be prescribed by FASB or determined by management’s judgment, which presumably would be based on the weighted average useful life of the assets the company acquired.

In the second instance, instead of a yearly test most of the work would occur upfront. Instead of having to hire external valuation specialists to generate a fair market value for a reporting unit, the issuer might be able to perform the work in-house.

There’s a caveat: Management would still be required to assess goodwill for impairment—even if straight-line amortization is adopted.

Some users indicated that amortization of goodwill would have little to no informational value for investors, especially if the useful life is prescribed.

The ITC explores other alternatives to the status quo. For example, the requirement to assess goodwill at least annually could be removed, and the standard could require only that an entity assess goodwill for impairment following a change in circumstances or a “triggering event.”

The FASB paper also raises the possibility of adding quantitative information to the qualitative descriptions of the factors that make up recognized goodwill. That option, though, seems likely to spark opposition from preparers and issuers.

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**CAREERS**

**CFOs Can Handle the COO Role, Too**

Study shoots holes in the notion that holding both jobs is ill-advised.

- Is it reasonable for CFOs to take on the additional position of chief operating officer?
- Indeed, there are reasons companies might hesitate to add COO duties to a CFO’s plate. For one, it can be argued that the dual role might overburden the executive. For another, the combination of operational objectives (tied to COO incentives) with financial reporting could lead the executive to opportunistically use accruals to meet operational targets.

A study in the *Journal of Management Accounting Research* could help allay such concerns. Its conclusion: “Managers from a financial background can fulfill operational roles admirably.” The research yielded no evidence that “CFO/COO duality” adversely affects operations.

Regarding financial reporting quality, accruals by companies with CFO/COO duality “are relatively more predictive of future cash flows compared with the accruals of control firms,” the researchers wrote.

The study, whose findings derive from data on a large sample of companies from 2000 through 2016, matched companies where the same person was CFO and either COO or president with similar companies where the two positions were separate.

In one analysis, such duality firms and their matches were compared on operations and financial reporting.

Controlling for numerous factors, the authors assessed the quality of financial reporting through measures of discretionary accruals—that is, non-cash accounting items that typically entailed some kind of estimate (such as anticipated revenues from credit sales or predictions of future write-offs of bad debt) and therefore can lead to managerial manipulation.

The researchers found that duality firms have an edge in estimations, as measured by the concordance between asset-increasing accruals in one year and increased cash the following year.

To assess the quality of operations, the researchers measured discretionary expenditures (advertising plus R&D plus sales, general, and administrative expenses) in one year against cash flow and return on assets the following year.

They found no evidence that the discretionary expenditures of CFO/COO duality companies influenced future cash flow or ROE “in a way that differs from matched firms.” —DAVID MCCANN
CFOs Stay Cautious On Cash Holdings

Credit may be bountiful and cheap, but finance chiefs refuse to play fast and loose with the cash on their balance sheets or spend big on capital investments that will deplete liquidity.

Restraint characterized the strategies for cash deployments and short-term investments for the bulk of 2018 and the beginning of 2019, according to the latest Association for Financial Professionals liquidity survey.

In the 12 months to March 2019, about half of the 496 surveyed finance and treasury professionals said the size of their cash hoards had not changed much, either domestically or outside the United States. Of those whose overall cash balances had changed, 20% said their cash levels were smaller and 30% said they were larger.

Increased operating cash flows, higher debt levels, and a pullback in capital expenditures were most often cited as the reason for more cash on hand.

The survey results, released in late June, were somewhat surprising, given 2017’s federal corporate tax cut designed to boost bottom lines and promote corporate investment.

“Advocates of the [Tax Cuts and Jobs Act of 2017] hoped the law would motivate organizations to loosen their purse strings and invest in hiring, increase capital spending, and raise wages,” the AFP noted.

By March 2019, when the survey was conducted, “business leaders had sufficient time to explore how their organizations could best benefit from the TCJA,” the AFP said. But a majority of them (57%) made no changes in their spending or allocation patterns as a result.

Less than one-fifth (17%) of organizations had paid down debt or supported their share repurchase programs (14%) with the proceeds from the tax cut. Only 11% said they increased capital expenditures.

Looking ahead, 61% of treasury and finance professionals reported that their organizations would continue to follow the same script in the coming months, retaining the size of their cash balances. | V.R.

U.S. Trade Policy Fails

Significant changes to U.S. trade policy aimed at bringing manufacturing back to America are not having the desired impact, according to a report from A.T. Kearney.

In fact, the consulting firm showed that manufactured goods imports to the United States from the 14 largest low-cost-country (LCC) trading partners in Asia actually rose by $66 billion last year. That represented a 9% increase, the largest annual spike since the beginning of the economic recovery a decade ago. By comparison, U.S. gross manufacturing output grew only 6% year over year in 2018.

“Manufacturers continue to view LCCs as a more desirable location than the U.S. to produce or purchase a wide variety of goods, notwithstanding the trade measures emanating from Washington,” A.T. Kearney said.

The government’s trade policy measures designed to stimulate U.S. manufacturing have included:

- Tariffs of 10% to 25% on hundreds of billions of dollars’ worth of Chinese goods
- Tariffs on steel (25%) and aluminum (10%) originating from Canada, Mexico, and the European Union
- The foreign-derived intangible income (FDII) tax deduction that allows companies to claim a deduction on income generated from goods produced in the U.S. and sold overseas

Why haven’t these policies produced an uptick in the reshoring of manufacturing?

“The fundamental economic benefits of manufacturing in LCCs have not significantly changed, and the FDII tax benefits have not outweighed the significantly lower unit costs to manufacture offshored products,” the report noted.

Manufacturing in China indeed is more expensive because of the tariffs, “but it was already heading in that direction as labor costs have continued to creep upward over the past several years,” A.T. Kearney wrote. And that has led manufacturers to shift operations in recent years to LCCs such as Vietnam and India.

“So rather than incentivizing manufacturers to reshore, the trade spat with China has just accelerated this ongoing shift toward those countries,” the report noted. | D.M.
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Most organizations will fail to realize the full value from purchasing new financial applications because they're not accounting for digital capabilities they'll need in the future, according to Gartner.

Finance departments should seek solutions that will enhance their ability to innovate, rather than settle merely for efficiency gains, Gartner advises.

“The criteria on which financial applications are being selected today largely do not reflect the future needs of these departments,” says Gartner analyst John Van Decker.

The firm’s research found that significantly more financial application buyers sought to improve efficiencies than targeted better business outcomes. (See below.) That suggests buyers are overemphasizing simply improving their systems of record, while not accounting for differentiation and transformation opportunities, according to Van Decker.

The purchase of financial software, including financial planning and analysis and financial close applications, continues to be driven by ease of use, functional capabilities, flexibility, and price. That suggests buyers largely view the market as commoditized, with the result that organizations aren’t capturing the solutions’ full value.

“We continue to see many organizations fail to go beyond the basic functionality of the solutions they purchase,” Van Decker said. “Some organizations see their solution as simply an upgrade on legacy technology and overpay for advanced functionality they never use.”

To ensure that a solution drives greater value, application buyers should define a project plan before implementation, Gartner counsels. Also, they should look for focused solutions that feature predictive analytics, AI/machine learning capabilities, and proven acceptance outside finance for use in integrated financial planning. | D.M.

Why Companies Upgrade Financial Apps

79% of financial application buyers sought to improve efficiencies

59% of them targeted better business outcomes

36% thought cost improvement was a reason to upgrade financial applications

9% cited driving revenue growth as a factor in their buying decisions

Source: Gartner

BUSINESS TRAVEL

A Strong Travel Culture Pays Off

Business travel costs should, of course, be managed. But CFOs who care foremost about managing the expense may not be aligned on travel priorities with a majority of leaders throughout their organizations.

Harvard Business Review Analytic Services surveyed 587 executives and managers who indicated they were familiar with their organization’s corporate travel policies and culture.

Two-thirds of them identified “treating travel as a strategic investment that adds business value rather than a cost to be minimized” as an important aspect of corporate travel culture.

Respondents could select up to three such aspects from a list of 11. The next-most-cited one, at 43%, was “providing a suite of corporate travel tools/technology that are effective and easy to use.” Close behind at 42% was “having a flexible travel policy (e.g., being able to travel any distance at any time to any location to support the business).”

Oddly, perhaps, “providing appropriate funding for corporate travel” and “having executive buy-in/support for corporate travel” were cited as important aspects of corporate travel culture by only 30% and 19% of respondents, respectively.

The survey was sponsored by Egencia, a travel management company and a subsidiary of Expedia Group.

Four in 10 survey participants (41%) said that having a strong travel culture is extremely or very important to their organization’s performance. However, less than a third (31%) of them self-identified their organization as actually having a strong travel culture. | D.M.
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TAX

Will Tax on Nonprofits Snare Companies?

Companies with affiliated tax-exempt entities could find themselves surprised to be on the hook for a new tax, in light of interim guidance recently released by the Internal Revenue Service. A controversial provision of the Tax Cuts and Jobs Act imposes a 21% excise tax on compensation that exceeds $1 million for the “covered employees” of tax-exempt entities. Such entities include 501(c)(3) public charities, private foundations, and other 501(c) exempt organizations.

Covered employees include the five highest-paid employees of an “applicable tax-exempt organization” (ATEO), as well as any employee who was a covered employee of the entity (or any predecessor) for a preceding tax year beginning after Dec. 31, 2016. “Once an employee qualifies as a covered employee, the employee remains a covered employee permanently, even in subsequent taxable years when the employee is no longer one of the five highest-compensated employees of the [tax-exempt organization],” law firm Goodwin Procter said in a recent notice.

The tax is assessed on the organization, not the covered employee. But why are for-profit companies at risk? As clarified by the interim guidance, the tax applies to companies with affiliated ATEOs where a company executive fitting the definition of “covered employee” is also an employee of the ATO. That’s the case even when the executive’s compensation is paid by the for-profit company. “As incredible as [it] may seem, it is possible that the IRS might seek to enforce that interpretation,” Goodwin wrote, citing recent remarks by IRS representatives.

The IRS has requested comments on how it should address that scenario in forthcoming proposed regulations that will serve as additional guidance for applying the excise tax.

COMPLIANCE

Walmart’s FCPA Fail

For more than a decade, retail giant Walmart failed to operate a sufficient anti-corruption compliance program and allowed subsidiaries in Brazil, China, India, and Mexico to employ third-party intermediaries who made payments to foreign government officials. As a result, the Securities and Exchange Commission in late June charged Walmart with violating the Foreign Corrupt Practices Act (FCPA).

The SEC detailed several instances when, beginning in 2005, Walmart planned to implement proper FCPA compliance and training, only to put those plans on hold. The company also allowed deficient internal accounting controls to persist in the face of red flags and corruption allegations, the SEC said, and didn’t thoroughly investigate instances of possible corruption upon becoming aware of them.

