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IAFEI News

Letter of the Editor **September 30, 2014**

Dear Financial Executive,

You receive the **IAFEI Quarterly XXVI th Issue**.

This is another issue of the **IAFEI Quarterly**, the electronic professional journal of IAFEI, the International Association of Financial Executives Institutes.

This journal, other than the IAFEI Website, is the internal ongoing information tool of our association,

destined to reach the desk of each financial executive,
or reach him, her otherwise,
at the discretion of the national IAFEI member institutes.

This issue contains a broad variety of articles on accounting, financial and tax matters. Articles are from three continents and from nine countries, and one article from the new Silver Sponsor of IAFEI, the AU Group.

Once again:

I repeat our ongoing invitation, to IAFEI member institutes, and to their members,
to send us articles for inclusion in future IAFEI Quarterlies,
and to also send to us your suggestions for improvements.

With best personal regards

Helmut Schnabel

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(1 September 2014 to 31 August 2015)

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-
by transferring the risk to the insurance market

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-
by assigning trade receivables to a bank or factor

CREDIT MANAGEMENT
-
by optimising credit management tools

It is the sponsorship policy of IAFEI, to thereby enhance the value of the organization to is member institutes and its individual financial executives members, around the world, while, at the same time, entering into a professional dialogue, by various ways and means, with the sponsoring corporations. In so doing, IAFEI is striving for having such corporations as sponsors, which are world class corporations, and among the best in their business sector, and with a truly global scope and focus of activities. Thus, IAFEI and its sponsors, want to jointly serve financial executives, worldwide, for their professional benefit.

Belgium, Article: Ten Mistakes to Be Avoided When Valuing a Company

By **Alexandre Streel**, Lecturer at the university of Liège,
BDO Corporate finance, and by **Virginie Meunier**, BDO Finance

This article is a summary of a study published in the journal Comptabilité et fiscalité pratiques (Editions Kluwer) in January 2013 (pages 2 to 16). An archive of this journal is available on http://www.monKEY.be

1. Introduction

A couple of recent studies have shown that around 20% of Belgian companies will change hands in the next five years. The transfer of a company is therefore a burning issue, which involves a particular elusive aspect for both the buyer and seller: the valuation of the company to be transferred. This exercise is not only important for the transfer of a company, but also for a number of other contexts, including group restructuring, fund raising, IPO, value enhancement, impairment testing, shareholders disputes, contribution in kind, succession planning, gift tax filing, etc. The valuation of a company, crucial in such situations, raises continuously a number of questions and all too often contains conceptual errors.

2. Valuation approaches

The value of an asset can be determined on the basis of three generally accepted approaches: the cost approach, the income approach and the market approach. These approaches encompass several valuation methods.

The cost approach is based on the principle that an asset is not worth more than what was originally paid for it. In the field of company valuation, the most commonly used

method, fitting with this approach, is the adjusted equity method. This method states that the value of a company corresponds to its net assets, i.e. the total assets less the liabilities and provisions as shown by the company accounts, adjusted by unrecognized gains or losses on these balance sheet items.

The second approach, based on the income, assumes that an asset is worth what it can earn in the future. On this basis, the value of the company is equal to the discounted value of the future cash flows that are available either for the shareholders (DCFE method - Discounted Cash Flow to Equity) or for the capital providers, i.e. both shareholders and banks (DCFF method - Discounted Cash Flow to the Firm). The DCFF method is more commonly used so that the mistakes presented in this article with respect to the income approach will relate only to this method.

The third and last valuation approach is the market approach, according to which an asset can be valued by comparison to the prices at which similar assets were recently bought and sold. With respect to the company valuation, this approach includes two common methods. The first method involves a comparison with recent deals in the private company's industry whereas the second one, most widely used, takes as a basis for comparison the trading prices of stock listed companies engaged in the same sector. Ratios or "multiples" (P/E, EV/EBITDA, etc.) are then derived from these observable market prices and applied to the financial parameters of the company to be valued.

3. Ten mistakes to be avoided when valuing a company

Based on our experience, we have mapped out the mistakes that most often occur in relation to the DCFF and Multiples valuation methods. The mistakes presented below only refer to the valuation technique in itself, and do not cover other steps of the valuation process, such as the preparation of financial forecasts and the normalization of the financial performances. Finally, we should emphasise that a few mistakes are here considered as such even though some controversy still remains in the specialised literature. The points of view given in this article reflect the opinions of the authors.

3.1. Poor assets…

The first mistake here listed relates to the DCFF method and possibly to the Multiples method (depending on the multiple used) and consists in ignoring the non-operating assets. Non-operating assets are assets that do not generate any cash flows for the company, such as a building that is neither used nor rented out by the company, or an investment in another company that does not yield any dividends. As these assets do not generate any cash flow for the company, they are not included in its value as captured by the valuation methods mentioned above. For this reason, the market value of these assets, adjusted for any potential tax impact on their sale, must be added to the valuation result arrived at.

3.2. The chicken or the egg?

The use of the DCFF method implies the prior determination of a discount rate, which is presumed to reflect, among other things, the financial structure (or gearing) of the company under review. This discount rate, called WACC, is a weighted average of, on the one hand, the cost of equity, i.e. the required return of the shareholders, and on the

other hand, the cost of financial debt. A common mistake is to calculate the cost of equity weight on the basis of the book value of the equity instead of its market value. Indeed, as soon as the market value of the equity is known, the shareholder will expect a return on that fair value (independently from the book value). A similar mistake consists in calculating the weighted average on the basis of the solvency ratio of the company (i.e. the ratio of shareholders' equity to the total assets).

However, the correct approach can reach a deadlock, as the equity market value is itself calculated on the basis of the weighted average cost of capital. Solutions could be to use (i) the iterative option in Excel, (ii) a company target gearing, (iii) a sector gearing or (iv) an equity market value derived from another valuation method.

3.3. Levered beta: it's easier!

The discount rate used in the DCFF method is calculated on the basis of various parameters, including the beta. This driver reflects the price sensitivity of a share (or a series of shares in the same sector) with respect to the fluctuations of a market index, and consequently enables the market risk premium to be adjusted to the risk of a specific sector. Conceptually, the beta comprises both an operational and a financial component. It is often assumed that the operational component is taken into account by applying the beta of the sector in which the company to be valued operates or the beta of the peer group formed by similar companies. The financial component is the result of the company gearing, whereby the risk increases as the amount of debt of the company increases (since debt interests are considered to be a fixed cost).

In contrast to what is now and then done, the beta must be based on the financial structure of the company to be valued and not on the gearing of companies in the peer group. The starting point is thus the debt-free or "unlevered" beta, which is then converted to a "levered" beta by means of a specific formula.

3.4. Beta in times of crisis

By definition and by structure, the beta of a given stock market is always equal to 1. In times of crisis, however, not all sectors are affected in the same way: a large number of sectors (such as the TMT sector at the end of the 1990s, or the banking, automobile and aircraft industry in 2008/2009) see their beta increase substantially, while the beta of other less affected sectors fall drastically to such an extent that it did no longer mirror the real industry risk. In such situations, the use of a sector beta observed over a longer period should be preferred to a "spot" beta at the time of valuation.

3.5. Stupid omission!

Discounting the future cash flows implies the estimate of these cash flows between the valuation date and infinity. Because this is impossible in practice, this estimate is divided into two phases: (i) the determination of the cash flows over a specific finite future period and (ii) the calculation of a terminal value at the end of this explicit period. Once the terminal value has been calculated, the discounting of this value to the valuation date may be forgotten. The impact of this mistake increases as the length of the explicit period or the discount rate increase. This mistake is obviously independent on the way in which the

terminal value is calculated (Gordon-Shapiro model, Multiples method or liquidation value).

3.6. The median, what's that again?

A common mistake in the application of the Multiples method is to use the average instead of the median of the multiples of the peer group. The median is the middle element in a sorted sample of data. As an illustration, the median of the numbers 3, 30, 2, 1, 4 is 3, while the average is 8 due to the effect of the abnormal figure 30. The use of the median thus enables extremely low or high values to be disregarded. In practice, abnormally high values are encountered when the financial results (earnings, EBITDA, etc.) of a peer company tend towards zero.

3.7. Doubled growth!

When using the Multiples method, the ratios can be calculated against the last available historic figures (N), as well as against forecasts N+1 or N+2. A mistake is to apply the multiples of the peer group based on year N to the financial parameters of future years of the company to be valued. Indeed, behind each multiple lurk parameters that drive value in a discounted cash flow approach, being mainly the growth of the company and its risk profile. By applying current multiples to future results, the expected growth is taken into account twice.

3.8. NWC vs. NFD

With the application of multiples to determine the enterprise value (for example EV/EBITDA or EV/EBIT), the company net financial debt (NFD) on the valuation date is deducted to obtain the value of the shares (or equity value). The net financial debt comprises the long and short term interest-bearing debts, less the excess cash. However, the net financial debt can be very volatile and affected both positively or negatively by an unusual level of net working capital (NWC). This unusual level of working capital is regularly not normalised, resulting in the net financial debt often being too high or too low, depending on the part of the business cycle in which the company finds itself.

3.9. Illiquidity of the E… quity

The problem that arises here is not unequivocally answered by experts, and it is therefore no surprise to hear that the specialised literature leaves this subject untouched. It relates to the illiquidity discount that is applied in the Multiples methods. We believe that it is incorrect to apply the illiquidity discount to the enterprise value (EV), i.e. before deduction of the net financial debt. The illiquidity reflects the difficulty of finding quickly a buyer for the shares of the company, and in our opinion must consequently be applied to the equity value (and not the enterprise value).

3.10. NFD… what else?

The tenth and last mistake is found in both the DCFF and the EV/x multiples methods

and consists in omitting the stakeholders who, next to banks, have a right prior to the shareholders, such as parties for whom provisions have been recorded, minorities, holders of stock options, etc. From a technical point of view, these different elements must be deducted from the enterprise value as well (ideally at market value).

4. Conclusions

The valuation of a company is a complex matter in which a thorough and professional approach is essential. The economic and financial logic is of crucial importance and, when ignored, it can lead to many, sometimes serious assessment errors.

We have found that, of the most common mistakes, the vast majority don't impact all valuation methods, which makes important to apply different methods for a valuation. In addition to increasing the credibility and consistency of the valuation results obtained, the application of more than one valuation method will also dilute the impact of possible individual errors.

Finally, we would like to emphasise that company valuation is not an exact science, notwithstanding all care and expertise given to this exercise. In addition to preventing technical mistakes and despite the objectivity that the valuer has to take on board, a valuation exercise will always include a certain level of subjectivity that has ideally to be confined and controlled by a transparent valuation approach. Economics belongs to human sciences, and as such, cannot deal with certainty…

Article provided by FEIB CFO-club, the Belgian IAFEI member Institute. Quoted from FEIB CFO- club Newsletter June 2014

China, Article: **Sizing up China: Will It Really Be the World´s Largest Economy in 2014 ?**

By **Payden & Rygel,** Los Angeles, California, USA, Summer 2014,
Point of View, Our Perspective on Issues Affecting Global Financial Markets

The world awoke on April 30, 2014 to discover that China would become the largest economy by year end, dethroning the United States from the top spot it has occupied since 1872. The global macroeconomic landscape shifted overnight.[1]

But how did this happen? Did it really come to pass overnight? Sure, two decades of double digit growth helped China, but was it really enough to make it the largest economy in the world?[2] In short, no. Hype (and national pride) aside, China's rise is as much a product of statistics as it is of economics.

Comparing the relative size of economies, each using different currencies, is difficult and often misunderstood. As we will see, despite the pinpoint numerical accuracy wielded by economists measuring national economies is very difficult. Rest soundly, America, you are still the biggest economy in the world. For now.

A LOOK INSIDE THE GDP FACTORY

While hotly contested in academic and policy circles, gross domestic product (GDP) still remains the most important metric of an economy's size. If for Winston Churchill "democracy [is] the worst form of government except all those other forms that have been tried," we feel the same about GDP. It works well, not perfectly, for measuring national economic activity.

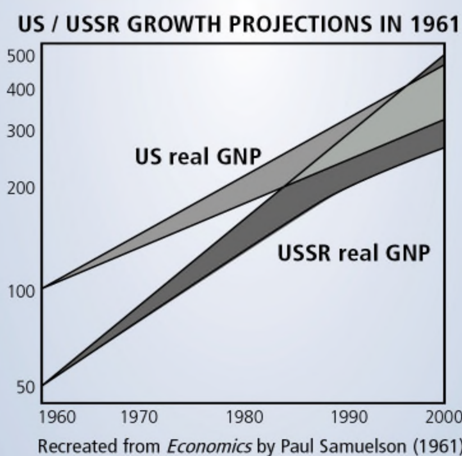
Strictly speaking, gross domestic product is the final market value of "stuff" produced within a country during a year and is computed by multiplying the price and volume of all the goods and services sold in an economy. This arithmetic exercise, while simple in theory, proves to be difficult with the sheer number of transactions in an economy.

DID YOU KNOW?

Sound Familiar?

In the 1961 edition of his best-selling macroeconomic textbook, Nobel Prize winning economist Paul Samuelson predicted that the Soviet economy would overtake the US economy in size by 1984. After it became clear this would not occur, the 1980 edition pushed out its forecast, now suggesting the USSR would beat the US in size by 2002. So much for that.

