# CFO Insights | Japan

2014 Q4

The CFO Program | Japan

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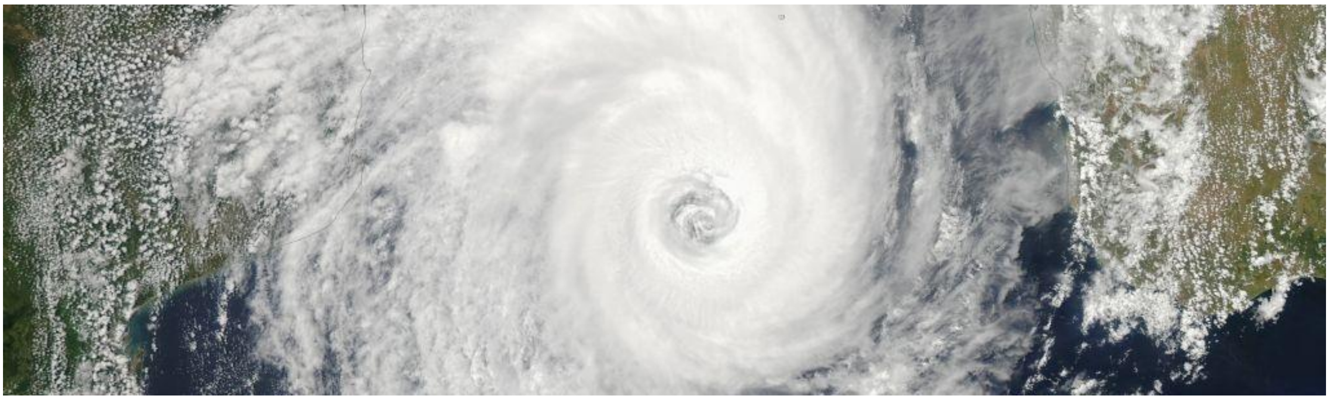


# Japan Economic Outlook

## The tax debate put to rest

The intense debate over whether the second phase of increasing the national sales tax will be implemented next year as planned has now quietened. Japanese Prime Minister Shinzo Abe finally decided to delay the consumption tax increase, which was originally scheduled for October 2015, by an additional 18 months. The decision was supposed to be taken in December 2014, but Abe called for a snap election in mid-November to put all speculation to rest. The sales tax increase will now likely be implemented in early 2017.

To some analysts, the postponing of the tax increase was inevitable, given the weakness in the economy. The economy witnessed negative growth in the second quarter post the sales tax increase in April.

### Japan is now back in recession after the government reported negative GDP growth for the second consecutive quarter in Q3 2014.

Investors lack confidence about the economy's ability to withstand another tax increase, prompting Abe to take this immediate action. Prominent economists and influential policy thinkers from around the world, such as Larry Summers and Nobel laureate Paul Krugman, have supported the decision to delay the tax increase. They have argued that if raising the tax causes the economy to falter, it would pose far more risks.

There is no contention that an increase in taxes could help rectify the imbalance in the country's pension system and go a long way in reducing sovereign debt, which is more than twice the size of the economy and the largest in the world. Japan's rapidly growing elderly population and declining labor force are a cause for worry, with the working population having to support the country's pensioners. On the other hand, it is also a fact that the true ability of an economy to service its debt is determined by its growth. Unfortunately, the economic data releases since April 2014 have only affirmed that growth has suffered and that the economy may be heading toward an unsustainable recovery.

However, the finance ministry, the Japanese economic minister, and the Bank of Japan (BOJ) have a different opinion. They strongly supported implementing the increase as planned in October 2015. The International Monetary Fund and the Organization for Economic Cooperation and Development also urged Japan to stick to the planned tax increase. According to them, any delay in sales tax increase could send a wrong signal about the government's sincerity regarding fiscal consolidation and public debt reduction. However, one week before and in anticipation of Abe's announcement, the Japanese yen fell to a seven-year low against the US dollar, and equity prices jumped 4 percent.

## Economy in doldrums post previous tax increase

The national sales tax was increased from 5 percent to 8 percent in April 2014. In the following months, the monthly consumer expenditure index and both wholesale and retail sales fell sharply. The production side also showed weakness, primarily due to a decline in domestic demand and lackluster growth in overseas, mainly advanced, economies. Consequently, economic growth turned negative on a quarterly basis in Q2 2014. The weakness continued in the third quarter, as GDP growth fell at an annual rate of 1.6 percent. A decline in inventory accumulation and poor investment were the primary reasons for poor growth; business fixed investment and residential investment fell at an annual rate of 0.9 percent and 24.1 percent, respectively. The index of industrial production (mining and manufacturing), which had contracted 3.8 percent in Q2 2014, fell further by 1.9 percent in Q3 2014 on a quarterly basis. A turnaround in real consumption of households and real exports in Q3 failed to offset the impact of investment contraction on GDP.