For example, in July 2011, an anonymous source sent an email to Walmart executives alleging that an employee of its India subsidiary was making improper payments to government officials to obtain store operating permits and licenses. Although a Walmart executive requested that internal investigators examine the allegations, Walmart did not conduct an inquiry.

Another corruption risk identified was a Mexico subsidiary’s practice of making payments in the form of checks, cash, and merchandise to Mexican municipalities and local government entities. In some instances, the donations were made around the time the subsidiary obtained permits or other government approvals.

The donations occurred for several years until April 2011, when the subsidiary implemented sufficient internal accounting controls regarding donations. “Walmart valued international growth and cost-cutting over compliance,” said Charles Cain, chief of the SEC enforcement division’s FCPA Unit.

Walmart agreed to pay more than $144 million to settle the SEC’s charges and approximately $138 million to resolve parallel criminal charges by the U.S. Department of Justice.
C-Suite Ignores Spreadsheet Risks

Companies are exposing themselves to financial and reputational risk by overlooking the vulnerabilities in spreadsheets, according to a survey by Forrester Consulting and Incisive Software.

In a survey of manager-level and above personnel at 170 midsize and large North American businesses, more than a third of respondents believed spreadsheet risk was not a priority in their organizations, and nearly a third said that while they recognized spreadsheet risk, executive management did not.

Many frontline workers recognize that spreadsheet risk is real, Forrester said in its survey report. However, “C-level executives are making decisions based on [spreadsheet] data that’s assumed to be accurate but can contain errors.”

While Excel, for example, has some protections, it is weak on content security and offers no location security.

“While Excel does provide worksheet and workbook password-based protection, cell locking, and hiding of formulas, and password protection of macros and add-ins, the level of protection provided is relatively low, provides a first-line-of-defense only, and can be broken fairly easily,” according to SpreadsheetSentry.com.

More than a quarter (28%) of respondents said they were “very” or “mildly” concerned and working to change their organizations’ approach to managing spreadsheet security. But 30% with similar levels of concern said they were not in a position to do so, and 11% weren’t sure how to go about risk mitigation.

The study, conducted in March, also confirmed that spreadsheets are still widely used for critical business tasks. For example, nearly 50% of companies still rely on spreadsheets for auditing and controls; and more than 35% of finance and accounting departments regularly use spreadsheets to fuel decision-making. | V.R.
What Are the Top Health Benefits Priorities for 2020?

Here’s what health plan sponsors should be thinking about this contract season.

By Dorian Smith

Employers and plan sponsors face no shortage of policy and compliance issues to consider when finalizing 2020 health and fringe benefit offerings, contribution strategies, vendor terms, plan operations, and employee communications. An array of recent and potential changes from Congress, federal regulators, courts, and the states—and the quickening pace of marketplace developments—makes monitoring and planning for these issues more demanding and complicated than ever.

The divided Congress, with its Democrat-controlled House and Republican-controlled Senate, dims the odds of major changes to the Affordable Care Act (ACA). But President Trump and federal agencies are pressing forward with numerous policy changes. For employers, some changes could increase cost-shifting and complexity.

Below are the compliance developments to address or monitor for the upcoming year.

Congress

Employers’ legislative wish list includes several reforms. Examples include measures to reduce health care costs, make health savings accounts (HSAs) more flexible, simplify ACA reporting duties, and ensure that legislation curbing surprise medical bills doesn’t increase costs for employers.

Major legislative changes are unlikely, but bipartisan support could move modest drug-pricing reforms and measures aimed at ending surprise medical bills to enactment this year.

Agencies

Wellness programs need review for 2020, since the Equal Employment Opportunity Commission (EEOC) rescinded its rules on financial incentives under the Americans with Disabilities Act (ADA) and Genetic Information Nondiscrimination Act (GINA). This action came after a court order nullified the incentive limits in the EEOC’s revised rules for wellness programs.

For employers offering mental health and substance use disorder benefits, confirming ongoing compliance with the Mental Health Parity and Addiction Equity Act (MHPAEA) is a priority, given heightened agency enforcement and increased private litigation.

Rapid development of new information technologies that allow quick access to data protected by the Health Insurance Portability and Accountability Act (HIPAA) means plan sponsors must evaluate each new IT vendor relationship for compliance with evolving guidance.

Courts

Action in the courts also has the potential to reshape benefits and program administration. Parties continue to seek broad repeal of the ACA through litigation. Other legal challenges seek changes to specific ACA regulations, such as the contraceptive coverage mandate’s religious and moral exemptions, and the association health plan (AHP) rules.

States

States are intensifying their focus on health care policy by taking steps to reinforce or weaken the ACA and pursue their own reforms, cost controls, coverage mandates, and consumer protection measures.

A major trend meriting close attention is the proliferation of state and local paid-leave laws. Many employers are now reviewing how to integrate their current leave programs with a growing patchwork of compliance duties.
2020 Group Benefit Planning

The following list highlights 10 top compliance-related priorities for 2020 health and fringe benefit planning.

Ongoing ACA concerns for large employers. Review coverage and eligibility terms in light of employer shared-responsibility (ESR) strategy, factoring in the 2020 affordability safe harbors and minimum value determinations.

Evaluate ESR and minimum essential coverage reporting processes, including the adequacy of records to respond to any IRS inquiries. Ensure that employer-sponsored group health plans comply with ACA benefit mandates. Monitor ACA developments, including litigation with ACA benefit mandates. Monitor sponsored group health plans comply any IRS inquiries. Ensure that employer-the adequacy of records to respond to

State activity. Appraise state laws raising concerns for group health plans. For insured plans, expect more activity on surprise medical bills, new health coverage mandates, and AHP options.

State initiatives that could affect all employers include health plan reporting mandates, prescription benefit manager regulations, and telemedicine laws.

Employers should also track state innovation waivers under ACA Section 1332 and state regulation of AHPs to identify any restrictions that may affect plan design. Employers should work with vendors to ensure compliance with these initiatives.

Data privacy and security. Evaluate each new tech vendor that has access to health and welfare plan data to determine whether HIPAA or other data-protection and privacy laws apply. Wellness and transparency tools, mobile apps, and artificial intelligence may implicate HIPAA and other laws.

Regularly review vendor compliance, since any breach or violation could create plan sponsor obligations and liabilities. Monitor how HIPAA enforcement and guidance evolves to address apps and emerging technologies. Track whether changes to public-sector HIPAA rules have an impact on data sharing in the private sector.

Health savings accounts and health reimbursement arrangements.

Review employer-sponsored health benefits and programs that might provide HSA-disqualifying coverage, and determine if changes are warranted. This review should include stand-alone, health-related benefits and programs available to all employees—regardless of high-deductible health plan (HDHP) enrollment—as well as benefits and programs available only to HDHP participants.

Adjust plan design and administration, and update plan documents and employee communications for 2020 HSA/HDHP inflation-adjusted amounts.

Mental health parity. In light of heightened focus on the MHPAEA and the opioid crisis, review benefit plans for compliance with parity guidance, ERISA standards, and best practices. Prepare to respond to disclosure requests.

Wellness programs. For wellness programs that include a health screening, evaluate the need for any design changes due to the removal of the EEOC’s incentive limit rules. Consider working with consultants and vendors to make adjustments that minimize litigation risk and program disruption.

Keep in mind that the EEOC’s other ADA and GINA rules for wellness programs still apply. If tied to a group health plan, wellness programs must also comply with HIPAA rules, including reasonable alternative standards for health-contingent wellness programs.

Paid leave. Assess employer-sponsored paid leave programs, including sick, disability, and parental/family leave. Monitor state and local legislation for new and expanded mandates and programs. Evaluate processes for integrating state and local paid leave mandates with existing plans, and revise plans as needed to comply.

Multi-jurisdictional employers should consider developing a long-term strategy for equalizing leave benefits across jurisdictions and administering increasingly complex programs.

Prescription drug costs and coverage. Monitor legal and other changes at the federal and state levels targeting the increasing cost of prescription drugs. Evaluate the impact of these changes on prescription drug benefits, and reassess health plans’ drug-purchasing strategies.

Cross-plan offsetting by ERISA plan service providers. Review whether third-party administrators or issuers are using a practice known as cross-plan offsetting to recoup over-payments to health care providers. Decide how to address this practice, if necessary. Comply with ERISA fiduciary standards when selecting and monitoring service providers, including reviewing fees for reasonableness.

Preventive services. Confirm that non-grandfathered group health plans cover ACA-required, in-network preventive services without any deductible, copay, or other cost sharing.

Modify preventive-care benefits for the 2020 plan year to reflect the latest recommendations from the U.S. Preventive Services Task Force, the Health Resources and Services Administration, the Centers for Disease Control and Prevention’s Advisory Committee on Immunization Practices (ACIP), and ACA guidance.

Dorian Smith is national practice leader for Mercer’s law and policy group. Mercer consultants Cheryl Hughes, Geoff Manville, Katharine Marshall, Kaye Pestaina, and Catherine Stamm contributed.
The Zero-Based Mindset

Starting from a “zero base” is not only a budgeting technique—it can reshape the customer portfolio, realign the organization, and unearth value in the supply chain. By Kris Timmermans and Chris Roark

Successfully balancing between increasingly evasive sales growth and earnings performance in the modern business environment would seem to require a finance chief with a magical touch. With evolving demands from stakeholders come evolving business strategies designed to respond to them. In finance, that means traditional cost management practices like zero-based budgeting (ZBB) are no longer enough. We’re in the age where companies need to embrace a holistic zero-based mindset, what we call ZBx. This mindset is underpinned by automation and digital tools and is designed to radically shift cost curves and reallocate the critical resources needed to fuel a business strategy. ZBx also creates a culture of innovation, allowing companies to achieve start-up speed at enterprise scale.

Increasingly, companies are adopting a zero-based mindset in response to market demands for corporate strategies centered around sustainable growth. Solving for the “x” in ZBx requires a four-pronged approach through a zero-based lens—zero-based organization, zero-based commercial, zero-based supply chain, and zero-based spend.

Organizational Realignment
Zero-based organization (ZBO) lets companies design the organization from a clean sheet, shifting talent toward work that contributes to the distinctive capabilities, operating model, and outcomes needed to fuel growth.

ZBO challenges a company’s strategic ambition, choices, and distinctive capabilities without the biases of the past. Think of it as kicking the tires on what a company will and will not do, as well as what it will do differently. Staying relevant means developing a growth strategy and quickly realigning to a more agile organization to support it.

However, serious soul-searching is a prerequisite for ZBO approaches. Companies must question what is happening in their company and use it to feed the clean-sheet design that informs a future operating model—at either the enterprise or functional level. The right people doing the right work is critical to fuel profitable growth. Yet, talent is a fluid ecosystem of fixed and variable human labor, bots, virtual and cognitive agents, and customers and suppliers. ZBO designs for this boundaryless ecosystem.

