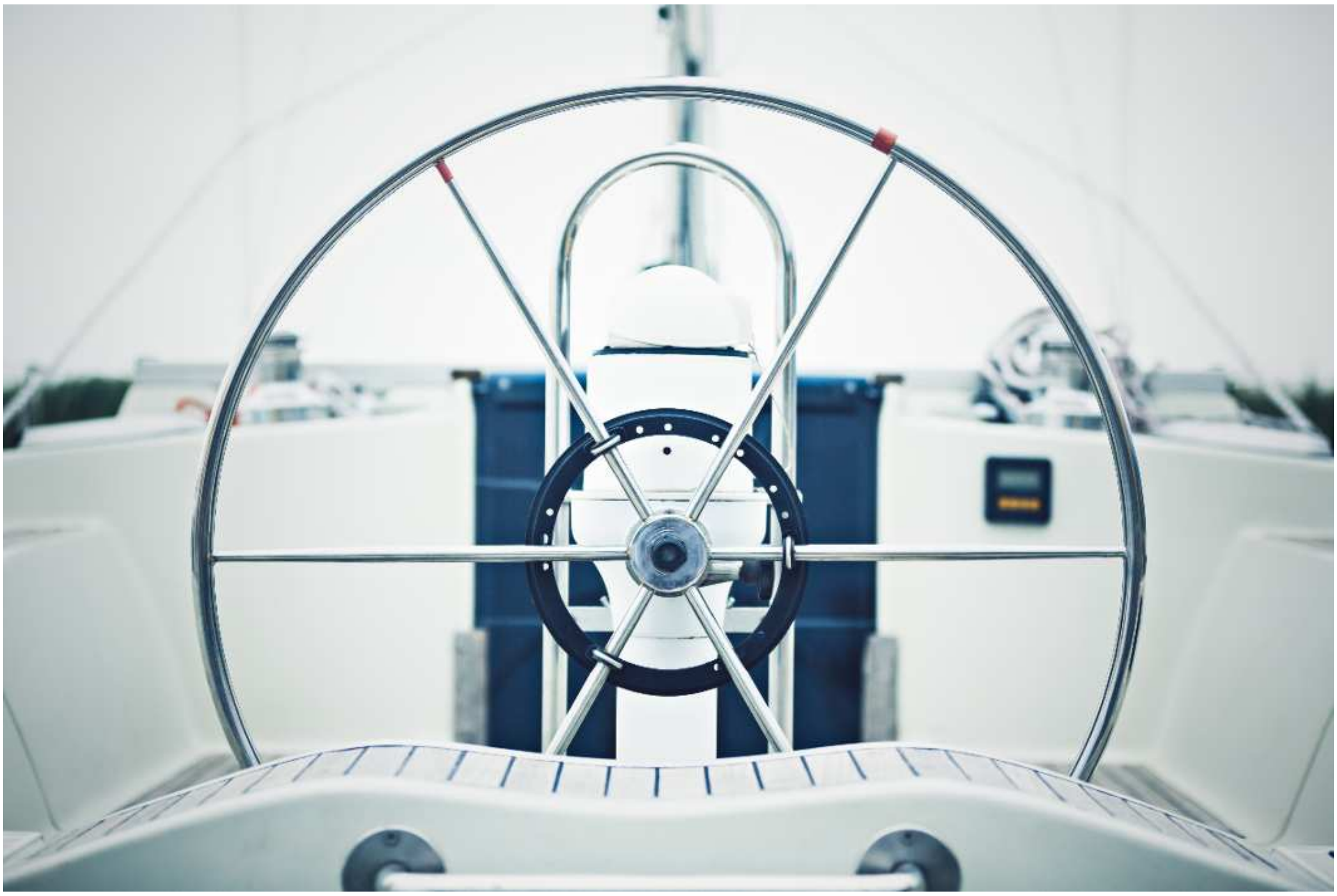
CFO Insights | Japan

2016 Q3



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Japan Economic Outlook: Will households oblige by spending more?

Private consumption holds the key to growth at a time of slowing exports—so how can Japan's policymakers create incentives for consumers to spend? The Bank of Japan actually may already be doing that, by both lowering borrowing costs and reducing the government's debt burden.

Over the past decade, there is an increasing sense among Japan's policymakers that growth must be stimulated and deflation countered. Arguably, the most spectacular of these measures has been aggressive monetary easing, especially the use of negative interest rates this year[1]. The verdict on some of these policies is mixed from a broad macroeconomic perspective. However, various components of the economy might throw pleasant surprises. Private consumption, which holds the key to growth at a time of slowing exports, is one such example. While consumers obliged by increasing spending in Q1, they face strong headwinds in the medium to long term from an aging and declining workforce. So how can Japan's policymakers create incentives for consumers to spend? The Bank of Japan (BOJ) actually may already be doing that, not just by lowering borrowing costs but also by reducing the government's debt burden.

Economic growth picked up in Q1

The economy grew at a seasonally adjusted annual rate (SAAR) of 1.9 percent in Q1, reversing from a 1.8 percent decline in Q4 2015 (figure 1). This was the second estimate for Q1, up from the 1.7 percent rise quoted in the first estimate. Private consumption (2.6 percent) was a key growth driver in Q1, with households spending more, especially on durable goods and services. Investments continued to disappoint, with both private residential and nonresidential investments declining during the quarter. A deeper look at business investment reveals that spending on buildings and structures as well on machinery and equipment has been weak for the past year. This is not an encouraging sign for an economy eager to ramp up productivity in the face of disadvantageous demographics. Exports provided much-needed succor to the

[1] Akrur Barua and Rumki Majumdar, "Impact of negative interest rates: Living in the unknown," Global Economic Outlook, Q2 2016, Deloitte University Press, April 29, 2016.

economy in Q1, expanding 2.4 percent. However, the pace is lower than what Japan's policymakers would want. It's likely that the impact of aggressive monetary easing on the Japanese yen has run its course.

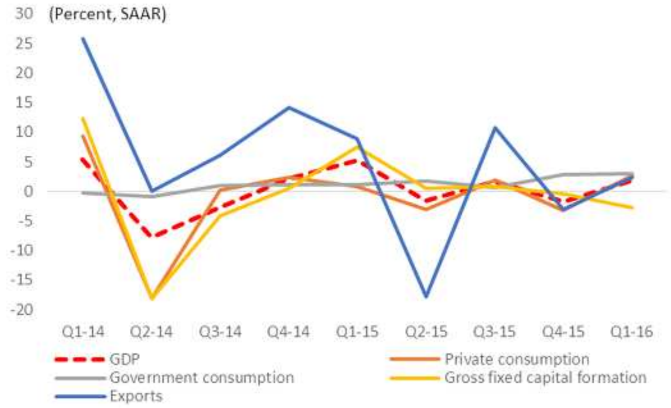
A key concern for private consumption is demographics

Analysis of national accounts data reveals that while compensation of employees—both nominal and real—has gone up in the past year (figure 2), the share of household spending in GDP has continued to decline (figure 3). This seems surprising, given a strong labor market—unemployment is at a two-decade low—and real income gains due to low inflation. Japan's low inflation, however, is due to deflationary pressures. So instead of spending more, consumers have held back, waiting for prices to stabilize. Moreover, as economic growth fluctuates, households appear pessimistic, with consumer confidence still in negative territory.[2]

Figure 2. In the last few years, employee compensation has slowed

Source: Haver Analytics, Deloitte Services LP economic analysis

Figure 1. GDP growth picked up in Q1, led by private consumption



Source: Haver Analytics, Deloitte Services LP economic analysis

Figure 3. Household consumption's share in the economy has gone down since Q1 2014

Source: Haver Analytics, Deloitte Services LP economic analysis

[2] Haver Analytics, June 2016.