Japan's consumer price indices also failed to rise at a desired pace, falling short of the BOJ's target rate of 2 percent.

> The latest data for September suggest that the annual inflation rate excluding fresh food was 3 percent.

However, after accounting for the effect of April's tax increase (which added 2 percent to inflation from May on), the inflation rate was merely 1 percent, which is the lowest rate in nearly a year. While the decline in global oil prices is partly responsible for the price fall, a drop in consumer spending after the sales tax increase also contributed.

The unemployment rate too has been rising, although marginally, over the past few months post the sales tax increase. The increasing entry of women into the job market, with more applicants for jobs, could be a reason for the rising unemployment rate, as evident from the increased labor-force participation rate. Nevertheless, the possibility that businesses are not willing to employ due to increased demand uncertainties cannot be ruled out, as indicated by the decreased ratio of available jobs to applicants.

## A monetary policy surprise

The governor of the BOJ argued until recently that the pace of the bank's asset purchases is sufficient to attain the target inflation rate of 2 percent. He even resisted the demand for expanding the program further, despite the economic slowdown post the sales tax rise. However, in the recent monetary policy meeting, the governor surprised the financial market by announcing that the BOJ will increase its asset purchases each year from the current 60-70 trillion Japanese yen to 80 trillion yen. Quantitative easing will be continued as long as necessary to maintain an inflation target of 2 percent in a stable manner. The bank now recognizes that the monetary easing undertaken so far has somewhat failed to push the economy into a sustainable inflation trajectory. The governor's announcement is also an admission that the sales tax increase this year has worsened growth prospects. The bank slashed its economic growth forecast of 1.0 percent for July by half, to 0.5 percent, in the current year up to March, citing poor exports and slack in consumer spending. It also trimmed its FY 2014 inflation outlook to 1.2 percent from 1.3 percent, and the FY 2015 outlook to 1.7 percent from 1.9 percent.

The BOJ's announcement of an aggressive monetary policy is intended to convince investors that the bank is serious about meeting its inflation target and willing to take action if necessity arises. Immediately after the announcement, the yen weakened against the US dollar, and Japanese equity prices soared to their highest levels since 2007.

> If the yen continues to remain weak, rising import prices will help push up overall inflation. A weaker yen will also boost exports, though in recent times there has not been enough evidence supporting this.

After the BOJ's aggressive move to boost asset purchases, the pressure is on the government to implement much-promised reforms. Abe has already decided to postpone the sales tax increase. Most likely, the government will soon decide whether to implement fiscal stimulus given the poor third-quarter GDP numbers. The aim of the stimulus is likely to boost the purchasing power of consumers, who were hurt by the tax increase in April. However, only time will tell if these actions will prove to be a temporary fix or help sustain economic growth in the long term

# Accounting News

## IFRS

**Annual improvements to IFRSs 2012-2014 Cycle - The amendments affect the following standards:**

- IFRS 5: Guidance is added regarding (1) reclassification of an asset from held for sale to held for distribution or vice versa and (2) discontinuation of held-for-distribution accounting.
- IFRS 7 (with consequential amendments to IFRS 1): These amendments clarify (1) whether a servicing contract constitutes continuing involvement in transferred financial assets "for the purposes of the transfer disclosure requirements" and (2) the applicability of the IFRS 7 amendments on offsetting disclosures to condensed interim financial statements.
- IAS 19: These amendments indicate that the high-quality corporate bonds that an entity uses in estimating the discount rate for postemployment benefits should be denominated in the same currency as the benefits to be paid (thus, the depth of the market for high-quality corporate bonds should be assessed at the currency level).
- IAS 34: The meaning of "elsewhere in the interim report" is explained and a cross-reference is required.

**Sale or Contribution of Assets between an Investor and its Associate or Joint Venture** resolves an inconsistency between guidance in IFRS 10 and that in IAS 28. Under the amendments, an entity would recognize a full gain or loss from transactions between an investor and its equity method investee that involves a business, as defined in IFRS 3. An entity would recognize a partial gain or loss when such transaction involves assets that do not constitute a business.

**Equity Method in Separate Financial Statements:** This amendments to IAS 27 permit an entity to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate financial statements, in addition to existing accounting options (i.e., at cost or at fair value in accordance with IFRS 9).

**Other News:**

- In addition to the issuance of these amendments, the IASB exposed a few **documents for public consultation** on topics such as the effect of rate regulations, unit of account for certain investments measured at fair value, deferred tax for unrealised losses on debt instruments and classification and measurement of share-based payments. The IASB is in the process of deliberating projects such as **insurance contracts, leases, conceptual framework, disclosure initiatives** and research projects.
- In November, Mr. Michel Prada, **Chairman of the Trustees of the IFRS Foundation**, visited Japan and delivered a speech entitled 'Japan and global standards' on developments in and out of Japan, presenting his thoughts on the future of IFRS. The script of the speech is available at the IASB's website.