With ZBO, companies work simultaneously on two fronts to drive competitive advantage and growth: One, they focus on “getting brilliant at the basics” with process excellence and more efficient execution of core functions. And two, they are always “cutting new ground” to drive innovation, build distinctive capabilities, and engage customers in wholly new ways.

Customer Economics
Companies that can identify their most strategic and profitable products, services, channels, and customers have created the foundation to crack the code on zero-based commercial (ZBC). ZBC centers around building competitive and economic models that allow for segmentation and prioritization of investment across the business. By starting with a clean-sheet view of investments in marketing and innovation, finance and business leaders can calibrate where both over- and under-investment is occurring.

But the insight and optimization does not stop there. This view also allows for better alignment of sales force coverage, customer service, and billing and shipping costs, among other go-to-market priorities.

Executives are often surprised to find the degree to which highly unprofitable customers can drag down an entire company’s economics and distract from strategic priorities. Insights like
these can help reshape the customer portfolio to improve profitability and rebalance customer experiences to align with value.

Today’s customer journey is more complicated than ever, so traditional analysis of customers, channels, and product mix may no longer provide the same insights as they did in the past. Achieving game-changing results from ZBC requires the strategic fundamentals of “where to play” and “how to win” to be addressed with rigor and granularity.

**Supply Chain Levers**
The supply chain holds more value than most companies realize. With half of a company’s costs in the supply chain or costs of goods sold, many companies fail to build a clear picture of who’s spending what and where.

To accelerate change and identify all unnecessary costs, zero-based supply chain (ZBSC) uses three levers: price, performance, and value engineering, focusing on long-term sustainable cost reductions. These initiatives cover every aspect of the supply chain, from turn-

![Chris Roark](image1.png) ![Kris Timmermans](image2.png)

ing by-products into a source of extra revenue, through reducing the amount of finished goods damaged in handling and transportation, all the way to analyzing the physical footprint of plants and distribution centers to identify consolidation opportunities.

For example, one global products company, which was under continual cost pressure, adopted a zero-based supply chain approach to reset its baseline yearly. The company expanded existing zero-based principles to cost of goods sold, with an initial focus on logistics.

By applying advanced analytics and technology across the supply chain—including automation for picking and packing and warehousing, and predictive analytics for optimizing move-

**The Zero Effect**

Applying the zero-based approach organization-wide, not only in SG&A, reallocates resources to new sources of growth.

<table>
<thead>
<tr>
<th>Costs</th>
<th>Zero-based commercial (ZBC)</th>
<th>Zero-based supply chain (ZBSC)</th>
<th>Zero-based organization (ZBO)</th>
<th>Zero-based spend (ZBS)</th>
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</thead>
<tbody>
<tr>
<td>Direct Costs</td>
<td>optimizes customer service and pricing to deliver superior customer economics.</td>
<td>identifies the “should-cost” of COGS and cost reduction opportunities across three levers: price, performance, and value engineering, while optimizing product and service complexity.</td>
<td>designs the organization from a clean sheet to shift talent from work that no longer contributes to desired outcomes to the distinctive capabilities required to win in the future.</td>
<td>enables organizations to identify discretionary consumption of nonlabor overhead expenses through a unique lens of granular cost visibility. This allows leadership to make the right choices to change the culture of the organization, ultimately freeing up cash that can funnel into growth initiatives and capability improvements, and improve EBITDA.</td>
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<tr>
<td>Revenues</td>
<td>Zero-based commercial (ZBC)</td>
<td>Zero-based supply chain (ZBSC)</td>
<td>Zero-based organization (ZBO)</td>
<td>Zero-based spend (ZBS)</td>
</tr>
<tr>
<td>People (direct)</td>
<td>optimizes customer service and pricing to deliver superior customer economics.</td>
<td>identifies the “should-cost” of COGS and cost reduction opportunities across three levers: price, performance, and value engineering, while optimizing product and service complexity.</td>
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<td>Operating Profit</td>
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<td>People (indirect)</td>
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<td>SG&amp;A</td>
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Source: “The Big Zero: The Transformation of ZBB into a Force for Growth, Innovation, and Competitive Advantage.”

**Visibility Into Spend**

Zero-based spend (ZBS) focuses on general and administrative (G&A) costs to an unprecedented level of granularity. As businesses rapidly expand and shift, they run the risk of G&A costs rising faster than sales. Taking a zero-based approach to spend helps companies identify G&A costs across the organization to free up non-working money for other growth initiatives.

However, companies must be careful about treating the task too lightly. Slashing administrative budgets that adversely impact culture or effectiveness can lead to inefficiencies. There is a need to understand what drives value versus what does not. By gaining true visibility into a company’s entire G&A spend, CFOs can help determine where consolidations, eliminations, and vendor adjustments can be made to reallocate funds to revenue-generating activities, such as digital transformation, new market entries, or joint ventures and acquisitions.

The momentum around ZBx today mirrors the early years of digital transformation. First movers ignored the skeptics and went “all-in” on digital. Today, digital has become non-negotiable for survival. Soon, we believe the same will be said for ZBx.

Kris Timmermans is a senior managing director and Chris Roark is a managing director for Accenture Strategy. They are co-authors of “The Big Zero,” from which this article is adapted.
10 Steps to Effective Finance Staff Meetings

Frustration with meetings is rampant in the corporate world. Here’s a playbook for making them work the right way. By Mitchell York

First, a confession: What I’m about to tell you applies to meetings of any department in an organization, not just finance. A high-functioning team needs to have a weekly meeting to make sure it stays on track with goals. That goes for finance, the company leadership team, the HR team, or any part of the company. Once finance leaders understand how to make these meetings better in their own area, they can be heroes and teach everyone else how to be more productive and solve problems fast.

The problems with meetings are numerous. Here are the biggest issues:

1. Meetings are often held inconsistently. Standing meetings get rescheduled or canceled because the team leader has something better to do.
2. When they are held, inevitably some people are late.
3. Meetings all too often run past their scheduled end time.
4. Most meetings are about reporting, not problem solving. “I did this last week, I’m going to do that next week. See, I’m earning my paycheck. Now leave me alone.” Maybe those aren’t the exact words people say, but that’s often the message they’re sending.

If you experience any or all of the above in your meetings, you have my sympathies. The good news is we’re about to fix them all, right now.

Here are the critical steps for holding a fantastic team meeting using part of the Entrepreneurial Operating System (EOS), which I teach and facilitate. It’s called the Level 10 Meeting (you’ll find out why at the end of this article).

**Step 1—Meeting Starts and Ends on Time**

If the meeting has a 9:00 a.m. start time, everyone is in their seats at 8:55 a.m. Those who are early are on time; those who are on time are late. Whether you have to lock the door, make latecomers put $20 in the pizza party jar, or just plain call them out for lateness, do it.

The Level 10 Meeting is 90 minutes long. So if it starts at 9, it ends exactly at 10:30. Not 10:31. The reason for time discipline is obvious, but just to state the obvious: We can’t respect each other and collaborate if we can’t do simple things like getting butts in seats and out the door timely.
While 90 minutes may seem like an arbitrary time frame, EOS instructors who have implemented the system in more than 8,000 companies over the last 20 years have determined that 90 minutes is the ideal length for a weekly team meeting.

**Step 2—Be Consistent**
The meeting needs to take place on the same day and at the same time every week, forever. There are only two reasons to miss the meeting: vacation and death.

**Step 3—No Electronics**
Collect the phones, or insist on airplane mode. No computers on the meeting table. (People will say they’re taking notes but will actually be on email.) Don’t compromise on this.

**Step 4—Have a Segue**
This is a five-minute segment of the meeting during which each participant gives the team one piece of personal good news and one piece of professional good news from the past week.

Not your idea of good meeting content? Trust me, there’s very good psychological behind this time-tested technique. Doing a segue gets everyone’s mind cleared from the many things they were thinking a nano-second before the meeting started.

**Step 5—Review the Scorecard**
Doing a scorecard review requires a scorecard. So what’s that? It’s a simple one-page spreadsheet that tracks the 5 to 15 most important numbers you need to know on a weekly basis.

These numbers should give you an absolute pulse on the business of your department or the company as a whole. For each measurable, there’s a column in the spreadsheet that says “Who”—as in, who owns this data point and is accountable for its achievement each week?

There’s another column that says “Goal,” which is the weekly goal for that data point. And then there are 13 columns to the right that are weeks of the quarter. When you review the scorecard, you simply ask the owner of each measurable, “Are we on track or off track?”

If the owner is on track, keep going with no further discussion. If the owner is off track, drop the item down to the Issues List (more on that in a moment)—do not start discussing it yet. The scorecard review takes five minutes max.

**Step 6—Rock Review**
A department needs to have three to seven critical goals each quarter, and all individuals on the team also need to have their personal three to seven quarterly goals. We call these goals “rocks.”

The rocks must be SMART (specific, measurable, attainable, relevant, and time-bound). Some person on the team owns each rock.

As with the scorecard, reviewing rocks is simply going through each rock one at a time—first the department rocks and then the individual rocks—and asking the owners if they’re on track or off track. If they’re on track you keep going, if they’re off track you drop the item down to the Issues List.

**Step 7—Headlines**
This is a five-minute rapid-fire review of big doings since last week’s meeting that everyone needs to know. No long discussions, just headlines.

**Step 8—To-Do List**
At every weekly meeting, each participant will bring a to-do list from the prior week’s meeting. A to-do is an action that someone on the team must take to address an issue. Ninety percent of to-do’s should be “ta-done” each week. This review also takes five minutes.

"A high-functioning team needs to have a weekly meeting to make sure it stays on track with goals.”
—Mitchell York, Professional Certified Coach and Professional EOS Implementer

**Step 9—Issues List**
Now the fun, 60-minute part of the meeting. There is an ongoing Issues List of items the team needs to discuss at the Level 10 Meeting. Add items that come up during the current meeting when anything is off track.

Then prioritize the list with the top three issues. Now you’re going to “IDS” those issues one at a time. Take the first issue and Identify its root cause. Then Discuss the issue, with each person stating their viewpoint once and only once—this is not a debate. Then Solve the issue, which means develop a solution where the outcome is one or more to-do’s that are assigned to people at the table.

When you’ve IDS’d the top three issues, if you have time, go back to the Issues List and select three more. But stop wherever you are when there are five minutes left on the clock.

**Step 10—Conclude**
The meeting is almost over. Before everyone leaves, make sure that any to-do’s to be handled by someone not in the meeting are communicated by someone in the meeting. That’s called a cascading message.