Private consumption faces a deeper problem: deteriorating demographics. In the last 10 years, Japan's population has fallen 0.6 percent, and its labor force, 0.7 percent (down 2.7 percent since 1996). This means that the number of earning individuals has declined. The burden of supporting welfare now rests on a shrinking workforce. Japan is also aging fast, which is evident in the composition of its labor force (figure 4). So a rising share of the labor force has to focus more on savings for retirement than on current spending. (See "Interview with Nobuhiro Hemmi" below for more insights on this.)

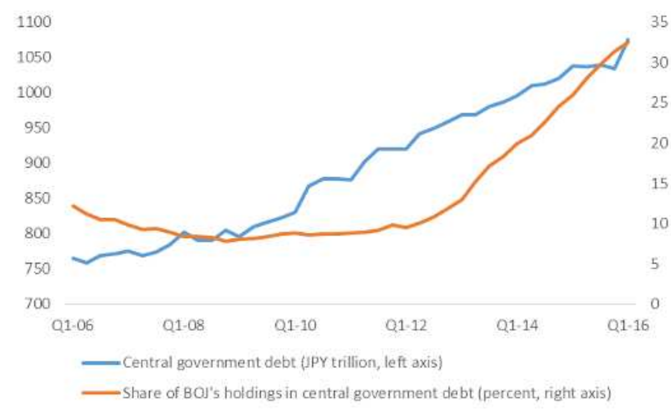
Figure 4. The labor force and, within it, the share of relatively young people are declining

Source: Haver Analytics, Deloitte Services LP economic analysis.

Will the BOJ's asset purchase program aid consumers?

The BOJ, through its quantitative easing (QE) program, has eased the government's debt burden—about 240 percent of GDP—by reducing the share of publicly held debt.[3] For example, between January 2013 and May 2016, the BOJ's holdings of government debt shot up 212.3 percent, while government debt increased just 12.1 percent. Consequently, the BOJ's share in total government debt has increased at the expense of others (figure 5). How does this help as total debt has not gone down? The BOJ now can easily convert this debt to perpetual-zero coupon bonds or, in the worst case, wipe it off its own balance sheet. Will this not increase risks and push yields up? Not really, because the level of publicly held debt has gone down due to the BOJ's rising share and hence has become more manageable. Moreover, the BOJ's ultra-loose monetary policy and global financial volatility have driven borrowing costs to extremely low levels (figure 6). Interestingly, the government has more leeway now to introduce fiscal stimulus without spooking markets about rising debt.

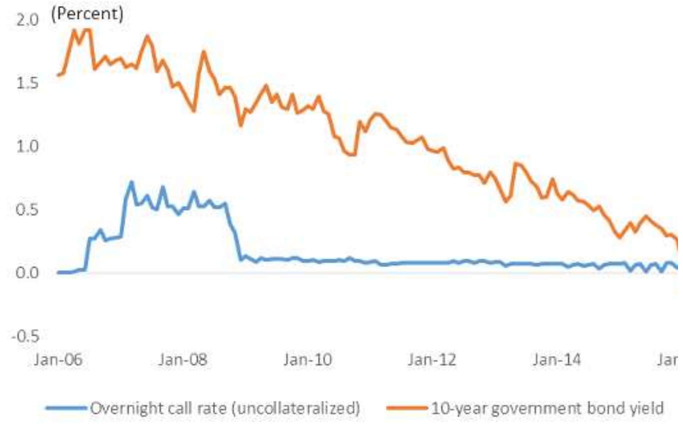
Figure 5. BOJ is transferring a large share of government debt to its balance sheet



Source: Haver Analytics, Deloitte Services LP economic analysis.

[3] Enda Curran and James Mayger, "Japan's debt burden is quietly falling the most in the world," *Bloomberg*, June 1, 2016; Kevin Buckland and Shigeki Nozawa, "BOJ owning more debt than Japan banks is slow death for the markets," Bloomberg, December 17, 2015.

Figure 6. 10-year government bond yields are now negative



Source: Haver Analytics, Deloitte Services LP economic analysis.

The BOJ's QE program aids consumers by making publicly held debt more manageable, allowing the government more time to service that debt, in turn allowing consumers some breathing space. For example, it is possible that the second part of the two-part sales tax (first introduced in 2014) may be pushed beyond the revised date of 2017. Also, with a declining and aging population, the government may be hoping to partially shelter its working population—those who pay taxes and contribute to social welfare—from the burden of rising debt. In addition, the BOJ's move could help in the fight against deflation. This argument probably runs counter to examples in Venezuela, Argentina, and Zimbabwe, where monetizing the government's debt has led to hyperinflation. Japan, however, need not to worry about that. Increasing consumption through reducing the debt burden might just help ease excess capacity in the country, thereby reducing deflationary pressures, which, in turn, might benefit Japanese companies who are likely to face increasing headwinds from slowing global growth. The BOJ and the government must be hoping the plan works, bringing much-needed respite for the economy.

Interview with Nobuhiro Hemmi

To understand more about recent policies and challenges ahead, we spoke with Nobuhiro Hemmi, partner and head of Global Business Intelligence at Deloitte Tohmatsu Consulting, Japan, and a member of the Deloitte Global Economist Council.

Akrur Barua (AB): The BOJ decided to keep rates on hold. Is it because BOJ thinks that monetary policy is not effective anymore? Or is it because the external environment is challenging, and the BOJ wants to wait and watch?

Nobuhiro Hemmi (NH): Both, I think. Officially, they seem to have announced a "wait and watch" policy as is evident from the BOJ governor's interview. However, they introduced negative interest rates, which is not traditional monetary policy. This sort of contradiction reflects the new challenges that the BOJ faces.

AB: We have seen fiscal stimulus and strong monetary easing. The initial results were good, but they appear to be faltering now. When is the "third arrow" of Abenomics coming? What are the challenges? Which reforms do you think they should target?

NH: The market appears to have overestimated the impact of the "third arrow," which has been the fundamental issue for Japan in the last two decades. So far, discussions around the "third arrow" have focused on growth strategies and easing regulations. However, the key issue is how to tackle the decrease in working population.

AB: The yen's rise is opposite to what Japanese policymakers would want. How are exporters coping? Where do they see additional demand coming from? And which economies do they think will be the big markets over the next 5–10 years?

NH: Overall, from a macroeconomic point of view, the yen's rise seems opposite to what policymakers would want. However, the impact (and implication) depends on industries and companies within these industries. Some companies have already shifted their operations outside of Japan, and others have hedged currency risk in the short term. Asia will still be a strong market for Japanese companies in the next 5–10 years. But there will be market segmentation, with a shift to a city-based approach from a country-based one.

AB: To stimulate domestic demand, Japanese corporates should invest more. Why have investments not picked up?

NH: If domestic demand is not positive in the near future, it will make sense for Japanese companies to be more conservative.

AB: With an aging society, what changes do you see in the next 5–10 years that will prop up domestic demand? More immigration or higher wages? Or longer working tenures?

NH: More than immigration, women's participation in the labor market is an important issue for Japan. If policymakers cannot successfully implement a "womenomics" policy, they will introduce a further extension of the retirement age. Wages and tenures are not the key issues right now.

Accounting News

IFRSs

No new standards or interpretations were issued by the International Accounting Standards Board (IASB) during this Quarter. Several amendments to existing standards as well as proposals came out from the IASB:

Amendments to IFRS 2

The IASB published final amendments to IFRS 2 **Share-based Payment** that clarify the classification and measurement of share-based payment transactions. The Amendments contains the following narrow-scope clarifications and amendments, addressing practical application issues:

- Added guidance that addresses the effects of vesting and non-vesting conditions on the measurement of cash-settled share-based payments.
- Introduced an exception into IFRS 2 so that a share-based payment where the entity settles the share-based payment arrangement net for withholding tax obligations is classified as equity-settled in its entirety, provided the share-based payment would have been classified as equity-settled had it not included such net settlement feature.
- Introduced some clarifications to accounting when a cash-settled share-based payment changes to an equity-settled share-based payment because of modifications of the terms and conditions.