## U.S. GAAP

- **ASU 2014-17: Business Combinations (Topic 805): Pushdown Accounting (a consensus of the FASB Emerging Issues Task Force)** provides an entity an option to apply pushdown accounting in its separate financial statements upon occurrence of a change-in-control event.
- **ASU 2014-16: Determining whether the host contract in a hybrid financial instrument issued in the form of a share is more akin to debt or to equity** requires an entity to determine the nature of the host contract based on the whole-instrument method. Under the method, an entity shall consider all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature on the basis of the relevant facts and circumstances.
- **ASU 2014-15: Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern** introduces guidance around disclosure of going-concern uncertainties in their financial statements. Before the issuance of this update, auditing standards and federal security laws served as the primary sources of guidance.

The new standard requires periodic assessments of an entity's ability to continue as a going concern and disclosure when applicable.

- **ASU 2014-14: Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure** requires creditors to reclassify a government-guaranteed mortgage loan upon foreclosure as an other receivable that is separate from loans and to measure the receivable at the amount expected to be received under the government guarantee if the mortgage loan meets certain conditions upon foreclosure.
- **ASU 2014-13: Measuring the Financial Assets and the Financial Liabilities of a Consolidated Collateralized Financing Entity (CFE)** gives entities that consolidate a CFE an optional practicability exception from applying the fair value measurement guidance in ASC 820 when all of the financial assets and financial liabilities of the consolidated CFE are measured at fair value through net income under other U.S. GAAP (e.g., when the entity had elected the fair value option for all of the CFE's financial assets and financial liabilities).

### Other News

- In addition to the issuance of the above ASUs, the FASB exposed a few **documents for public consultation** on topics such as fair value disclosure for items measured based on net asset value per share, measurement dates for defined benefit obligations/plan assets, presentation of debt issuance costs and internal use software. The FASB also continues to work on its technical agenda which includes **framework projects, financial instruments, insurance contracts, leases**, etc. Further, In October, James Kroeker, the FASB vice chairman, announced the FASB's outreach plan to reassess the effective date of the **ASC 606, Revenue from contracts with customer**, at the second meeting of the FASB/IASB joint transition resource group for revenue recognition. He emphasized that the FASB is considering whether to defer the effective date of the new revenue guidance and noted that a decision will be made no later than the second quarter of 2015.
- **SEC:** In October, James Schnurr, the new chief accountant in the SEC's Office of the Chief Accountant (former partner of the Deloitte U.S. firm) announced that he hopes to make a recommendation in the next few months on whether the SEC should move toward switching U.S. companies to using IFRS.

## Japanese GAAP

### Revisions to Ordinances related to Disclosures by Public Companies in Japan

Ordinances and other regulations including the Cabinet Office Ordinance on Disclosure of Corporate Affairs, etc. were revised and became effective in August. Among others, the revisions have eased the burden for using consolidated financial statements based on IFRSs that may be included in a Securities Registration Statement at the time of a new securities listing.

### FASB and ASBJ hold biannual meeting in Tokyo

The FASB and the ASBJ held their biannual meeting in October. They provided updates on each board's activities and exchanged views on technical topics.

### Japan updates lists of 'designated' IFRSs

The FSA has designated all pronouncements issued by the IASB up to 30 June 2014. Newly designated IFRSs include IFRS 14, IFRS 15 and amendments to IAS 16, IAS 38, IAS 41 and IFRS 11.

For more information, please visit: IASPlus.com (IFRS) or USGAAPPlus.com (U.S. GAAP) or speak to our Deloitte experts Shinya IWASAKI, Partner (shinya.iwasaki@tohmatsu.co.jp), Etsuya WATANABE, Senior Manager (etsuya.watanabe@tohmatsu.co.jp) or Laurent FOUGEROLLE, Senior Manager (laurent.fougerolle@tohmatsu.co.jp).

# Tax News

## Japanese Consumption Tax

### Increase to 10% rate is postponed

Given the challenging economic conditions in Japan, Prime Minister Shinzo Abe announced on 18 November his intention to postpone a planned Japanese Consumption Tax ("JCT") rate increase (from 8% to 10% scheduled for October 2015) until 1 April 2017, and call a snap election on 14 December to confirm public support for his economic policies.

This was in light of a JCT rate increase in April this year from 5% to 8%, and subsequent data that suggests that private consumption, which accounts for 60% of Japan's GDP, grew only 0.4%, which suggests the rise in consumer prices following the April increase to the JCT rate has taken a toll on the economy.

### Multiple rates

Furthermore on 19 November the ruling coalition parties agreed on efforts to introduce a reduced JCT rate on daily necessities at the same time as the second JCT increase on 1 April 2017. They also confirmed that this policy will be incorporated in their joint campaign platforms for the general election.

If, as predicted, the coalition retains a two-third majority in the Lower House (which is required to override rejections of bills in the Upper House), there should be some progress on discussions around the introduction of multiple JCT rates.