Source: Marginal Revolution

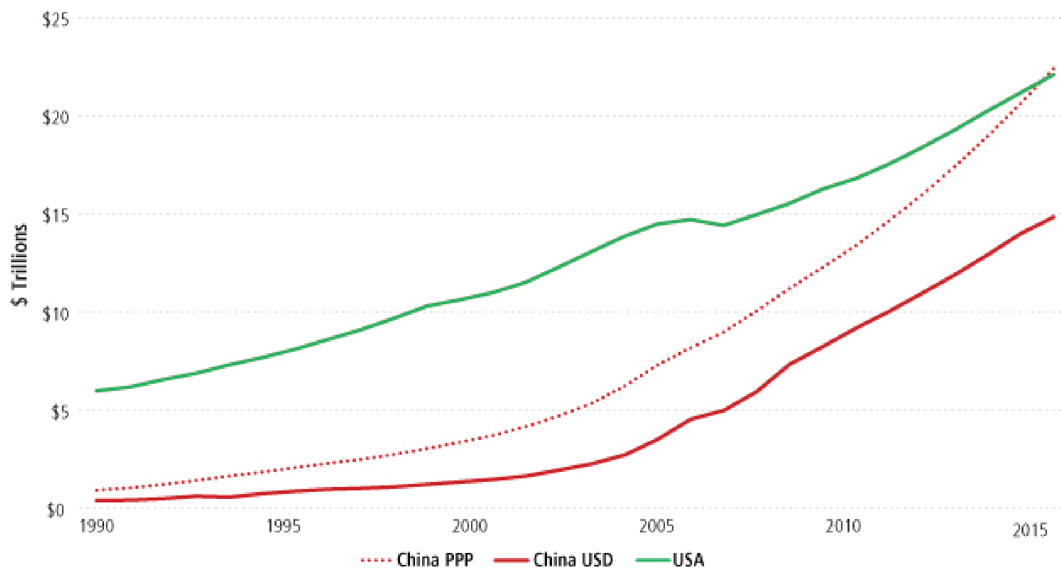


Recreated from *Economics* by Paul Samuelson (1961)

Consider the world's most complex economy, the United States. Each quarter, economists and statisticians at the Bureau of Economic Analysis gather behind locked doors, with all forms of communication disabled, and utilize more than 10,000 streams of data to calculate GDP.[3] They use techniques that have been improved through time and still publish numbers that change by more than two percentage points during revisions! How can we rely on China's secretive National Statistics Bureau to be any better when even the most advanced national accounts system cannot get it right?

But, if we do take the GDP of China and the US at face value (a huge leap, we know), we run into another problem: how to compare GDP measurements in different currencies (the Chinese Yuan with measurements in United States Dollars).[4]

figure 1 **Two Different Measures of Chinese GDP Compared to U.S. GDP**



Source: IMF WORLD ECONOMIC OUTLOOK 2014 (ICP 2011)   * Purchasing Power Parity

MARKET EXCHANGE RATES - A SIMPLE COMPARISON TOOL

The easiest way to compare GDP size across countries would be to convert them all to a single currency using market exchange rates. Unfortunately, this kind of simple exchange calculation assumes that all goods are tradable and that international trade drives foreign exchange rates.

In reality, goods are often not tradable across countries (e.g., labor, rent) and market exchange rates are volatile, driven by speculation, capital flows and government policy.[5] In China, government policy plays a particularly potent role: the exchange rate is set at a non-market rate (presumably below the rate that would prevail on the market so as to keep the currency cheaper to benefit exporters).

DID YOU KNOW ?

CAN WE TRUST CHINA´S NUMBERS ?

Aggregate macroeconomic measures are not precise. Even the US GDP growth in Q1 2014 was revised to – 2.9 % from 0.1 %. China is notorious for its GDP data, and a recent report by Conference Board estimated China´s growth at 7.2 % between 1978 and 2012 which is far lower than the reported 10 %. China also takes 2 weeks to collect data compared to 6 weeks in Hongkong with a much smaller economy. But even Premier Li Keqiang once opined that GDP is a " manmade and therefore unreliable " statistic.

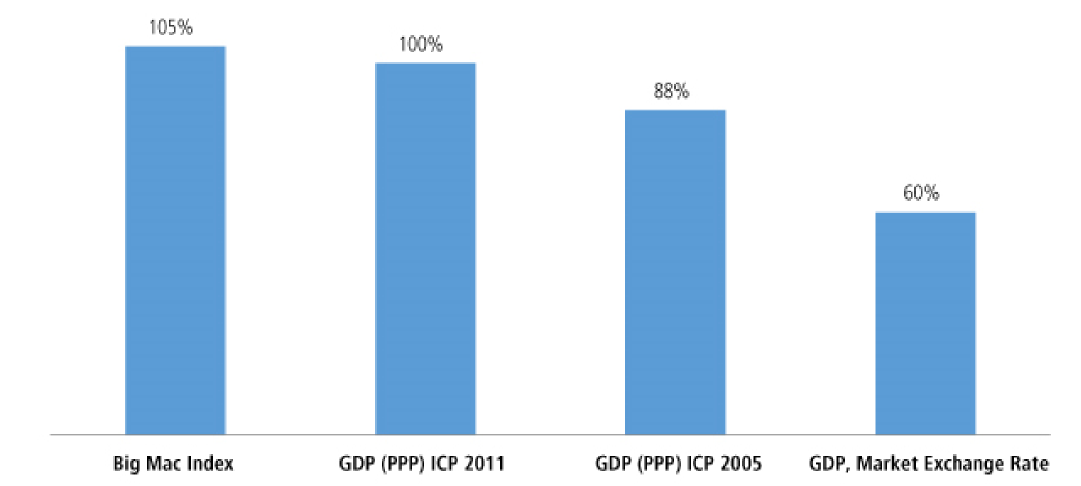
Source: Wall Street Journal, The Diplomat

FEAR NOT, PPP IS HERE

To solve the market exchange rate problem, statisticians developed purchasing power parity (PPP) exchange rates to more accurately compare the size of economies which use different currencies. Purchasing power parity is a theory of exchange rates which posits that an identical basket of goods and services in one country should cost the same as it does in another country, once we account for the exchange rate.

The most famous example of a PPP index is the "Big Mac Index" published by The Economist.

figure 2 China´2 2014 GDP as a Share of the US: It Depends on How It is Measured



Here is how the index works. It costs 16.60¥ to buy a Big Mac in China and $4.62 in the United States. However, if we are to convert 16.60¥ into U.S. dollars using exchange rates, we arrive at $2.74. Therefore, a person in China with 16.60¥ could not buy a burger in the United States. Their "purchasing power" in dollars is much lower than it was in local currency in China. In order to fix this, The Economist simply divides the cost of a Big Mac in local Yuan by the cost of a Big Mac in the United States to arrive at a "PPP" exchange rate of 3.59¥/$. In theory, a PPP exchange rate like this one can have spectacular ramifications. As shown in Figure 2, the Chinese economy would be 5% larger than the United States using the Big Mac Index Exchange rate, while it is 40% smaller using the market exchange rate.

In practice, statisticians do not rely on burgers to measure economies. Instead, calculating PPP exchange rates for countries, the World Bank's International Comparison Program (ICP) uses a basket of 155 categories of goods and services, controlling for quality and cultural preference. The task is so time-intensive and complicated that PPP calculations are made only once every six years.[6] However, since PPP and inflation measure prices for different baskets of goods, often times we end up with extrapolations that are incorrect. As shown in Figure 2, depending on which exchange rate we use, the global macroeconomic landscape is very different, with China predicted to be anywhere from 60%-105% the size of the U.S. economy by the end of 2014.

By basing exchange rates on the price of baskets of goods and services, we obtain a better estimate of relative size. Markus Rodlauer, chief of the IMF's China mission, instructs: "The advantage of using GDP at PPP rates is that it better measures welfare, and also PPPs tend to be more stable and thus the $GDPs of countries (used for international comparisons, etc.) don't jump around as much."[7] While it is not perfect, at least the latest central bank move does not immediately upset the calculus.

CHINA, THE US, PPP, AND THE WORLD LARGEST ECONOMY

We can now make better sense of the latest news: China may claim the title as the world's largest economy by 2014 year end. In local currency, Chinese GDP at the end of 2014 looks likely to be 62.8¥ trillion, while US GDP should clock in close to $17.5 trillion. In dollar terms, we would see the Chinese economy register at only $10.0 trillion.

However, using PPP rates from ICP 2005, we find the gap narrowed: the US is only roughly 12% larger than the $14.6 trillion Chinese economy. But, using the PPP rates from ICP 2011, we find that the gap is closed and China's GDP catches up with the USA.

All this is not to say that China has not grown. Quite the opposite. China's ascension over the past few decades qualifies as nothing short of an economic miracle. By drawing attention to the methods economists use to compare economic size, it becomes evident that things are not so clear. Different measurements produce different results.

SOURCES

1 Chris Giles, "China poised to pass US as world's leading economic power this year", Financial Times, April 30, 2014.

2 Ibid

3 Jon Gertner, "The Rise and Fall of GDP", New York Times, May 13, 2010.

4 "Purchasing Power Parities - measurement and uses", OECD, March 2002.

5 "Summary of Results and Findings of the 2011 International Comparison Program", IMF, 2014.

6 "Trying to Understand the PPPs in ICP 2011: Why are the Results so Different?", NBER Working Paper, June 2014

7 Tom Wright. "China's economy surpassing the U.S.? Well, yes and noas.", Wall Street Journal, April 30, 2014.

INSURANCE, FINANCING
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STUDY OF THE CREDIT INSURANCE MARKET

2014

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1 THE DIFFERENT INSURERS AND THEIR MARKETSHARE

Two main categories of insurers can be distinguished:

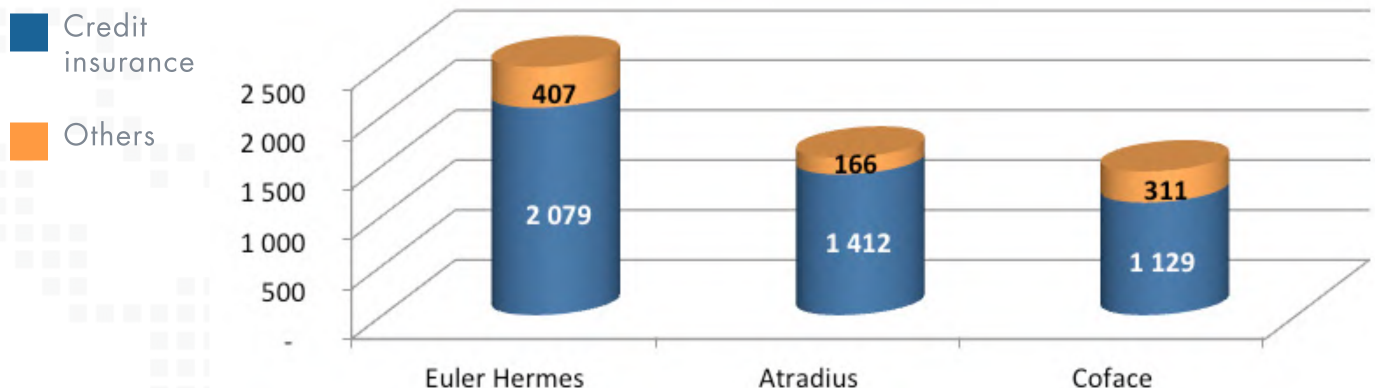
"Global" insurers, characterised by:
- a strong international presence
- detailed information on enormous numbers of buyers in their global databases
- global capabilities in providing credit management services

Leading insurers in this category: Euler Hermes, Coface, Atradius, QBE (for Asia and some other selected countries).

"Niche" insurers, characterised by expertise in:
- particular products: pure excess coverage, shared excess coverage, top-up, single risk (e.g.: AIG, TCRe, QBE, Lloyd's, ACE, Markel, Equinox, etc.)
- certain geographical areas (e.g.: Credimundi, QBE, etc.)
- different types of risk: political risk, non transfer (e.g.: Lloyd's, Garant, Liberty Mutual...)

