ISSUE 72 • SUMMER 2017

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Management & Performance

The Top Risks Facing Businesses in 2017

BY **BRIAN GREGORY**

Former NCAA basketball coach Bobby Knight once said, "The key is not the will to win... everybody has that. It is the will to prepare to win that is important." Whether it's winning a basketball game or managing a business, the fundamental message of Knight's quote rings true: preparation is vital. Preparation is particularly important when it comes to risk management.

Sophisticated cyberattacks, advancements in technology and new government regulations can catch executives unprepared, leading to devastating consequences. Reducing your company's exposure to the risks inherent in new developments and technology is essential to protecting your company, but this can be difficult if you are blind to your areas of vulnerability. The trick to managing risk is not only seeing the storm brewing this week but also anticipating any potentially nasty weather coming in the months ahead.

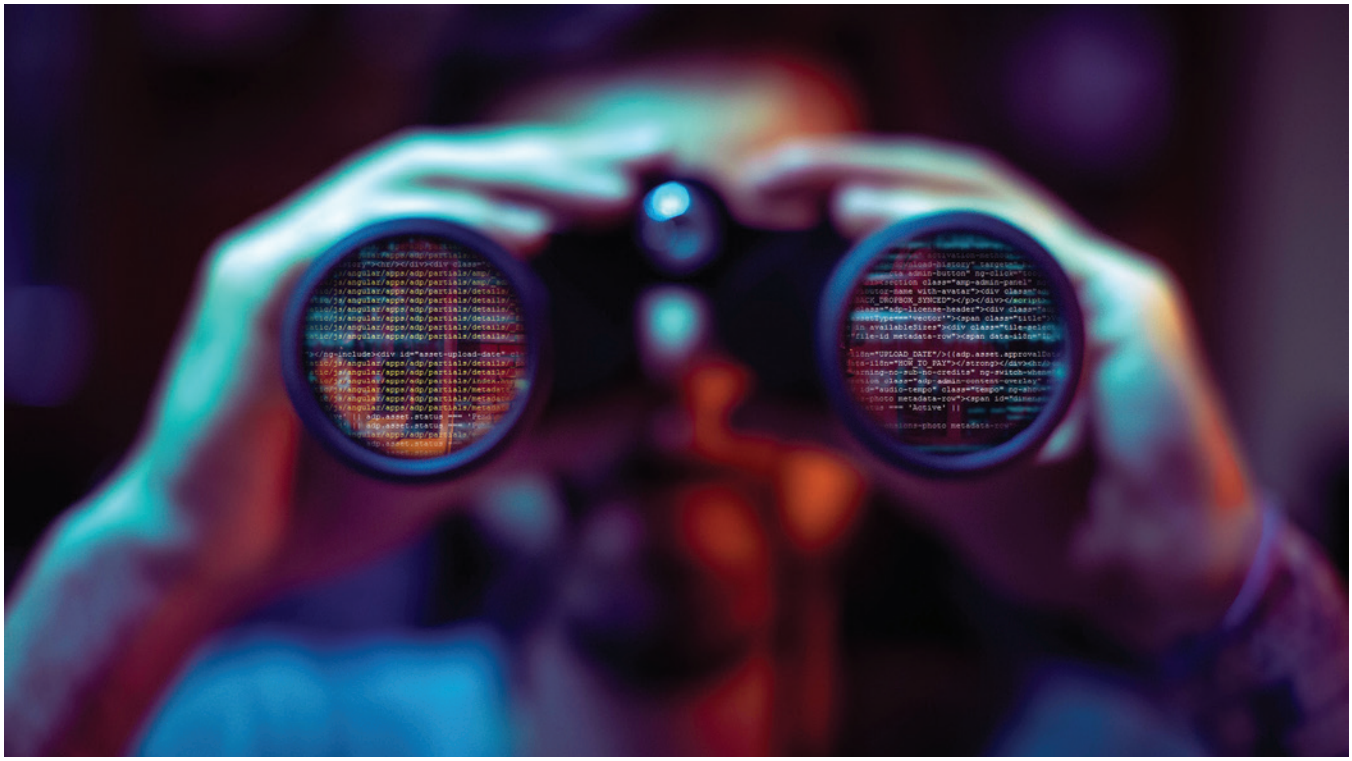
The following are this year's top risks and how your business can develop a plan to deal with them.

Cyberattacks

Cyber hackers have become a threat to businesses in every sector and of every size. Health care, manufacturing and financial services have been among the hardest hit and topped IBM's 2016 X-Force Cybersecurity Intelligence Index list of industries most frequently attacked by information security threats.

Unfortunately breaches are becoming more sophisticated than ever. Symantec found that vulnerabilities were found in three quarters of websites, and there were over one million web attacks each day in 2015.

This risk is an expensive one. Cyberattacks cost the average American business $15.4 million per year, according to a 2015 report by Hewlett Packard and the U.S.-based Ponemon Institute of Cyber Crime. Protecting your company is just as expensive. The average U.S. company of 1,000



employees or more spends $15 million a year battling cybercrime, the report states.

Businesses must continue to invest time and money into securing their assets. Your best defense is to evaluate current assets and operations and focus on implementing strategies to protect the ones primary to your business. Many options exist, including:

- purchasing up-to-date software
- encrypting business-owned mobile devices
- training employees on the dos and don'ts of cyber protection
- buying property and casualty insurance
- partaking in a penetration test or vulnerability assessment of IT systems

Your organization can determine what combination of these strategies will best suit your needs and budget.