### Cross border digital services

Proposed changes to impose JCT on cross-border digital services that are currently being discussed by the Tax Commission will still likely be included as part of the 2015 tax reform. As a result of the December snap elections, the 2015 tax reform proposals, which were originally expected to be released in December, will likely be delayed to January 2015. Timing for when the changes to how digital services are taxed for JCT purposes has yet to be decided, but current speculation is that the new rules may become effective from 1 October 2015.

## Base Erosion and Profit Shifting update

During September 2014, the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development ("OECD") released the documents (the "2014 deliverables") that it had promised, in the 2013 Action Plan on Base Erosion and Profit Shifting (BEPS), to produce this year. The 2014 deliverables represent seven of the 15 actions of the BEPS Project, a project undertaken by the 44 countries that are, or will soon be, members of the OECD or of the G20 group of countries.

Some of the 2014 deliverables provide draft recommendations, agreed to by negotiators for the 44 countries, to change domestic tax laws, treaties, and other measures so as to combat government concerns regarding BEPS.

We will provide further comments on Japan's potential reaction to the 2014 deliverables and other recently published discussion papers in a webinar, which is part of Deloitte's Dbrief series on 5 March 2015, 3:00 - 4:00 PM Japan time. Please refer to the following link for further details of how to register: www.deloitte.com/ap/dbriefs/aptax.

The Dbrief will particularly focus on Action 10 (transfer pricing - proposed modifications to relating to low value intragroup services), Action 7 (artificial avoidance of PE status) and Action 6 (treaty abuse), all of which may have an impact on how inbound groups that utilize cost-plus arrangements, commissionaire structures, and/or holding company locations, approach their business operations in Japan. The Dbrief will also focus on the 2015 tax reform proposals and the expected impact to corporations and individuals. As well as the expected changes to the consumption tax rules, including an update on the rate increase, treatment of cross-border digital services, and what the delay in the second consumption tax rate increase means to businesses and consumers.

# Amended Japan - UK Tax Treaty

The Japanese and UK authorities have confirmed that an updated income tax treaty (the “Updated Treaty”) will be applicable from next year.

### Date of Application for Japanese tax purposes:

In relation to withholding tax this will apply to amounts taxable on or after 1 January 2015. The provisions concerning taxes on income which are not withheld at source (e.g. corporate income taxes) will be applicable for tax years beginning on or after 1 January 2015.

### Significant Updates

Overall, these changes should encourage trade between Japan and the UK. Furthermore, multinational companies may wish to consider investment into Japan through the UK as the tax costs for qualified taxpayers should be reduced due to favorable revisions.

### Key beneficial amendments:

- Reduces the ownership requirement from 50% to 10% for exemption on dividend withholding tax for qualified taxpayers.
- Introduces an interest withholding tax exemption to all qualified taxpayers (previously the exemption was only available to financial and government institutions).
- Removes the requirement that capital gains on the sale of shares must be “subject to tax” in the UK in order to obtain an exemption from taxation in Japan.
- Amends the Business Profits article language to require recognition of internal dealings (i.e. transactions between a permanent establishment in Japan and other parts of the enterprise).
- Introduces mandatory binding arbitration for mutual agreement procedure cases.

### Potential issue:

The Updated Treaty contains anti-abuse provisions, including a "Limitation on Benefits" (LOB) article. The LOB contains tests, one of which must be satisfied in order to obtain certain treaty benefits. It should be noted that some taxpayers currently claim reduced withholding tax in relation to certain income (e.g. interest income), which does not require the satisfaction of the LOB article. However, under the Updated Treaty the withholding tax exemption is only available if the LOB is satisfied. Conversely, if an LOB criterion is not met, the exemption is not available, and as there is no longer a reduced rate, such taxpayers will have to pay the domestic withholding tax rate of 20.42%. So for these taxpayers the withholding tax may actually increase.

It is recommended that taxpayers review the Updated Treaty including the LOB article to confirm that they are able to obtain the benefits available.

For more information, please speak to our Deloitte experts Sunie OUE, Partner (sunie.oue@tohmatsu.co.jp), or Jun TAKAHARA, Partner (jun.takahara@tohmatsu.co.jp).