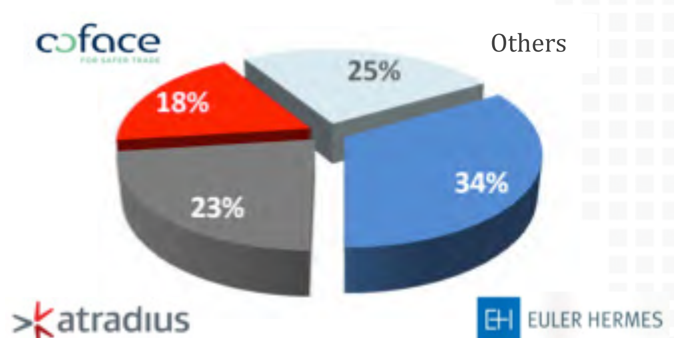
GLOBAL MARKET SHARES

In 2013, turnover breakdown of the leading insurers can be displayed as follows:



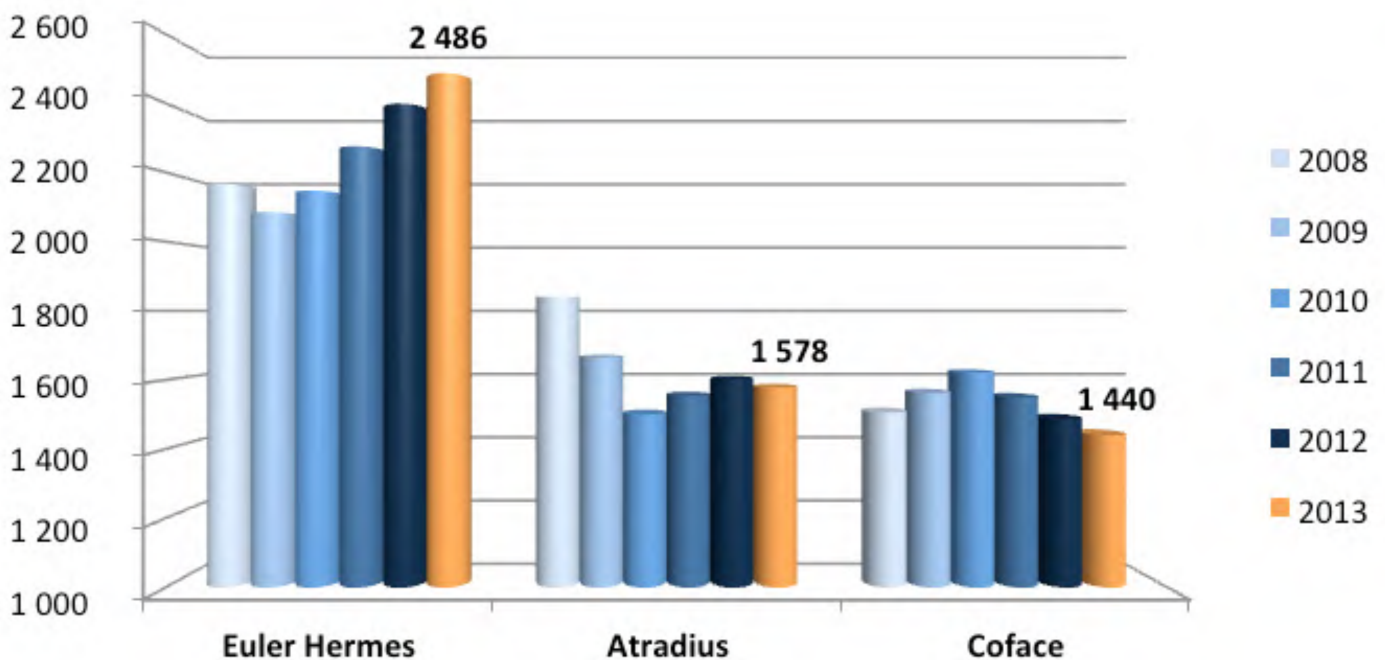
Data taken from consolidated financial statements for 2013 (in M€)

The size of the credit insurance market is estimated around €6.2 billion (source: ICISA-2012). The global market shares of main leaders is estimated at:



REVENUE (M€)

For five years in a row, Euler Hermes sales have increased on a regular basis, while Atradius and Coface's turnover has slightly decreased. In a challenging economic environment, credit insurers have seen their overall performance deeply impacted by the global economic slowdown. (Revenue includes premiums earned through credit insurance activity and, in some cases, sales from factoring, bonding and intelligence as well as enquiry and monitoring fees).



Those evolutions hide some large geographical disparities, and important differences in performances among players, e.g.:

- **Americas**: In the North, Coface registered a decrease of 9.6% in its sales, when Atradius sales rose by 5.4% and Euler Hermes by 3.4% compared to last year.
- **Asia/Pacifique**: Euler Hermes "outperformed" the market (+15.1%), while Coface turnover fell by 16% in the same period, Atradius remained stable in APAC in 2013.
- **Europe**: Northern Europe market showed dynamism (+ 5.6% for Coface, + 5.1% for Euler Hermes), as in Central Europe (+ 4.5% in for Atradius). On the other hand Western countries (credit insurance traditional markets) struggled (-7.1% for Coface in this zone, -3.8% in France for Euler Hermes)

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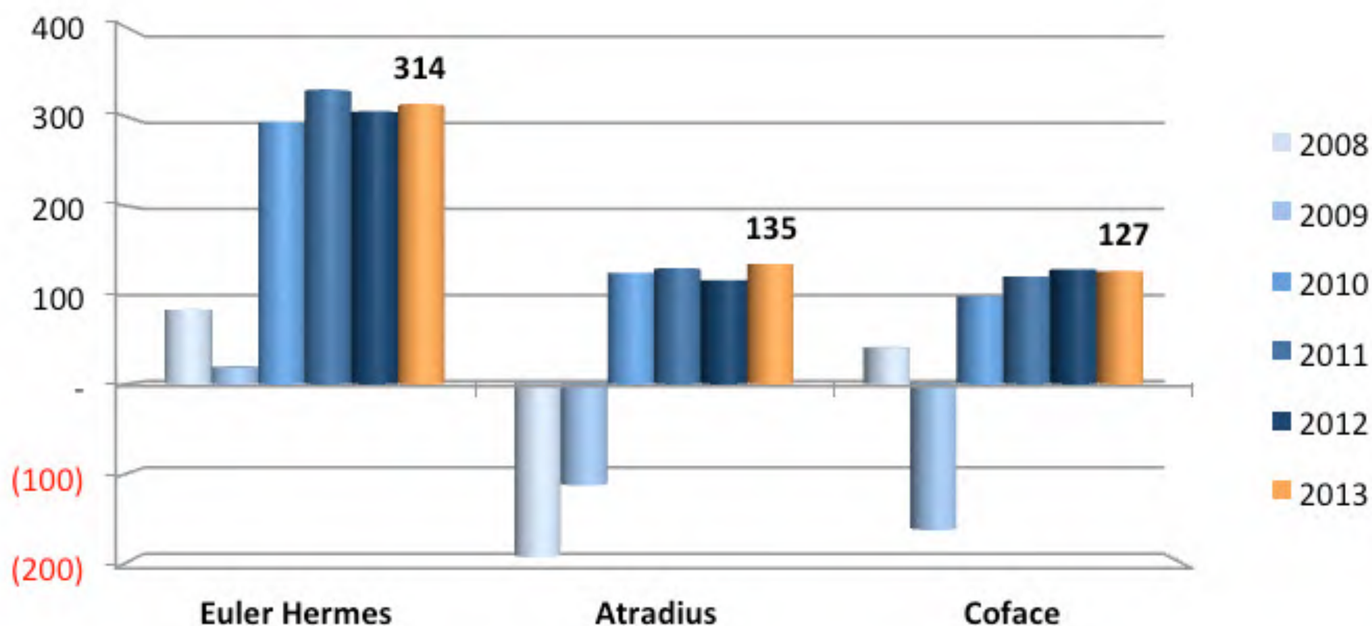
NET PROFIT (M€)

Insurers "Net Profit After Tax" reflects the economic cycles. Earnings were seriously hurt by the financial crisis of 2008 and 2009. Atradius and Coface posted heavy losses during these years.



We notice that leading players show stable profits for 4 years in a row. Compared to 2012, Euler Net profit rose from M€ 306 to M€ 314; meanwhile Atradius posted a significant increase in its results of 15% reaching M€ 135 (against M€ 117 in 2012). Coface, which is preparing its IPO in 2014, showed results in line with last year M€ 129 in 2012 against M€ 127 in 2013.

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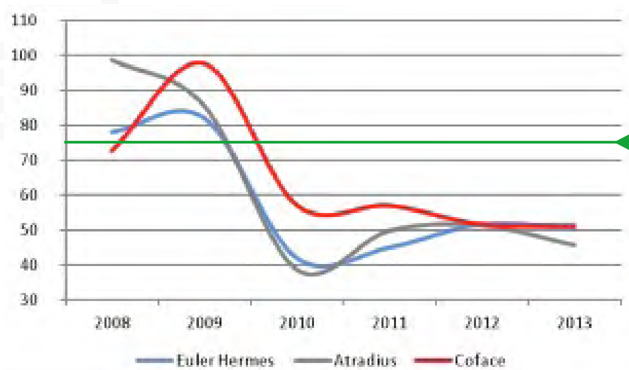
LOSS RATIO AND COMBINED RATIO (%)

An insurer's profitability is determined by the Loss Ratio (claims/premiums) and the Combined Ratio (Loss ratio plus overhead expenses). During the financial crisis, insurers (including Euler Hermes) were shaken by increased payments defaults and bankruptcies and the resulting claims to be paid to their insureds.

Change in Loss ratio

Loss ratio (in %)	Euler Hermes	Atradius	Coface
2008	78	99	73
2009	82	85	98
2010	42	39	57
2011	45	50	57
2012	52	51	52
2013	51	46	51

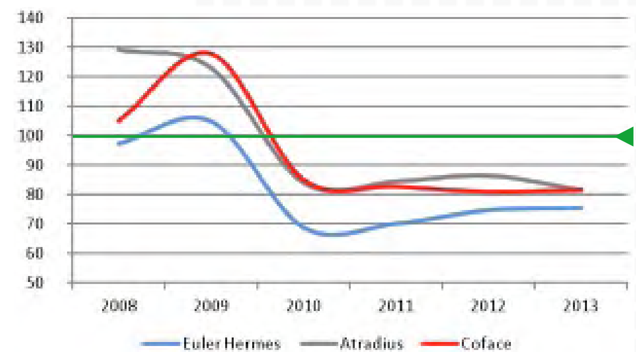
The theoretical break-even point of this ratio is 70% (above which Insurers consider that their operations generate a loss).



Change in combined ratio

Combined ratio (in %)	Euler Hermes	Atradius	Coface
2008	97	129	105
2009	105	123	128
2010	69	84	85
2011	70	85	83
2012	75	86	81
2013	75	82	82

The theoretical break-even point of the combined ratio is an estimated 100% (above which Insurers consider that their operations generate a loss).



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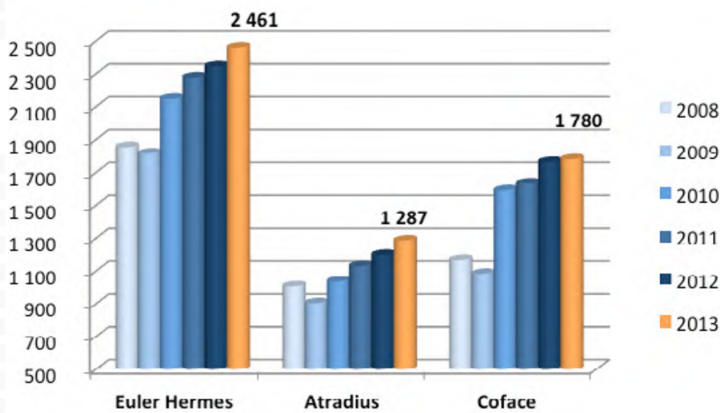
NET EQUITY (M€)

Further to changes in the financial regulations (Solvency II), insurance and reinsurance companies are required to increase the weight of capital equity. Thus, the level of credit insurer's net equity must be in line with the risks they carry.



Since 2009, Credit insurers kept on strengthening their equity. For instance, Euler Hermes and Coface report an equity higher than their annual turnover.

STAFF

Employees are some measure of an insurer's capacity to provide quality service anywhere in the world. The staff cost to revenue ratio reflects the company's productivity.

	Euler Hermes	Atradius	Coface
Headcount	6 140	3257	4 400
Turnover per capita	404 886	484 495	327 273

Atradius is the company presenting the best turnover per capita.

REINSURANCE

Reinsurance contributes materially to the solvency of insurance companies. Its role becomes more essential as credit insurance becomes more important with the growth of trade credit and the tightening of traditional financing across the world.

Euler Hermes, Atradius and Coface, which currently cover 80% of credit insurance risks, would be unable to maintain growth without reinsurance.
These insurance companies use reinsurance treaties.

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3 FINANCIAL RATINGS

To provide the most realistic view of the ratings of the leading insurers, we have analysed those issued by the major rating agencies.
The major insurers are currently rated as follows:

Companies	Ratings			
	Standard & Poors	Moody's	Fitch	A.M. Best
Euler Hermes	AA- Outlook stable	Aa3 Not on watch	-	A+ Outlook stable
Atradius	-	A3 Not on watch	-	A Outlook stable
Coface	-	A2 Not on watch	AA- Outlook stable	-

There have been no changes since our last study in May 2013.
This gives the following positions in the rating scales:

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Today's CFOs
Beyond Financial Caretakers to Business Champions and Conductors of Growth

CFOs and finance executives may now be the most influential players in the shared services and outsourcing community, wielding more influence on investment decisions than any other C-suite executive. Natural guardians and promoters of corporate resources and capabilities, CFOs expect business services to support strategy and deliver business outcomes, not just cost advantages. Armand Angeli and Anne Duncan discuss what is behind the trend of "CFO as business champion and conductor in addition to financial caretaker" and what it means for the SSC/BPO/ITO industry.

