CFO Insights | Japan

2016 Q2

The CFO Program

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Japan Economic Outlook: Finding the right policy mix

Growth

The Japanese economy contracted at an annualized rate of 1.1 percent in the fourth quarter of 2015. Real GDP has declined in five of the last nine quarters, and in two of the last three.[1] For all of 2015, real GDP was up only 0.4 percent from the previous year, having not grown at all in 2014. The economy is clearly not recovering in the manner that the government had hoped, especially given the massive monetary stimulus undertaken by the Bank of Japan (BOJ). Consumer spending fell at a rate of 3.4 percent, and public investment fell at a sharp rate of 12.7 percent—indicating that the fiscal stimulus component of Abenomics is not taking place. Plus, exports fell at a rate of 3.3 percent, despite the weakness of the Japanese yen. On the other hand, business investment grew at a rate of 6.3 percent after a long period of no growth. In part, Japan is suffering through a demographic shift, as the working-age population shrinks rapidly. On a per capita basis, Japan's economy is actually growing at a slow but more reasonable pace. However, Japan could probably grow faster under the right set of circumstances. Fiscal stimulus and market-opening reforms, the second and third "arrows" of Abenomics, would probably help. However, only the first "arrow," monetary stimulus, has been tried in a significant way. Some observers hope that implementation of the Trans-Pacific Partnership will compel the government to address structural reform issues.

Moving into the first quarter, Japanese exports grew modestly from December to January, while imports fell, leading to an increase in the trade surplus. Yet nominal Japanese exports were down 12.9 percent from a year earlier, and imports down even more steeply, at 18 percent. Exports to China were especially poor, declining 17.5 percent from a year earlier, reflecting the weakness of the Chinese economy. Exports to the United States were down 5.3 percent, while imports from the United States were down 9.7 percent. Exports to the European Union were down 3.6 percent, while imports from the European Union were up 6.0 percent.[2] The weakness of

[1] Cabinet Office, Government of Japan, "Quarterly estimates of GDP: Oct.–Dec. 2015 (the 2nd preliminary)," http://www.esri.cao.go.jp/en/sna/data/sokuhou/files/2015/qe154_2/gdemenuea.html, accessed April 2, 2016.

[2] Ministry of Finance Japan, "General trade statistics," http://www.customs.go.jp/toukei/srch/indexe.htm, accessed April 2, 2016.

exports is despite the fact that the yen is now competitively priced. On the other hand, exports performed better in volume terms: The weak yen has enabled exporters to cut prices, thus boosting volume while reducing nominal revenue. Meanwhile, the recent rise in the yen, from about 120 yen per dollar to about 112 yen per dollar, was fueled by the flight to safety that followed global financial turbulence. If sustained, this increase could have a negative impact on export volume.

Fiscal policy

Japanese Prime Minister Shinzo Abe recently met with two Nobel Prize–winning US economists known for favoring fiscal stimulus for the Japanese economy. The economists, Joseph Stiglitz and Paul Krugman, are known for being left of center compared with Abe's known conservatism. Thus Abe's decision to meet with them and publicize the meetings suggested that he might be preparing the way for a shift in fiscal policy. In addition, it has been suggested that, as he did when he postponed the last tax increase, he will call a new election in order to obtain a voter mandate for this important shift in policy. When he postponed the tax increase last year, he said that it would not happen again, and that the tax increase set for 2017 would definitely take place. Thus a new mandate might be seen as essential to covering any political risk associated with this shift in policy. On the other hand, failure to postpone the tax increase could lead to yet another recession for Japan's fragile economy. Stiglitz and Krugman's view is that monetary policy alone has been inadequate for boosting economic activity, and that a fiscal stimulus is needed as well—not only for Japan but for other developed economies that suffer from weak credit market activity. While this view has gained credence among economists, the International Monetary Fund, and the Organization for Economic Development, it has not been adopted anywhere other than in Canada and, to a lesser extent, in the United States.

Still, Abe has lately reiterated his intention to go ahead with the tax increase. However, he also suggested that there is room for fiscal stimulus as well. As such, he has directed his finance minister to frontload spending planned for the new fiscal year. That would provide a temporary boost to the economy. Yet he continues to indicate an aversion to backtracking from his original pledge to go ahead with the next tax increase, a pledge he solemnly made when he postponed the last tax increase. Meanwhile, it was reported that real (inflation-adjusted) retail sales fell in January. This indicates continued weakness in the consumer sector and shows the potential danger of another tax increase.

Negative interest rates

Not long ago, BOJ Governor Haruhiko Kuroda said that the Bank of Japan (BOJ) will not consider negative interest rates, despite continued very low inflation.[3] Recently, however, the BOJ implemented a policy of negative interest rates for the first time. Specifically, the benchmark interest rate was cut to -0.1 percent for new cash reserves. The rate will remain 0.1 percent for existing reserves. Thus banks that receive new deposits will have an incentive to avoid holding excess cash and, instead, to lend that money to the private sector. The bank's policy committee narrowly approved this decision by a vote of 5 to 4. Kuroda said that "through the minus interest rate combined with quantitative easing, I hope we can support companies and individuals in breaking their deflationary mindset." In addition, he said that the bank might "cut the interest rate further into negative territory if judged as necessary." Kuroda also said that the BOJ would leave the pace of asset purchases (quantitative easing) unchanged for now. However, he indicated that the decision to cut rates did not preclude boosting the pace of asset purchases if need be. He noted that the economic slowdown in China, declining oil prices, and global financial market volatility are suppressing inflation and damaging business confidence in Japan.[4] He evidently hopes that negative rates will encourage a rebound in credit market activity.

The BOJ is not the first central bank to do this. The central banks of Sweden, Switzerland, and the Eurozone have all tried this recently due to the persistence of deflation or near deflation. The European Central Bank (ECB) initiated negative rates in 2014 when it started charging banks for holding cash reserves with the central bank. That action likely contributed to the acceleration of money supply growth in Europe. However, Europe continued to suffer from low inflation for a prolonged period. Investors were surprised by the BOJ's action and reacted accordingly. The yen fell sharply against the US dollar, Japanese equities soared, and equity prices in other developed countries increased following the news from Tokyo.

What exactly does a negative interest rate entail, and what impact might it have? The BOJ, like other central banks, allows commercial banks to deposit short-term cash at the central bank, and it pays those banks a modest interest rate for holding that cash. If the BOJ were to set that interest rate relatively high, it would be an incentive for banks to hold more cash with the BOJ, thus reducing the incentive to lend money to the private sector. As such, the money creation that comes about from lending money would be inhibited. Conversely, if the BOJ wants to encourage more bank lending to the private sector, it sets the interest rate at a low level. Yet when there is virtually no inflation (or even deflation) in the economy, even a modest interest rate can seem high in real terms. Thus some central banks choose to set the rate at a negative level in order to encourage more credit creation. This entails requiring that commercial banks actually pay for the privilege of depositing cash with the BOJ. Other central banks that have done this include the ECB and the central banks of Switzerland and Denmark. The latter two banks have set rates at -0.75 and -1.1 percent, respectively.