# M&A News

### Deal Value

On a quarterly basis, disclosed deal value decreased 57% from 3,798 billion yen in Q3 2013 to 1,651 billion yen in Q3 2014.

| Values (Billion JPY) | IN-IN | IN-OUT | OUT-IN | TOTAL |
|---|---|---|---|---|
| 2013 Q3 | 305 (8%) | 2,263 (60%) | 1,230 (32%) | 3,798 |
| 2014 Q3 | 262 (16%) | 1,041 (63%) | 348 (21%) | 1,651 |
| % Change | -14% | -54% | -72% | -57% |

### Deal Volume

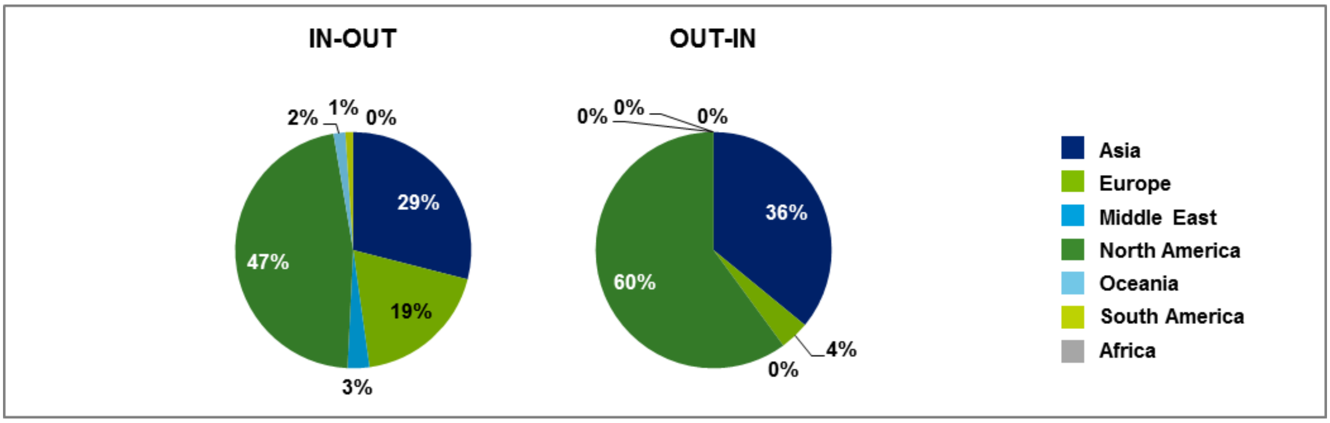
On a quarterly basis, deal volume increased 10% from 512 deals in Q3 2013 to 566 deals in Q3 2014.

| Volumes (Transactions) | IN-IN | IN-OUT | OUT-IN | TOTAL |
|---|---|---|---|---|
| 2013 Q3 | 346 (67%) | 131 (26%) | 35 (7%) | 512 |
| 2014 Q3 | 380 (67%) | 138 (24%) | 48 (9%) | 566 |
| % Change | +10% | +5% | +37% | +10% |

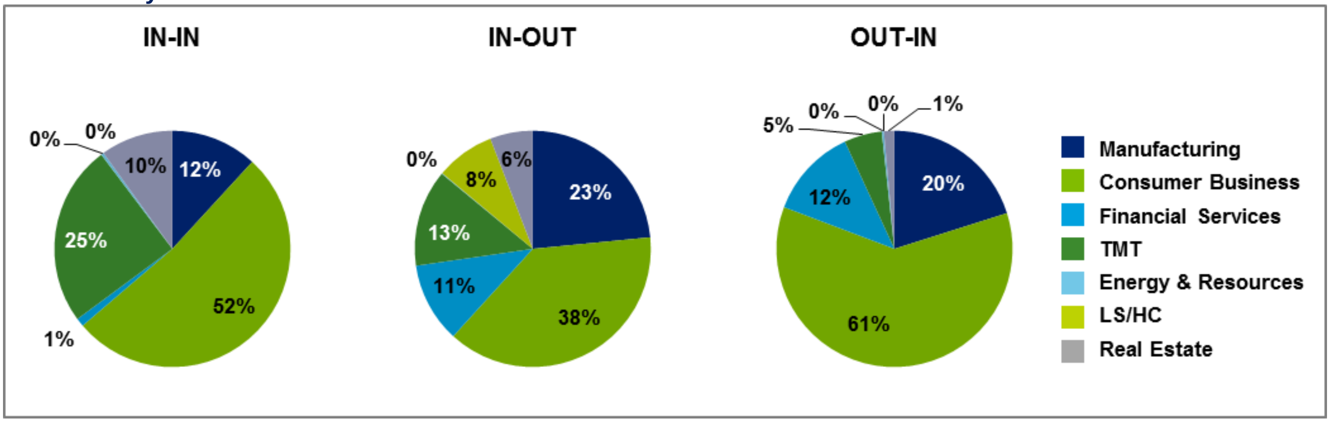
### Top 3 deals occurring in 3Q 2014

The top 3 deals were all outbound transactions. The top deal was Mitsubishi Corp's outbound acquisition of Cermaq, the third largest salmon aqua farmer based in Norway, for 152 billion yen, via a tender offer bid. Mitsubishi-Cermaq's combined production volume will create the world's second largest salmon aqua farming business.

### Deal Value by Region




### Deal Value by Sector




IN-IN | Acquisition of Japanese companies by Japanese companies (domestic)
IN-OUT | Acquisition of non-Japanese companies by Japanese companies (outbound)
OUT-IN | Acquisition of Japanese companies by non-Japanese companies (inbound)

# Talent: Building the Team You Need Now

Whether you are a new or veteran CFO, having the right team in place is essential to your success. Among the fundamental resources (that is, time, talent and relationships) executives must manage during a transition, securing high-performing talent may be the most critical to achieving a CFO's priorities - and one fraught with minefields.