Today companies compete by leveraging their resources and capabilities, while overcoming a long list of challenges: economic crises, uncertainty and volatility; threats from competition, new entrants and substitutes; creating growth in changing, globalised markets; financial and geopolitical risks; increasingly complex regulations; cost pressures and limited human and financial resources

To adapt, companies are making step-changes and engaging in continuous transformation projects, "top line" (e.g. new markets or new offerings), "bottom line" (e.g. outsourcing or offshoring), and through reshaping their organisations (e.g. M&As, divestiture, restructuring).

What does all of this have to do with CFOs and the link with shared services and outsourcing? CFOs have traditionally served as caretakers of finance, accounting and reporting and played a more limited role impacting companies' business processes, IT systems and support functions as compared with functional heads such as CIOs, COOs, HR directors.

But things have changed. Today's CFOs and other senior finance directors are a new breed: business people, not just finance people. As business partners, they are championing, initiating, leading or supporting transformations and driving new models of organisation. Leveraging their complementary skills and experience with those of other executive team members, CFOs are now co-pilots, responsible for corporate strategy and assuring alignment of their organisations and operations to achieve better performance, while at the same time driving growth and mitigating risk. Previously cautious, many CFO's now embrace transformation and the move to shared services, outsourcing or a hybrid mix having gleaned benefits from reduced costs, and improved cycle times and quality, and better data and information across their enterprises.

Let's look at a few facts

Today's CFO has more influence over IT investments than any other executive including the CIO. A 2011 survey by FEI and Gartner determined that CFOs had a more significant role in authorising IT investment decisions (51%+) than did CIOs (32%). By 2013 the CFOs' influence on IT investment decisions had further increased according to the 237 organisations responding, due in large part to the CFOs' role as an "enabler of corporate strategy" and CFOs belief that, "IT plays an important role in achieving corporate strategy".

The same survey revealed that IT now reports most often to the CFO (46%), as compared with all other C-level executives (including CEO, CIO and COO), a relationship predicted to increase.

CEO tenure tends to be five to seven years. McKinsey & Company (2013) analysed the 100 top multinational corporations and discovered relatively few CFOs hired in the last five years had the traditional CFO profile of "finance expert". The majority were either "generalists" with broad business experience or "performance leaders" with strong track records in transformations both within the finance function and throughout the organisation.

The IAFEI global network of CFOs and finance directors has witnessed this trend first-hand. With increasing frequency, CFOs are being called upon to assume responsibility or directly influence business services beyond the finance function. In several cases for world-leading companies, senior finance executives were recently named to head global business services (GBS) with a mandate to challenge and take them to the next level.

CFO types, profiles, focus and approaches to shared services and outsourcing

CFO type	CFO profile	Focus	General approach to SS/outsourcing
Generalist	(60% of new hires since 2009) Broad experience outside of finance (operations, strategy, marketing, general management). Valued more for management, communication and personal influence skills than for deep technical expertise (twice as likely to have MBA or other advanced degree rather than F&A qualification).	Drive corporate and business strategies through building and leveraging operational capabilities and effectively allocating resources across geographies and businesses.	Champion for captive shared services across a wide range of functions, ultimately configured in global business services (GBS). Views GBS as strategic capability providing competitive advantage that competitors cannot duplicate. The optimal combination of cost control, operational excellence and agility is best achieved through internal GBS delivery centres, and centres of expertise/excellence, serving as an additional reason for customers to do business with the company. Most likely CFO to support organic expansion and synthesis of GBS capabilities across businesses, functions and geographies, over time transferring less value-added/transactional activities to outsourcing providers as GBS goes up the value curve, or else used for specific needs (ITO, analytics, coverage in some local geographies, compliance, languages). Otherwise, the view is that world-class capabilities should be continually built and improved via acquiring and integrating innovation (via new technologies/methods/niche providers/consultants/ new hires.)
Performance leader	Strong track record in transformations both within the finance function and throughout the organisation	Optimise performance by focusing on cost management, promoting the use of metrics and scorecards, and working to standardise data and systems	Conductor who supports clear strategy for transformation and generating measurable value from a combined SS/outsourcing model. Most likely to support hybrid model optimisation (SSC plus outsourcing leveraging specialist/niche providers). Believes the distinctive value-creating capability lies in integration (rather than the buy versus sell decision). Ready to accept the company outsourcing to partners (BPO/ITO/etc.) to address capability or talent gaps, obtain faster transformation and cost reductions. Supports strong retained organisation to create/manage/leverage outsourced activities for agility and value. Use of analytics and regular benchmarking of both internal-external capabilities, and tendency to push the model where possible to more activities/functions and to generate higher gains in performance.
Financial expert	Advanced accounting/finance qualifications and subject mastery for relevant industry, plus years of experience rotating through multiple roles within finance function (controlling, treasury, audit, financial planning and analysis, business unit finance).	Leverage rigorous analytics to compare performance across businesses, meet aggressive growth or cost targets in the near term, carefully allocate scarce resources	Depending upon the company's situation either: Champion of outsourcing compelled to reduce costs and regain competitiveness quickly, with undistracted focus on core business. Inclined to support outsourcing-based model leveraging specialist providers to bring innovation while containing costs. Caretaker, favouring conservative approach, mostly retaining functions and control internally. If quality and scale advantages exist, supports process transformation and shift to functional shared service model for individual activities/ functions. Concerned about risks and security of outsourcing viewing it essentially for non-sensitive, low-risk, transactional or commodity activities, often technology-enabled.
Growth champion	Usually external hires valued for networks, M&A experience, independent thinking and strategic insight gleaned through working as CFOs, or in professional service firms, investment banking/ private equity	Lead dramatic changes in resource allocation, either to respond to industry disruptions or else achieve rapid growth or portfolio reshaping through aggressive M&A or divestiture programmes	Champion of common platforms and services capabilities as principle vehicle for standardisation and integration of businesses across a changing portfolio. Particularly interested in cross-business data (visibility, timeliness, analytics) deployed rapidly and flexibly with scale (cloud-based services). However, CFO 's attention is on growth strategy, not internal focus. Unlikely to be personally engaged with business services unless it IS the company's core business (services provider, in which case CFO is actively growing the strategic capability). Combined with lean finance function, CFO may have limited oversight of SS/outsourcing configurations, but leans heavily on key functional heads to be accountable for delivering world-class platforms and services.

Source: Typography by McKinsey and Company, Today's CFO: Which profile best suits your company? McKinsey on Finance Number 45, Winter 2013; Analysis and approaches to SS/Outsourcing by Armand Angeli and Anne Duncan (2014)

The CFO's role and profile has changed and is having impact across the business services sector

Why are companies turning more and more to the CFO as a leader, champion and conductor for shared services and outsourcing?

The CFO is a key enabler of strategy

With a role and spanning the organisation, and skills and experience that complement those of the CEO and top management team, the CFO is uniquely placed to ensure the links between strategy, operations (e.g. shared services and outsourcing), investments and tracking of results. According to McKinsey & Company: "The CFO is at the helm of value creation efforts company-wide ... he or she can use the finance function to test new ideas and set best practices, aligning stakeholders so everyone sees value creation through the same lens".

CFOs bring experience with shared services and outsourcing

If early waves of shared services and outsourcing were driven mainly by cost reduction, today the requirement is to deliver quality and value that supports corporate strategy. Twenty years ago, many CFOs had little experience with shared services and outsourcing. Today, according to Alsbridge (2014), finance and accounting is the function most frequently performed in shared services centres (75%), followed by human resources (61.5%), procurement (47.7%), payroll (44.6%) customer contact/call centre (30.8%) and IT (21.5%). Thus, many of the new breed CFOs have experience leveraging shared services, which for 34% of companies is how they deliver F&A services. Of the rest, 13% of companies outsource F&A, 25% employ a hybrid model of SSC and outsourcing, while 28% have not moved to shared services or outsourcing for F&A, according to an HfS/ACCA (2012) survey.

CFOs lead at a time of less dazzle and more ROI

The analytical, results orientation of CFOs arrives at a time when many organisations are asking: "What next?" While executives are generally 'satisfied' many studies suggest organisations expected more from outsourcing, particularly in terms of innovation. What's more, they remain underwhelmed by the returns on a never-ending stream of promising technology investments, promoting calls to action for greater C-Suite involvement in IT decisions ("*Why isn't IT spending creating more value*", PwC 2008). Less "wowed" by new, buzzy technology, the CFO is well placed to work with CIO's to set priorities and ensure corporate investments and initiatives support strategy, create value, and are backed by solid business cases with ROI targets against which results are measured.

What approaches do CFOs take to shared services and outsourcing in their organisations?

We think the CFO's role and approach varies in line not only with company strategy and industry requirements but also their individual focus and profile. To illustrate the point, taking a CFO typography developed by McKinsey and Company (2013) we have analysed possible implications for differing approaches to shared services and outsourcing (caveat: for simplicity we have left aside other important variables such as industry sector, size of company, etc, which clearly have important impacts).

The CFO approaches outlined in the table are based on experience and intended for illustrative purposes. To be clear, we do not assert that CFO's are now the responsible person for shared services and outsourcing in all companies, nor that CFO influence alone determines a particular company's approach. Instead, we are saying CFO's roles have shifted dramatically, and very many of them have direct experience, which has warmed their view of particularly, shared services but also outsourcing. Further, in most companies the CFO is one of the top two or three leaders and his/her particular profile is an important indicator of organization's priorities. Thus whether or not IT, shared services and outsourcing, GBS or other report directly to the CFO, rarely will the CFO's view be unimportant to the shape of the a company's business services profile and investments. We are currently refining the approaches outlined above and testing them with members of the IAFEI association. In the meantime based on the CFO profiles, preliminary insights on organization behaviour toward outsourcing and shared services are provided in the full version of this article which can be found on the following website: www.lumiu.com/publications

The CFO's role and profile has changed and is having impact across the business services sector. While still serving *as caretaker* overseeing finance and accounting, today the CFO is also *a champion* for organisation-wide transformation and *a conductor* leading and influencing multiple initiatives, functions and global processes, and mobilizing resources to achieve corporate strategy across geographies. CFOs are natural guardians and promoters of their company's "crown jewels", now among them strategic business services capabilities beyond those of F&A. While CFO approaches and influence over shared services and outsourcing clearly differ depending upon industry factors, company strategy and profile, and individual profiles, the CFO's role and impact is this realm is greater than ever. To the extent that business services capabilities add increasing value and help organisations and their CFOs to seize opportunities and overcome challenges, we can expect to see more champions supporting investments in the sector. ●

EN SAVOIR PLUS

A COMPLETE VERSION OF THIS ARTICLE APPEARS IN THE SUMMER 2014 ISSUE OF PROFESSIONAL OUTSOURCING MAGAZINE

www.professionaloutsourcingmagazine.net

France,
Interview:

"Philanthropy Is at the Heart of Economic Efficiency and Civil Development of Tomorrow"

Interview with **Ariane de Rothschild,** Board Member of Compagnie Financière de Rothschild, France, and Chairwoman of Fondation Rothschild, Geneva, Switzerland, from **Le Monde des Fondations,** June, 2014

From yesterday to today, Ariane de Rothschild returns to the spirit of the Edmond de Rothschild Foundations! "If the Rothschild are bankers, they are also patrons and philanthropists. There is in this story a true cross between build and give",she says. In this exclusive interview, she discusses the development of philanthropy in France and around the world and analyses the tremendous work done with her teams under the direction of Firoz Ladak. For her, it's obvious: Philanthropy is a great tool to dare, innovate and build!

Could you please define in simple words the spirit of the Edmond de Rothschild Foundations, which you chair alongside your husband Benjamin de Rothschild?

Social engagement because for two centuries, it has been part of our family DNA; innovation because each generation imagine new solutions to the challenges of the moment, humanism as our Foundations enrich everyday multiple human experiences and accompany the progress and knowledge sharing.

How has your family taken the path of philanthropy? What is the origin of this strong and displayed commitment that is part of its story?

The family tradition you mention never really distinguished business on the one hand, and generosity on the other. If the Rothschilds are bankers, they are also patrons and philanthropists. There is in this story a true cross between building and giving. In the 19th century, for example, they played a key role in the industrial revolution in Europe while imagining alongside other large families, new models for social progress. James de Rothschild, at the origin of the French

branch which we are part of, is therefore one of the precursors of the concept of low-income housing.
Similarly, Julie de Rothschild in 1905 ushered, in the explosive context of the Dreyfus Affair, one of the first hospitals in Paris displaying completely free treatments without religious or political distinction. We are still very proud of this Ophthalmological Foundation Hospital. In turn, Edmond James, the great grandfather of my husband, bequeathed to the Louvre an extraordinary collection of drawings by great masters who initiated the Department of Graphic Arts. For us, philanthropy is a matter of citizenship, which is hexagonal, European and global.

Would you, Ariane de Rothschild, say that your commitment is also based on your personal history and values that are unique?

Absolutely. I was born in El Salvador and grew up in Colombia and Africa, before my studies first in France and then in New York. My education was strongly influenced by these experiences as well as the values that were instilled in me by my parents, in particular the requirement towards oneself and openness to others. This route gave me the great chance to meet many cultures and feel close to both a farmer in Colombia, an entrepreneur woman in Kinshasa, a restaurant owner in Manhattan or an artist called"national treasure" in Japan. I have always thought this questioning of my own credentials as a privilege. I hope I'll be successful in passing it on to my four daughters.