Finally, each person gives the meeting a score from 1-10 with 10 being the highest. Record the average score on your scorecard. The goal is to get to a Level 10 score, and over time, you will. And then get up and get the heck out of the meeting room before 10:30. You have just had the most effective meeting of your life. #aus

Mitchell York, a former president of Lending Tree, is a Professional Certified Coach and Professional EOS Implementer.
Effective Capital Allocation: A Force Multiplier

A disciplined, rigorous approach to making investment decisions is the key to winning superior returns. By Glenn Schiffman

One of the most important functions of any company is effective capital allocation. But while it is a critical component of the CFO’s job to steer the placement of capital, it should be in fact everyone’s job. Allocating capital effectively needs to be a mindset and a lens through which decisions are made across the entire organization. It means better decisions and better returns. A CFO, therefore, must provide the right set of tools, analyses, and frameworks for making it happen—as well as serve as a constant reminder that while opportunities are infinite, dollars are finite.

How effectively capital is allocated either accelerates or hinders business performance and determines whether equity value grows in excess of or lags enterprise value. Effective capital allocation, then, can be a force multiplier of the great work teams do to create value.

Some companies have very strict criteria that define effective capital allocation: return on investment, assets, or equity from the investment; or the ultimate EBITDA, earnings per share, or free cash-flow yield realized. Whatever the metric is, it should be well understood, consistently applied, and universally respected.

In addition, the approach needs to be analytically rigorous and pressure-tested. But the up-front analysis is just the start. After arriving at “yes,” success must be benchmarked against the underlying projections.

At IAC (parent of publicly held subsidiaries Match Group and ANGI Homeservices, along with wholly owned companies like Vimeo and Dotdash), we view capital allocation as one of the most important things we do. We allocate our capital toward three pursuits: (1) investing in our existing businesses; (2) acquisitions; and (3) share repurchases and dividends. Our financial flexibility does not require these decisions to be mutually exclusive, but our discipline does.

Disciplined capital allocation is especially important to us because our structure—a composition of diverse businesses with different profiles, in different stages of development, and some with their own capital structures—affords us an incredible range of opportunities.

This diversity, however, makes it difficult to use a single, fixed framework within which to determine the merits of any project. Instead, we generally focus on projected cash-on-cash returns for each opportunity, with the threshold often different for each business.

Since we are “forever” owners of our assets, we also avoid looking at current market multiples to validate a decision. We track the progress of our investments regularly.

Doing that with rigor across an organization acts as a force multiplier by ensuring that opportunities with the best ability to create value are the ones that get funded.

Our goal is to be able to analyze at any given time, across the range of choices, how to deploy capital for the best risk-adjusted return. With the right inputs from each business and through open, rigorous debate, decisions are often made unanimously.

While the “rules” of capital allocation are vastly different depending on the company or business, there are several best practices that all financial executives should apply.
Feed Your Winners, Starve or Eliminate Your Losers
The least risky thing you can do is invest in your winners. The odds of success are dramatically higher because you have a knowledge advantage and a competitive advantage.

Moreover, it’s when the odds are tipped a bit in your favor that you can really compound capital. So, throw as much capital as you can responsibly invest at the winners. Ironically, since winners are often held accountable for near-term results, investors may be less likely to cut you slack. Easy to say, but do your best to defy that short-term thinking.

Conversely, losers need to earn the right to have capital. For example, a few years ago our digital publisher Dotdash (formerly About.com) was struggling. Rather than pouring more money into the business or pursuing M&A to bail it out, we drew a hard line: the status quo was unacceptable. Shortly thereafter, the executive team came up with a radical shift that involved killing the About.com brand and breaking up the website into vertical brands. We now have a thriving publishing asset. The experiment could have failed, but an underlying principle always applies: when you confront the hard truth, necessity becomes the mother of invention.

Allocating capital effectively needs to be a mindset and a lens through which decisions are made across the entire organization.”
—Glenn Schiffman, CFO, IAC

Editor’s Choice
SURVEY SEES CAUTIOUS INVESTOR SENTIMENT
Institutional investment managers worry that slowing global growth could hurt returns, but more than 70% do not think the U.S. is headed for a recession in the next 12 months, according to a second-quarter Corbin Advisors survey. “Neutral” or “bearish” sentiment was 53%, up from 33% last quarter. Managers were also perceived to be more cautious.
Navigating Reference Rate Reform

With Libor’s days numbered, companies should start transitioning immediately to lessen the impact of adopting new reference rates. By Ramona Dzinkowski

Regulators, standard setters, financial institutions, and other industry participants around the world have been working on replacing the London Interbank Offered Rate (Libor) for several years. By the end of 2021, Libor is expected to be out and a new reference rate will be in. At first hearing, that sounds like bank reform at a macro level, and as a CFO of a small to medium enterprise, or a manufacturing company in the Midwest, maybe you think this isn’t really your problem. Guess again.

Replacing Libor extends to pretty much every company that has rate referenced debt or contracts, assets, hedges, or accounting systems—basically everyone. Even the average consumer will not be spared. Credit cards, car loans, student loans, and adjustable rate mortgages that reference Libor will all be affected.

Why Stir the Pot?
Libor is defined as the average interest rate used when major global banks borrow from one another in the international interbank market for short-term loans. The trouble, however, is that interbank loan volumes have been falling for years. Libor is based on the opinion of between 11 and 16 privately held banks, as opposed to widely observable market transactions. On a typical day, for example, the volume of three-month funding transactions between banks is about $500 million, often a lot lower. That compares with almost $400 trillion of global financial contracts that reference Libor.

Randal Quarles, vice chairman for supervision at the New York Federal Reserve noted how thin the market is: “We observe six or seven transactions per day at market rates that could underpin one- and three-month Libor across all of the panel banks. The longer maturities have even fewer transactions.... On average, there is only one transaction [per day] that we see underlying one-year Libor, and many days there are no transactions at all.”

Libor has also been associated with corporate malfeasance. It was at the core of the 2012 banking scandal in which some banks were found to have manipulated the rate to their own ends.

Approaching Deadline
In the United States, the Alternative Reference Rates Committee, convened by the Fed, has identified the Secured Overnight Financing Rate (SOFR) as its preferred alternative to U.S. dollar Libor. However, SOFR is a recommended rate, not a required rate. That means contract counterparties may choose to replace Libor with a different rate.

SOFR, based on U.S. Treasury repo transactions (repurchase agreements), provides a broad measure of the cost of financing U.S. Treasury securities overnight. Federal Reserve chairman Jerome Powell and chairman of the U.S. Commodity Futures Trading Commission Christopher Giancarlo have noted that SOFR “resolves the central problem with Libor, because it will be based on actual market transactions currently reflecting roughly $800 billion in daily activity.”

Each business day, the New York Fed publishes the SOFR on its website at about 8 a.m. One-year Libor as of August 12, 2019, was 2.12%, whereas SOFR was 2.11%.

With the expected drop-dead date for replacing Libor in 2021, the Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) are promoting awareness of, and helping provide
relief for, this important market transition. As FASB has noted, “There are trillions of dollars in loans, derivatives, and other financial contracts that reference LIBOR, and consequently, the related cash flows are tied to that rate.... This will be a major undertaking for not just banks, but for anyone with loans or debt on their books.”

One of the problems created in transitioning to an alternative reference rate is related to the adjustment of loan terms. When loan terms change, both the loan originator and the borrower are required under Generally Accepted Accounting Principles (GAAP) to perform tests to determine if the loan is considered a modified loan or a new loan. This quantitative test must be performed for each loan modified.

For example, the “10% test” states that if the present value of future cash flows under the modified loan is less than 10% different from the present value of future cash flows under the old loan, the new loan is considered a continuation of the old loan rather than the establishment of a new loan for accounting purposes. In that situation, no gain or loss would be recorded because the modified loan would not be fair valued upon modification.

Consequently, as pointed out by the Loan Syndications and Trading Association, transitioning to Libor “could lead to a significant amount of work, and possibly financial statement volatility as well, depending on how many loans have to be recorded at fair value.” And apparently, that number is large. In the United States there are about $36 trillion in notional loans outstanding that will not mature before Libor is set to end. And that assumes there are no new Libor-based issuances, says the New York Fed. There are still new loan agreements being entered into using Libor, but there is no way of knowing how many.

Similar difficulties arise with interest-rate hedging. As noted in KPMG’s recent examination of the issue, under both U.S. GAAP and International Financial Reporting Standards, if a hedge’s underlying reference rate is changed, “entities need to evaluate whether such a change would be considered a termination of the hedging instrument, resulting in a need to de-designate the hedging relationship, which may result in unexpected income statement volatility going forward.”

The end of Libor will have wider implications as well. “Potentially affected contracts are not limited to financial instruments and credit agreements but also may include other commercial contracts, such as contracts with customers, vendors, and employees,” according to an SEC July staff statement.

Experts such as Ming Min Lee, principal, financial services, for Oliver Wyman, point out that the more indirect areas of impact that CFOs need to consider include late payment fees and software systems. For example, on oil and gas contracts with a late delivery or late payment fee, the penalty rate is based on Libor.

In addition, “accounting rules typically have Libor as an input,” says Lee, and many systems have Libor as a data feed.

Audit firms have been giving their clients the heads up for some time. Moving from Libor to SOFR “could have a cascading affect beyond contract terms into the operations and financial reports of thousands of institutions,” according to KPMG. “Organizations that don’t act now may face increasing costs and resource needs to manage the transition in coming years.”

**Easing the Pain**

FASB knows there will be a significant amount of work involved in transitioning from Libor to an alternative reference rate. On July 17, it agreed to move forward with optional accounting relief to reduce the cost and complexity associated with accounting for contracts and hedging relationships affected by reference rate reform.

The proposal would simplify the accounting evaluation of a contract modification. If certain criteria are met, changing the reference rate from Libor would count as a continuation of a contract rather than a new contract. The change to hedge accounting would simplify the assessment of hedge effectiveness and allow hedging relationships affected by reference rate reform to continue. FASB expects to release an exposure draft on the topic this September.

“Ultimately our project is about reducing cost and complexity so that the accounting rules do not impede this market-wide transition,” said Alex Casas, assistant director of research and technical activities at FASB.

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**Start Planning Now**

Ready to get started on the Libor transition? These steps will help you prepare and plan.

- Start with an impact assessment to determine which projects and contracts will be affected by the transition. Be sure to look at all business processes and models, including third-party vendors.
- Work with the head of IT or procurement to evaluate artificial intelligence software that can help identify existing Libor contracts.
- Begin to identify financial and operational risks. Help mitigate risk by linking new agreements to alternative reference rates.
- Start to amend current contracts that will mature after 2021.
- Keep an eye out for upcoming FASB guidance on reference rate reform relief, and stay on top of continued developments from the Alternative Reference Rates Committee and the International Swaps and Derivatives Association.

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September 2019 | CFO 25
Disclosing vital data about a company’s workforce will soon be the norm. Will U.S. businesses fall in line?

By David McCann

This is one genie that’s not going to be stuffed back into its bottle.