Still, when CFOs were asked in a recent Deloitte CFO Signals survey for their top insights on building a strong finance function, they resoundingly said retaining top performers is worth the effort - and recruiting talent that is not only top-notch, but also fits the long-term needs and culture of the organization is vital. Moreover, they encourage hiring not simply for technical skills, but also for mind-set, breadth and partnering ability.

It is obviously a tall order. But while there are no simple answers to decisions pertaining to people, knowing fleeting trade-offs and how to effectively gauge skills may help you better navigate these decisions. Following are ways to review your current staff and strategies for shaping the team you need to achieve the priorities you've set.

## Right People, Right Seats

Getting the "right people in the right seats" is a goal we often hear from seasoned executives during their transitions. Having the wrong people in certain positions can cost you valuable time - often your most precious resource - as you have to review and repair work. Those wrong people can also cost you credibility if you are viewed as carrying and not attending to nonperformers in a timely way.

Accomplishing this goal begins with gauging the capabilities of direct reports and other critical staff and deciding whether to improve individual capabilities or recruit new talent. A starting point is to peruse performance reviews, which are often not sufficiently informative, or to quiz a previous leader, if he or she remains with the organization. But, typically, you have to make your own observations.

Aside from gut impressions, the following seven questions can help provide you with a quick snapshot of your key staff members and their capabilities:

### How confident are you in each of your direct reports and the key staff below them?

You want to have confidence in your staff in three areas: competence, judgment in critical situations and execution abilities. To gauge competence, it is useful to frame the Occam's razor question for each functional area. For example, CFOs may ask their tax directors what they would do differently if there were no taxes, and why. A good question can provide insight into competence. Good observations probably lend more insight into the behaviors and judgment of your staff in a business and social context. Thus, 360-degree evaluations of staff can provide insight into the observations of others regarding the competence and judgment of your staff.

### Who gives you and your team positive energy, and who sucks energy from you?

Those who drain your energy are probably energy vampires in the broader organization. You generally want to build a team around those who give positive energy overall.

### Who would you take with you if you left tomorrow?

Asking who you would take with you is a good way of identifying high potential team members and stars. They are likely to be your "keepers."

### Who is a good brand ambassador to other organizations for you?

In most functions, you need people who are technically competent and able to represent the brand you want to create. Good brand ambassadors can partner with clients and help enhance the reputation of your organization.

### Who is or is not a team player?

Typically, you want team players in your organization. You will have to decide your strategy with those who choose not to team.

### Who is a flight or retirement risk?

You need to identify flight and retirement risks and establish retention or succession plans to mitigate them.

**Who is technically competent but managerially incapable?**

Another challenge is a direct report who is technically very good but a poor manager. This can manifest itself in poor delegation skills, bottlenecking of work, turnover on a team or poor hiring choices.

## Taking Action on Talent

While there are other important questions, these seven can help identify where you need to improve talent. Generally, you have three options: replace problematic team members, reassign staff or remediate performance gaps through training or coaching.

Ideally, you will want to have high confidence in all your direct reports. For reports you are unsure about, you may want to assign them key tasks to test their competence or judgment to determine your confidence in them. For those reports you do not have confidence in, you will likely want to replace or reassign them.

One trap you do not want to fall into is the “rescue fantasy.” In discussions with CFOs, we find two common variations. The first is when you have a very congenial and well-liked individual who is not performing at the required level. Conversely, you may have a talented individual who is good at his or her specialty or execution of projects, but does so in a manner inconsistent with the culture, teaming and other norms you wish to establish.

As rescue efforts do not always succeed and can be costly in terms of time and effort, you have to carefully determine the likelihood of success and the trade-offs of individual rescue efforts versus recruiting staff with the requisite skills and temperament to succeed in these roles. Rescue efforts with direct reports should generally maintain an established timeline that helps resolutions occur in the first year. You also have to consider the opportunity cost of your time in a failed rescue. However, using third-party resources such as external coaches, training programs or internal and external networks to help individuals develop the skills they lack can give you leverage in these efforts.