"A modern philanthropy is the one that favours the transversality".
The deep economic unrest our society is facing often causes an identity confinement and inability to renew. This is where a philanthropic commitment means any sense. It should not only help to identify solutions to current social challenges but also inspire capitalism turned to humans. Today, I am mom, banker and philanthropist. When our Foundations submit projects, I study them with financial reflexes. Thus, I hope, with our teams to strengthen professionalism of the social sector. On the contrary, I agree with the employees of the Edmond de Rothschild Group values and lessons from the philanthropic world. For example, I associate our Foundations with the improvement of skills patronage. Some speak about"philanthropic capitalism". I would say I prefer an overall approach of leadership.

You re keen to communicate your innovative vision of philanthropy. How does it look like in the early 21st century?

Our Foundations are a great space of freedom and exploration, but take real responsibility in building sustainable models, in education, arts and social entrepreneurship. They do not live in isolation; they feed their reflection in a

nearby ground, the experience of each project they accompany and by the sharing of information.
For example, the support we provide to the Guggenheim Museum in New York for the teaching of art practices in schools located in the Bronx, feeds the program we are building in partnership with the École Nationale des Beaux Arts in Paris, the City of St. Ouen and the French Ministry of Éducation Nationale. It aims to train young artists to intervene in the fragile schools. Moreover, the success of a social enterprise incubator that we launched in India allows us to better understand the issues around scaling and training entrepreneurs, in India, France and Tunisia.
According to me, a modern philanthropy is one that favours the transversality, not only between countries and people, but also across different professional fields. Let me explain: "I do not believe in a fragmented world where on the one hand wealth and skills accumulate and where on the other you give. With the current breakneck speed the information circulates, it is essential, for example, architects, sociologists and investors together design the future social housing".

"The philanthropist has become mature"

Does the philanthropy know a revival?

The evolution of philanthropy reveals real changes: apart from the extent of the financial resources deployed, it strengthens its rigor, transparency and impact. As I mentioned earlier, porosity between sectors seems positive. I do not speak of new life but would rather say that philanthropy has become mature. It shall take account of its shortcomings and adapts to the environment. Philanthropy has stopped to be "only" donation or sponsorship, and is at the heart of economic efficiency and development of the citizen of tomorrow. This is why we innovate; we open up sectors, tools and methodologies to imagine with our partners a world where excellence is synonymous with pluralism.

The Edmond de Rothschild Foundations are a unique international network: what are the lessons you have learned?

I am very excited about the growth experienced by the philanthropic sector, in France of course, but also in emerging countries. Whether in India, Africa or the Middle East, many families like ours ask themselves about a valuation of the social impact, on the creation of innovative educational systems or on practical tools for a better dialogue between communities. If there are common fundamentals between these different geographical areas, it is also interesting to see how each culture and community expresses its generosity. As for the economic change taking place in favour of the southern countries, I am convinced that the philanthropy of tomorrow must reckon with new models from Kenya or India.

We hear a lot about philanthropists in the United States, especially figureheads such as Bill Gates and Warren Buffet? Is this really different in this country?

Indeed, I think that America is characterized by a tremendous commitment to both individual and collective tradition. Because the state is less present, because citizenship is inseparable from the gift, and because tax incentives have existed for long, the philanthropic sector is huge. It funds so many sections of society - schools, religion, health ... - so that may raise some questions about the weight it has on public policy. I had the opportunity to meet Bill Gates and Warren Buffet. I admire both their success in business and philanthropy behind which they mostly pull American fortunes. However, our history in Europe is based on different principles: proximity to the state, capital preservation, transmission of values.
On this point, I feel closer, for example, to an Asian tradition, but we can learn some good things from American practices, like supporting the development of the academic world. We learn every day from our partnership with the Guggenheim Museum, the Carnegie Hall or the Juilliard School in New York. However, I understand that it is necessary to adapt the philanthropy from one country to another, from one community to another or from one family to another.

"Education is the pillar for all of our projects"

And in France, how would you assess the situation?

France has been facing for recent years a real change in the social sector: alongside an always very dynamic associative world, in close link with public bodies, Foundations and other donor entities play a complementary role in decision concerning the common good. From my point of view, it is vital to carry on this dynamic exchange of skills, experience and talent. This movement is beneficial because, as I said earlier, philanthropy is a space of both freedom and responsibility that can test models, solutions and share. I would also like to underline the exceptional work of the Centre French Foundations or Chair in Philanthropy at ESSEC Business School, which we support. However, the state should not give in to this short-term temptation aiming at threatening tax benefits from the sector. Apart from few inevitable opportunists, today's philanthropists-, and I, hope those who will follow them, commit themselves with sincerity and intelligence.

Back to the Edmond de Rothschild Foundations involved in several areas: the arts, social entrepreneurship, intercultural dialogue, and health. What is their guideline?

When Benjamin and I have entrusted in 2005 the strategic refocusing and development of our Foundations to Firoz Ladak, we wanted to preserve both continuity and innovation. After a comprehensive review of what is the philanthropic tradition in the Rothschild family, we agreed that education would remain a mainstay for all of our projects. This focus allows us to maintain flexibility and consistency and, as much as possible, to develop cross in our different fields of intervention. Thus, we developed a training enabling social entrepreneurs from Muslim and Jewish communities to be framed, or by teachers involving management and humanities at the Columbia Business Scholl, and the University of Cambridge. A new approach to intercultural dialogue and to promote social entrepreneurship as a vehicle for change.
Philanthropy is a great teaching and learning tool that eliminates barriers, take risks, see the world with different eyes. It is interested in art, science, politics, economy or education. This is with the desire to share this citizen tool that we have invested in a new area in France: the one of philanthropic education with the creation of an association named the School of Philanthropy. This new program, initiated with the Culture and Diversity Foundation and the Rector of the Academy of Paris, offers the possibility to 4th and 5th year primary school pupils to discover philanthropy and commitment in favour of a project of general interest proximity. The School of Philanthropy aims to allow the emergence of a new generation of adult citizens and entrepreneurs who will better understand the social issues they will face.

You have chosen to equip your Foundations with a professional team. Can you tell us some more?

Firoz Ladak spent his early career in investment banking. He combines both an Anglo-Saxon education, financial expertise, monitoring of complex projects and experience in developing countries. But beyond his competences, Firoz shares our humanist values, thanks to his intercultural experience. It is not surprising that he gathered around him young and dynamic people from the best schools. Firoz and his team contribute to the professionalization of all partners in France and abroad, whatever the sector. Their work is similar to a "venture capital" and requires close involvement to achieve targeted results. Ensure they meet a genuine "return on engagement." Our Foundations are a place of learning but also of expression and creativity. This is also our tradition: we invest in exceptional teams. Foundations, which convey our family values, must embody this excellence.

"This is a great chance to be in a position to give..."

Have you experienced special moments in your philanthropic commitment?

This is a great chance to be in a position to give, but not without responsibilities. We must be attentive, be true and share. However, it is important to include a long-term target as well as some results in your commitment. For example, when we launched our Scale Up program in 2010, training of French social companies allowing a change of scale, I felt a great pride and a real hope. Getting to know these women and these men at once passionate and eager to learn, I thought we were on the right way.

Finally, if one day we were to summarize and describe your action in the field of philanthropy, what would you like to hear?

The world must now be seen in its entirety, a place that is changing faster and faster, where inequality is increasing and where it is urgent to reinvent models. If resources become scarce, it is vital that public sphere, private sector and philanthropists strengthen their cooperation.
The aim is to achieve a virtuous ecosystem in which a new form of leadership could emerge. Personally, I try to pass the respect for others and their multiple identities on to both my four daughters and our financial group. Philanthropy is part of my life as a woman, mother and professional. This is a great tool to dare, innovate and build!

Article provided by DFCG, the French IAFEI Member Institute

Germany, Article: Mandatory Convertible Bonds, Debt or Equity

IFRS has set new accounting standards for these bonds, bearing with the characteristics of such bonds.

By Andrea Bardens, partner, in the area Capital Markets, Accounting Advisory, PricewaterhouseCoopers, Germany

When searching for sources of financing, corporations recently often ended up issuing so-called mandatory convertible bonds. As an example, in 2012 and 2013, Volkswagen Corporation has issued mandatory convertible bonds amounting to roundabout 3.7 billion Euro in total; in 2013, ArcelorMittal raised 2.25 billion US-dollar by a mandatory convertible bond. From the issuer's point of view mandatory convertible bonds have the charm that they will always be settled at the end of the maturity by way of shares of the issuing corporation. Therefore, the corporation can be sure, already by making such issue, that the financing will never lead to an outflow of liquidity apart from interest payments and possible cancellation rights.

In this regard, mandatory convertible bonds are differing essentially from classical convertible bonds for which still has to be decided whether repayment is -, either in shares or cash. In economic terms, the result is a capital increase, whereby the new shareholders already provide their investment in advance.

Variety of Options

If this economic advantage could already be flanked by accounting for a mandatory convertible bond as equity in the financial statements, then this would be a significant step towards optimal financing from the point of view of the corporation. However, equity is only presented under certain conditions as described in the following. The mandatory convertible bonds seen on the market can be differentiated depending on whether the number of shares which have to be delivered at repayment is determined already upon issuance of the bond (case 1) or finally at the end of the term (case 2). In the second case, the investor usually receives shares with a countervalue of the nominal value of the bond at maturity. In the case of an upfront fixed conversion ratio, the chances and risks concerning the development of the share price are already with the investors, whereas otherwise the existing-shareholders are exposed to the danger of a potential dilution of their share investments.

The risk-situation is clearly reflected by a simple numerical example. When issuing a mandatory convertible bond with a nominal value of 1,000 Euro, the price of the underlying share, as an example, is 100 Euro and only 50 Euro upon maturity. If the number of shares was already fixed at 10 due to the market situation at the time of

issue (case 1), the investor would lose 500 Euro. As he only receives shares of a value of 500 Euro at maturity. Whereas, if the number of shares is variable (case 2), the original shareholders will have to accept a dilution, because – unlike as planned when issuing the bond – 20 shares have to be issued (and not 10 shares) to provide an equivalent value of 1,000 Euro to the investors.

Mixed Forms

In practice, mixed forms will often be seen. So, as an example, the variable number of the shares delivered can be limited upwards by a so-called cap or can be guaranteed by a so-called floor downwards. If the number of the shares to be transferred was capped at 15 in the example mentioned above, the loss from the decrease of the share price of 50 Euro would be shared equally between the parties. The investors loose a part of the invested capital, because the 15 shares delivered only have a value of 750 Euro, the corporation must issue more than the originally planned 10 shares for repayment. A very popular variant of the mandatory convertible bond includes a combination of cap and floor (case 3).

The interest rate to be paid on the mandatory convertible bonds directly depends on the distribution of chances and risks. With an increasing risk for the investor, ceteris paribus, also the coupon increases, which is demanded for the provision of capital, as well as it increases the resulting costs of capital of the issuing corporation.

The decision as to what extent the shares to be delivered at maturity are fixed upon issuance of the mandatory convertible bond, has not only impacts on the risk distribution between corporation and investor. It is also decisive for the accounting of such bonds in line with international financial reporting standards (IFRS).

If the number of shares is fixed from the beginning (case 1), the issuer of the bond will be able to show equity and will only have to account for an obligation to pay interest as a separate financial liability. However, if the number is variable (case 2), the accounting for the bond will be as debt. So, if a corporation plans to issue a mandatory convertible bond, it will be regularly faced with a dilemma: Should it choose the "favourable" way with the consequence of accounting as debt, or it is willing to accept higher capital costs in exchange for accounting as equity?

So far, the accounting treatment of mixed forms was controversial among both issuers and external auditors, such for example in the case of mandatory convertible bonds having a cap and/or a floor (case 3). The majority opinion was that a classification as debt is mandatory under IFRS because in spite of limitations, the number of shares to be issued upon repayment remains variable looking at the instrument as a whole. The limitation of the number of shares upwards (cap) respectively downwards (floor) should be split apart and accounted for separately as a derivative and should run through the P&L at the fair value to be applied to this derivative instrument. Deviating from this, to some extent also the opinion has been voiced, that a bifurcation of the instrument in an equity-portion and a debt portion should be at least acceptable as well. For the corporations the separate accounting of a derivative has the unpleasant side effect that fluctuations in the own share price lead to volatility in the statement of profit-and-loss.

The Standard Setter Decides

In the meantime, the International Financial Reporting Standards Interpretations Committee, formed by the standard setter (IFRS, IC, Meeting of May 13 and 14, 2014), has brought light into the thick forest of accounting for mandatory convertible bonds. It has decided – following the majority opinion – that mandatory convertible bonds are to be reported as debt when the number of shares to be delivered is not determined at inception even if there are limitations up- and downwards. A bifurcation of the instruments into equity and debt is not allowed therefore. Cap and floor are representing embedded derivatives which have to be separated from the bond and have to be accounted for separately.

New Way ?

Besides the mandatory convertible bonds with cap and floor, the IFRS-Interpretations-Committee has recently discussed another form of mandatory convertible bonds. Here it is also a bond which mandates upon maturity repayment by a variable number of own shares, limited by a cap and a floor. The bond, however, in addition grants the right to the issuer to settle at any time in a fixed number of own shares which has already been determined upon issuance of the bonds. Other than at the initial instrument, in this case it does not depend on the development of the share price whether the repayment of the bond will be made by way of a fixed number of own shares already determined upon issuance of the bonds, but it is rather left to the corporation itself, which might settle in a fixed number of shares at any time.