The amendments are effective for annual periods beginning on or after 1 January 2018 with earlier application is permitted. The amendments are to be applied prospectively. However, retrospective application if allowed if this is possible without the use of hindsight.

Proposed amendments to IFRS 3 and IFRS 11

The IASB has published ED/2016/1 **Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11)** for public consultation.

The post-implementation review of IFRS 3 **Business Combinations** confirmed some issues in the area of business combination accounting. Among others, entities have difficulties when determining whether they have acquired a business or a group of assets. As the accounting requirements for goodwill, acquisition costs and deferred tax differ on the acquisition of a business and on the acquisition of a group of assets, the IASB decided to address the issue.

In addition, the IFRS Interpretations Committee received and discussed several issues around certain transactions involving previously held interests to determine whether or not such interests should be remeasured. The Interpretations Committee recommended to the IASB to make certain amendments to relevant standards.

To deal with these two issues, the IASB issued the ED proposing following amendments:

Definition of a business:

While three elements of a business (i.e. input, process, and output) are retained without material changes, guidance is added to clarify that a set of these lacking in certain elements may still be considered as business. A more operational test is also introduced - substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, then the set of activities and assets is not a business.

Accounting for previously held interests:

Acquisition of control over a joint operation that meets the definition of a business is a significant economic event that warrants remeasurement of previously held interests in the assets and liabilities of the joint operation at fair value at the time an investor obtains control of the joint operation. In contrast, acquisition of joint control over a joint operation that meets the definition of a business is not an event that warrants remeasurement of previously held interests in the assets and liabilities of the joint operation at the time an investor obtains joint control over the joint operation.

Comments on the exposure draft are requested by 31 October 2016.

New Revenue Standards

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

IFRS Foundation

In June 2016, the Trustees of the IFRS Foundation concluded the 2015 review of structure and effectiveness of the IFRS Foundation by issuing a feedback statement. Based on this review, the Trustees have proposed amendments to the Constitution on matters such as the changes to trustees geographical distribution, the size, professional background, geographical distribution, reappointment terms and voting requirement of the IASB.

The comment period on the proposal ends 15 September 2016.

IFRS Foundation Monitoring Board

In July 2016, Ryozo Himino, Vice Minister for International Affairs of the Japan Financial Services Agency (FSA), was appointed by the IFRS Monitoring Board, responsible for the oversight of the IFRS Foundation, to serve as Chair for the remainder of Mr. Kono's term until February 2017.

U.S. GAAP

The FASB has issued several Accounting Standards Updates, including:

ASU No. 2016-13 – Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.

The main objective of this Update is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. To achieve this objective, the amendments in this Update replace the "incurred loss" impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates.

The main provisions of this Update are as follows:

- Assets Measured at Amortised Cost

  The amendments in this Update require a financial asset (or a group of financial assets) measured at amortised cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortised cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset.

  The income statement reflects the measurement of credit losses for newly recognised financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period.

  The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectibility of the reported amount. An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances.

  The allowance for credit losses for purchased financial assets with a more-than-insignificant amount of credit deterioration since origination (PCD assets) that are measured at amortised cost basis is determined in a similar manner to other financial assets measured at amortised cost basis; however, the initial allowance for credit losses is added to the purchase price rather than being reported as a credit loss expense. Only subsequent changes in the allowance for credit losses are recorded as a credit loss expense for these assets. Interest income for PCD assets should be recognised based on the effective interest rate, excluding the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition.

- Available-for-Sale Debt Securities

  Credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses.

  Available-for-sale accounting recognises that value may be realised either through collection of contractual cash flows or through sale of the security. Therefore, the amendments limit the amount of the allowance for credit losses to the amount by which fair value is below amortised cost because the classification as available for sale is premised on an investment strategy that recognises that the investment could be sold at fair value, if cash collection would result in the realisation of an amount less than fair value.

The allowance for credit losses for purchased available-for-sale securities with a more-than-insignificant amount of credit deterioration since origination is determined in a similar manner to other available-for-sale debt securities; however, the initial allowance for credit losses is added to the purchase price rather than reported as a credit loss expense. Only subsequent changes in the allowance for credit losses are recorded in credit loss expense. Interest income should be recognised based on the effective interest rate, excluding the discount embedded in the purchase price that is attributable to the acquirer's assessment of credit losses at acquisition.

For public business entities that are U.S. Securities and Exchange Commission (SEC) filers, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.

Early adoption is permitted.

SEC Issues revised CD&I on guidance on the Use of Non-GAAP Financial Measures

The SEC updated its **Compliance and Disclosure Interpretations (CD&Is)** on non-GAAP measures in response to its increasing concerns that such measures may be misleading, more prominent than comparable GAAP measures, or inconsistently presented from period to period.

The CD&Is update does not prohibit companies from using non-GAAP measures that comply with the SEC's existing rules; however, it provides guidance on the following questions related to non-GAAP measures:

- What is misleading or prohibited?
- When is the disclosure of a non-GAAP measure more prominent than that of a GAAP measure?
- How should a registrant present income tax effects for a non-GAAP measure?

Given the SEC staff's recent remarks urging registrants to 'self-correct' misleading disclosures in their next fiscal quarter, now is the time for companies to take a fresh look at their use of non-GAAP measures.

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 analysing 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** in April 2016.

The amendments address certain topics identified subsequent to the issuance of the IFRS15 including transition relief. 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; and
- Transition relief

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. Similarly, in April 2016, the FASB issued ASU 2016-010 **Identifying Performance Obligations and Licensing** which amends certain aspects of the Board's new revenue standard, ASU 2014-09 'Revenue From Contracts With Customers'.

Furthermore, the FASB published in May 2016, ASU 2016-012 **Narrow-Scope Improvements and Practical Expedients** amending 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. The following table compares the FASB's guidance on identifying performance obligations and its licensing implementation guidance under ASU 2016-10 with the IASB's guidance of its recently issued clarifications to IFRS 15:

Identifying Performance Obligations

Topic	FASB Guidance	IASB Guidance
Immaterial promised goods or services	An entity is permitted to evaluate the materiality of promises at the contract level; if the promises are immaterial, the entity does not need to evaluate such promises further.	No changes to IFRS 15.
Shipping and handling activities	Clarifies that shipping and handling activities that occur before control is transferred to the customer are fulfilment costs. Allows entities to elect a policy to treat shipping and handling activities as fulfilment costs if they occur after control is transferred.	No similar policy choice is available for shipping and handling activities after control is transferred.
Identifying when promises represent performance obligations	Reframes the separation criteria to focus on a bundle of goods or services. Adds illustrative examples.	Same as FASB's guidance.

Licensing Implementation Guidance

Topic	FASB Guidance	IASB Guidance
Determining the nature of an entity's promise in granting a license	Requires an entity to characterise the nature of a license as either functional or symbolic.	Clarifies the guidance on when an entity is expected to undertake activities that will significantly affect intellectual property and, if so, to characterise a license as a right to use.
Sales-based and usage-based royalties	Clarifies that rather than splitting a royalty, an entity would apply the royalty constraint if the license is the predominant feature to which the royalty is related.	Same as FASB's guidance.

Transition Resource Group (TRG) activities

The TRG is responsible for soliciting, analysing, 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.

American Institute of CPA (AICPA) - Revenue Recognition Task Force

In early July, the AICPA's Financial Reporting Executive Committee (FinREC) released for public comment nine working drafts of accounting issues associated with implementation of the new revenue standard. This is the second set of working drafts of revenue recognition implementation issues release by FinREC; in November 2015, the Committee also issued nine working drafts. The working drafts apply to entities in the following industries: (1) aerospace and defence, (2) airline, (3) broker-dealer, (4) engineering and construction contracting, (5) gaming, (6) health care, (7) investment asset management, (8) not-for-profit, and (9) software. Comments on the working drafts are due by September 1, 2016.