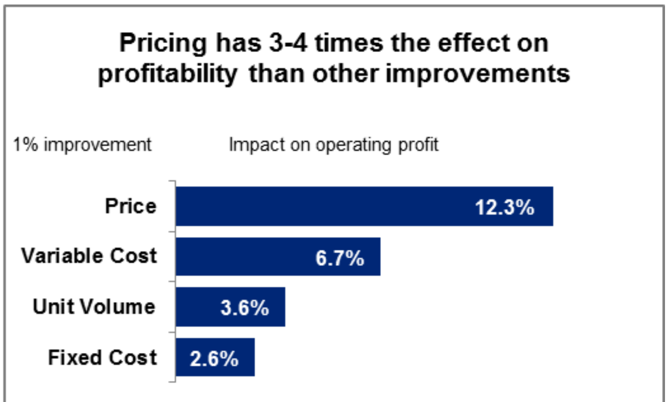
Finally, replacing or reassigning staff or remediating performance will require partnership with human resources (HR) across multiple dimensions. Depending on existing performance management systems, replacing staff can take time to build the case for dismissal. Furthermore, existing compensation systems may need to be renegotiated to recruit critical talent. Reassigning staff to roles for which they are best suited and providing coaching and training programs to staff are also likely to require HR support. Thus, it is important to get HR on board as quickly as possible to assist with your talent agenda.

## Act Quickly, With No Regrets

When we ask executives about their single biggest regret after their first year of transition, we often hear they did not move quickly enough on talent performance issues. Getting the right people in the right seats as quickly as possible is likely to free up your time to attend to the truly important issues.

# Pricing for Profitability: Understanding the Pocket Margin

CFOs have long been confident in their ability to affect the cost side of the margin equation. But with multiple layers of overhead wrung out of the system and product costs rising unabated, unlocking the price side has taken on a certain sense of urgency.



Source: Compusat, Deloitte Analysis
Note: Impact estimate is based on the average Fortune 1000 company

Effectively implementing a pricing strategy, however, is more than simply viewing products on a cost-plus basis. It is also more than tracking pricing performance at the aggregate level. Instead, the promise of pricing is in the details: an effective strategy should rely on understanding economic profitability at the customer, product and segment level - the so-called pocket margin - and using that information to inform overall decision-making.

To get to that level of detail, though, may require overcoming cultural, data and compensation barriers to determine pocket costs. The effort is worth it, however: research has shown that pricing has up to four times more impact on profitability than other improvements.

## What Are Pocket Margins?

Clearly, finance chiefs recognize the power of pricing. In a recent Deloitte CFO Signals survey, three-fourths of CFOs reported that their finance organizations were at least moderately involved in tracking and reporting pricing performance and profitability. In addition, more than half reported substantial involvement in aligning pricing strategies with corporate strategies, managing exceptions to general policies and setting pricing based on data and analytics.

It is also clear that finance chiefs are not afraid to wield the pricing baton. That same survey found that 65% of CFOs reported having raised prices, and 42% said more increases were coming. Still, how they raised prices was not totally apparent, and when it came to profitability analyses, customer-level profitability was comparatively less utilized and influential than, say, geography-level profitability analysis.

But it is the customer-level economic profitability that can offer an untapped reservoir of information - and potential for improved margins.

For example, which customer segments are being given unwarranted volume discounts; which are unaffected by slight price increases; and where are delivery promises being made that materially increase transaction cost, but are not being charged for? To get at that level of information, however, may require moving past the aggregate view of pricing (gross margin, net margin) that finance typically demands to the "pocket" view that takes into account everything from payment terms to freight costs in order to identify the true profitability of a transaction (that is, gross margin less detailed allocations of fixed costs and SG&A).

And from that information, CFOs can extrapolate how profitable individual products, customers and channels are and inform decisions that include, but are not limited to the following:

- What price premiums should be associated with products that significantly impact working capital?
- On a regional level, how should we assess and adjust our product portfolio based on geographic dynamics?
- Instead of subsegmenting the market with multiple products, are there loss leaders that can be cut from our portfolio?
- Is discounting being used by our sales force uniformly across the board or in a strategic way with our best customers?
- Are there ways to use the pocket cost information to effectively increase prices without losing customers?
- Are we waiving our fee policies on low gross margin transactions and simply breaking even?

## Identifying and Leveraging Pocket Information

While the analytic tools exist to identify costs at a pocket level, the data is often widespread and incomplete, and frequently siloed. Sales executives typically worry about revenue and the commissions associated with it; supply-chain professionals care about containing fuel and other factors; manufacturing wants the lowest unit costs; marketing focuses on which discount campaign to offer next; and all are concerned with optimizing their particular piece of a product's life cycle.

But to fully assess pocket costs, finance should identify the components that add or subtract value from the business on a marginal basis. Those include factors that are not part of cost of goods sold (COGS), such as expedited shipping, fixed-asset or fixed-cost productivity, the cost of capital included in payment terms, and the various discounts and promotions offered. And one effective tool to identify those factors is the price waterfall. Working backwards from the list price, CFOs can use the tool to identify margin leakages and create visibility from a reference list price down to the pocket margin, including discounts, rebates and other cost elements. Moreover, the visual representation makes comparison with competitors very easy - and offers convincing proof of where price erodes in the multiple steps between making and delivering a product.