According to the IFRS-Interpretations-Committee it has to be analyzed whether the settlement alternative has "economic substance" and was not only added for accounting reasons. If the right has substance, which means there are real scenarios imaginable in which it will be actually exercised, then the mandatory convertible bond must be accounted for completely as equity. Depending on the terms of the contract, an obligation to pay interest has to be accounted for separately as a financial liability in this case.

A Question of Substance

Whereas the door for accounting as equity for mandatory convertible bonds which have a cap and / or a floor only, has been definitely closed by the decision of the IFRS Interpretations Committee, it has been opened a bit for this new kind of mandatory convertible bond. However, the question is thrilling when an instrument respectively an embedded feature has "economic substance", indeed, and how such "economic substance" can be proven in reality.

Article provided by GEFIU, the Association of Chief Financial Officers Germany,
Responsible for translation: GEFIU, translator: Helmut Schnabel

Germany, Article: Bayer Issues Largest Corporate Euro Hybrid Bond Worldwide

Bayer Corporation raises hybrid capital of € 3.25 billion

By **Helmut Schnabel,** Chairman Association of Chief Financial Officers Germany

Leverkusen, Germany, June 25, 2014 – On Wednesday Bayer issued two hybrid bonds with a total volume of € 3.25 billion. This issuance is the first step in the refinancing of the USD 14.2 billion bridge loan arranged to finance Bayer's acquisition of the consumer care business of Merck & Co., Inc., Whitehouse Station, New Jersey, United States. The bridge loan had been previously arranged with a syndicate of 23 banks. The two hybrid bonds replace 31 % of such bridge loan.

The bonds are structured to receive equity credit of 50 % from the relevant rating agencies so that Bayer's single A-rating remains intact. Bayer has a rating of Moody's of A3 and of Standard & Poor's of A-. The two hybrid bonds are rated by Moody's with Baa2 and by Standard & Poor's with BBB.

Investor demand for the bonds was exceptionally strong, and the orderbook was more than 3 times oversubscribed.

The first tranche of € 1.75 billion has a maturity of 61 years and a coupon of 3.0 %. Bayer has an early redemption option for the first time in 2020. The second tranche of € 1.5 billion has a maturity of 60 years and a coupon of 3.75 %. On this tranche, Bayer has an early redemption option for the first time in 2024. From 2020 and 2024 respectively the coupons will be reset at regular intervals. The bonds are subordinated to all other financial liabilities of Bayer and rank pari-passu to Bayer's existing hybrid of € 1.3 billion issued in 2005.

"This hybrid transaction represents an important step in the financing of the acquisition of Merck & Co., Inc.'s consumer care business – and is proof of our commitment to a conservative financial policy," said the CFO of Bayer AG, Werner Baumann. "Our continuously strong backing in the capital markets is the optimal basis for further financing measures."

The 14.2 billion USD-acquisition by Bayer group of the Merck's over the counter drugs unit is the second largest acquisition of the Bayer group proceeded in the previous decade by the largest acquisition of the Bayer group of € 17 billion of the pharmaceutical group sharing.

The acquisition of Merck's over the counter drugs unit makes the German drug maker Bayer group the world's second biggest group for non-prescription medicines, behind

US conglomerate Johnson & Johnson. The acquired Merck's over the counter drugs unit comprises products such as the allergy-medicine Claridine, the Coppertone sun lotion, the foodcare brand Dr. Scholl, and others.

"This acquisition marks a major milestone on our path towards global leadership in the attractive non-prescription medicines-business", said Bayer Chief Executive, Dr. Marijn Dekkers.

ADDENDUM: BAYER – SCIENCE FOR A BETTER LIFE

Bayer is a global enterprise with core competencies in the fields of health care, agriculture and high-tech polymer materials. As an innovation company, it sets trends in research-intensive areas. Bayer's products and services are designed to benefit people and improve their quality of life. At the same time, the Group aims to create value through innovation, growth and high earning power. Bayer is committed to the principles of sustainable development and to its social and ethical responsibilities as a corporate citizen. In fiscal 2013, the Group employed 113,200 people and had sales of € 40.2 billion. Capital expenditures amounted to € 2.2 billion, R & D expenses to € 3.2 billion. For more information, go to www.bayer.com.

Sources: press releases of Bayer Group and other publicly available information.
Article provided by Association of Chief Financial Officers Germany

Greece, Article: "Risk Management and the Role of CFOs"

By **Anastassios Rodopoulos**, Group CFO, MAMIDOIL JETOIL S.A., Athens, Greece, and President Governing Committee EEDE/ EIOD, the Greek IAFEI member Institute

<u>1. How to Direct a Risk Team</u>

CFOs are playing a bigger role in risk management. To succeed, they have to assemble and lead the right cast and crew.

Twelve (12) years after the Sarbanes-Oxley Act highlighted the need for better corporate risk management, many experts say that companies' misguided efforts to do so actually poses a new kind of risk.
The main problem, they argue, is that **companies are not defining risk in the right way.** They pay too much attention to a common subset of risk management activities, such as insurance coverage, fraud detection, and regulatory compliance, while ignoring more-important risks. Risk management "typically'' focuses on:

- **operational risks,** such as: customers credit risk, commercial market risks, suppliers risk, customs risks, IT operational risks, HR and general strategy risks,
- **compliance risks**, such as: technical (compliance) risk, environmental risk, licenses risks, legal risks, corporate governance risks,
  <u>But</u>, those are a small piece of the puzzle!, against the MAIN risks we are facing this period of times, which are:
- **Financial risks**, like: Interest risk, credit (banking) risk, tax risks, cash flow risk, FX risk, Insurance risks, bad debt or fraud risks…

And all above, in terms of shareholder-value loss, are very, very important !, as we are facing **the business globalization affects**. This came over mainly the last decade and will definitely stay over the next decades to come and even more.

<u>2. Researches and statements of experts on risks issues:</u>

1. Instead, a Booz & Co. study of 1,200 large companies over a five-year period suggests that "more than 60% of [shareholder] value lost over the last decade has been attributable to strategic risks, like being in the wrong market with the wrong product". Very few risk management programs would regard the "What product in what market?" question as falling in the risk domain.

2. Another flaw in many risk programs is that they're too complex, putting form over content. Board members and management "need to be mindful of a risk management program that is so extensive it paralyzes the company," says Michael Peregrine, a partner at law firm McDermott Will & Emery specializing in corporate governance.

3. The role of the CFOs:

Some CFOs would argue that they dodge these pitfalls by approaching risk management not as a formal process but as a concern that is woven through all strategic decision-making.
My way of thinking, with over 25 years of experience, acting in the Financial and General Management tasks, is:

- Senior management doesn't think about managing risks; we think about managing the business, where there are risks around every corner,

- Risk management is just part and parcel of everything we do,

- Whatever the starting point, the good news is that CFOs can and should be leading the risk management charge, in whatever form it may take.

- A major key to handling that successfully, as many CFOs believe, is to inculcate risk management savvy into every corner of the organization.

My motto always was and still is: **I see every risk translating into a number, in some way or another, whether it's the loss of sales or the loss of opportunities.**

4. Create a Risk Team:

You start with **Human Capital**: **How to Build a Risk Team** ?

The first step: Get the rest of the senior leadership team on board. If you put something in place but the executive management team doesn't buy into it, ''it dies on the vine''. So, you have to prepare well when you present the case of the risks issues and you have to see All Risk areas globally.

Step two: Is to assemble the right people to assess the firm's risks, in this case by **creating a risk management committee**. Some Tips, can be the following:

1. **NO large number of staff in the committee.** It should have no more than 4-5 key members with always present IT, and the company's chief actuary / controller. A high level commercial officer should always be there.

2. You fist collect all the risk area data by involving all heads of business units and geographies. To make sure everyone had a common understanding of risk management, ran a brief survey with open-ended questions asking committee members what they thought risk was, and how they might measure it.

3. You get the approvals for the main issues from CEO and / or the BoD, where necessary.

4. The chairing of the committee (leader) should be the CFO. CFOs are playing a bigger role in risk management. To succeed, they have to assemble and lead the right cast and crew.

5. The group meets often, monthly or quarterly with predefined agenda.

6. Then, the Decisions are going through to all heads of business units and geographies and you ask ALWAYS their feedback and perform the audits necessary.

Step Three: The team tasks and the risks data valuation:

1. Once everyone was up to speed on the working definitions, the group then collectively set a risk-appetite level for the organization based on the impact the risk would have on several key metrics, including revenue growth, earnings, and shareholder equity.

2. For any given decision to move forward, its potential estimated negative impact can be no more than half the total risk appetite, since there could be more than one incident in a year.

3. Committee members self-assess their parts of the business before each meeting and report on the top 5 to 10 risks they face and what they're doing about them. From there, each risk is plotted on a grid according to its potential severity and likelihood, with the results helping the committee winnow many dozens of items down to a list of the top 10 risks for the corporation as a whole.

4.

A main area of risk in our days is **Supply Chain:** The question is ***How to Find Out What Risks Lie Beyond Your Walls !***

If there is one part of the organization that has proven more vulnerable in the past year, it's the supply chain. The supply chain is usually cited as the biggest driver of uncertainty, because it has become much more globalized and in some cases much more vulnerable to disruption.

A relevant (serious) incident:
Natural disasters and man-made ethics violations have combined to create major headaches even for companies that have diversified their supplier base. Dell CFO Brian Gladden few years ago explained to analysts that the company was forced to give up some margin gains in 2011 due to the strain Thailand's floods put on its hard-disk-drive makers.
The news of the runaway success of Apple's iPhones was mingled with headlines about the harsh conditions at its contract manufacturing facilities in China.

Another crucial area of risk in our days is **Governance Risk:** The question is ***How to Equip Your Board !***

Ironically, getting the best from frontline employees may start with sorting things out with the board. Experts say that requires careful guidance from the CFO. "The board has the duty to exercise oversight, so they should be part of the conversation on how detailed and extensive risk management is," says Peregrine, "but it's the executives who know what the fine line is between too heavy and too light."

The relevant (to risks) measures from the International Financial Authorities:

While routine supplier audits are standard procedure at many firms, what happens in between audits can still be damaging. That's why Jin Leong, chief procurement officer for

the International Monetary Fund, few years ago implemented a “supplier observation database” designed to capture the procurement staff’s current concerns about the institution’s most critical vendors. Since the IMF operates as a financial-services organization, Leong, based in Washington, D.C., is most concerned about firms like the fund’s offshore IT providers, back-office function outsourcers, and key economic data providers.

The question remains: How can CFOs get more intelligence on those critical elements outside their direct control?

The Overall Conclusion: The goal in risks is to anticipate things before they come up!

The last tip is that risk team leader and mainly the team is always count:
Last but not least, **The critical issue is the treatment of the risk team:** If you have a good team that’s challenging each other, you get some of that, But trust among the team is critical, so they can share their areas of exposure, rather than trying to prove they don’t have any.

A little friendly rivalry can boost employee performance. But if you don't handle contests carefully, they can backfire.

Good Luck! (I have chosen deliberately a women team… They are sometimes better perform in a team; working with men, i.e.A mix team is always better)

Article provided by Hellenic Institute of Financial Management (EIOD) / Hellenic Management Association (HMA), the Greek IAFEI member institute

Greece, Article: The Difference Between a Boss and a Leader

By **Anastassios Rodopoulos**, Group CFO, MAMIDOIL JETOIL S.A., Athens, Greece, and President Governing Committee EEDE/ EIOD, the Greek IAFEI member Institute

I spent quite a few years compromising myself for the sake of a paycheck, trying to insure a lifestyle of security and consistency for my sons.
Imagine, going to the people who are supposed to be guiding you and what they do is simply tell you to keep your head down, question nothing and be grateful for that paycheck. Are we being set up to work for a leader or a boss? How can you tell the difference?

1. The basis:

Sit down and write your resume. Write about your current position and your every day duties. List the skills needed to complete those tasks. It will either be easy to do it, or very difficult to do.

Does your resume show an elevation of learned skill-sets or are you stagnant in them?
Now weigh what you've done at your job/career over the years you've done it. Has doing the same tasks and functions created an expert in those tasks? Have you learned new skills over the years you've been there? Do your skills translate well on the page or are you looking at the same skill sets over a long period of time?

2. The Characteristics:

A leader learns all they can about their employees. They interact with them on a consistent basis and learn about their strengths and weaknesses, inside as well as outside of the work day. **A boss does not. A boss shows up** once a day / month, says a few words and leaves just as effortlessly as the person delivering your breakfast order that morning.

A leader recognizes where more training is needed and provides it.

A leader cross trains and motivates the employees to want to produce more, produce better for a team as well as an individual. A leader is like a coach, who can be gruff but who inspires excellence and does not evoke hatred or disrespect.

A leader will nurture their team into a championship team, not out of competition but out of pride for the team and the end results. A boss just wants to get whatever they can from people and not bother to get to know them - not even care.

A leader teaches the team to see the best of each other, recognizes more than just result, recognizes effort. **A boss insists on obedience and doesn't care** if the employees don't want to be there or not**.**

A leader elevates their team with pride and recognition and doesn't see it as a budget constraint. An employee breakfast goes a long way when you're sincere and you want amazing results from your people.