A climate ripe for extensive disclosure of human capital data is blanketing the corporate world, with European companies taking the initial lead. The United States has been lagging well behind, but in August the Securities and Exchange Commission proposed that companies be required to report on human capital “to the extent such disclosures would be material to an understanding of the registrant’s business.”

Over the past two years, a litany of events has combined to create a groundswell of momentum for such disclosure. (See “It’s About Time,” page 30.)

Propelling the idea is the ever-broadening consensus among stakeholders that effective assessments of a company’s performance and prospects require solid information on workforce costs, productivity, and how employees are hired, developed, and managed.

Most notably, disclosure guidelines issued last December by the International Organization for Standardization are expected to have a powerful impact. (See “What ISO 30414 Calls For,” page 28.)
Companies in Europe generally take standard-setting organizations more seriously than do U.S. companies. “Given that many [European] companies are talking about implementing the standard as soon as possible, it will soon be possible to incorporate human capital issues into fair value analysis,” noted a recent research report by Deutsche Bank. (See “Bank On It,” page 32.)

Says Hilger Pothmann, the bank’s head of human resources for the Eastern region of Germany and a member of the ISO task force that created the standard, ISO 30414: “The awareness and transparency around this in Europe since the beginning of this year have been extraordinary. There is also some very positive momentum in Asia and Australia.”

In the United States, an eventual, similar move to transparency appears likely—even if it takes some time—as global investors grow accustomed to having human capital information at their disposal when investing in Europe-based companies.

“As soon as it becomes a differentiator in the market, as more investors make decisions based on this type of information, everyone will jump on it,” says Rob Etheridge, head of group workforce management and analytics for Deutsche Bank, which along with fellow German companies Allianz and SAP is a leading voice in the disclosure movement. “It will inevitably spread in the Americas, where the capital markets play such a large role in dictating the activity and concerns of CFOs and CEOs.”

From there, Etheridge adds, “It should become the norm for any public company that wants to demonstrate the value created through good human capital management.”

According to Vicki Villacrez, CFO of telephone and cable services company TDS Telecom, today’s investors and analysts are viewing human capital metrics through two lenses:

“Investors want to invest in companies with a moral compass, and disclosure on issues like human capital is one way to measure that and give investors greater context,” says Villacrez. “Topics such as diversity, human rights, labor, safety, employee volunteerism, and charitable giving are increasingly important context to highlight material risks, illustrate company values, and show how a business generates results.”

Some U.S. companies have cited competitive concerns in resisting calls for human capital disclosure by organizations like the Human Capital Management Coalition (HCMC), a group of 26 institutional investors with some $2.8 trillion under management.

“They’re worried that they’d be spilling their secret sauce,” says Cambria Allen-Ratzlaff, the group’s chair and the corporate governance director at the United Auto Workers Retiree Medical Benefits Trust. “But I think having examples of large multinational companies reporting this information should allay some of those concerns.”

The HCMC is hardly the only group of institutional investors worldwide that is making no secret about its thirst for such information. Several of them, collectively representing more than $100 trillion of assets under management, are

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**What ISO 30414 Calls For**

The human capital reporting standard requests that companies provide 23 metrics, divided into 9 categories.

- **Ethics** (number and type of employee grievances filed; number and type of concluded disciplinary actions; percentage of employees who have completed training on compliance and ethics)
- **Costs** (total workforce costs)
- **Workforce diversity** (with respect to age, gender, disability, and “other indicators of diversity”; and diversity of leadership team)
- **Leadership** (“leadership trust,” to be determined by employee surveys)
- **Organizational safety, health, and well-being** (lost time for injury; number of occupational accidents; number of people killed during work)
- **Productivity** (EBIT/revenue/turnover/profit per employee; and human capital ROI, or the ratio of income or revenue to human capital expense)
- **Recruitment, mobility, and turnover** (average time to fill vacant positions; average time to fill critical business positions; percentage of positions filled internally; percentage of critical business positions filled internally; turnover rate)
- **Skills and capabilities** (total development and training costs)
- **Workforce availability** (number of employees; full-time equivalents)
Michigan has always attracted renegades, visionaries and risk-takers. Our diverse workforce, business-friendly environment and low cost of living are a few of the many reasons so many innovative startups choose to come here. If you want to start or grow your business, Michigan is the place to make it happen. Get here or get left behind.

Visit michiganbusiness.org/pure-opportunity
engaged in various formal and informal efforts to coax human capital data from companies. They are also lobbying government agencies to mandate more human capital disclosures.

Some of the world’s single largest asset managers, including BlackRock and State Street, have also made it known, in one way or another, that their sights are trained on such data.

Asked about the ISO standard, Allen-Ratzlaff says, “It’s much more efficient for investors to have clearly defined standards. In the United States, the conversation is around how much should be voluntary and how much compulsory. But we’re just looking for efficiency.”

She adds: “That’s not to say we don’t recognize that some human capital information might be more relevant to certain industries, or to certain companies within industries, depending on their business strategy. But there still need to be standards [like ISO has put forth]. I think it’s hard for someone to say that data on turnover or total cost of workforce isn’t relevant to all companies.”

**Regulatory Forecast: Hazy**

The SEC’s September proposal suggested that companies be required to report on “any human capital measures or objectives that management focuses on in managing the business.” Concern over industry-to-industry variables was one reason for the commission’s delay in taking action on human capital disclosures.

To be sure, SEC chair Jay Clayton sounded a positive note earlier this year. “The historical approach of disclosing only the costs of compensation and benefits often is not enough to fully understand the value and impact of human capital on the performance and future prospects of an organization,” he said.

But he also thinks each industry, and even each company within a specific industry, has its own human capital circumstances. “For example, I would expect that the material human capital information for a manufacturing company will be different from that of a biotech startup, and different from that of a large health care provider,” he said.

“Because of those differences and the principles of materiality, comparability, and efficiency,” he continued, “I am wary of jumping in with rules or guidance that would mandate rigid standards or metrics for all public companies.”

**“Human capital is a highly qualitative dynamic, and no uniform definition has emerged to enable dependable comparisons.”**

—Fred Crawford, CFO, AFLAC

CFOs of some large U.S. companies have a similar viewpoint. At recent meetings with Stanley Black & Decker, institutional investors’ environmental, social, and governance (ESG) leaders have shown significantly heightened interest in human capital metrics, notes Donald Allan, the toolmaker’s finance chief.

“The question,” he says, “is how to make the reporting requirements helpful to investors and ensure they provide the right context for evaluating the disclosure, as company size and the scope and nature of business varies so widely.” At AFLAC, finance chief Fred Crawford says the company believes diversity and proactive investment in human

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**It’s About Time**

Activity around human capital disclosure has accelerated the past two years.
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capital are key factors in the company’s long-term success. Not only investors but also companies that “walk the talk” will benefit from disclosure, by virtue of positively differentiating themselves from the field, he adds.

“However, as with any metrics approach, there are potential tradeoffs, as metrics alone do not often tell the entire story and can, in some cases, mislead,” says Crawford. “Human capital is a highly qualitative dynamic, and no uniform definition has emerged to enable dependable comparisons.”

Crawford further notes that he frowns on one-size-fits-

Bank On It

- One sure sign that a trend is capturing the attention of investors is the appearance of investment banking reports analyzing the trend.

Thus, it was notable that Deutsche Bank recently waded into the human capital disclosure arena with such a report.

“This report is truly groundbreaking,” says Jeff Higgins, CEO of the Human Capital Management Institute and perhaps the leading U.S. advocate of extensive human capital reporting. “It’s the first time I’m aware of that an investment banking house made a recommendation for ‘human capital ROI’ as a metric with value.”

Higgins has been pushing the importance of human capital ROI for many years, and it was included in the list of metrics called for by the new ISO standard.

The metric results from a simple equation: subtract labor costs from total revenue and divide the result by the labor costs. “It assumes that you break even on your non-people costs, and that all the real leverage that creates revenue comes from people,” Higgins says.

The Deutsche Bank report zeroes in on human capital ROI. It found that there’s a 19% correlation between that metric and one-year share price returns. That compares with a 10% correlation between human capital ROI and return on equity (ROE), which Higgins, a former CFO, calls “the bread and butter for publicly listed companies.”

But the relationship between ROE and human capital ROI is more meaningful for the worst-performing companies. That implies that if companies with poor ROE can increase the quality of their hiring decisions, it can have an outsized effect on their profitability, according to Deutsche Bank.

Maximum Transparency

Allianz, for its part, in March 2019 publicly released a 53-page document, “Allianz People Fact Book 2018,” which may contain the most extensive human capital disclosure any company has yet made.

The report wasn’t the result of a brand-new effort. Allianz has been at the forefront of external reporting on human capital since 2010. But the volume of information disclosed has grown incrementally year by year.

“As we receive positive feedback, we’re constantly working on this with our relevant stakeholders at a high level, and we’re in various networks where this is discussed and [ideas are] exchanged,” says Jochen Fehringer, head of workforce intelligence for the world’s largest insurer.

While work on the 2018 fact book was completed before ISO unveiled its new standard, it contains most of the information the standard calls for, according to Jeff Higgins, a former CFO who was the lead U.S. representative on the ISO task force.

“I would consider Allianz to be the first company that is essentially compliant with the standard,” Higgins says.

Pointing to highlights of the insurer’s disclosure, he notes that it not only reports on salaries and wages but breaks them down into several sub-components, “which few companies do.”

Allianz also revealed its workforce turnover rate, which was 15.8%. The metric “often comes up as companies’ biggest fear” when it comes to human capital disclosure, says Higgins.

“They say, “If we’re losing more people than our peers, how bad does that make us look?’ I tell them that it depends: if they’re bringing in tons of young talent and simply don’t have enough growth opportunities, they might actually look good. It’s only bad if they’re making poor decisions or not taking care of people.”

Also, Higgins observes, Allianz provided a level of detail on workforce diversity beyond what the ISO standard calls for. It broke down both its management ranks and overall workforce by gender in each of eight worldwide regions.

By comparison, even given the intensifying climate of demand for such data, U.S. companies are unlikely to make such detailed disclosures unless forced to—but therein lies a contradiction.

“Allianz, Deutsche Bank, and SAP would not tell you that they’re the most advanced companies in the world at analyzing their human capital data,” says Higgins. “The companies that are very good at that are mostly in the United States. They’re just not disclosing very much.” He cites Johnson & Johnson and United Parcel Service as examples of particularly advanced U.S. companies in this area.
“Yes,” says Deutsche Bank’s Pothmann, confirming Higgins’ statement, “I would say that a majority of organizations that are well on their way in this area are U.S.-based.”

Disclosure-Performance Link?
Human capital disclosure isn’t just good for investors. There’s pretty convincing evidence that companies that disclose more of such information perform better.

That conclusion came out of a separate effort to define standards for human capital reporting that was a key aspect of the early activities of the Embankment Project for Inclusive Capitalism (EPIC).