Japanese GAAP and other local developments

ASBJ issues Practical Solution on a change in depreciation method dues to Tax Reform

On June 17, 2016, the ASBJ issued the PITF No.32 **Practical Solution on a change in depreciation method due to Tax Reform** (the 'PITF'). The Tax Reform amended the tax law to require taxpayers to use the straight line method for leasehold improvements that are acquired on and after April 1, 2016. The PITF provides guidance on the accounting treatment when entities change to the straight line method for accounting purposes to align with the depreciation method for tax purposes. The PITF is effective from annual financial statements ending on and after April 1, 2016. Early adoption is permitted.

ASBJ releases for public comment the Exposure Draft of Practical Solution on Accounting for Risk Sharing Pension Plan

On June 2, the ASBJ released the Exposure Draft of **Practical Solution on Accounting for Risk Sharing Pension Plan**. The Ministry of Health, Labour and Welfare is currently discussing a new risk sharing mechanism for a defined benefit pension plan. The Exposure Draft proposes guidance on the classification of the pension plan with the new risk sharing mechanism (the 'New Pension Plan') for accounting purposes and the consequential accounting treatment.

The comment deadline is August 2, 2016.

ASBJ publishes amendments to 'Japan's Modified International Standards'

The ASBJ issued Japan's Modified International Standards (JMIS): **Accounting Standards Comprising IFRSs and the ASBJ Modifications**. JMIS was issued as a result of the endorsement process on standards and interpretations issued by the IASB as at 31 December 2012.

Since then, the ASBJ examined the Standards issued by the IASB during 2013 and in July 2016 issued an updated version of JMIS. New or amended Standards issued by the IASB during 2013 covered by the endorsement process for this round included:

- IFRS 9 Financial Instruments (Hedge Accounting and amend-ments to IFRS 9, IFRS 7 and IAS 39)
- IFRIC 21 Levies

The ASBJ's amendment identified two additional limited modification to IFRS9 should be incorporated into JMIS, both of which are related to recycling from other comprehensive income to profit or loss.

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

The FSA published the illustrative quarterly consolidated financial statements that are prepared in accordance with IFRSs for companies voluntarily applying IFRSs in Japan. The report could be found at:

http://www.fsa.go.jp/en/news/2015/20150430-4.html

Support of IFRSs by Japanese government continues

On June 2, the Cabinet in Japan adopted a revised **Japan Revitalization Strategy 2016** summarizing the nation's growth strategy and policy. Among many other measures IFRSs are included in the document.

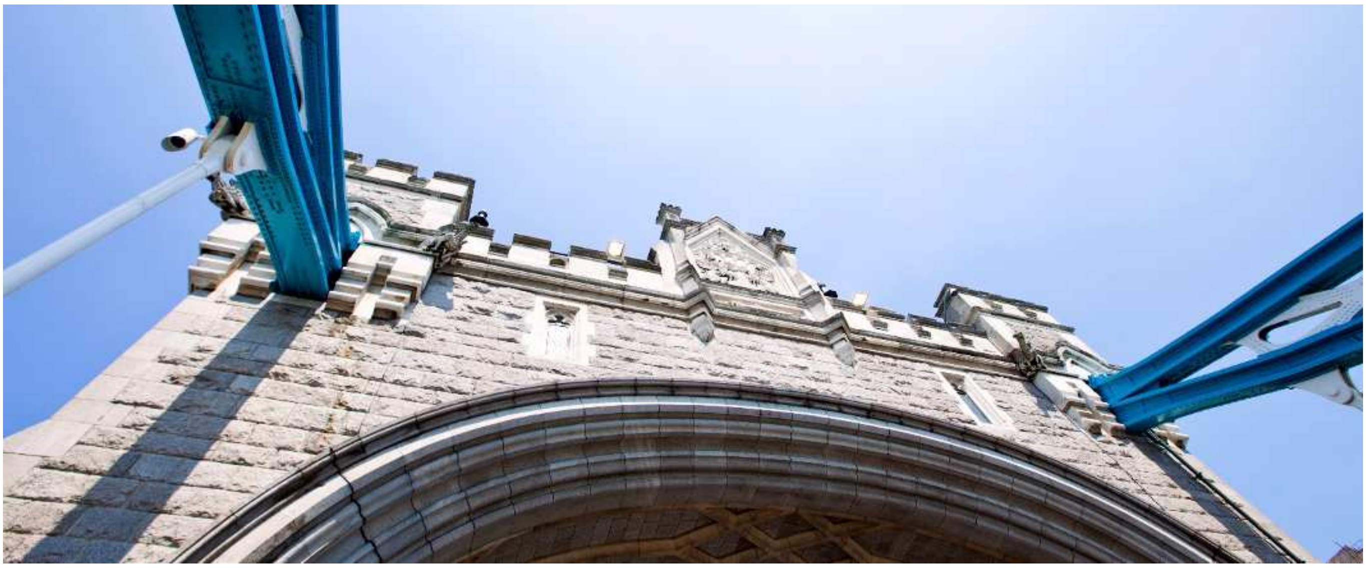
On IFRSs, the document express cabinet's intention to promote the voluntary adoption of IFRSs by sharing experience and knowledge of IFRS.

The document also expresses support for accelerating the efforts by the ASBJ to develop a new Japanese revenue standard that is likely to be modelled on IFRS 15 **Revenue from Contracts with Customers**.

The new revitalisation strategy does not require Japanese companies to adopt IFRSs. However, the government's consistent support of IFRSs sends very encouraging signals, and the planned convergence of the Japanese revenue standard with IFRS 15 might mean that another obstacle to switching to IFRSs will be removed.

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



The UK referendum vote on 23 June 2016 to leave the European Union (EU) is one of the most significant political and economic events in modern British history. The implications will potentially be felt far beyond the shores of Britain and continental Europe, and multinational companies (including many from Japan) with investments in the UK are now carefully evaluating the potential consequences for their businesses going forward.

Although a British exit (Brexit) from the EU is of acute importance for business leaders with direct responsibilities for investments into the UK, the consequences are of wider concern.

The reshaping of the UK's relationship with the rest of Europe, and its impact on business, is a matter that leadership of many multinational corporations (MNCs) will continue to monitor. Prudent organizations will debate the impact internally, and it is likely that leaders throughout the management hierarchy will want to remain knowledgeable in order to follow and contribute to these strategic discussions.

In addition, the ripple effect of events in the UK has the potential to affect sentiment and growth prospects in markets outside of Europe that may have a direct impact on those responsible for business performance in those markets. In this respect, Japan's Prime Minister Shinzo Abe, in announcing a JPY28 trillion economic stimulus package, commented that Britain's decision to leave the EU threatens to have a negative impact on Japan.

For finance personnel wishing to be informed about, and participate in, strategic discussions within their organizations in advance of the UK's secession from the EU, it will be important to understand the potential tax impact of any proposed commercial or corporate structural changes. Whilst it is possible to plan for different future scenarios, it should be remembered though that until a secession agreement is concluded with the EU, the UK will remain an EU member state, and EU laws and treaty obligations will continue in effect. It is unlikely, therefore, that the decision to leave the EU will have a significant immediate impact on direct or indirect taxes.

Following secession, however, the UK's approach to taxation could diverge from the current position. The UK would need to introduce its own customs duty system, although some models of engagement with the EU might allow the UK to remain in the customs union with EU member states. Importantly, if post-secession trade with EU member states is recognized as "imports" and "exports", duty may be payable when goods move to and from such states. This, and the related administrative formalities, could create some barriers to trade, as well as additional compliance costs.

Value added tax (VAT) is already part of UK law and would continue to be so. It is possible though that, freed from the requirement to comply with EU VAT law (on rates, scope of exemptions etc.) the UK could make changes in these areas. Given though the global trend towards VAT equivalent taxes, and the importance of VAT revenue to the UK's finances, radical change seems unlikely.