Currently, the BOJ is struggling to kick-start credit creation in order to boost inflation and to stimulate economic activity. One problem is that, although banks may be willing to lend at very low interest rates, many businesses are reluctant to borrow for fear that deflation will kill the return on any new investment projects. Thus the BOJ is eager to boost expectations of inflation so that businesses feel comfortable investing in new projects. Yet despite two years of massive asset purchases (quantitative easing), expectations have barely budged. Indeed, they have declined due to the impact of declining energy prices. Now, with negative rates, the BOJ is looking for a new tool to boost expectations of inflation.

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[3] Leika Kihara, "BOJ's Kuroda says no plan to adopt negative rates now," *Reuters*, January 21, 2016, http://www.reuters.com/article/us-japan-economy-boj-idUSKCN0UZ0AN.

[4] Robin Harding, Sam Fleming, and Claire Jones, "Japan joins negative rates club," *Financial Times*, January 29, 2016, http://www.ft.com/intl/cms/s/2/23ff8798-c63c-11e5-b3b1-7b2481276e45.html#axzz44brAsNy1.

The implementation of negative interest rates is creating concerns. The program involves charging commercial banks for holding cash reserves with the central bank. The idea is to discourage them from holding excess cash reserves and to encourage them to lend money to the private sector. However, banks must still hold some cash reserves. If they pay a positive interest rate on their deposits, then they lose money on part of their deposits. If, however, they charge individuals to deposit money with them (offer negative rates on deposits), they risk losing deposits as individuals might choose to hold physical cash at home. Interestingly, banks are now paying zero interest on deposits. The result is that there has been a surge in sales of safes so that people can store cash at home. Also, even if banks offer to lend more to businesses at low interest rates, it is not clear that businesses will want to borrow more unless they are convinced that inflation will rebound and demand will improve. Thus the risk exists that negative interest rates will simply hurt bank profitability without doing much to stimulate credit market activity.

Bond yields

Recently, the yield on Japanese 10-year government bonds fell below 0 percent for the first time ever. Indeed this is one of the few 10-year bonds for any country to have a yield below zero. Switzerland's 10-year bond has a negative yield, but Switzerland has significant deflation. Many lower-maturity bonds in several countries now have negative yields. This includes the two- and five-year bonds for both Germany and Japan. Why did Japan's 10-year bond yield fall so far? First, the global financial volatility and uncertainty led to a flight to safety, and Japanese bonds are seen as exceptionally safe.

Second, lower oil prices have suppressed expectations of inflation in Japan and elsewhere, despite aggressive monetary policy. Third, the BOJ's decision to impose negative short-term rates means that investors are looking elsewhere to park their funds. Plus, negative policy rates have hurt shares in banks, with investors selling shares and purchasing sovereign bonds. For sovereign debtors, there has never been a better time to borrow money— which leads to the question of fiscal policy. Given the stagnant global economy, now would likely be a good time for governments to issue new bonds to finance infrastructure and other forms of investments.

Accounting News

IFRSs

No new standard or interpretation was issued by the IASB, except for clarifying amendments to IFRS15 which is covered in the later part of this letter, namely, IFRS & U.S.GAAP – New Revenue Standards.

On voluntary adoption of IFRSs by Japanese public companies, Tokyo Stock Exchange issued a report summarizing the situation in April 2016. The report is available at the following:

http://www.jpx.co.jp/english/news/1020/b5b4pj0000011fwn-att/20160413e.pdf

U.S. GAAP

The FASB has issued several Accounting Standards Updates, including:

ASU No. 2016-02 - Leases (Topic 842): Balance Sheet Classification of Leases and related sections

This new standard introduces a new lessee accounting model that brings substantially all leases onto the balance sheet. The amendments in this update increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Previous leases accounting was criticized for failing to meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, it did not require lessees to recognize assets and liabilities arising from operating leases on the balance sheet.

The Board decided that, consistent with all three proposals that led to this ASU, lessees should be required to recognize the assets and liabilities arising from leases on the balance sheet. However, for leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term.

The new standard is effective for fiscal years beginning after December 15, 2018, for public entities and beginning after December 15, 2020, for all other entities.

Early application of the amendments in this update is permitted for all entities.

ASU No. 2016-04– Liabilities - Extinguishments of Liabilities (Subtopic 405-20): Recognition of Breakage for Certain Prepaid Stored-Value Products (a consensus of the Emerging Issues Task Force)

The objective of this update is to address the current and potential future diversity in practice related to the derecognition of a prepaid stored-value product liability. Prepaid stored-value products are products in physical and digital forms with stored monetary values that are issued for the purpose of being commonly accepted as payment for goods or services such as prepaid gift cards, prepaid telecommunication cards, and traveler's checks.

ASU 2016-04 amends the guidance on extinguishing financial liabilities for certain prepaid stored-value products. If an entity selling prepaid stored-value products expects to be entitled to a breakage amount (i.e., an amount that will not be redeemed), the entity will recognize the effects of the expected breakage "in proportion to the pattern of rights expected to be exercised" by the product holder to the extent that it is probable that a significant reversal of the breakage amount will not subsequently occur. That is, an entity would not recognize breakage immediately but rather proportionally as the prepaid stored-value product is being redeemed.

This update is effective for public business entities, certain not-for-profit entities, and certain employee benefit plans for financial statements issued for fiscal years beginning after December 15, 2017. For all other entities, the update is effective for financial statements issued for fiscal years beginning after December 15, 2018. Earlier application is permitted.

ASU No. 2016-05 - Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships (a consensus of the Emerging Issues Task Force)

A derivative novation occurs when one party to the derivative contract assigns its rights and obligations to a new party (i.e., legally replaces itself with another party). Approval for the novation is typically required of the existing derivative counterparty. After the novation, the entity that was replaced by the new party no longer has any rights or obligations under the contract.

Under ASC 815, an entity must discontinue a hedging relationship if (1) the hedging derivative instrument expires or is sold, terminated, or exercised or (2) it wishes to change a critical term of the hedging relationship. ASC 815 does not, however, explicitly address how a novation of a hedging derivative affects a hedging relationship, and this ambiguity has resulted in inconsistent application in practice. ASU 2016-05 clarifies whether a change in the hedging derivative's counterparty should, in and of itself, trigger discontinuation of a hedging relationship (i.e., require the entity to dedesignate the hedge).

ASU 2016-05 clarifies that "a change in the counterparty to a derivative instrument that has been designated as the hedging instrument in an existing hedging relationship would not, in and of itself, be considered a termination of the derivative instrument" or "a change in a critical term of the hedging relationship". As long as all other hedge accounting criteria in ASC 815 are met, a hedging relationship in which the hedging derivative instrument is novated would not be discontinued or require resignation. This clarification applies to both cash flow and fair value hedging relationships.

For public business entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2016 and December 15, 2017 for other entities.

Early adoption is permitted.

ASU No. 2016-06- Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments (a consensus of the Emerging Issues Task Force)

To determine how to account for debt instruments with embedded features, including contingent put and call options, an entity is required to assess whether the embedded derivatives must be bifurcated from the host contract and accounted for separately. Part of this assessment consists of evaluating whether the embedded derivative features are clearly and closely related to the debt host. Under existing guidance, for contingently exercisable options to be considered clearly and closely related to a debt host, they must be indexed only to interest rates or credit risk.