EPIC—a broad global project spearheaded by Ernst & Young and involving large corporations, asset managers, and asset owners—is aimed at establishing metrics that measure long-term value creation. Sue Hohenleitner, vice president of finance for innovation at Johnson & Johnson, chairs EPIC’s working group on human capital deployment.

For human capital reporting, EPIC came up with a somewhat similar but less-detailed set of recommended metrics than did ISO. However, extensive research was performed to support the standards creation effort.

In March 2019, Anthony Hesketh, the lead researcher, filed a comment letter with the SEC’s investor advisory committee, which had been having its own discussions about the value of human capital disclosure.

According to Hesketh, a senior lecturer at Lancaster University Management School in the United Kingdom, about 15% of S&P 500 companies consistently report their total human capital costs. Among those, 60% were consistently in the top-performing 100 companies in the index from 2015 through 2017, as measured by EBIT (earnings before interest and taxes) margin. Only 6% of the companies were consistently in the bottom 100 performers.

Using a measure he calls return on investment in talent (ROIT), calculated similarly to return on invested capital, Hesketh was also able to show that the deeper the disclosure, the greater the economic returns from talent.

Based on an index he developed to measure the volume of data points companies report on their investor relations websites, the ROIT for companies in the upper quartile of human capital reporting levels was nearly three times that of those in the lowest quartile.

Hesketh didn't claim a cause-and-effect relationship between disclosure and performance. Members of EPIC’s human capital working group “favor the interpretation that well-run businesses that are confident enough to articulate their metrics around human capital in quantum form might be better placed to make financially accretive material interventions,” Hesketh wrote in the study report.

He concluded that “even the slightest performance gain from a more transparent approach to disclosing and managing human capital resources might be substantial for the U.S. economy.”

Shortly after receiving Hesketh’s comment letter, the investment advisory committee recommended that the SEC consider imposing human capital disclosure requirements on publicly held companies.

And, after a large asset management firm did its own analysis of the performance of companies that reveal higher-then-normal levels of human capital information, it is said to be preparing an investment fund that will be populated with stocks of companies that comply with ISO 30414.

“The financial materiality of human capital to firm valuation has evaded the accounting industry’s grasp for half a millennium,” wrote Hesketh. The way things look now, a new epoch may be at hand.

David McCann is deputy editor of CFO.
Private capital providers are fighting to finance middle market firms. But finance chiefs should proceed with caution.

BY RUSS BANHAM

If money makes the world go 'round, Earth must be spinning like a top. Plentiful private capital from myriad sources has created an unprecedented supply of financing. Midmarket and smaller companies that have historically relied on a commercial bank loan or an initial public offering to fuel robust growth ambitions have access to massive amounts of both private debt and equity. The private sources include pension funds, sovereign wealth funds, family offices, hedge funds, mezzanine funds, business development corporations, and traditional private equity firms.

“There’s a ton of dry powder out there,” says Jimmie Lenz, assistant professor of finance at the University of South Carolina’s Darla Moore School of Business.

John Deering, a managing director at Deloitte Corporate Finance who has advised on financings for 25 years, says his firm has never been busier: “Entrepreneurial companies now have the opportunity to consider a wide range of more flexible and creative capital options.”

The sudden availability of so much debt and equity capital comes at an opportune time, as growth companies look to spread their wings geographically, enter new markets, streamline internal operations, and enhance customer experiences through the use of digital technologies.

That so many different kinds of providers are jumping in is good news as well. Says Steven Horowitz, CFO at CareCentrix, a provider of at-home health care to 26 million customers: “The more sources of capital, the better a CFO will find the right fit to grow the business or raise money to sell it at a better price.”

Abundance also means large capital raises. Companies with a market value of half a billion dollars in the past almost always had to become a public entity to access the large amounts of capital needed to achieve scale; now they can tap large private sources even if they have negative profitability and cash flow, says Michael Balistreri, managing director, investment banking, at Alvarez & Marsal. They just have to be able to “prove an ability to achieve high growth and capture market share.”
Momentum

Why is private capital seeking out investments in midsize businesses, and why are midsize businesses eager to tap these funds?

Jeff Majtyka, president of investor relations communications firm Ellipsis, explains: “Investors are having a hard time finding growth in the public markets and are looking for new places to invest. With more public capital moving to exchange-traded funds, the change in the traditional role of stock markets is causing the pendulum to swing back to private capital.”

There are also fewer public issuers to invest in. The number of publicly held U.S. companies has fallen precipitously—down more than 50% from the 7,400 public entities listed in 1996. New issues have also dropped: from June 2018 to June 2019, the number of IPOs fell 14%.

On the demand side, more companies are staying private longer. They are also finding that they can achieve ever-higher valuations through several rounds of this kind of financing. What’s more, being publicly held is expensive; rife with oft-changing reporting and regulatory compliance obligations; and time-consuming. Listing on an exchange also increasingly exposes corporate boards of directors to securities class-action lawsuits. Such lawsuits more than doubled in number this year from just four years ago, according to insurer Chubb.

“The common refrain I keep hearing from people wanting to join boards is that they won’t even look at a public company because of the liability potential,” Horowitz says.

Finally, leaders of entrepreneurial businesses are concerned about relinquishing equity and ownership. They also don’t want to dilute the value of their holdings. Private capital, fortunately, bypasses some of these obstacles. “If you can take in a lot more money from investors to acquire other companies, grow the business internationally, and achieve the owners’ plans for a rewarding exit,” says Horowitz, “it almost doesn’t make sense anymore to go public.”

Limited Options

Prior to the Great Recession, there were only two forms of capital available to the middle market—bank debt provided by traditional commercial lenders and private equity, Balistreri says. Each had disadvantages.

Bank loans were (and are) dependent on the financial value of a company’s tangible assets like property, equipment, accounts receivables, and inventory. If companies needed capital beyond what the bank offered, private equity was an option. However, PE firms generally insisted on obtaining strong management control positions. “You had this big gap between bank financing that could only stretch so far and control-oriented private equity,” Balistreri says.

Other traditional private capital sources shied away from midsize and smaller companies (generally, under $500 million in revenue). Things got worse when “the local banks serving the borrowing and other needs of those companies got absorbed by larger banks or closed up shop,” says Muhammad Azfar, managing partner at Auctus Capital Partners, a real estate investment firm.

In the last few years, the supply picture has really turned around as private capital has rushed in to fill the void left by banks. “We’re seeing some really significant allocations of private equity and private debt—I don’t mean 5% of a pension fund, for example, but 25% and 30%,” says Lenz.

Private equity funds are equally eager for their slice of the midmarket pie, diversifying their portfolios beyond venture capital and buyout funds, the “two main flavors” of the past, Azfar says. Funds also are less insistent on taking majority positions, with many very open to a minority stake on a partnering basis, he says.

Moreover, “many funds are interested in being long-haul investors of ten years and more, which is a lot different from the four to five years we used to see,” Azfar adds. “They still want the traditional 20% internal rate of return, but on more of a long-term basis with a lower risk-return.”

Doing the Homework

As with anything that looks too good to be true, accepting a large amount of private capital requires reading the fine print first. Some investor oversight demands are potentially intrusive. The provider’s timing for liquidating the investment may not be in sync with the company’s expectations.
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And the fund’s vision may be vastly different from that of the management team. As a result, the borrower can easily bite off more than it can chew.

“When investors are flush with cash and money is easy to get, the company might not have the same discipline, scale, and structure (it needs) to stay out of trouble,” says Mark Partin, CFO of BlackLine, a developer of cloud-based accounting solutions.

The expanse of available private capital calls for prudent due diligence, particularly in choosing the right investor partner. “You need to do as much homework on them as they’re doing on you,” says Balistreri. To perform that diligence and vet the provider or fund, midsize and smaller companies may want to retain the deal-oriented services of an investment banker, financial adviser, or law firm.

Regardless of who does it, it is important to reach out to other companies in which the provider previously staked an investment. Horowitz pursues this approach at CareCentrix. “Over the last five years, I’ve met with 40 private equity firms,” he says. “In each case, I find people who have worked with them in the past to solicit what the experience was like. The responses run the gamut. ... Investors have different personalities.”

Management teams should seek out financing partners that have expertise in the company’s industry and market space. This is especially important for new companies with young leaders, as the capital provider’s opinions can be a competitive shot in the arm. “Money is just table stakes; look for what else they can bring—their expertise and introductions to help you grow the business and tap international markets,” says Jeff Grabow, U.S. venture capital leader at EY.

**Finding a Fit**
The crafting of the business narrative justifying the need for capital is a key part of the process. Just like an IPO road show, companies must assemble a pitch deck presenting a quick overview of how much capital is needed, what its purpose is, and how it will be deployed. Expect the provider to ask questions about past performance—market challenges, key competitors, business processes, working capital. If interested, the provider will present its rationale for a return on the investment.

Internally, the company should look to the CFO to be the lead on these activities.

“Really the CFO is in the best position to know how much capital is needed and who best to take it from, since the investors have different track records and aims,” Horowitz says.

Partin agrees: The CFO is the crucial person “in narrowing down the choices to who the company wants to work with, how much the capital costs, and what is the value derived. The CFO is in the best position to measure the use of the proceeds for the intended purpose. And he or she is pivotal when it comes to negotiating the terms and conditions.”

In contrast to CFOs, many CEOs tend to be overly optimistic when capital is bountiful. “The entrepreneurial CEO sees business going to the moon and nothing blocking the way,” says Partin. “It’s the CFO’s job to point out what can go wrong—if ‘this problem’ rears, it will cause these risks.’”

And, though private capital might not feel as constraining as listing in the stock market, there are significant risks for a company to consider, Partin says. For example, deal agreements often include downside protection for the investor. If the business doesn’t perform as expected, the deal might have what is called a “ratchet,” whereby the investor gets more ownership interest, more voting control, and maybe another board seat or two. There’s also the question of exit strategy. At some point, the debt or equity provider will want to liquidate its holdings at the pre-agreed cash-out “landing” date. “It’s important to carefully assess the timeframe the investor has in mind for the eventual landing; some capital providers like pension funds don’t need the cash back quickly, but others may have a shorter duration in mind,” says Alexander De Mol, a partner at Bain & Co. and a member of its private equity practice. “It really depends on the investor.”

Some providers may want to receive annual dividends on the invested capital, while others may seek additional equity positions over a longer payout horizon. “Another investor may come in for a minority stake initially, with a long-term vision to be a majority owner, building up the stake over time,” De Mol says. “There is no perfect formula. What

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**High Stakes**

- **$2.9 trillion**
  - Amount raised in private markets in the United States, 2018

- **$2 trillion**
  - Amount of uncalled capital at private equity firms*

- **$53.2 billion**
  - Venture capital investments, 1H 2019

- **$120.4 billion**
  - Buyout-stage investments, 1H 2019

- **$109 billion**
  - Money raised by private debt funds, 2018

*As of August 2019


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“The common refrain I keep hearing from people wanting to join boards is that they won’t even look at a public company because of the liability potential.”