Direct taxes are less likely to be affected by Brexit, as these are not expressly dealt with by EU treaties. Such taxes are legislated for by individual EU member states, although this authority must nevertheless be exercised in accordance with EU treaties. These treaties have authorized the European Council to issue directives to approximate laws, regulations and provisions directly affecting the establishment and functioning of the EU internal market, and EU members have chosen to implement a number of directives that aid intra-EU trade and investment. These include directives covering the elimination of withholding taxes on certain dividends, interest and royalties, and the deferral of tax on gains at company and shareholder level for certain cross-border reorganizations taking place within the EU.

Subject to any transitional provisions, the above directives would in principle cease to apply after the UK leaves the EU, although the domestic UK legislation that has implemented the directives would presumably remain in force unless repealed by a future UK government. In partial mitigation of the directives ceasing to apply, it should be remembered that the UK has a broad bilateral tax treaty network, including treaties with the other 27 EU member states. The UK's treaty policy is to eliminate withholding taxes (and the UK applies no withholding tax on dividends under domestic law). Notwithstanding this, certain of the UK's existing bilateral tax treaties do not provide for an exemption from taxes withheld by other member states on payments to the UK. Notably, there would therefore be withholding taxes on dividends from Austria, the Czech Republic, Germany and Italy to the UK, and also on interest and royalties from Italy, Portugal and Romania.

In terms of adherence with initiatives to encourage tax transparency and the elimination of harmful tax practices, the UK would no longer be committed to the EU code of conduct for business taxation. The objectives of this code, however, are broadly aligned with those of the Organization for Economic Cooperation and Development's (OECD) Base Erosion and Profit Shifting initiatives. As an OECD member, therefore, the UK is unlikely to see significant change in this area upon leaving the EU.

Full details of the tax consequences of the UK's departure from the EU will not become apparent until some years after Brexit.

In the meantime, it will be important for corporations to monitor the ongoing negotiations, to understand the issues for their particular business, and to plan accordingly for the possible alternative outcomes.

For all organizations, the finance and tax function will have an important role in informing this debate.

For more information, please speak to our Deloitte experts Kazumasa YUKI, Tax Partner (kazumasa.yuki@tohmatsu.co.jp), or David BICKLE, Tax Partner (david.bickle@tohmatsu.co.jp).

CFO Careers: Carving Out Diverse Paths to the Top

The expansion of the CFO role into nontraditional arenas, such as business strategy and enterprise risk, is creating a more flexible path to finance leadership than the rigid career development model of the past. To keep pace with changing business needs and avoid losing valuable talent, finance organizations can build a talent infrastructure with the right opportunities for development of finance professionals. Effective CFO career paths should provide opportunities for both vertical and lateral career progression, and be flexible to adjust to changing employee interests and business circumstances.

When asked to name their top priorities for 2016, surveyed CFOs named helping their executive teams achieve key business priorities and delivering on the organization's financial commitments, and developing and acquiring finance talent, according to results of Deloitte's first-quarter, 2016 CFO Signals™ survey. Those goals dovetail with concerns over their teams' ability to meet the expanding needs of the business and an overall shortage of finance talent revealed in other surveys[4].

As CFOs play a greater role in executing strategic choices for their company, they are expected to be more focused on firm performance and shareholder value, and their teams are expected to deliver a financial perspective to the overall business strategy. That expectation requires a different set of skills for finance professionals.

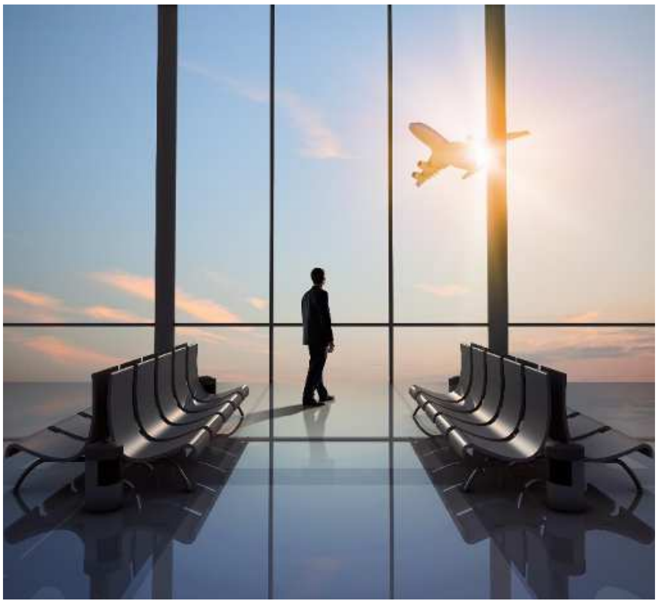
Developing a Talent Strategy That Meets the Business's Expanding Requirements

Although CFOs understand the importance of building the data analysis and personal communications skills that finance professionals need to be effective business partners, many finance organizations aren't providing their finance team adequate opportunities to gain these experiences. Many finance leaders find themselves with talent who were not necessarily hired for their partnering skills, while the finance organization is not set up to provide in-depth partnering experiences.

An effective finance talent development strategy should identify top talent needs, lay out paths for employees to acquire and expand required skill sets and experiences, promote customized career development plans and address succession planning.

Four Building Blocks of Finance Mobility

While there are multiple pathways to the top, four interconnected building blocks correlate to upward mobility in finance: core finance capabilities, broad business skills, career-shaping experiences and relationships. Each component is critical, especially as finance leaders seek to deliver strategic insight and decision-support capability.



[4] Deloitte's 2013 Global Finance Talent Survey.

1.Core Finance Capabilities:

Finance capabilities remain fundamental to the CFO career path, especially foundational skill sets related to accounting and finance; however, they should be combined with other strengths — such as incorporating strategic relationships and unique project experience.

2.Broad Business Skills:

These are the competencies critical to leading the organization, such as industry and sector knowledge, strategic thinking, decision making and communications.

3.Career-shaping Experiences:

By seizing opportunities to grow, finance professionals can develop their skill sets in meaningful ways. In the case of a company facing a specific challenge, such as a liquidity issue or the turnaround of a business unit, certain finance talent could be offered the opportunity to hone in on litigation, negotiation and other skill sets that are not native to the traditional finance organization.

4.Relationships:

Of the four building blocks, relationships are perhaps the most deeply underrated. Business relationships—those key internal and external connections— build the foundation for business partnering by helping to bring specialized perspectives and resources from across the business function, build a sounding board and establish credibility.

The Lattice: A Framework for Finance Career Development

The broader business demands being made of the finance organization require a more flexible model to create the necessary talent pipeline. In addition, careers today are multidirectional— made up of climbs, lateral moves and even descents. These realities can be well supported by a lattice-like career development framework that finance executives can use to build a broad set of skills to help prepare them to secure and succeed in leadership roles. Attributes of the lattice career development framework (compared to the traditional career development model) include:

−Multiple paths upward or across (vs. singular path upward)

−The option to move faster, slower or change directions (vs. move up or stop moving)

−Career-life fit (vs. work-life balance)

−Flexibility to adjust to changing needs of employees and the business (vs. fits traditional family structure)

−More conducive to matrix approach (vs. assumes employees needs remain the same over time)

How to Apply a Lattice Model: Considerations and Examples

To apply a lattice model in a finance organization, CFOs can take a few initial steps: First, determine what are you trying to achieve and the core areas you want to develop within the finance function. Then, consider the distinct skills sets that are aligned with the functional and professional competencies that drive the specific types of opportunities you want to provide—those that will create the paths to leadership—which can vary widely by organization. For example, an organization considering new markets will likely want its finance organization to help provide the financial analysis and risk perspective to support the decision. Relevant competencies that finance could look to develop include core financial analysis, critical thinking, the development of global financial perspectives and navigating ambiguity.

Once the appropriate competencies are defined, establishing an aligned career development program or related career path becomes straightforward. Professionals who aspire to be CFO or take another finance leadership role must take deliberate career steps to master the four building blocks. Finance leaders can help them get there by encouraging high-potential talent to get diverse skills and business experiences and by establishing a finance talent development model aligned to that goal.