ASU 2016-06 addresses inconsistent interpretations of whether an event that triggers an entity's ability to exercise the embedded contingent option must be indexed to interest rates or credit risk for that option to qualify as clearly and closely related. Diversity in practice has developed because the existing four-step decision sequence in ASC 815-15-25-42 focuses only on whether the payoff was indexed to something other than an interest rate or credit risk. As a result, entities have been uncertain whether they should (1) determine whether the embedded features are clearly and closely related to the debt host solely on the basis of the four-step decision sequence or (2) first apply the four-step decision sequence and then also evaluate whether the event triggering the exercisability of the contingent put or call option is indexed only to an interest rate or credit risk (and not some extraneous event or factor).

This update clarifies that in assessing whether an embedded contingent put or call option is clearly and closely related to the debt host, an entity is required to perform only the four-step decision sequence in ASC 815-15-25-42.

For public business entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2016 and December 15, 2017 for other entities.

Early adoption is permitted.

ASU No. 2016-07 - Investments -Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting

The Board issued this update as part of its Simplification Initiative. The amendments in this update eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment qualifies for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required.

The amendments in this update require that an entity that has an available-for-sale equity security that qualifies for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment qualifies for equity method accounting.

This update is effective for all entities for fiscal years beginning after December 15, 2016. The amendments should be applied prospectively and earlier application is permitted.

ASU No. 2016-09 - Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting

ASU No. 2016-09, **Improvements to Employee Share-Based Payment Accounting**, simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows.

For public business entities, the amendments are effective for financial statements issued for fiscal years beginning after December 15, 2016 and December 15, 2017 for other entities. Early adoption is permitted.

New Revenue Standards

Please see IFRS & U.S.GAAP – New Revenue Standards below.

FASB Transition Resource Group (TRG) for credit losses standard

In April 2016, the FASB's Transition Resource Group (TRG) for its upcoming credit losses standard held its first public meeting.

The purpose of the credit losses TRG is similar to the one jointly established by the FASB and IASB on new revenue recognition standard. That is, it does not issue guidance but provides feedback on potential implementation issues associated with the FASB's upcoming standard on accounting for credit losses. However, the TRG on credit losses are FASB only TRG, operated separately by one by the IASB. By analyzing and discussing such issues, the TRG helps the FASB determine whether it needs to take additional action, such as providing clarification or issuing other guidance.

The topics included in its first discussion included the TRG's observations on how an entity would estimate expected credit losses on loans.

IFRS & U.S. GAAP – New Revenue Standards

IASB and FASB have been jointly trying to address implementation issues identified since the issuance of new converged revenue standards in 2014. However, the direction of their travel has showed difficulty to get to the identical solution for issues identified.

Clarifying Amendments

The IASB published final clarifications of IFRS 15 **Revenue from Contracts with Customers**.

The amendments address three of the five topics identified and aim at transition relief for modified contracts and completed contracts. In all its decisions, the IASB considered the need to balance helping entities with implementing IFRS 15 and not disrupting the implementation process. The topics included in the clarifications are as follow:

Identifying performance obligations,
Principal versus agent considerations,
Licensing,
Transition relief; and
Other topics.

The FASB issued in March 2016 ASU 2016-017 **Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)** in response to concerns identified by stakeholders, including those related to 1) determining the appropriate unit of account under the revenue standard's principal-versus-agent guidance and (2) applying the indicators of whether an entity is a principal or an agent in accordance with the revenue standard's control principle.

Furthermore, to date the FASB has exposed the following two exposure drafts to clarify new revenue standards:

Issued in:	Title
12 May 2015	Proposed Accounting Standards Update, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing.
30 September 2015	Proposed Accounting Standards Update, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedient

The proposal issued by the FASB in September is to amend the guidance related to collectability, non - cash consideration, and completed contracts at transition, and the addition of new practical expedients.

Since these clarifying proposals/amendments from both Boards are not identical, a careful analysis is needed in understand similarities and differences.

Transition Resource Group (TRG) activities

The TRG is responsible for soliciting, analyzing, and discussing issues arising from implementation of the new revenue standards in order to assist the IASB and the FASB to determine what, if any, action will be needed to address those issues. Clarifying amendments discussed above reflect past discussions by the joint TRG.

Although in January 2016 the IASB announced that it would not attend future TRG meetings, the FASB scheduled three TRG meetings in 2016. Accordingly, the FASB-only TRG met on April 2016 and discussed the following topics:

Scoping Considerations for Incentive-based Capital Allocations
Contract Asset Treatment in Contract Modifications
Scoping Considerations for Financial Institutions
Evaluating How Control Transfers Over Time
Class of Customer

Although the revenue TRG is now FASB only, IFRS reporting companies, in particular, FPIs registered with the SEC, are advised to monitor activities in line with the SEC Staff suggestions.

Japanese GAAP

ASBJ publishes Exposure Draft of further 'deletions or modifications' to IFRSs

In 2015, the ASBJ issued **Japan's Modified International Standards (JMIS): Accounting Standards Comprising IFRSs and the ASBJ Modifications**', which covered standards and interpretations issue by the IASB by December 31, 2012. The ASBJ has now completed consideration of the IASB pronouncements issued by December 31, 2013 and has made a proposal to modify JMIS in a form of an exposure draft.

The exposure draft proposes 'deletions or modifications' for the following items related to IFRS 9 (2013) **Financial Instruments**:

Non-recycling of the hedging gain or loss on fair value hedges of investments in equity instruments measured at fair value through other comprehensive income (FVTOCI): The ASBJ proposes to modify IFRS9 (2013) to reclassify the gain or loss on a hedging instrument recognized in other comprehensive income into profit or loss when gain or loss on hedged FVTOCI instrument is recognised in profit or loss.

Basis adjustments in cash flow hedges: The ASBJ proposes to modify IFRS9 (2013) to prohibit direct transfer from cash hedge reserve to carrying amount of the hedged item. Instead, the transfer should be made through other comprehensive income.

The comment is due on May 31, 2016.

ASBJ discusses the potential accounting issues in the negative interest environment

The ASBJ received queries on accounting implications of negative interest environment triggered by the interest rate policy change by the Bank of Japan implemented in February 2016.

ASBJ considered discount rate to be used to account for post-retirement benefit when the discount rate is determined based on yields of Japanese Government Bond (JGB) as permitted by Japanese GAAP.

ASBJ did not amend standards but released a summary of its Board meeting indicating both of the following methods may be accepted for the fiscal year ended March 31, 2016:

- Method A: Using negative yield as the discount rate, based on observable yield curve of JGB.

- Method B: Flooring yield at zero even though the market yield of JGB is below zero.

Another issue deliberated by the ASBJ is whether entities may continue a special accounting treatment of an interest rate swap (the 'IRS') where IFRS and hedged items are treated as if these were single non-derivative instrument (the 'special treatment'). Although Japanese GAAP explicitly permit a simplified accounting treatment if the principal terms of the IRS and the hedged item are the same but the negative interest environment may result in mismatching terms. Without formally amending the standard, the ASBJ indicated that the application of the special treatment is not precluded for the financial year ended March 31, 2016 in its summarised Board meeting record.