Such an exercise also allows finance to match revenue and costs for individual transactions. While a product that earns 40% margin may look like the a winner in the product portfolio, if it turns out to be highly engineered and highly specialized, and requires extra sales support, it may not be. Instead, it may be the product that earns 20% margin and only has to be packed and shipped that you should be expanding. Knowing what your costs are going forward may allow you to make the decisions that fit into the overall product strategy and build economic models that do the following:

**Affect strategy:**

By making sure everyone involved in the pricing equation has a proper understanding of the economics of the business, CFOs can influence not just pricing policies, but overall business strategy.

**Educate stakeholders:**

Having pocket-margin information can allow a CFO to educate his or her peers, CEO and the board about pricing policies that work. If, for example, the data shows that the sales and marketing are pushing pricing strategies that sell products that don't contribute to the overall value of the business, those policies can be adjusted.

**Institute controls:**

One outcome of pocket costing is often the exposure of "unwarranted discounting" - awarding discounts to customers whose volumes do not justify such action. One solution is to put limits on who can discount to what level and assign a finance person to authorize discounts that exceed that level.

**Create a single version of the truth:**

Pocket costing exposes which products or customers are contributing value and which are not. That single version of the truth also allows individual functions to make decisions about resource deployment, such as where distribution centers should be located, how much product should be kept in inventory and how goods should be delivered.

## Five Questions for Your Pricing Manager

For CFOs, acquiring and leveraging pocket-pricing information should start with a series of questions for their designated pricing managers. Specifically:

**Who are our most profitable customers according to the sales force? According to finance?**

Evaluating profitability may be a very different process depending on who is doing the evaluating. While the sales force may be enamored with a particular customer based on sheer volume, you may be barely breaking even on that customer after selling and servicing costs are taken into consideration. Armed with customer-profitability information, however, a CFO can figure out where unwarranted discounts are being given or where special handling may be inflating costs. It also gives CFOs the profitability data to reassess which customers can be offered discounts and which can't.

**What are our transaction patterns, and what do they tell us?**

Transactions over time speak volumes. Take a customer with average gross margins of, say, 40% that has a large portion of annual transactions under $100. If it costs $20 on average just to deliver the goods, and sales is offering free delivery on these small orders, it becomes very difficult to conclude that the revenue stream is profitable. Gaining visibility into such margin erosion can allow a CFO to challenge strategic decisions such as offering daily deliveries or at least explore the option of going back to the customer to renegotiate terms.

**How do we allocate pocket costs in determining price?**

Often in making pricing decisions, it is not readily apparent how to allocate pocket costs. What we typically observe is a smooth distribution of those costs. So while at an aggregate level everything may appear profitable, in reality most companies have winners and losers - they just don't know which is which. CFOs should develop a better policy for allocations in order to make better pricing choices.

**Do we have the analytical talent to accurately decipher pocket margins?**

These days, it is essential to have finance staff, particularly in finance, planning and analysis (FP&A), who can analyze pricing-trends data by geography, customer profile, product line, and other dimensions. As in other areas of finance, however, such specialized analytical knowledge is in short supply, and CFOs need to figure out how to build that capability either by developing talent in-house or hiring from outside. In this case, CFOs should also be open to developing someone from sales or marketing who is knowledgeable about individual customer pricing information. The point is that accounting knowledge is insufficient in this case - you need someone who has some operational knowledge to attain a better allocation of costs.

### Do our compensation practices help or hinder our pricing strategy?

Since sales and marketing professionals are often compensated differently, it can lead to pricing decisions that do not create value. For example, if sales executives are paid commissions on revenue or gross profit, they often don't care if the company charges for hazmat or has a large safety inventory. None of that shows up in gross profit, but it does affect overall financial performance. For CFOs, aligning the compensation plan with pricing and profitability objectives takes a true understanding of the economics of the business, so the rewards offered are aligned and are commensurate with the goals of the business.

## Out-of-Pocket Benefits

To adequately price in today's competitive marketplace, finance should build economic models that maximize sale-by-sale profit. Central to creating those models is a granular understanding of customer analytics on a product-by-product basis.

The companywide deployment of such information can help clear the way for informed decisions about everything from channels and products to sales and advertising. In addition, once a company has an understanding of the impact on individual products and customers, that information can offer a window into other areas of operations, such as the proper levels of safety stock and the cost-effective delivery methods.

Finally, gaining a handle on pocket margins can give CFOs another tool for growth and allows them to further drive the alignment of pricing approaches with corporate strategies. Pricing, after all, can expand earnings faster than cost-cutting.

## The CFO Program for International Companies

Deloitte's Chief Financial Officer (CFO) Program brings together a multidisciplinary team of Deloitte leaders and subject matter specialists to help CFOs stay ahead in the face of growing challenges and demands. The Program harnesses our organization's broad capabilities to deliver forward thinking and fresh insights for every stage of a CFO's career - helping CFOs manage the complexities of their roles, tackle their company's most compelling challenges and adapt to strategic shifts in the market. Deloitte's vision is clear: To be recognized as the pre-eminent advisor to the CFO.

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