—Steven Horowitz, CFO, CareCentrix

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**EASY MONEY**

Courtesy of CareCentrix
Opening the Floodgates

The SEC may ease restrictions on private placements, including allowing retail investors to participate in financings.

- The pool of capital available to midsize and smaller companies may grow even larger, as the Securities and Exchange Commission is exploring loosening restrictions on private placements.

  In 2018, about $2.9 trillion was raised in the private markets, compared with roughly $1.5 trillion on public stock exchanges, according to the SEC. The SEC says it wants to examine ways to “simplify, harmonize, and improve” today’s highly complex regulations governing private placements. It conceded that current rules make it difficult for smaller entities to “navigate the most efficient path to raise capital.”

  A June 2019 concept release from the SEC says the commission is in particular seeking answers to whether it should ease the restrictions on who can invest in private financings. Currently, only “accredited” individual investors with a certain amount of wealth can participate in larger deals. The SEC asks whether it should also consider an investor’s sophistication, the amount of the investment, or both in deciding which investors can participate. To date, the SEC has erred on the side of protecting mom-and-pop investors.

  The concept release also examines the issue of expanding issuers’ ability to raise capital through pooled investment funds. Pooled funds could give retail investors greater access to growth-stage issuers, which they have on a limited basis through some of the provisions in the Jumpstart Our Business Startups (JOBS) Act of 2012.

  While the JOBS Act has been a catalyst for some kinds of private placements and for raising capital online, its success has been uneven. Rule 506(b) offerings got a boost, but Regulation A transactions, which allow a company to raise up to $50 million in a 12-month period, have proven difficult to execute. From the second half of 2015 through 2018, 359 businesses filed offering statements seeking $7.7 billion, and 132 actually raised funds through Reg A (also called “IPO-lite”) for an aggregate total of $1.4 billion.

  Among the questions the SEC asks in the concept release is whether the costs associated with conducting a Reg A offering dissuade issuers from relying on the exemption. Reg A deals come with some heavy disclosure requirements, including filings with state securities regulators.

“Opening the Floodgates” Russ Banham is a Pulitzer-nominated financial journalist and best-selling author.

“When investors are flush with cash and money is easy to get, the company might not have the same discipline, scale, and structure it needs to stay out of trouble.” —Mark Partin, CFO, BlackLine

matters most is the CFO’s ability to handle the liquidity constraints when the payback is due.”

  In this regard, Deloitte’s Deering advises CFOs to negotiate as much flexibility as possible into the terms and conditions. “The key term we use is ‘headroom’—space between the company’s projections versus those in the covenant package,” he says. Headroom ensures peace of mind, because if the business is 20% off of growth projections, it will still be in compliance with the covenants, says Deering.

Just Right

Given the intense competition to invest in portfolio-diversifying sources of financial gain, providers may offer a company more capital than it needs. In these cases, caution is warranted.

“If the company takes too much money because it’s easy to get and it doesn’t put the funds to work, it will end up with a lot of unhappy investors,” says Horowitz. “If it takes too little, it may be stuck holding the cup out for more.”

  Most of all, CFOs need to accept that the easy money won’t last forever; neither will today’s economic upswing. “Five years from now the economy may not be as buoyant,” Partin warns. “If a company is obligated to liquidate the investment when business is down, it can feel like a big balloon mortgage.”

  Partin’s last piece of advice should resonate with all finance chiefs. “Typically, the CFO is the one who often has to say no. The investment banker says yes, the lender says yes, and even the CEO says yes,” says Partin. “But it’s the CFO’s job to make the tough decisions, particularly in situations where there’s a potential ratchet, default, or equity conversion in play.”

  Concludes Partin: “All this capital is a great thing, but there’s a reason why money is supposed to be hard to get.”

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

Acquirers play a risky game if they cut corners on due diligence.

By Tam Harbert

In 2018 the value of mergers and acquisitions worldwide was a cool $3.9 trillion, according to the Institute for Mergers, Acquisitions, and Alliances. Companies very much like to make deals, which ideally provide strategic synergies, operating efficiencies, and a fast path to growth. Yet it’s equally certain that some transactions are the product of wishful thinking. After analyzing 2,500 deals, L.E.K. Consulting found that more than 60% of them destroyed shareholder value. What’s more, many companies are flailing about with no vision: In a survey of 400 top executives by Grant Thornton, only 31% of participants said they had a clear, well-understood M&A strategy.

In short, combining companies is a risky proposition. Acquirers may misread economic conditions. Expected sales may not materialize. Effectively merging disparate corporate cultures is notoriously difficult. Same for IT systems. Failure to retain key employees is common.

That’s problematic because when it comes to M&A, the pressure on companies to grow sales and profits is translating into a need for speed.

“Companies are moving fast,” says Margaret Carlson, CFO of health care consultancy Alira Health, which has acquired two small companies over the past two years. “Some may figure a deal offers enough profitability and synergies to cover costs that might have been of more concern five years ago.”

Haste does provide opportunity, in a sense. “The good news is that the speed at which you can get to closing is one way to win at deal-making,” says Curt Gendron, practice leader for operational transaction advisory at professional services firm Crowe. “The bad news is that it can drive some negative behaviors.”

Compliance Glitches

First on that list is insufficient due diligence. In the best of worlds, acquirers would conduct every element of the process thoroughly. Today, they’re more likely than before to cut corners. Crowe calls it the “shrinking report syndrome.”

Shockingly, a big failure on the due diligence front is investigating whether the target company is compliant with applicable regulations. In a recent study by law firm Baker McKenzie, based on interviews with more than 300 corporate leaders and legal advisers, 56% of them expressed regret that they had dedicated too little effort to the task.

“Compliance due diligence is the stepchild of many transactions,” says William Devaney, co-chair of global compliance and investigations at Baker McKenzie. “It’s often paid attention to late, and sometimes not at all.”

The United States and most other Western countries enforce laws and regulations more effectively than many others, according to Devaney. When a U.S. company acquires a target from a jurisdiction with a low level of enforcement, there’s “a very good chance” that the target won’t have well-developed compliance programs, policies, and procedures, he says. “Under U.S. law, you are buying that problem.”

Such research has always been a key element of due diligence, but it may be even more important in today’s volatile trade environment, in which more countries are targets of tariffs and trade sanctions. Companies that are adept at due diligence make liberal use of scenario modeling, says Gendron.

“Compliance due diligence is the stepchild of many transactions. It’s often paid attention to late, and sometimes not at all.”

—William Devaney, co-chair of global compliance, Baker McKenzie
moving them to another country. And that likely will be a moving target. “With the trade wars, things can change with a tweet,” says John Falcon, CFO and treasurer at Ross Controls, a maker of valves and systems for the fluid power industry that has made several acquisitions in the last two years.

If the target is in a country that’s subject to trade sanctions, it’s especially important to set up appropriate governance. The U.S. Treasury’s Office of Foreign Assets Control has increased its enforcement of such sanctions on deal-making companies, announcing four penalties in the first half of 2019 ranging up to $1.8 million.

Cyber Diligence
For obvious reasons, the importance of evaluating a target’s technology is surging, with no end to the trend in sight. That applies not only to IT infrastructure but also to software and apps used in operations.

A target’s data privacy and cybersecurity profile should, of course, be a due diligence priority. As data breaches continue to make big headlines, investigating a target’s data protections and its compliance with data privacy laws is crucial.

One of the latest and largest breaches is a cautionary tale. The U.K.’s privacy regulator—the Information Commissioner’s Office (ICO)—in July fined Marriott International $123 million for a breach of Starwood Hotels & Resorts’ guest reservation database, in violation of the European Union’s General Data Protection Regulation (GDPR).

The ICO said Marriott hadn’t conducted proper due diligence when it acquired Starwood in 2016. Even though the hackers had breached Starwood’s systems two years before the acquisition, Marriott didn’t discover it until 2018.

Despite nightmare headlines, data privacy and cybersecurity are often neglected. The category of data protection, privacy, and information governance was ranked fairly low on the list of M&A risks in the Baker McKenzie study. Only 43% of participants found it to be among the most challenging compliance risks in recent M&A deals, while 35% said the same about cybersecurity.

Respondents expected that to change, however: 78% believed data privacy risk would increase in the next 12 to 18 months, and 73% expected cybersecurity risk to do so.

Small companies may be in the greatest danger. “Security doesn’t come cheap, and usually small firms are moving fast without a ton of infrastructure,” says Carlson of Alira Health, a 100-employee company with offices worldwide.

Privacy compliance is somewhat of a moving target in the United States, where there are no federal data privacy regulations. However, California’s Consumer Privacy Act is set to take effect in January 2020, and other states are working on their own data privacy laws. “These are rapidly changing domains,” says Gendron. “It’s not something that most companies’ IT managers are going to be able to adequately assess on their own.”

For example, last year Alira acquired a small research organization that manages clinical trials. The target obviously handled highly sensitive health care data, so Alira hired an outside IT security expert to inspect the company’s systems. Such an expert can not only make sure systems are locked down and compliant, but also, if issues are found, they can quantify the cost of bringing the company into compliance, says Carlson.

Part of security-related due diligence is a hard look at all insurance that’s in place, she adds. That could include errors and omissions insurance, representations and warranties insurance, and special cyber-insurance policies. “You need to look at how the contracts are worded and understand what would be covered and what would not be covered should something from the past arise,” says Carlson, as

Belly Floppers
How many transactions as a percentage of mergers and acquisitions have failed as a result of compliance issues in the past three years?

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<td>Europe</td>
<td>38%</td>
<td>39%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>North America</td>
<td>50%</td>
<td>38%</td>
<td>12%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Baker McKenzie

“Security doesn’t come cheap, and usually small firms are moving fast without a ton of infrastructure.”

—Margaret Carlson, CFO, Alira Health

 Courtesy of the companies
in the Marriott-Starwood case.

Another precaution is to delay the integration of IT systems, especially if the acquirer hasn’t had the time to thoroughly yet the acquired ones before transaction close, says Joseph Castelluccio, a partner at law firm Mayer Brown. Acting too quickly could, for example, risk malware infection of the buyer’s software.

When the value of data is a major driver of an acquisition, buyers need to do an especially deep dive into the target’s privacy policies, Castelluccio adds. “If the policies under which that data was collected don’t permit you to [monetize it the way you intend], you may have a very hard time realizing that value,” he says.

Booming-Economy Risks
The “people” aspect of due diligence has taken on added importance. That is particularly so in small companies and highly specialized industries. “The low unemployment in all of our markets is impacting us dramatically,” says Carlson. That puts a premium on making sure the employees of acquired companies will be happy in their new and different environment.

Speed Bumps
Companies are doing many things to speed through due diligence, but most of them involve some degree of risk, notes Crowe’s Curt Gendron.