ASBJ releases Exposure Draft of Practical Solution on a change in depreciation method due to Tax Reform 2016

On April 22, 2016, the ASBJ published the Exposure Draft of '**Practical Solution on a change in depreciation method due to Tax Reform 2016**'. The Tax Reform 2016 sets out that a declining balance method is not permitted for leasehold improvements acquired on and after April 1, 2016 and therefore only a straight-line method is permitted to apply to those assets for tax purposes. The Exposure Draft proposes that the change in a deprecation method (i.e. from a declining balance method to a straight-line method) for accounting purposes due to Tax Reform 2016 may be accepted for accounting purpose upon meeting certain conditions.

The comment deadline is May 23, 2016.

ASBJ released Request for Information about the Development of the Comprehensive Accounting Standard for Revenue Recognition

ASBJ has been in a process of considering development of a comprehensive accounting standard for revenue recognition based on IFRS15 **Revenue from Contracts with Customers**.

The ASBJ's aim is to make such process complete and new standard available for use by the time IFRS15 becomes effective.

In order to adequately address potential challenged that may arise due to the development and implementation of such standard in Japan, ASBJ released the Request for Information in February 2016, to widely gather the stakeholders' opinion on potential implementation issues.

The comment is due on May 31, 2016.

ASBJ issues Revised Implementation Guidance on Recoverability of Deferred Tax Assets

On March 28, 2016, the ASBJ issued the revised Guidance No.26 **'Implementation Guidance on Recoverability of Deferred Tax Assets' (the 'Amendment')**. The Amendment revises the Guidance No.26 issued in December 28, 2015 for entities that early adopts the Guidance No.26 to clarify how entities would retrospectively apply the Guidance No.26 to comparative information in the quarterly financial statements within the subsequent annual reporting period.

An entity is required to apply the Amendment when it applies the Guidance No.26.

ASBJ issues Implementation Guidance on tax rates used in applying tax effect accounting

On March 14, 2016, the ASBJ issued the Guidance No. 27 **'Implementation Guidance on tax rates used in applying Tax Effect Accounting' (the 'Implementation Guidance')**. The existing standard requires using tax rates publicly notified/announced by the government by the end of financial year. However, such announcement is often made immediately after the end of financial year.

The Implementation Guidance requires that deferred tax assets and liabilities are calculated by reference to the tax rates of which the Diet passes the legislation by the end of a fiscal year.

An entity is required to apply the Implementation Guidance for annual years ending on and after March 31, 2016.

The FSA publishes the illustrative consolidated financial statements that are prepared in accordance with IFRSs

The FSA updated the illustrative consolidated financial statements (the 'Illustrative Disclosure') in accordance with IFRSs for Japanese companies voluntarily applying IFRS. Since the original issuance of the Illustrative Disclosure in 2009, certain enhancements have been made, such as to reflect new standards etc. As the FSA periodically updates the Illustrative Disclosure, one may provide feedback to the FSA.

To download an electronic copy, please point your browser to:

http://www.fsa.go.jp/news/27/sonota/20160331-5.html.

Japan updates list of 'designated' IFRSs

On February 24, the FSA announced that additional IFRSs issued in 2015 were designated for use by companies voluntarily applying IFRSs in Japan.

Newly designated IFRSs include effective date of IFRS 15 **Revenue from Contracts with Customers** and effective date of amendments to IFRS 10 **Consolidated Financial Statements** and IAS 28 **Investments in Associates and Joint Ventures**.

The Update make designated IFRSs fully aligned with IFRSs as issued by the IASB as of the end of 2015.

IFIAR permanent secretariat set in Tokyo

The International Forum of Independent Audit Regulators (IFIAR), comprised of independent auditor regulators from 51 jurisdictions, covering major economies including Japan, approved establishing IFIAR's Permanent Secretariat in Tokyo. It is expected that IFIAR is enhancing its capabilities and activities level by this office and other measures to improve audit quality globally.

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) or ALEJANDRO Saenz, Senior Manager (alejandro.saenzmartinezgeijo@tohmatsu.co.jp).

Tax News

Japan's Authorized OECD Approach (AOA)

A. Japan's AOA Approach

As part of Japan's BEPS reforms, Japanese domestic law was amended by the 2014 tax reforms to adopt the principles reflected in the OECD Report on the Attribution of Profits to Permanent Establishments. The new Authorized OECD Approach ("AOA") under domestic law focuses on the attribution of profits to a permanent establishment ("PE") and has not amended the existing definitions of activities that create a PE. The new law will come into effect beginning with fiscal years that begin on or after April 1, 2016 for PEs of corporations and the 2017 calendar year for PEs of individuals.

Under Japanese domestic tax law applicable to years beginning before 1 April 2016, Japan generally may tax a foreign enterprise when: (i) the foreign enterprise carries on a business in Japan through a PE, and (ii) Japan source income is earned by the enterprise. Japanese domestic tax law applies the "Force of Attraction" principle to tax all Japan source income when a foreign enterprise has a PE in Japan whether or not the income is attributable to the PE. Domestic law can be modified by an applicable tax treaty with Japan so that the "Attributable Income" principle applies to only tax Japan source income that is attributable to the activities performed in Japan by the PE.

By adopting the AOA attribution of income principle, Japanese domestic law generally aligns with OECD model treaty concepts on how to determine the scope of revenue that should be taxed in Japan by only taxing income that is attributable to the activities of the PE. However, the scope of potential income attributable to the PE has been expanded to also include foreign source income that is attributable to the PE (previously, only Japan source income could be attributable to the PE). By expanding the scope of potential taxable income for a PE, the amount of taxable revenue for existing PEs in Japan could increase if attributable to the PE.

In addition, Japanese domestic law should respect transactions between the PE, the PE's headquarters, and other foreign related enterprises by adjusting those transactions to an arm's length basis. Therefore, previously unrecognized internal transactions like interest expense, royalties, actual charges between the PE, headquarters, and other affiliated entities should be recognized.

As of now, only the UK-Japan treaty has adopted the AOA approach, and the U.S.-Japan treaty has adopted a quasi-AOA approach, i.e., by virtue of a treaty protocol, transfer pricing concepts should be applied to determine the profits attributable to a PE. PEs of countries with non-AOA treaties will be subject transition rules that deny certain related party transactions (e.g., interest, royalties, etc.) between a headquarters and its PE in Japan.

B. Attribution of Income – A Two Step Analysis

Under the new domestic AOA rules, profits attributable to a PE should be determined using a two-step analysis. The first step requires a functional and factual analysis, and the second step requires the application of transfer pricing methodologies to price internal transactions between related corporations. Note, there are specific rules that apply to the banking and insurance industry.

Step 1: Functional and Factual Analysis

The attributions of profits to a PE should take into account the functions performed, assets used and risks assumed. This is accomplished through the following functional and factual analysis:

- Attribution to the PE of the rights and obligations arising out of transactions between the enterprise and separate enterprises.
- Identification of significant people functions relevant to economic ownership of assets, and attribution of economic ownership of assets to the PE.
- Identification of significant people functions relevant to economic ownership of risks and attribution of economic ownership of risks to the PE.

- Identification of other functions of the PE
- Recognize and determine the nature of dealings between the PE and other parts of the same enterprise.
- Attribute capital based on the assets and risks attributed to the PE.