The Dangers of Being Too Decisive

As CFO, you confront multiple decisions every day. Some, such as fixing a meeting agenda, may border on the pedestrian. Others, like launching a new product, pursuing a merger, or filling critical personnel vacancies, can have a material impact on your company's fortunes. Compounding the challenge, many CFOs face external or self-imposed pressure to quickly reach a conclusion.

And no wonder. We are inundated with breathless proclamations about the unprecedented pace of modern business and competitive intensity. The implication is that by waiting a week (a day, an hour) before choosing a course of action, an opportunity might be missed, to the perpetual detriment of the fence-sitter. Serious business writing touts the importance of "decisiveness" for effective leadership. [5] Classes profess to make you decisive, for both personal and professional gain. And we are told that "indecisive" is among the worst epithets that can be levied against an executive.[6]

However, a rich body of research in social psychology and behavioral economics suggests that decisiveness is not an unequivocal good. Studies on "mindset" reveal that, when contemplating an important decision, prematurely focusing on execution can exacerbate decision-making biases and lead to excessive risk-taking. Following is a discussion of the different decision-making phases and suggestions for mitigating the pitfalls of execution-oriented mindsets.

Crossing the Mental Rubicon

The theory of action phases, pioneered in the 1980s by Peter Gollwitzer and Heinz Heckhausen, suggests that individuals move through distinct states of mind leading up to and following a decision.[7] Each mindset is tuned to a specific task, so switching from one to the next changes the way people receive, process and act on information.

During the pre-decision period, individuals adopt a deliberative mindset. Here, people focus on adjudicating potential goals. They weigh information about the likelihood and value of different outcomes. Eventually, "the die is cast," and in the post-decision stage, an implemental mindset takes over. This is when a firm commitment culminates in a course of action. People stop deliberating, and turn to executing the decision. Consider a company exploring a major acquisition. In a deliberative mindset, the CFO and her team might look at many potential targets, considering their capabilities, cultures and prices. Once the acquisition is complete, an implemental mindset focuses on making the decision a reality by, for example, making announcements to shareholders and integrating employees.

Naturally, the switch from a deliberative to an implemental mindset occurs at some point. Unfortunately, many individuals and groups cross over prematurely. People might "trust their gut" and jump to a quick decision, driven perhaps by a desire to appear decisive. Alternatively, decision points may be imposed externally, based on deadlines set elsewhere in an organization. Similarly, the decision threshold can be crossed when an individual concludes that a particular outcome is inevitable. Even prudent steps, such as "thinking ahead" about how a decision would be executed, can prompt a shift to an implemental mindset—often without an individual even being aware.

Herein lies the danger. Even if a decision seems correct at the time, new facts may arise, warranting reconsideration. However, implemental mindsets can lead to a host of decision-making biases. Having an execution-oriented frame of mind may encourage "tunnel vision" and lead to overconfidence and excessive risk-taking. In the end, individuals may stick to decisions that simply no longer make sense.

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[5] Nick Tasler, "Just make a decision already," Harvard Business Review, October 4, 2013.
[6] Lynne Guey, "Instant MBA: The most important trait a leader can have is decisiveness," Business Insider, June 7, 2013.
[7] Heinz Heckhausen and Peter Gollwitzer, "Thought contents and cognitive functioning in motivations versus volitional states of mind," Motivation and Emotion 11, no. 2 (1987): pp. 101–20.

Traps in Decision-making

Consider the following decision-making traps:

Disregarding new information and making biased inferences.

Preoccupied with a task, individuals in an implemental mindset often downplay or ignore new information. This closed-mindedness can manifest, for example, in poorer short-term memory. In lab experiments, subjects in a deliberative mindset have better memory recall than those in an implemental mindset when asked to repeat a string of nouns unrelated to their decision. [8] In a separate study, participants were presented with information about the pros and cons of an action and, simultaneously, the steps required to execute it. Asked to recall the information, those in an implemental mindset remembered a greater proportion of the execution-focused information and less of the pros-and-cons information than those in a deliberative mindset.[9]

What's worse, the information that is received is processed in a way that reinforces the already-made decision. When asked to consider the advantages and disadvantages of a course of action, those in an implemental mindset report few, if any, downsides. In contrast, those with a deliberative mindset are relatively balanced between positive and negative implications. [10] Moreover, the implemental mindset encourages the onset of confirmation bias—the tendency to rely on information that confirms what we already believe, and to discount data that may contradict our pre-existing positions.[11]

The illusion of control.

Individuals in an implemental state of mind are also more likely to overestimate the influence they have over outcomes. In a series of trials using lab equipment, researchers asked participants to estimate how much control they could exercise over whether a light turned on by pressing a button. In reality, participants had no control (researchers controlled the light), but those who were in an implemental mindset believed they had a significantly greater degree of influence than others.[12] In addition, individuals in a deliberative mindset were even less likely than the control group to fall victim to an illusory sense of control, underscoring the benefits of a deliberative mindset when weighing the feasibility of alternative goals.

Excessive optimism.

All individuals are susceptible to illusions of invulnerability, but those in implemental mindsets are particularly prone to downplaying risk. [13] For example, one study placed participants in a deliberative or implemental mindset by having them ruminate on a significant life decision or on the steps required to execute a recent choice, respectively. They were then asked to evaluate their personal vulnerability and the average college student's vulnerability to an array of controllable risks (such as developing a drug addiction) and uncontrollable risks (such as having a partner die young). Participants in an implemental mindset saw themselves as significantly less vulnerable than either the deliberative or

[8] Peter Gollwitzer, "Action phases and mind-sets," in Handbook of Motivation and Cognition: Foundations of Social Behavior Vol. 2, edited by E. Tory Higgins and Richard M. Sorrentino (New York: Guilford, 1990), pp. 53–92.
[9] Peter Gollwitzer, Heinz Heckhausen, and Birgit Steller, "Deliberative and implemental mind-sets: Cognitive tuning toward congruous thoughts and information," Journal of Personality and Social Psychology 59, no. 6 (1990): pp. 1119–27.
[10] Peter Gollwitzer and Heinz Heckhausen, "Breadth of attention and the counterplea heuristic: Further evidence on the motivational and volitional mind-set distinction," unpublished manuscript, Max-Planck-Institut für psychologische Forschung, Munich (1987).
[11] Irving L. Janis, Victims of groupthink (Boston: Houghton Mifflin, 1972); Zweig, Jason, "How to ignore the yes-man in your head," Wall Street Journal, November 19, 2009.
[12] Iain Bamford, Nik Chickermane, and Jessica Kosmowski, Growth through M&A: Promise and reality, Deloitte University Press, July 1, 2012.
[13] The Standish Group, "Big bang boom", accessed July 1, 2015.

control groups, and they judged themselves to be particularly immune to controllable risks.[14]

Business leaders are no less vulnerable to overconfidence. Using massive, multiyear surveys of CFOs, researchers found that respondents significantly underestimated the volatility of an overall stock index and the share performance of their own company.[15] During the sample period, about 33% of the stock index's actual returns fell within CFOs' 80% confidence estimates (had their estimates been accurate, 80% of returns would have fallen within that 80% interval). Those who erred in their market forecasts were similarly off when estimating the ROI for internal projects. Just as troubling, the more optimistic the CFO, the more his or her company invests (as measured by net investments).

The Dangers of Decisiveness

While a decision-making bias may not result in a bad decision, real-world evidence suggests that poor decisions are often the by-product of prematurely switching to an implemental mindset.

On February 1, 2003, the space shuttle Columbia broke apart as it reentered Earth's atmosphere. All seven crew members died. The proximate cause was a piece of insulating foam that broke during liftoff, impacting the shuttle's wing and causing catastrophic failure upon reentry. Implemental mindsets, coupled with other decision-making problems, may have served as contributing causes. For example, soon after launch, NASA officials became aware that debris had impacted the wing. While working-level engineers voiced concerns, senior managers—who were more directly responsible for the decision to launch—reportedly downplayed the risk. In the view of engineers, "Management focused on the answer—that analysis proved there was no safety-of-flight issue—rather than concerns about the large uncertainties that may have undermined the analysis that provided that answer."[16] In other words, they interpreted new information in a way that likely reinforced their chosen decision—to proceed with the mission.