A leader takes you and all the team members along the journey. A journey that includes projects, tasks and assignments. On the other hand complaining about spending $50 for breakfast for a team becomes petty when it's obvious you'd rather be anywhere, but with the team you are responsible for.

A leader is there for the long haul, not once a quarter because it's the least amount of work they can put in.

A leader is someone you can respect because they respect you. So, if you are an amazing clerk then over the years you should be able to list the different programs or processes you've learned and mastered, correct.

A leader is someone who works with you to make you a better team member, because it's the team who gets the glory and the accolades, not just them. Many were never promoted because their careers were never cultivated to do more than the clerical shortsighted needs of the current tasks.

A leader takes pride and shows off its team, not degrades it by never being there and then complaining and making demands at the last minute. If the person you work for doesn't do any of these things then you know, you do not work for a leader.

3. The Conclusions:

After having placed myself in the position of leader along the way all those years I was able to not only salvage some of that time wasted but also able to cultivate my skill sets outside. **I've helped others do more and be more, for themselves as well as the projects we committed ourselves to.**

Well, I've come close to making that million of things within the last years and I'd give every cent back to get those years back. **Nothing is worth more than your self respect**, your peace of mind and knowing your worth.

I grinned and bared the brunt of working with people whose idea of excellence, were far removed from my own. For every leadership and management course I took and then later taught young people, **THIS is what I really enjoyed.**

Note that you need a ‘’power machine’’ to support you in all these efforts: What Gives You The Most Power?

The answer is (by order): **My family, my job/s, my enthusiasm to help and develop others around me**. **It's a voluntary job, it's a way of thinking about human, it's something like a journey!**

Finding myself now, happier than I've ever been, sleeping better, enthusiastic about my contributions to others, who recognize true passion and pride in one's work, **I realized WHAT the difference is between a Boss and a Leader.**

Try your own way to find it !!!, for your wellbeing and a better future.

Article provided by Hellenic Institute of Financial Management (EIOD) / Hellenic Management Association (HMA), the Greek IAFEI member institute

Mexico, Article: Mexican Supreme Court Tax Decision on Payments Made Pursuant to Crossborder Cost Sharing Agreements

By **Luis Ortiz Hidalgo**, Chairman IAFEI

Since 1959, the Mexican Income Tax Law disallows the deduction of payments made abroad on a prorated basis with other parties that are not subject to Mexican income tax such as foreign residents. In other words, payments made pursuant to cost sharing agreements are not deductible.

The rationale for such prohibition was that the Mexican tax authority did not have the means to verify whether such expenses were necessary or even actually made. Naturally, many things have changed since then. We now have transfer pricing rules, agreements for the exchange of information and many other mechanisms that allow the tax authorities to review crossborder transactions. Yes, the prohibition remains.

A multinational company based in Mexico represented by the tax practice group of Basham Ringe y Correa, S.C., member of IMEF (Mexican Financial Executives Institute) challenged the provision that disallows the deduction of payments made pursuant to cost sharing agreements.

After years of litigation, the Mexican Supreme Court of Justice recently ruled in favour of said company, thereby allowing the deduction of such payments, as long as these are strictly indispensable for the Mexican taxpayers activity.

Probably, many multinational companies will now challenge said prohibition, based on this case.

Source: Article provided by IMEF, the Mexican IAFEI Member Institute

SPAIN

The world's 13th largest economy is back on track, six years after the global financial crisis struck. Miguel Cardoso reports on the Spanish recovery

PHOTO: MIRENSKA OLGA/SHUTTERSTOCK

The Torre Agbar tower, Barcelona

For the first time since the beginning of 2008, Spanish economic forecasts have an upward bias. A year and a half ago, 25% of forecasters thought that Spanish GDP was going to contract in 2014. Today, no one foresees a contraction, and there is an increasing probability that growth could accelerate over the next quarters to levels of around 2% on an annual basis. Overall, growth should average above 1% in 2014 and around 2% in 2015. All of this reflects the huge turnaround that Spain has undergone over the past year and points to the fact that the country is ready to start what should be a sustainable recovery, although some challenges still remain.

The most important reason for this improvement has been the swift and decisive action taken by European and Spanish institutions. The "whatever it takes" pledge by European Central Bank president, Mario Draghi, in July 2012 has built a bridge that has allowed European governments to take steps towards breaking up the vicious cycle linking sovereigns and the financial sector.

In the case of Spain, it has allowed the country to restructure and recapitalise a part of its financial sector, as well as to implement growth-enhancing reforms. In particular, Spain has taken huge steps towards correcting the imbalances that were accumulated before and after the global financial crisis.

For example, the country's current account has gone from a deficit of around 10% of GDP to a surplus of 0.8% in 2013. Meanwhile, the fiscal deficit has been lowered from 11% of GDP to around 6.5%, which has been particularly difficult to achieve during a recession. Finally, the private sector has undergone an ambitious deleveraging process, moving from demanding significant resources from the rest of the world (14% of GDP in 2007) to generating a surplus of resources of around 5% of GDP on average since 2009.

Despite the adverse impact that these adjustments have had on domestic demand, economic activity and employment in Spain are beginning to show solid improvement. Current information shows that for the fourth quarter in a row, GDP will grow in the second quarter of 2014 (+0.4% quarter-on-quarter), and for the first time since 2008, the economy is displaying net job creation. The recovery has been, and will be, supported by export growth. Since 2012, Spanish exports have outperformed those of the EU (+12.1% versus 2.1% since Q1 2012). Spanish exporters have been especially successful at diversifying both the destinations they export to and the type of products they export (75% of export growth during the crisis can be attributed to these factors), but they have also been able to gain competitiveness, as evidenced by a negative inflation differential with the European Monetary Union (EMU) during the crisis (average of around 1% year-on-year with respect to the core eurozone countries since the beginning of the crisis).

Competitiveness gains have been led by productivity growth coupled with wage moderation, thanks to increased flexibility in the Spanish labour market (gains in terms of unit labour costs have reached 14% since the pre-crisis peak).

In particular, thanks to an ambitious labour market reform, businesses have been able to use more efficient adjustment mechanisms, which have allowed them to continue in existence while saving jobs. In fact, the reduction in real wages per worker that the Spanish economy experienced in 2012 is likely to have prevented the destruction of around 220,000 jobs in 2012 and 2013. The labour market reform makes it more likely, therefore, that competitiveness gains are permanent – unlike the reversals observed

Country file

Population size: 47.2 million **Area:** 505,370km^2

Type of government: Parliamentary constitutional monarchy

Official language: Spanish

Co-official languages: Galician, Catalan, Aranese and Basque

Capital and largest city: Madrid

GDP (PPP) 2012: $1.322 trillion*

Govt debt as a proportion of GDP: 93.9%

% growth in 2013: -1%

Currency: Euro

Currency rate against the dollar: 1.37

* SOURCE: WORLD BANK

TOP TIPS FOR DOING BUSINESS IN SPAIN

1. Be straightforward. People will appreciate it.
2. Take some time at the beginning of meetings to build some rapport.
3. Lunch is a good place to talk business. Face-to-face meetings are normally preferred for discussing serious issues.
4. Be on time – punctuality is becoming more appreciated every day.
5. Avoid politics as an ice-breaker.

Madrid skyline with Metropolis Building in the foreground

PHOTO: SYLVAIN SONNET/GETTY IMAGES

after past crises, when they were achieved through temporary instruments such as exchange-rate devaluations. Furthermore, it could also boost job creation in the future by ensuring that wages evolve according to productivity.

Other reforms that have been introduced recently have also played a key role in improving long-term growth forecasts. Specifically, an ambitious reform of the pension system practically guarantees its solvency, by linking expenditures to revenues, and by increasing the retirement age (to 67 years). Moreover, the government has also put into place certain mechanisms to control the deficit of regional and local governments, which was a huge source of uncertainty in the past.

Savings banks have been recapitalised, and quality reviews by independent auditors under the supervision of the European Central Bank, the European Commission and the International Monetary Fund have dispelled doubts regarding their balance sheets. As solvency doubts have been left behind, the financial system has begun to contribute positively to the recovery. Indebtedness needs to be reduced still further, since certain sectors and certain parties still show excessively high levels, but debt repayments will remain above new credit flows (implying the stock of credit will still fall). The latter are starting to show a turnaround and this has been increasing over the past few months. Successful recoveries after a financial crisis like the one Spain has experienced show the relevance of these new credit flows to supporting economic activity.

These changes have attracted investors, as can be evidenced by the strong capital flows experienced over the past year that have considerably lowered interest rates on public debt.

But financial markets are not the only ones attracting investors. The boom in the export sector is now transferring to productive investment (in machinery and equipment). While this area of domestic demand has only increased in Europe by 8% since its lowest level, in Spain it has gone up by almost 20%, and it is now close to its peak when taken as a ratio of domestic demand. This shows both the improvement in perceptions owing to the strong reform effort, and the ability that Spanish businesses have to export, differentiating themselves from other European competitors.

Moreover, the government is planning on more reforms that should boost the attractiveness of the economy going forward. In particular, a reform of the tax system is in the works. The intention is to make it simpler, more efficient and more consistent with the new growth model (promoting savings, foreign direct investment and job creation), while also keeping in mind the fact that the public deficit still has to be reduced. In addition, the introduction of more competition on the provision of services should also help to boost competitiveness.

Finally, the government is reducing the costs of doing business and cutting red tape, thereby making it easier and cheaper to start a business and unifying regulation across Spanish regions.

Challenges remain, since some imbalances will take time to be absorbed. A 25% unemployment rate is unacceptable. Public debt will stabilise at around 100% of GDP. The net investment position is still above 90% of GDP. Meanwhile, the residential construction sector shows an oversupply of new homes that will not allow it to contribute positively to growth as in previous recoveries.

All these, along with the early success of the reforms already taken, should give the government enough reasons to keep on improving the economy. Nonetheless, in the future, Spain will probably show a growth rate above that of EMU, making it one of the most attractive countries to invest in throughout Europe.

Miguel Cardoso is chief economist for Spain at BBVA Research

FROM EAST TO WEST

THE ORIGINS OF SUKUK MAY LIE IN THE ISLAMIC WORLD, BUT THE REACH OF THESE FUNDING INSTRUMENTS IS INCREASINGLY BECOMING GLOBAL. FAWAZ ABU SNEINEH EXPLAINS

On 25 June 2014, the UK government successfully priced its debut £200m, five-year, Regulation S sukuk. Following a series of investor meetings in Malaysia, Qatar, Saudi Arabia, the United Arab Emirates (UAE) and the UK, the sukuk offering was approximately 11.5 times oversubscribed and priced flat to the 1.75% July 2019 conventional gilt.

This ground-breaking transaction, being the first-ever sovereign sukuk outside the Islamic world, as well as the first-ever, public sterling-denominated sukuk issuance, not only marks the growing market share and demand for this sharia-compliant instrument, but it also highlights the recent trend that sukuk issuances are expanding internationally beyond the Islamic world.

The West is not completely new to issuing international sukuk. In 2009, US financial services firm GE Capital and the International Finance Corporation both issued US-dollar sukuk. Sukuk issuances have benefited issuers greatly in terms of offering investor diversification. They allow issuers to tap liquidity from Islamic institutional investors, such as Islamic banks and Islamic-dedicated funds, mainly in the Middle East, as well as from Islamic investors in the UK and Malaysia. Furthermore, sukuk issues have generally been priced close to the conventional curve for the same issuer and, in selective cases, pricing has actually come in relatively tighter than the comparable conventional bonds for the same issuer.

Historically, Malaysia was the pioneer in Islamic capital markets and it remains the world's largest global sukuk market (including domestic issues), with a share of more than 43% in the first half of 2014. But the Gulf Cooperation Council (GCC) has taken the leadership over international sukuk. The UAE ranks highest in international sukuk issuances, with a stellar 43% market share, followed by Saudi Arabia with 21%, compared to only 7% for Malaysia.

Additionally, over the past few years, a new entrant, Turkey, is gaining momentum in the market, with volumes climbing to $2.2bn in 2013, up from $350m in 2011. In 2014, we saw notable international sukuk issues from Turkish financial institutions, with Albaraka Türk, Kuveyt Türk and Türkiye Finans tapping the market, allowing Turkey to take 21% of the market share by number of issuances, in line with Saudi Arabia. In 2013, Bank Asya, the largest participation bank in Turkey, successfully issued the first-ever, fixed-profit-rate, subordinated, tier 2, US-dollar sukuk transaction, which falls due in 2023.

While the tapering of quantitative easing in the US remains the main factor affecting the global debt capital markets, Islamic bond issues stood at a record half-year high. Approximately $10bn was raised during the first half of 2014, representing 36% growth since 2012.