Step 2: Transactions between Related Enterprises

Related party transactions should be priced in accordance with OECD Transfer Pricing Guidelines (“Guidelines”), which Involves pricing on an arm’s length basis of related party transactions through:

- Comparability between dealings and uncontrolled transactions using the Guidelines’ comparability factors directly (i.e., characteristics of property or service, economic circumstances and business strategy) or by analogy (i.e., functional analysis or contractual terms).
- Application by analogy of one of the Guidelines’ methods to arrive at an arm’s length compensation.

C. Capital Allocation

For purposes of determining the deductibility of related party interest expense for the PE, a PE may elect to allocate capital using either the capital allocation approach or the thin-capitalization approach. The capital approach allocates capital based on total assets. The thin-capitalization approach allocates capital based on a comparable corporation in the same trade method, which will require additional transfer pricing analysis and therefore should be more burdensome to implement.

D. Double Tax Relief

As a result of applying the above transfer pricing analysis, non-Japan sourced income of a foreign enterprise could be attributable to a PE, which ordinarily could lead to double taxation. To mitigate the potential for double taxation, a PE should be allowed to claim a foreign tax credit for foreign taxes imposed on foreign source income.

E. Internal Transactions

Profits and losses from internal dealings will be recognized at the time of the transaction rather than when realized through a third party transaction.

Dividends and interest payments between the PE and its foreign headquarters will continue to be exempt from withholding tax.

Common expenses will be allocated to the PE and its foreign headquarters using a consistent and reasonable formula.

The PE will recognize a fair market value tax basis in assets acquired from its foreign headquarters and treat the transfer as a non-taxable contribution of capital.

For more information, please speak to our Deloitte experts Timothy O’BRIEN, Partner (timothy.obrien@tohmatsu.co.jp), or Gary THOMAS, Partner (gary.thomas@tohmatsu.co.jp).

Rethinking the CFO's Role as Strategist

Transitions are a tricky time, and can give you and your staff some anxious moments. Your entry as a new team leader can be disruptive to the existing norms and relationships in the team.

You may be uncertain about whether your new team members will commit their best energies to you as a leader and how you will fit in and be accepted by the staff. The team and broader staff may be anxious about your intentions and the direction in which you want to take the organization. Each of them is watching and deciding if you are good for them personally or for the organization as a whole. As the new incoming leader, you have to re-recruit and engage the team you inherit to commit their best energies to work for you and deliver the company's vision and intent.

How you re-recruit and engage your team sets the context for creating a high-performing team. Yet, in our transition labs we often see new leaders not having thought through how they will systematically engage and communicate with their new team, and thus stumble in re-recruiting it. To keep the best and critical talent on your team, you need to recruit them to your leadership and create an attractive context for them to choose to stay and deliver their best on your behalf. This will take time and effort. This article outlines some critical considerations that drive the time, effort and communications required to effectively connect with your new team as well as some steps to facilitate re-recruitment.

Three Considerations in Engaging Your Team

While there can be many considerations in shaping how you engage your new team, three are most commonly observed in Deloitte`s CFO transition labs:

Your team inheritance

Generally, executives are found to put their inherited team into four buckets: a) a strong functioning team with shared goals, clear roles and responsibilities, and shared ownership of results, b) a medium or weak team, where there is goal and role clarity but a lack of accountability and ownership of team outcomes, c) a broken team, where goals and roles are clear but there are silos, interpersonal conflicts and lack of mutual trust, d) a non-team or work group, where there is no clear alignment on brand, goals and roles. The more broken or low-performing the team, the more time you will need to allocate for persuading, recruiting and developing your team to deliver higher performance.

What your CEO or boss wants

Your CEO or boss probably has expectations about how you will manage your new team going forward. They may have a fundamentally different mind-set than you and be reluctant to let people go that you find wanting in critical positions. This can be especially challenging if they were promoted to CEO from your current role. They may also have expectations for you to participate in dinners and socialization outside of work hours, which they feel is essential to building esprit de corps. In a large multinational organization, they may have expectations of you visiting your staff in key locations quickly despite all the other issues on your plate. Thus, as you begin to frame your strategy to re-recruit your team, it is important to understand the values and expectations of your CEO and other key leaders in the company. They are observing how you handle your team through lenses that reflect their values and beliefs.

WIIFM ("What's in it for Me?" from your staff's perspective)

When you are coming in as a new team leader, most of your staff is likely to be asking, "What's in it for me?" and assessing the likelihood of the organization's success going forward. Key leaders on your team, some of whom may have aspired to your new role, are asking if your appointment will block their career progression. Indeed, in our CFO transition labs, we often find key talent choosing to leave fairly quickly for another company because they feel they can better achieve their aspirations to join the C-suite there. Others on your staff are watching to see how much you will invest in growing their careers or how much support you have from the CEO and the rest of the organization for continued investment and improvements in your area. As you engage your new team you have to be cognizant and responsive to their WIIFM.

The Seven Steps

Given the above considerations, here are some steps to facilitate re-recruiting your team during your transition as their new leader.

1. Communicate and set expectations of how you are using your time during the transition.

As a new leader you cannot easily predict what you are stepping into. Some CFOs have joined a new company and have immediately been thrown into executing an acquisition or addressing another extraordinary situation that creates immediate and exceptional demands on their time. In other situations, you may have inherited a broken team and want to learn how your clients view your team. At the same time, your team and organization want to connect with you and hear from you. All of this can create tremendous conflicting demands on your time. To effectively engage your team, it is important to communicate and share with your team the key demands on your time and shape their expectations as to when and how you will engage with them during the transition.

2. Allocate sufficient time to authentically connect with your direct reports and select skip-level staff.

During the transition, your staff generally wants to hear from you and be helpful to you. At a minimum, you want to personally connect with all your direct reports in the first few weeks and key skip-level staff within the first three months. On an average, executives who go through our transition labs have eight employees directly reporting to them. They in turn will have a similar number of direct reports. Even attending a first, two-hour dinner meeting with each of your direct reports one-on-one to get to know them and the issues confronting your team can take 16 hours. Add one-hour skip-level meetings with select individuals or groups (assuming each of your team leaders has eight direct reports), and it is likely to consume another 16 to 64 hours of meetings. In addition, there may be travel to select locations in a global company. Assuming a 60-hour work week in the first three months, just initially connecting with your key reports and key skip-level staff will generally consume at least a week or more of effort across the first 12 weeks. Yet, it is important to make time for these meetings to make a preliminary assessment of your team and to establish a personal connection with key staff.

3. Listen first, and focus on your team, not yourself.

When connecting with your staff members, it is important to note they are initially assessing the implications of your new leadership role on them. During this time, it is important to really listen and learn about critical issues from your staff's perspective. In addition to learning their hopes and aspirations, you can ask them what they see as the one area the organization does really well in and the one area in which it does poorly and that needs to be addressed by the entire team. These questions can help you triangulate on your go-forward agenda. While this is a chance to mutually acquaint yourself with your staff, be aware of what you say about yourself. Especially, be aware that your story of sacrifice, accomplishment and prior work may not be something your staff connects with, empathizes with or can envisage for themselves. For example, if your idea of sacrifice in taking this new job is moving to a smaller apartment near Central Park in New York City from a large property in the suburbs of Washington, it may not elicit much understanding as a sacrifice from your employees who commute daily to New York City for an hour each way from New Jersey or Connecticut. Make the effort to really learn about your staff, and if you communicate stories about yourself, ensure that they are meaningful to your staff.