The consequences of such biases for CFOs may be less dire, but no less real. These biases contribute to underperforming deals, cost overruns and failed product launches. A study of more than 100 M&A transactions, whose express purpose was enhanced growth, found that nearly three-fourths were "low-performing" in that the combined companies' growth was equal to or less than what could have been expected had they remained independent.[17] Just 6% of large software projects come in on-time, on-budget, and with a successful implementation.[18] Moreover, the failure rate for new products ranges from 30% to 50%, often because new products take on a life of their own within an organization.[19]

These shortfalls can be amplified by other biases. For example, if a decision-maker already believes in the merits of a particular course of action, the previously mentioned confirmation bias can skew how new information is interpreted. Similarly, individuals may exhibit sunk cost bias as they move further down a decision path. In this trap, people find themselves throwing good money after bad and escalating their commitment to courses of action in which they have made substantial prior investments of time, effort and money. Consider the momentum that sometimes builds as a CFO and other leaders analyze a potential acquisition. The implemental mindset may take hold as managers value synergies, conduct due diligence and discuss integration. They can't back away even if new risks emerge, since they have invested so much time preparing for the deal.

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[14] George Castellion and Stephen K. Markham, "Perspective: New product failure rates: Influence of argumentum ad populum and self-interest," Journal of Product Innovation Management, 30 (2013): pp. 976–79; Joan Schneider and Julie Hall, "Why most product launches fail," Harvard Business Review, April 2011.
[15] Itzhak Ben-David, John Graham, and Campbell Harvey, "Managerial miscalibration," Quarterly Journal of Economics 128, no. 4 (2013): pp. 1547–84.
[16] Michael A. Roberto, Richard M. J. Bohmer, and Amy C. Edmondson, "Facing ambiguous threats," Harvard Business Review, November 2006; National Aeronautics and Space Administration, "Report of Columbia Accident Investigation Board," vol. 1, chapter 6, pp. 160.
[17] Iain Bamford, Nik Chickermane, and Jessica Kosmowski, Growth through M&A: Promise and reality, Deloitte University Press, July 1, 2012.
[18] The Standish Group, "Big bang boom," 2013, accessed July 1, 2015.
[19] George Castellion and Stephen K. Markham, "Perspective: New product failure rates: Influence of argumentum ad populum and self-interest," Journal of Product Innovation Management, 30 (2013): pp. 976–79; Joan Schneider and Julie Hall, "Why most product launches fail," Harvard Business Review, April 2011.

Of course, implemental mindsets are well-suited to certain tasks. Indeed, some research suggests that those in an implemental mindset execute tasks better than those caught in a lengthy deliberation mode.[20] Still, for business leaders in general and CFOs in particular, prematurely switching to an implemental mindset seems the greater danger. Ignoring new information, foreclosing alternative courses of action and succumbing to the “illusion of control” can lead decision makers to pursue excessively risky plans or miss opportunities to short-circuit a looming crisis.

Being Deliberate About Decisiveness

Thankfully, research suggests that mindsets are an “active” phenomenon, meaning we can consciously control them.[21] In many lab experiments, for example, mindsets are cued by simply asking subjects to think about the pros and cons of an impending choice (deliberative) or how to execute a decision they’ve made (implemental).

Accordingly, one way to successful implementation is adequate deliberation. To this end, executives should consider the following tactics before letting their mindset cross from deliberative to implemental:

−Make sure you have multiple options.

−Put the decision point on a timeline or calendar, and before that deadline, focus on understanding the issue, rather than on the “go/no-go” decision.

−Conduct a “premortem.”[22] Imagine that the decision has failed, and ask what contributed.

−Consider using structured analytic techniques, such as a “devil’s advocate” (several people assume responsibility for offering a constructive critique) or “dialectical inquiry” (multiple subgroups present the advantages of different alternatives, and then critique one another’s proposals.)[23]

− Keep project-management tools on ice until you’ve committed to executing.

−Pay attention to discordant data. Charles Darwin collected data about his emerging theory of evolution, but he also kept a separate notebook with contradictory observations.[24]

− Institute a “cooling-off” period before moving from deliberation to implementation.

−Consider bringing unbiased outsiders into the conversation.

You should not simply discuss what you will do, and then analyze how to do it. Decision-making processes should not necessarily unfold in such a linear fashion. You should consider implementation obstacles and risks as you make decisions. Moreover, you should encourage the team to step back occasionally from the “how should we execute this plan” discussion to consider whether the plan is the proper course. By implementing these techniques, CFOs can improve the likelihood that their decisions yield favorable results.

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[20] Veronika Brandstätter and Elisabeth Frank, “Effects of deliberative and implemental mindsets on persistence in goal-directed behavior,” Personality and Social Psychology 28, no. 1 (2002): pp. 356–78.
[21] Gollwitzer, 1990. Indeed, research suggests that tasks can be “reframed” even after a decision has been made and implementation has begun, and that shifting from a “performance” frame focused on process and outcomes to a “learning” frame focused on exploration is associated with improved results. See Amy C. Edmondson, “Framing for learning: Lessons in successful technology implementation,” California Management Review 45, no. 2 (2003).
[22] Gary Klein, “Performing a project premortem,” Harvard Business Review, September 2007.
[23] Michael A. Roberto, Why Great Leaders Don’t Take Yes for an Answer: Managing for Conflict and Consensus (Upper Saddle River, NJ: Wharton School Publishing, 2005), chapter 4.
[24] David Garvin, Building a Learning Organization (Boston: Harvard Business Press, 2000), pp. 79–80.

Designing Risk-sensing Programs to Focus on Both Opportunity and Risk

Business disruption stemming from economic upheaval, market evolution, regulatory demands and technological change continue to affect organizations, as well as entire industries. In response, many organizations are developing risk-sensing programs that use human insights and advanced analytics capabilities to identify, analyze and monitor emerging risks.

However, understanding which events pose the greatest opportunity, not just the greatest risk, is important to developing effective risk sensing. Such understanding enables leaders to focus resources on what matters most, and in turn, helps design programs that are informed by the decision-making requirements of senior executives, aligned with risk management requirements and guided by an enterprise-wide view of risks.

“ Risk sensing should focus on both key opportunities and risks, those that could affect competitive advantage, market position and performance,” says Henry Ristuccia, Deloitte`s global Governance, Regulatory and Risk leader. “Risk sensing should incorporate mechanisms for developing an integrated view of opportunities and risks, and support economical, practical, productive responses,” he adds.

The integration of risk sensing into risk management and governance programs calls for clear communication and response plans. In addition, a direct line from the sensing team and CRO to the CEO and board of directors can be useful, particularly in the case of emerging strategic risks.

While strategic risks vary among organizations, many executives have identified top threats to their business. For instance, C-level executives expect their business strategy to be affected by risks related to economic trends, business models, reputation and competition during 2016, according to a global survey[25] conducted with Forbes Insights on behalf of DTTL. Of the 155 executive respondents, 29% named economic trends as the risk likely to affect strategy, 26% cited business model disruption, and 24% named risks related to reputation/competition (a tie).

The results vary somewhat from answers provided three years ago, when C-level executives named reputation (40%), business model disruption (32%) and economic trends/competition (tie at 27%) as top risks. “These findings underscore the fact that management’s views of risks are always shifting, although not radically,” observes Mr. Ristuccia. “That shift underscores the value of casting a wide net when defining risks because definitions of risk tend to direct risk-sensing efforts. Yesterday’s risks are rarely the same as those of today or tomorrow, which argues strongly for forward-looking risk-sensing capabilities,” he adds.

[25] Deloitte 2015 Risk sensing: The (evolving) state of the art.