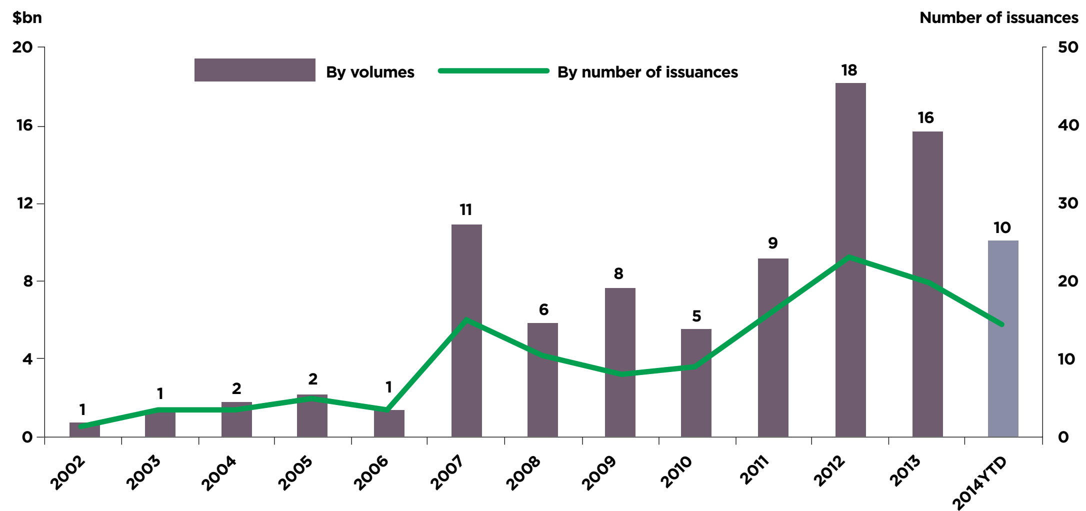
The half year witnessed a large amount of debut issuances, mostly from Dubai-based corporates, namely Dubai Investments Park, DAMAC Real Estate, the Investment Corporation of Dubai and Emaar Malls.

With international sukuk evolving into a cross-border market, Dubai announced a three-year programme to promote the city as the world's Islamic banking and finance hub in 2013. The city is currently the third-largest venue for sukuk listings globally, via the NASDAQ Dubai stock exchange, and it aims to focus on the role of financing services in the Islamic economy to reach its goal.

Innovation

In 2002, the Malaysian government was the first sovereign to issue an international sukuk and it paved the way for other sovereigns, such as Bahrain, Indonesia, Pakistan, Qatar and Turkey. The $600m floating-rate trust certificates had a five-year tenor and employed the sharia concept of ijara (leasing). Since then, notable

INTERNATIONAL SUKUK ISSUANCE, 2002-2014 YEAR TO DATE



SOURCE: DEALOGIC

global sukuk transactions have taken place, such as the first-ever exchangeable sukuk issued by Malaysian sovereign wealth fund Khazanah Nasional Berhad in 2006. In 2011, the Malaysian government again displayed its innovative leadership by being the first sovereign to issue an international sukuk, using the concept of wakala (agency). The sukuk assets under the wakala principle comprise: (i) a tangible asset component consisting of leasable assets and sharia-compliant shares; and (ii) a murabaha (marked-up) receivable component arising from the sale of sharia-compliant commodities.

In light of the new capital adequacy standards related to market risk, sukuk has also been a tool for banks to comply with regulatory requirements. In November 2012, Abu Dhabi Islamic Bank (ADIB) issued the world's first sharia-compliant hybrid, tier 1, perpetual sukuk. The main challenges of the deal were to merge the conventional context with the Islamic principles. Structured as a hybrid, tier 1 instrument ('preferred shares', as referred to in the US), the flexibility to cancel coupons and the perpetual nature of the instrument provided the equity-like features and recognition. In March 2013, Dubai Islamic Bank followed ADIB's lead by issuing tier 1 capital certificates. Both deals attracted strong demand, with oversubscription levels of approximately 15 times.

While formal legislation and implementation of Basel III remain at a preliminary stage in the UAE, in June 2014, Al Hilal Bank printed the world's first-ever, US-dollar, bank-capital sukuk issuance with Basel III-compliant mechanics.

Longer tenors and increased sizes

Tenors have extended towards the long end of the curve and deal sizes have increased. Apart from the perpetual tier-1 capital instruments, the Dubai government issued the longest-ever sovereign sukuk with a 15-year tenor in April 2014. The extension of the tenor resulted in increased interest from US offshore account holders, relative to the 10-year offering by the Dubai government a year earlier. In 2013, Saudi Electricity Company issued a $2bn, dual-tranche sukuk with 10-year and 30-year tenors in Regulation S/Rule 144A format. In April 2014, the utility company tapped the market again with a similar dual tranche, increasing the size of the 10-year tranche by $500m. Meanwhile, in February 2014, the Saudi-based multilateral development bank, the Islamic Development Bank, successfully raised $1.5bn via a five-year sukuk issuance. This deal represented a landmark transaction, since it was the tightest spread ever achieved for an international benchmark sukuk issuance. In addition, the transaction is the largest amount that the Islamic Development Bank has raised through the capital markets.

In order to increase the efficiency of the Islamic market, a few organisations are trying to build up a regulatory framework. The most active is the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). By issuing standards (88 to date) on sharia, accounting, auditing, governance and codes of ethics, the AAOIFI has enhanced the standardisation and harmonisation of international Islamic finance. The AAOIFI standards are accepted globally, since they are now adopted and implemented in a few countries and by the market, with the Dubai International Financial Centre leading the pack.

Despite the absence of standardisation in sukuk structures, international sukuk issuances have predominantly adopted the ijara, wakala and, in cases of bank capital, mudaraba sharia concepts. Investors' increasing familiarity with these concepts, especially non-Islamic-based investors, has reduced, or even eliminated, the need to educate investors on the underlying sukuk structures.

Having said that, and looking ahead, there are areas that can still be explored in international sukuk, such as project finance sukuk and other forms of asset-backed sukuk. These areas could benefit many GCC countries and issuers that need to fund a large number of infrastructural developments and capital expansions.

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The views expressed in this article are those of the author and not necessarily those of the bank

NOT JUST A CHALLENGE FOR BANKS

WHAT WILL THE BASEL III LIQUIDITY COVERAGE RATIO MEAN FOR CORPORATES? SUZANNE JANSE VAN RENSBURG EXPLAINS

One of the challenges facing corporates in recent years has been keeping up with the accelerating pace of regulatory change. Numerous initiatives designed to stabilise the global financial system, the transparency and accuracy of financial information, and the efficiency of payments, have directly affected companies and required significant investment in order to achieve compliance.

Now the banking system is undergoing major change, with the introduction of the liquidity coverage ratio (LCR) under Basel III in January 2015. To date, few corporates have made preparations for its introduction because there is a widespread assumption that it only affects banks. While Basel III does not apply directly to corporates, however, it will have some implications for them, and therefore they should prepare for upcoming change.

Why Basel III matters

Banks have always held a liquidity buffer – funds specifically dedicated to cover outflows of cash that may be withdrawn in a crisis – to maintain stability during turbulent conditions. But the financial crisis showed that this buffer was, in some cases, insufficient. Now, a component of new banking regulation Basel III – the LCR – crystallises and, in many cases, could significantly increase banks' liquidity buffers. (For more, see Basel III: the details box, on page 35.)

The LCR is important for corporates because, as a result, banks will value deposits differently because they will be required to hold high-quality liquid assets (HQLAs) against assumed outflows in the first 30 days of a stress scenario. The higher the outflow assumption, the higher the HQLAs banks will have to hold.

For example, for every $100m of corporate deposits that are linked to the day-to-day working capital requirements of a corporate or financial institution, a bank will have to hold $25m in HQLAs on its balance sheet. The requirement to hold HQLAs increases the cost of doing certain types of business to such an extent that these costs may be passed on to banks' clients in one form or another. Most importantly, the LCR assigns different HQLA requirements to different types of deposits and clients. Banks are already changing their business models and pricing, and focusing on deposit types with low HQLA requirements and the products and services associated with them.

> While Basel III does not apply directly to corporates, however, it could have profound implications for them

Crucially, application of the LCR framework represents a major break with past experiences since it relates to bank deposits: corporates used to expect a higher rate of return for excess balances than for their day-to-day working capital. Typically, working capital balances sit in non-interest-bearing demand deposit accounts. Corporates often maintain excess cash in a mix of non-interest- and interest-bearing deposit accounts, however. Because working capital cash (referred to as 'operational deposits' in the Basel III framework) will be assigned lower outflow rates under the LCR, those balances will become more attractive to banks. Conversely, excess (or non-operational) deposits on banks' balance sheets – depending on the tenor, terms and industry – could require banks to hold up to 100% HQLAs, thus signalling a potential change in pricing.

Taking action

Corporates can prepare for the changes that will result from the introduction of the LCR since the new regulatory framework ultimately changes the way they should view their cash. In order to optimise cash, corporates will need to become more effective at segmenting day-to-day operational flows from excess or investable cash.

Efforts to improve visibility and control of cash have been

at the top of corporates' agenda for years now. Difficulties in obtaining access to liquidity when the financial markets were in an unsettled state increased the importance of internally generated cash (which is usually the most economical form of funding), and spurred efforts to enhance payables, receivables and inventory management. The LCR is certain to drive further efforts to improve efficiency, however.

For working capital management to become more efficient, corporates must improve their visibility and control of cash. Specifically, cash flow forecasting disciplines may need to be made more robust so that corporates know that cash will be where they need it at any given time. Improved knowledge of the whereabouts of cash, and more accurate predictions of when it will be required, will enable companies to centralise and consolidate cash using automatic liquidity structures.

Most importantly, greater visibility of cash makes it easier to segregate cash into working capital requirements, reserve and strategic categories. While Basel III may mean that banks will no longer be able to offer attractive returns for certain types of deposits not linked to the day–to-day working capital flows that sit on a bank's balance sheet, other off-balance sheet investment options, such as money market funds, are readily available. By allocating cash into the right liquidity bucket, organisations will be able to use these options to manage their liquidity more effectively and achieve their yield expectations while operating within the bounds of their investment policy framework.

A deeper relationship between banks and their customers

Corporates have long been accustomed to a certain level of scrutiny, whether for compliance with anti-money laundering or Office of Foreign Assets Control sanctions. But with the introduction of LCR, banks will need to spend even more time understanding transaction-level detail as a result of the increased information that regulators will require. At the same time, banks will need to help corporates adapt to the changes that will result from the introduction of the LCR. Banks are positioned to do this, since they are already immersed in developing methodologies and investing in pricing models and other technology to determine the impact of the LCR on their own balance sheets. This resulting expertise can help corporates adjust to the changing value of their day-to-day working capital deposits and their excess deposits currently sitting on banks' balance sheets. Basel III will undoubtedly result in deeper relationships between companies and their banking providers, since it will be more important than ever for banks to understand their clients' objectives.

It is essential that corporates clearly recognise the effects of the LCR well ahead of its introduction in January 2015. Organisations must put in place appropriate working capital management structures and cash flow forecasting models. Necessarily, these are long-term decisions that may require significant investment and are not to be taken lightly. Moreover, some changes may require board approval and should therefore be addressed imminently to ensure readiness for the introduction of Basel III at the beginning of next year.

BASEL III: THE DETAILS

Basel III, the latest version of the Bank for International Settlements' guidance on global regulatory standards, was developed in response to the experience of some banks during the financial crisis, which – while having adequate capital – failed due to a lack of liquidity. In contrast to previous versions of the Basel accord, Basel III addresses both liquidity and capital. Specifically, Basel III requires financial institutions to have access to sufficient liquidity to cover their short-term liabilities should a stress event occur. Liquidity is addressed by two main measures: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).

In the EU, Basel III is being transposed into national law through the Capital Requirements Regulation (CRR) and the Capital Requirements Directive IV. The LCR, which is dealt with by the CRR (which acts as a single rule book to ensure uniform application of Basel III across the EU), will be implemented from January 2015, with 60% compliance in the first year, ramping to 100% by 2019. In the US, regulators have published their proposals for the implementation of LCR through a Notice of Proposed Rulemaking. It has a 2015-2017 time frame, with 80% compliance in 2015. The NSFR will be introduced from January 2018 onwards.

The LCR requires banks to hold different levels of high-quality liquid assets (HQLAs) based on run-off assumptions for different types of short-term liabilities (which are primarily deposits). HQLAs are tightly defined, but are generally assets that can be easily and immediately converted into cash at little or no loss of value. They cannot be used for other purposes. The levels of required HQLAs vary according to whether deposits are operational or non-operational, and whether they come from corporates or financial institutions (with further distinctions made between different types of financial institutions). The run-off assumption estimates the percentage of the liability (the deposit) that can be expected to be withdrawn from the bank by clients in the first 30 days of a stress event. For example, corporate operational deposits have a run-off assumption of 25% and a 25% HQLA requirement (the most favourable level). Corporate non-operational deposits have a 40% run-off assumption and HQLA requirement, while certain financial institutions could have significantly higher HQLAs for both types of deposits.

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Bank of America Merrill Lynch

IAFEI Executive Committee Meeting, Manila, The Philippines, October 14, 2014

IAFEI Board of Directors Meeting, Manila, The Philippines, October 15, 2014

44th IAFEI World Congress 2014, Manila, The Philippines, October 15 to 17, 2014

Hosting IAFEI member institute will be the Financial Executives Institute of the Philippines, FINEX

45th IAFEI World Congress, 2015, Milano, Italy, October 15 to 17, 2015

Hosting IAFEI member institute will be the Financial Executives Institute of Italy, ANDAF