Making assumptions about retaining key employees, for example, has become far more problematic, according to Gendron. “We are seeing many companies pushing to get access to key employees in advance of closing to increase the level of confidence that they will be retained post-close,” he says. That key salesperson who has critical relationships with the target’s five largest customers, for example, might make or break the deal’s success.

“We are seeing many companies pushing to get access to key employees in advance of closing to increase the level of confidence that they will be retained post-close.”
—Curt Gendron, practice leader, transaction advisory, Crowe

Meanwhile, the longest economic expansion in U.S. history—121 consecutive months of GDP growth through July 2019—is starting to give some companies jitters.

“Question becomes, from a risk standpoint, how is this business that we’re looking at going to fare during that next downturn?” says Gendron.

In response, acquirers are expanding their financial modeling during due diligence. Rather than looking at only the trailing 12 months and the two prior full years, he says, some companies look for reassurance by going all the way back to 2008 to see how the company performed during the Great Recession.

Perils and hazards lurk in every potential deal. But, with thorough due diligence, CFOs and M&A teams can minimize post-close surprises or even steer the organization clear of a disastrous, value-destroying purchase. Speed in analyzing targets is essential in the current climate, but there are no shortcuts to a transaction that outperforms and produces real value.

Tam Harbert is an award-winning journalist specializing in technology, business, and public policy.

September 2019 | CFO 43
U.S. finance chiefs are showing strong support for immigration reform as they struggle with a talent shortage domestically, according to the latest quarterly Duke University/CFO Global Business Outlook survey.

Eighty-three percent of U.S. CFOs surveyed supported expedited granting of green cards to allow foreign graduate students in science, technology, engineering, and math (STEM) to work in the United States. Providing expedited work visas (H-1B) for STEM undergraduate students was favored by 82% of survey respondents. Two-thirds of finance chiefs favored increasing the cap on temporary work visas (H-2B) for seasonal and lower skilled immigrant workers.

“In the late stages of a business cycle, it is not unusual for CFOs to be confronted with tight labor markets and face difficulty hiring and retaining top talent,” said Campbell Harvey, a Duke Fuqua School of Business finance professor. “However, this time is different. Given the reshaping of the American economy toward technology, there is an acute shortage of qualified labor. CFOs are strongly advocating immigration reform to fill the gap.”

Nearly 80% of respondents said the U.S. government should drop its lottery system in favor of a merit-based immigration policy. “Some [survey respondents] expressed frustration that qualified workers have to win a visa lottery to be hired long-term, when these workers are needed to fill a talent gap,” said John Graham, a Fuqua professor and director of the survey. “The business community is sending a strong message to lawmakers about the importance of immigration reform.”

But many CFOs were also adamant that existing immigration laws should be fully enforced. One CFO called for “a fair, efficient system for all candidates regardless of education.” But he also said, “the borders must be secured and benefits and legal protections for illegal immigrants must be eliminated and illegal immigrants must be deported.”

The tight labor market was a top worry of CFOs, with 45% of U.S. finance chiefs naming hiring and retaining qualified employees their top concern. Other concerns included government policies (37%), economic uncertainty (29%), and data security (26%).

“If the shortage of technologically-oriented talent is not addressed, [it] will stifle innovation, slow growth even further, and winnow away at America’s traditional position of being the world leader in tech,” said Harvey.

**Economic Optimism Slightly Rises in the U.S., Falls Elsewhere**

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

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

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U.S. finance chiefs are strongly in favor of more accommodative immigration policies, even as they prepare for a potential recession in 2020. **By Lauren Muskett**
likely reflects continued uncertainty about trade policy and weaker global economic growth,” said Graham. Another factor is the ominous inversion of the yield curve, which occurs when some short-term interest rates are higher than long-term rates for at least a full quarter. As of early August, the yield on the 1-month Treasury bill was 29 basis points higher than the yield on the 10-year note. Inverted yield curves have predicted the last seven recessions.

Global Gloom
What may be more worrying than economic trends in the United States were the signs occurring globally. The International Monetary Fund forecasts tepid real gross domestic product growth for the U.S.'s four trading partners (after China): Canada’s GDP is expected to grow 1.5%, Mexico’s 1.6%, Japan’s 1.0%, and Germany’s 0.8% on an annual basis.

The dim view showed up in the CFO optimism index in both developed and emerging economies. In Europe, optimism dipped by one point over the first quarter, to 57. European CFOs' top concern was economic uncertainty. These finance executives projected capital spending would grow by a median 4.6% in the next 12 months, but expected no growth in full-time employees. Optimism about their own companies’ prospects dropped also, to 62 from nearly 68 in March.

In Asia (not including Japan), CFO optimism about the economy slid to 54 (from 65 in the first quarter). Economic uncertainty remained the top worry, followed by difficulty attracting qualified employees. This region’s CFOs forecast that capital spending would grow a median of 2% and employment 2.5% in the next year.

The hopes of finance executives in Latin America also ebbed in June, with the region’s overall economic optimism dropping to 58 from 65 in the first quarter. A majority of the drop was attributed to a steep fall in optimism in Brazil, to 56 this quarter from 69 in March. Brazil faces a raft of economic challenges, including high unemployment, a government fiscal crisis, and lasting effects of a recession in 2015-2016.

Japan saw the steepest drop in CFO optimism, to 39, from an already low 55. Japan's longstanding economic struggles won’t be over anytime soon, as finance chiefs projected earnings growth of 1.4%, no capital spending growth, and a fall in revenue of 1.9% over the next 12 months. Japanese CFOs' top worry was economic uncertainty.

The Duke University/CFO Global Business Outlook survey concluded June 6 and generated responses from nearly 600 global CFOs.
CFOs are collaborating with other functional areas in their companies as their role expands enterprise-wide. Increasingly, senior executives within the finance function are contributing data, analysis, strategy, and insights that improve efficiency, effectiveness, and company performance.

A recent survey of 157 senior finance executives conducted by CFO Research, in collaboration with FTI Consulting, looked at how they are doing this in three key areas: performance management, technology strategy, and talent development. Nearly 90% of those surveyed said their firm’s finance chief played key roles in supporting these three areas. Most CFOs should welcome the shift: they are not constrained anymore to just reporting on performance; they can now positively influence it.

### Analyzing Operations

Increasingly, the CFO and the finance function have the data, analytical expertise, and stature within the organization to support operations performance management effectively. Of the finance executives surveyed, 88% agreed that the CFO has a substantial role in supporting operations performance across the enterprise. And 91% of those surveyed said their CFOs either currently identified key areas of operational risk or planned to begin doing so within two years.

Finance leaders cited two ways that they support enterprise operations: through traditional finance processes and through insights enabled by advanced analytics. Traditional processes include providing timely cost analysis to business leaders, identifying key areas of operational risk, flagging variances from plan, and providing recommendations for remediation where appropriate. Several routine tasks, like cost and variance analysis, were still not conducted by many firms.

When it came to supporting operations performance management with more advanced analytics and external data, the survey found that a majority of CFOs were providing customer and market analytics, as well as delivering real-time financials. Nearly half of respondents were providing competitive market analysis. (See Figure 1.)

### Finding and Keeping

Another way CFOs can add value beyond their traditional responsibilities is to be more involved in key aspects of corporate talent. While the talent strategy function is the clear domain of the chief human resources officer (CHRO), CFOs are playing a part in improving their companies’ ability to...
Many organizations believed there was a disconnect between the CFO and the CHRO, and only 39% of those surveyed believed that in their organization the two had an effective partnership. The individuals within an organization tend to shape the value of their functions, which translates into the quality of cross-functional collaboration.

Tech Collaborator

With technology strategy deeply embedded in corporate strategy, the stakes are high when defining the role of technology in the enterprise. Historically, CFOs have played an integral role in corporate technology strategy, and 81% of those surveyed confirmed that their organizations’ CFOs had a key role supporting technology strategy development.

The line where finance ends and IT begins is increasingly blurred, and many senior managers are developing a more sophisticated technology knowledge base. Nearly three-quarters of those surveyed believed their organization’s CFO would have a substantially larger role supporting the development of technology strategy in the next two years.

Investing in technology is becoming a focus for CFOs because of the changing value and perception of advanced analytics. Specifically, 89% of those surveyed either had or were developing a strong analytics team within the finance function. In addition, 48% of those surveyed were currently collaborating with IT to leverage cloud platforms, advanced analytics, and automation to increase performance of the finance and accounting organization and reduce the cost of delivery.

But in many related areas CFOs have work ahead. Surprisingly, only 56% of those surveyed said that finance was currently identifying key areas of technology risk. Forty-three percent said that their organizations invested in IT spend transparency and measured the return on investment of technology projects. About half (49%) supported efforts to improve bench strength of key corporate functions, including finance.
Back to School

At a time in their career when veteran finance chiefs are huddling with their CEOs on strategy, wooing institutional investors, and finding new markets, do their technical skills remain rust-free? Is their basic finance knowledge still accessible at a finger snap? The Corporate Finance Institute puts forth the following questions as examples of what young finance professionals need to know. Can you score 100% on this test? No cheating!

1. Which of the following is a simple formula to calculate cost of capital?
   A. total assets/net debt x cost of debt + total assets/equity x cost of equity
   B. net debt/equity x cost of debt + equity/net debt x cost of equity
   C. net debt x cost of debt + equity x cost of equity
   D. net debt/total assets x cost of debt + equity/total assets x cost of equity

2. The correct order of a capital stack from the most to least secured is:
   A. equity > subordinated debt > senior debt
   B. subordinated debt > senior debt > equity
   C. senior debt > subordinated debt > equity
   D. senior debt > equity > subordinated debt

3. The formula for calculating future value (FV) is:
   A. FV = PV/(1+r)^n
   B. FV = PV/(1+r)*n
   C. FV = PV x (1+r)^n
   D. FV = PV x (1+r)*n

4. What is the enterprise value of a business?
   A. The market value of its equity
   B. The book value of its equity
   C. The entire value of the business without giving consideration to its capital structure
   D. The entire value of the business considering its capital structure

5. Which of the following is true when a bond is trading at a discount?
   A. Coupon Rate > Current Yield > Yield to Maturity
   B. Coupon Rate < Current Yield < Yield to Maturity
   C. Coupon Rate = Current Yield = Yield to Maturity
   D. Coupon Rate < Current Yield = Yield to Maturity

6. _________ underwriting is when the underwriter agrees to buy the entire issue and assume full financial responsibility for any unsold shares.
   A. Best-efforts
   B. Firm-commitment
   C. All-or-none
   D. Full-purchase

7. The concept of present value relates to the idea that:
   A. The discount rate is always higher when you invest now than in the future
   B. The discount rate is always higher when you invest in the future than now
   C. The money you have now is worth less today than an identical amount you would receive in the future
   D. The money you have now is worth more today than an identical amount you would receive in the future
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