Elements of Effective Risk Sensing

Developing, launching and maintaining a risk-sensing program require dedicated resources, as well as internal resources that understand the organization's business and unique risks. Further, external resources also may be required, given the need for a technology platform, sophisticated analytics and outside-in perspectives.

There are four primary steps to consider when framing and implementing an effective risk-sensing program:

- Identify the strategic risks to be monitored and the scope of the effort;
- Define the elements required to enable strategic risk monitoring;
- Configure the platform to enable scanning, analyzing and tracking of strategic risks;
- Continue monitoring the data sources and generating ongoing insights.

Executives also may want to consider using a strategic approach to risk sensing as it can benefit their organizations in several ways. For, example, such an approach primarily focuses on risks that can undermine management's fundamental assumptions or the organization's ability to achieve its strategic goals. It also may elevate risk sensing from data mining or media monitoring to one that goes further, covering relevant risks to the organization and integrating risk sensing with risk management and risk governance. Further, the results of a strategic approach to risk sensing often is used by senior executives, the businesses and functions in planning and decision-making.

Although boards of directors do not engage directly in risk sensing, directors have a role in ascertaining that risk management practices are sufficiently robust and forward looking. Further, as risk-sensing capabilities mature, they extend beyond an operational and tactical focus to a more strategic focus to provide more data and insight of relevance to the board.

Looking for Anomalies

Along with strategic risk identification and monitoring, effective risk sensing encompasses detection of rare events and observations—the anomalies outside the expected patterns or existing trends. When considering outlier detection and analysis, organization may want to focus on a few initial steps.

—Embrace data scarcity.

Rare events by nature provide few observations to detect and analyze. Sophisticated analysis and modeling can work with low-probability outliers to provide more insight into developments and events, despite scarce data.

—Build context.

Rather than dismissing outliers as insignificant, consider each new event or piece of information as providing an opportunity to refine organizational vision and recalibrate the context. If an occurrence is strategically relevant, its rarity does not in itself diminish its potential significance and impact on the organization.

—Maintain situational awareness.

Keeping the 5 Ws (who, what, when, where and why) in mind can help in aligning rare-event analyses with evolving business goals and realities. Linking anomaly detection to the organization's strategy and business context keeps it rooted in risk management rather than reducing it to forecasting for its own sake.

To be effective, risk sensing should evolve as an organization and its strategies and risk environment change. Continuous improvement via periodic recalibration should be considered and designed into the program, as should a feedback loop from executives, risk managers and business units back to the analysts to ensure that results are of practical use.

" The value of risk-sensing programs will reflect the extent to which they are tied to strategic risks and priorities, supported by senior executives, integrated with risk governance and risk management, and comprised of the right technological and human resources," adds Mr. Ristuccia.

Should FX Swings Affect Incentive Compensation?

The recent strengthening of the U.S. dollar has had a significant impact on corporate earnings at many U.S.-based companies with significant foreign operations. The magnitude of the change also caught a lot of companies by surprise. Moreover, because these currency fluctuations were not fully anticipated in the budgeting or incentive-plan goal-setting process, the treatment of foreign exchange (FX) in calculating incentives became a boardroom topic.

Most companies decided not to make major changes to their incentive calculations. In Deloitte's most recent CFO Signals™ survey, 70% of CFOs agreed that the issue was relevant for their companies, but more than three-quarters of those same CFOs did not plan to make adjustments[26]. Instead, the prevailing sentiment was to keep the fates of shareholders and executives closely aligned.

But the question remains: Should unanticipated FX swings affect incentive compensation? Shareholders are obviously interested in a resolution, since investors want to see a stronger correlation between compensation and company performance. Boards also want to ensure alignment of incentives and shareholder returns and make sure executives are properly motivated and rewarded for decisions within their control.

Three Schools of Thought

FX swings are cyclical. When the dollar was weak against foreign currencies, its impact on incentive compensation was generally positive but relatively immaterial, as there was not a lot of year-over-year variation. But the recent surge in the U.S. dollar made it the strongest it has been for many years against most world currencies, including the Canadian and Australian dollars, the British pound and the euro. The resulting change took a $31.7 billion toll on the earnings of American and European multinationals in the first quarter of 2015, according to a survey by FiREApps.[27]

In many cases, annual bonus and long-term incentive targets were built on the same financial assumptions as earnings. Because of FX's recent adverse impact on earnings, there's a more pressing need to raise the issue of whether or not incentive plans, which are partly impacted by FX fluctuations, should be revisited, and whether or not incentive compensation should be adjusted to reflect unanticipated FX fluctuations.

There are three schools of thought in this regard:

1. Do nothing.

This approach is based on the notion that changes in budget assumptions occur all the time, and it is up to management to adopt and adjust to the new conditions. This view also considers the fact that if shareholders are experiencing lower-than-expected profits, management should earn less than expected incentive pay. Proponents also argue that because incentive compensation was not adjusted when profits received a boost from a weak U.S. dollar against foreign currencies, then for consistency, no adjustment should be made when profits suffer from FX swings.

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[26] CFO Signals, Deloitte CFO Program, see 2Q 2015, July 2015.
[27] "FiREapps 2015 Q1 Corporate Earnings Currency Impact Report," based on the analysis of the earnings calls of 1,200 publicly traded North American and European companies, June 2015.

2. Hold-harmless approach.

This approach neutralizes the impact of certain unplanned or unbudgeted items that affect profits used for incentive purposes, including FX. The rationale is that unplanned or unbudgeted items are largely out of management's control, and excluding such items from incentive plan calculations allows the board to more properly recognize management's performance. Advocates of the hold-harmless approach also exclude unplanned gains—such as lower commodity costs, gains on sale of assets and positive FX—from reported earnings when calculating incentives.

3. Corridor approach.

In this scenario, the board holds management accountable for a portion of the variation in FX. Unlike the hold-harmless approach, management is not completely insulated from FX fluctuations, and will be more inclined to take prudent steps to manage the impact of FX on earnings, such as sourcing of raw materials in local currency, borrowing in local currency and so on. To illustrate, suppose the euro is budgeted at US $1.14; as long as it remains within a given range, say, US $1.07 to US $1.21, the company allows the FX impact to flow through to the incentive plan calculation. When the exchange rate falls outside of that corridor, an organization can exclude the impact on earnings outside the FX corridor, whether positive or negative. In that way, management is not indifferent to FX, nor is the organization taking extraordinary measures to manage the impact of FX swings.

While the majority of companies that participated in the CFO Signals survey favored the do-nothing approach, there was some support for the corridor approach. Just over 11% of finance chiefs were in favor of making management accountable for FX movements within a corridor of currency fluctuations (about 20% of manufacturing CFOs cited a preference for this approach). Another 9% of the CFOs cited a belief that holding their management accountable for FX fluctuations is not appropriate or is impractical.[28]

Bridging the Information Gap

Still, some boards may worry that they will be criticized for making an adjustment to incentive compensation—upward or downward. That's particularly true in the event incentive compensation is adjusted upward when an organization is earning less. In such cases, it's important for boards to have a strong rationale for the adjustment and to clearly communicate it to shareholders. In general, boards can help minimize the risk of being criticized by being consistent, having a strong rationale for their decision, being transparent about the factors that went into their decision, and making clear disclosures around the adjustment.

For their part, CFOs can help shape the discussion and the decision by getting to know shareholders' expectations through their interactions with analysts and major investors. In addition, it is important for finance chiefs to focus on what is affordable, albeit striking a balance with what is competitive.

CFOs, even while struggling with the budget and trying to project out earnings for the next two to three years, should establish acceptable limits on compensation in terms of its dilutive effect on earnings.

Finally, CFOs could spend considerable time with the audit and compensation committees to bridge the potential knowledge gap on compensation and financial performance. In the case of FX fluctuations, their input can help decide—in the case of either positive or negative swings—how these amounts should be reflected in incentive compensation targets and payouts.

[28] CFO Signals, Deloitte CFO Program, see 2Q 2015, July 2015.

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