4. Co-create or communicate a winning vision.

It is important to create a brand within your team. You may not be certain at the outset of your tenure what the vision for the organization should be. You can initially set expectations that you are listening to your team before committing to a vision. Visions are powerful rallying and unifying statements that help align all members of your team to a common purpose. For example, Deloitte's vision is "to be recognized as the pre-eminent advisor to the CFO." Our work on transition labs in the CFO Program is consistent with this overall vision, and in the context of those who deliver transition labs, our subsidiary vision is equally simple and focused: "Deliver exceptional transition labs to at least 50% of the annual global 1000 corporate CFO transitions (approximately 75 per year)." Framing what winning means helps the entire team focus on how to help you win. Co-creating the vision with the team, helping to craft the language, can increase their buy-in.

5. Announce and commit to developing a tangible talent agenda.

Your team and organization want to know you are committed to developing them. Enquiring about how talent is developed in the organization, the stars in the group and talent programs for staff is the starting point for creating a talent agenda. Explore early with your team members how you can develop them as individuals and as part of the overall organization, and recruit them into the process of creating a talent agenda for your entire organization.

6. Demonstrate sponsorship and support for your leadership.

As you frame an initial agenda with your team and have a broader staff meeting, it may be a good idea to open or close the meeting with an in-person or telephone visit from your CEO or boss. This can be designed in a way that visibly demonstrates his/her commitment to you and your organization's success and sponsorship for your agenda.

7. Address team dysfunctions early in your tenure.

Your team inheritance can include a number of dysfunctions. This may range from mistrust and lack of information sharing and silos among team members to outright conflict. It's important to address these dysfunctions quickly and set the tone and operating model for the team that you want. Sometimes this can be done through direct conversations with those concerned. At other times, more drastic actions are warranted—from assigning two individuals who do not work together the same shared office until they improve their collaboration to letting someone go. Addressing inherited dysfunctions quickly is likely to gain you respect, while allowing dysfunctions to persist will likely undermine you with your team and peers.

There is no guarantee that the above seven steps will by themselves build the confidence of your inherited team in your leadership. But systematically undertaking these steps can avoid common blunders and ease the way to gaining engagement and followership from your team.

The Takeaway

Every incoming leader has to engage and re-recruit the team they inherit. The more broken your team inheritance, the more time and effort you will need to expend to create the team you want. Re-recruiting the team often has to be done within the context of the CEO's perceptions of the team and its intrinsic needs and motivations. The seven steps above can help you engage more effectively with your new team.

Facing (and Embracing) Strategic Risks

Risk management has undergone a refocusing in recent years in an attempt to make its techniques and processes more adaptable to shifts in business and the economy, and more responsive to the demands of C-suite executives. And those same executives, including CFOs, are finding that by focusing on strategic risks, they are better equipped to identify what could undermine their future business, adapt to new challenges and take advantage of emerging opportunities.

What exactly are strategic risks? In short, they are the risks that threaten to disrupt the assumptions at the core of an organization's strategy. Think everything from black swans to political upheavals and financial crises, as well as new technologies that can render a business model obsolete. When asked to name specific risks that will impact their business strategy over the next three years, C-level executives surveyed by Forbes Insights on behalf of Deloitte Touche Tohmatsu Limited (DTTL) ranked pace of innovation (30%) and increased regulation (30%) as the main ones, but many reported not fully applying their risk sensing capabilities to strategic risks.[1]

Often hard to spot and manage, strategic risks typically do not respond to traditional risk management approaches, such as hedging or mitigation. Since such risks can also point to an organization's next opportunity that forces executives to make a choice: "Are we going to try to resist this, avoid it and push it off if possible? Or are we going to embrace it as an indicator of where the market is going and where our next big opportunity may be?"

The Challenge Is Us

Part of the trouble many organizations have in navigating strategic risks is inevitable; organizations are populated by humans, and human thinking is inherently flawed. The growing discipline of behavioral economics has shed light on just how hard-wired humans are for some key cognitive biases that tend to keep executives from seeing the strategic risks that may be on the horizon. For example:

The overconfidence bias convinces executives to trust their gut when they shouldn't, and makes them unable to calibrate the limits of their own knowledge. They don't know what they don't know, and they overestimate the truth of what they believe.

The availability bias encourages executives to inflate the importance and likelihood of things they saw or read recently, giving them a distorted view of what is really important.

The confirmation bias causes them to pay more attention to information that fits what they already believe while discounting information that may contradict what they currently believe.

And perhaps worst of all, **the optimism bias** fools executives into thinking that nothing bad will happen and all their plans will work out as they intend.

These and other biases can cause companies to misunderstand the likelihood of events that could reshape their businesses and confound their ability to respond to them. And if biological and cognitive biases don't present enough barriers, some common organizational constraints—everything from poor internal communication to bureaucracy and groupthink—may conspire to prevent executives from making the choices they'd like to make with the kind of clarity they'd like to have.

[1] Risk sensing: The (evolving) state of the art, Forbes Insights on behalf of Deloitte Touche Tohmatsu Limited (DTTL), October 2015.

Tools for Risk Detection

For these and other reasons, spotting strategic risks is tough, but increasingly valuable as many forward-looking companies attempt to connect risk more closely with strategy. They understand that every strategy, every strategic choice, carries risk. Moreover, having the ability to scan and monitor strategic risks on an ongoing basis and create regular, high-quality reporting can create a competitive advantage going forward.

That's because strategic risk management can also point to the next horizon. Consider the automotive industry. Five or six years ago, that sector was just detecting the emergence of car sharing. Now, sharing cars is accepted not just in urban areas, but also increasingly in suburbs, and many companies are embracing the concept. They are using the strategic risk of consumers doing new things empowered by technology and supported by changing demographics as a new business opportunity, rather than viewing it simply as a market threat.

To aid in the identification and tracking of emerging strategic risks—and future opportunities—companies have a number of tools at their disposal. Specifically:

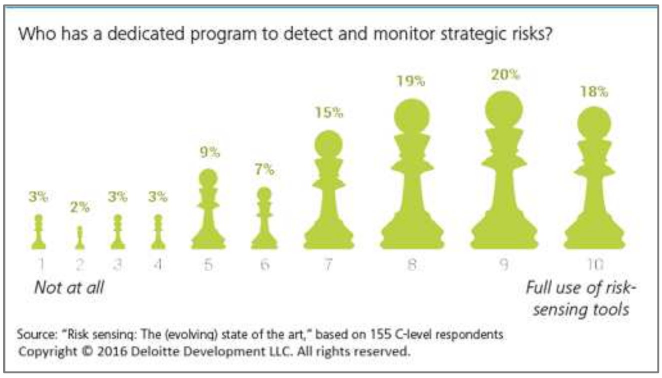
Scenario planning can help organizations see a set of both risks and opportunities more broadly, to imagine potential futures that might challenge their current strategic assumptions, and to spot potential sources of risk that may not surface in other ways. By rigorously exploring uncertainties in the environment and involving multiple stakeholders, scenario planning can also address the cognitive biases that impede the risk/strategy discussion and offer alternative paths for when risks materialize.

Risk sensing technologies can also be useful in identifying and tracking potential strategic risks. There have been a number of advances over the last few years in data analytics and the ability to analyze huge sets of structured and unstructured data for a variety of risks, both internal and external. For example, the ability of the Internet of Things to make the performance of physical objects visible digitally has allowed power plant operators to monitor the condition of key machinery in real time. Even more, they can then use that data to create accurate digital models of the machinery to examine how it would react in different scenarios, say if demand for electricity spiked at an unexpected time. Using such tools, organizations may also be able to monitor their environment for those signals, or changes, both inside and outside the company that point to new technologies, new regulations, new social trends, and new customer behaviors. Yet, while some 80% of companies surveyed in the Forbes Insights/DTTL report say they use risk-sensing tools, those tools are more focused on such risks as financial and compliance risks, rather than strategic risks.

Horizon scanning can inform the discussion. In their recent article Pattern of Disruption: Anticipating Disruptive Strategies in a World of Unicorns, Black Swans and Exponentials, leading researchers from Deloitte's Center for the Edge identified nine patterns of disruption—ways that disruptors created new value through a new approach under specific market conditions—that seem generalizable in both the past and the future.[5] For example, by unbundling products and services or by shortening the value chain, competitors have been able to upend certain marketplaces—and some incumbents' businesses. And while these patterns can't describe every possible challenge a business will encounter, they do help make sense of the changing dynamics many companies are experiencing. Moreover, armed with this

[5] "Pattern of disruption: Anticipating disruptive strategies in a world of unicorns, black swans, and exponentials," John Hagel, John Seeley Brown, Maggie Wooll, Andrew de Maar, Deloitte University Press, September 2015.

understanding, executives can start asking the right questions of their business and the world around them to not only anticipate changes, but also make the "unexpected" expected.



Finally, a strategic risk decision framework can help executives and boards zero in on the risks that could upend the business or open up new opportunities. Think about it: the problem for most business leaders is not a lack of information, it's an inability to identify and distinguish the signal from the noise. In fact, a glut of data can make it harder to see strategic risks and can put executives and boards in a defensive posture. An effort should be made to not just present information, but to present it in ways consistent with people's ability to manage and navigate it, and in ways that help break down built-in institutional challenges or biases to getting and acting on information. This is where the combination of scenario planning, horizon scanning and risk sensing can create a platform for early discovery and decisive action on potential threats.

Whatever approach you choose, however, be prepared to confront your biases. No matter how experienced, no human is immune to cognitive or institutional biases. Consequently, at every strategic turn or important decision, ask what uncertainties or biases might be in play. Aggressively seek out information that challenges what you believe. And consider involving third parties who will constructively critique and challenge your point of view.

CFOs as Risk Integrators

Because strategic risks can threaten the logic of management's strategic choices, the leaders responsible for those choices should own them. Obviously, the CFO is a crucial part of conversations about the future of the company, but his or her input is even more important given that traditional risk management remains critically important to good corporate governance. CFOs' voices are magnified since they serve as strategic advisors on a host of issues—the allocation of resources against strategy, investment options and capital decisions, and the management of a portfolio of financial risk assets—and in that capacity, they are well positioned to connect the CEO, the board and other senior stakeholders in the conversation about strategic risks.

Strategic risk is the next frontier of risk management, one that will generate a more nuanced conversation about the risks that are sometimes imposed on companies and the opportunities for new businesses. Armed with the right tools, leaders can accelerate how quickly they discover such risks and fit them into their ongoing risk management processes. Those that do are going to see how strategic risk—and the ability to name it, track it, and deal with it—can turn into an important organizational resource going forward.

How CFOs Can Advance Their Organization's Innovation Agendas

About 95% of innovation attempts fail to return their capital, according to research from Doblin, the innovation unit of Monitor Deloitte. Yet, innovation is not a choice but a strategic necessity for companies.

This is a key point of John Levis, global chief innovation officer and regional managing director—Americas for Deloitte Touche Tohmatsu Limited.

With companies devoting greater attention and investment to growth through innovation, Mr. Levis describes how innovator companies work to avoid the high failure rates that plague many organizations and how CFOs can help advance their organization's innovation agenda while managing the investment risk that comes with it.

Q: What distinguishes companies that effectively and consistently foster innovation from other organizations?

John Levis: Tone at the top, commitment to invest and a disciplined approach are the three elements that I find separates the most effective innovators from the rest of the pack. At the top innovative organizations, leadership makes it a priority to define what innovation means to the organization and is vocal about its strategic importance to the entire organization, from the C-suite and down through the organization.

When I say being committed to invest in innovation that means making the necessary investments not only when times are good and cash is plentiful, but also when there are downturns and difficult choices need to be made. It also means investing in human resources and a variety of other areas, such as technology, that are needed for innovation. These resources go beyond what might be needed to run a steady business, and innovator companies typically make these types of investments.

Last, these companies have an innovation process that is disciplined and systematic. They pursue both incremental and radical innovation and innovate in many areas, such as business and profit model.

Q: How can CFOs support their company's innovation agenda, while maintaining their role as steward?

John Levis: First and foremost, CFOs looking to help establish an innovative organization need to think about taking a portfolio approach to funding and investing innovation. This approach can help CFOs manage the overall level of risk in innovation projects while allowing the organization to pursue innovation initiatives that might have a higher level of risk than the standard risk threshold.

The portfolio approach entails distributing innovation investments across three categories or types of innovation. First, there's innovation at the core, investments that aim to achieve 10% to 15% improvement on, for example, the productivity of an operation or the sales of a product, with a proportionally low risk of failure. Core innovation investments should make up the vast majority of the portfolio, up to about 70%, for a large organization. The second category is adjacent innovation, efforts to extend a product set or customer base by way of new products or a new set of business for the organization. Adjacent innovations aim for a higher impact and will likewise have a higher level of risk. They generally should account for no less than 10% and no more than 50% of an innovation portfolio. The third category - transformational innovation - is usually the smallest piece of the innovation portfolio at about 10%. These are projects that could bring a fundamental change in the direction or growth of the organization, often the ones with the biggest potential return and the highest risk of failure.

If CFOs apply the risk criteria they use for typical business investments to innovation projects—especially those that might be transformational—that could make it very hard to provide funding approval. But taking an approach that looks at the risk profile of the entire investment portfolio rather than just the risk profile of individual projects allows the organization to balance the 10% of the portfolio's high-risk innovation projects with lower-risk investments, which typically would be the majority of the portfolio.

Q: Should CFOs be using different metrics to measure the performance of the organization's innovation investments?

John Levis: When organizations create innovation in a consumer business or in a business-to-business model, they need to create alongside of that a value capture model—a pricing model, you could call it— that's going to support the innovation and reflect the fact that it's not business as usual in the organization. CFOs who say, "We've got to start measuring our ROI on innovation," are missing the point because innovation is not a financial decision; it's a strategic decision and more than that, it's a necessity. Organizations today cannot simply opt out of innovation because it's too difficult to establish a process to get it done or to measure it. There's too much at stake and too much change that happens too quickly for organizations to say, "No, that's not something for us."

Because innovation is an iterative process of trial and error, CFOs must be careful to not burden the innovation process with a heavy ROI investment model or too many cost-benefit checkpoints too early in the innovation process. The front end of an innovation project needs to be left as unencumbered as possible, so people can explore and experiment and allow for that rapid iteration of new ideas without worrying about meeting an ROI target. That's especially true for large organizations, where the innovation process happens when one idea is combined with another and is layered on top of a third and so on, until you truly have something that is an impactful innovation.

If you start applying cost-benefit analysis and ROI metrics too early in the innovation cycle, you may nip in the bud something that has real potential. Measuring ROI and doing a more rigorous cost-benefit analysis can start once the idea has made it through a set of pilot projects and the organization is ready to scale up the innovation across many customers or different business units.

Q: What do CFOs need from their finance talent to help them more fully support innovation?

John Levis: When it comes to innovation what CFOs need from their talent it is no different than what the rest of the organization needs from talent: the willingness to be innovative. For organizations to be innovative, employees have to be encouraged to explore ideas, experiment with them and see how viral they become in the organization. Moreover, it's critical to have a performance management model that recognizes that innovation requires failure. Ideally, the performance model not only protects employees involved in an innovation project from being dinged for failure, but even rewards it under certain circumstances, such as when an innovation journey that doesn't work out provides a valuable learning experience.

In the same way, the CFO and finance need to be just as innovative as the rest of the organization. For example, an innovative CFO might look at the close process and ask, "Would doing the close in real-time be valuable?" If there were real value to the organization to have much faster financial reporting, if capital markets rewarded companies with a more efficient close process, for example, then asking, "What's stopping us from doing that and what do we need to do to make that happen?" could be the front end of a whole new set of innovation.

CFOs who want a finance organization capable of innovating financial management processes or becoming a stronger business partner need to provide their people training in innovative methods and techniques like design thinking. These tools encourage looking at things differently, questioning what's in place and looking for new solutions to challenges that perhaps were not even previously recognized as constraints.

Q: In your role as chief innovation officer, what has surprised you in terms of what works or doesn't work in driving innovation?

John Levis: Coming in to this role, I expected the biggest challenge to be generating new ideas because being an innovative company requires coming up with a lot of new ideas on a sustainable basis. I was completely wrong about that; we had no problem with ideation. Instead, the real challenge was figuring out a process to evaluate the many ideas being proposed so that the truly top-shelf ideas could be advanced.

Another assumption I brought to the role was that establishing a culture of innovation would require bringing in a lot of young people. I've found, however, that innovation has nothing to do with age. We get out-of-the box ideas from all generations. What was important was convincing others that it's OK to risk failure and that trying out new ideas that fail is even a positive. As I said earlier, for an organization to have a culture of innovation, the talent and performance model should not only tolerate experimentation and failure, but also reward those who advance innovative thinking, regardless of the outcome.

Why Data Storytelling Is So Important

In the following essay, Tom Davenport, the President's Distinguished Professor of Information Technology and Management at Babson College, a Fellow of the MIT Center for Digital Business and independent senior advisor to Deloitte Analytics, discusses why storytelling with data is critical to success with analytics programs, and several reason why it doesn't work well.

Whenever I speak with successful analytics people—and I do that all the time—it's usually not long before they mention the phrase "telling a story with data." It may seem obvious that anyone who is doing data analysis would want to create a narrative of the process and outcome, but to many data analysts it's not obvious at all. So in this essay I'll describe five reasons why data and analytics-based stories are important to organizations, and four reasons why so many people and organizations do it badly or not at all.

Here's why I think people who love data and analytics also need to be people who love stories and tell them well:

1. Stories have always been effective tools to transmit human experience; those that involve data and analysis are just relatively recent versions of them.

Narrative is the way we simplify and make sense of a complex world. It supplies context, insight, interpretation—all the things that make data meaningful and analytics more relevant and interesting.

2. With analytics your goal is normally to change how someone makes a decision or takes an action.

You're attempting to persuade, inspire trust and lead change with these powerful tools. No matter how impressive your analysis is, or how high-quality your data are, you're not going to compel change unless the stakeholders for your work understand what you have done. That may require a visual story or a narrative one, but it does require a story.

3. Most people can't understand the details of analytics, but they do want evidence of analysis and data.

Stories that incorporate data and analytics are more convincing than those based on anecdotes or personal experience. Perhaps the most compelling stories of all are those that combine data and analytics, and a point of view or example that involves real people and organizations.

4. Data preparation and analysis often take quite a while, but we need shorthand representations of those activities for those who are spectators or beneficiaries of them.

It would be time-consuming and boring to share all the details of a quantitative analysis with stakeholders. Analysts need to find a way to deliver the salient findings from an analysis in a brief, snappy way. Stories fit the bill.

5. As with other types of stories, there are only a few basic types; couching our analytical activities in stories can help to standardize communications about them and spread results.

It has been argued that there are only seven basic plots in all of literature (http://bit.ly/1gwjQrQ). I once argued that there are 10 types of analytical stories (http://bit.ly/1sJhtYv). Regardless of the number, if an organization is clear on the different types of stories that can be told with data and analytics, it makes it more likely that analysts will explore different types over time. Most importantly, the story repertoire should go well beyond basic "here's what happened" reporting stories.

Despite these compelling reasons for the importance of stories, most quantitative analysts are not very good at creating or telling them. The implications of this are profound—it means that analytical initiatives don't have the impact on decisions and actions that they should. It means that time and money spent on acquiring and managing data and analyzing it are effectively wasted.

So why are individuals and organizations so bad at telling stories with data? Let us count the reasons:

1. Analytics people often aren't that motivated or successful at communicating with carbon-based life forms.

They gravitated toward structured, unambiguous, unchanging fields like math and statistics and computer science in school, and they continue to favor interaction with numbers over interaction with humans in their work careers. Of course, not all quantitative analysts are of this persuasion, and someone with a strong numerical focus can transition over time to be more human and literary in their orientations. But let's just acknowledge that telling compelling stories to other humans may not come naturally to many analysts.

2. If analysts don't gravitate naturally toward storytelling, they probably don't get a lot of instruction on it in school either.

Many college faculty members teaching quantitative courses are themselves not terribly good at storytelling. And they may feel that it's more important to impart more instruction on methods than to "waste time" on storytelling approaches. This is incorrect, however, from the customer's perspective; a survey (see this link for a summary–http://bit.ly/1xk5sl2) of about 400 recruiters of analytical college graduates found that the highest-ranked of all desired skills was communication.

3. To indulge in storytelling, some analysts may believe, is an insult—or at least a relatively less valuable investment of time in comparison—to an analysts' technical capabilities.

Capable quantitative analysts may justifiably argue that many people can tell good stories, but relatively few can run a logistical regression model with heteroscedasticity corrections. They may feel that the highest and best use of their time and brain cells is to do quantitative analysis, and to rely on others to tell stories about it. They may have a point, but relying on others to translate analytical results into stories has some perils of its own, in addition to being more labor-intensive.

4. It takes a lot of analysts' time to think creatively about how to tell a good story with data.

In fact, one senior analyst at a pharmaceutical company told me that he (and most members of his analytics group) spend about half their time thinking about how best to communicate their analytical results. Many analysts will be reluctant to devote that much time to the issue, even if it would make them more effective.

So there are several reasons why storytelling with data is critical to success with analytics programs, and several reasons why it doesn't work very well. I've constructed this story so that there are more reasons to tell good stories than there are obstacles to the objective, so the story ends happily.

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.

The CFO Program in Japan hosts regular events for executives of international companies to provide insights and networking opportunities.

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