Rapid Technology Changes

The rapid rate of technological and digital advance was the biggest challenge for global business leaders, according to a survey conducted by CEMS. Your executives must spend time understanding your technological needs to stay ahead of the curve.

Technology updates require changes to internal controls and information security protocol, as well. The new technology may be involved in data sharing and business activities that involve the transfer of potentially sensitive information; therefore, businesses must ensure adequate controls are in place to protect data.

The best preparation for adapting to these changes is to clearly communicate any changes or updates to internal and external stakeholders. There are bound to be obstacles along the way, so creating one or two contingency plans ensures you can continue to operate if something goes wrong.

Trump Administration

Changes in government administration bring uncertainty, and the start of President Trump's term is no exception. President Trump has advocated for major overhauls to taxes, regulations and foreign relations, which could usher in new risks for your business.

Trade negotiations could have an impact on supply chains. Proposed acts like the American Health Care Act and the Family and Medical Leave Act could have an impact on your employee benefit packages if passed. Reductions in regulations could affect your decision-making.

Companies should monitor political developments closely and consider folding some of these considerations into their enterprise risk management approach. There may be proactive adjustments to policies and practices you can make that will mitigate your company's risk of being blindsided by drastic regulatory overhauls.

In Summary

Your risk environment is always in a state of flux. Only by periodically reviewing your areas of exposure can you keep up with those changes.

BRIAN GREGORY
CBIZ Risk & Advisory Services
Denver, CO • 720.200.7000
bgregory@cbiz.com

4 Repercussions of the New Leasing Standard

BY **BRAD HALE**

Accounting Standards Update 2016-02, Leases (ASC Topic 842), affects all leases (e.g., property, equipment, copiers) with only a few minor scope exceptions. The new guidance begins to take effect in the 2019 calendar year. Although public companies will adopt first, all entities need to be proactive in evaluating the impact of the standard. The accounting changes may affect debt covenant compliance, evaluation of leasing alternatives, responsibilities of accounting and finance departments, and lease negotiations.

Summary of Major Changes

Lessees will classify a lease as either operating or financing, and nearly all leases will be presented on the balance sheet. The evaluation of operating versus finance leases will be similar to current practice with a new criterion to consider assets of a specialized nature. Bright lines established in current guidance have been removed.

Impact on Rental Leases

The type of lease will impact how you report rental expense on your income statement. For most operating leases, a lessee will recognize rental expense on a straight-line basis over the lease term. For finance leases, a lessee will recognize rental expense under the effective interest method.

In regards to lease term, any renewal options that are reasonably certain to be exercised should be included in the lease term. The conclusion requires reassessment upon triggering events.

Effect on Debt Covenants

Operating and finance leases are recognized on the balance sheet through right-of-use (ROU) assets and related lease obligations. Classifying leases as liabilities may affect metrics for your debt covenant compliance, and while banks are likely already using a factor to adjust operating lease payments in situations where these payments are a significant expense, you should discuss lease liability classification with your bank.

Impact on Types of Leases

Changes to lease accounting may trigger more synthetic lease structures or structures where a special purpose entity is created and “owns” the leased asset and leases the assets to an operating entity. However, given their highly specialized nature, it is likely that synthetic leases will primarily be seen in sophisticated investment markets.

A demand is also expected for other types of alternative lease structures because of the effect of the standard on financial statements. For example, short-term leases may be more appealing because a lessee is permitted to forgo recognizing an ROU asset and related lease liability on its balance sheet. Other companies may consider buying assets or funding tenant improvements instead of including them in leases if cost of capital is less than the interest rate implicit in the lease.

Additional Responsibilities for Accounting & Finance Departments

Previously, if leases embedded in contracts were missed, the impact would be misclassification of operating expenses (e.g., cost of goods sold (COGS) vs. rent). However, because leases are now presented on the balance sheet, there is a much greater risk of misidentifying embedded leases.

Identifying the appropriate unit of account by which to measure the lease and distinguishing between lease and non-lease components will also require involvement from the accounting and finance functions.

Finally, impairment models will need to address the new lease related assets. Consideration must be given to how cash flows are calculated and compared to the asset base.

More Time Needed for Lease Negotiations

More time will be needed for leasing decisions, and given the potential effect on your financial statements, alternatives to leasing may need to be explored. For upcoming renewals or new deals, be sure your projections and those of your bank include the accounting standard’s effect on debt covenant compliance.

In the interim, consider whether you need to modify your internal controls to help ensure compliance with the new requirements and have the appropriate, audit-ready documentation to comply with the standard. You should also evaluate whether the relevant system solutions you are using are capable of accounting for your leases with the new guidance.

BRAD HALE
CBIZ MHM, LLC
Tampa Bay, FL • 727.572.1400
bhale@cbiz.com

Employee Benefits

Biosimilars: Cost Relief for the Self-Funding Employer?

BY **NEIL MODEL**

Self-funded benefits plans have become a popular option among employers desiring to cut costs and design coverage provided to employees. As the cost of Rx spending has been increasing at a far greater rate than the basic medical trend, more employers are concerned about the significant expense of specialty drugs.

Hence, while self-funding has the potential to provide cost savings, employers must carefully consider aspects such as the contractual language of stop loss coverage, the potential for lasers and other coverage land mines, which all affect an employer's financial liability. Now employers will be looking to medication advancements, such as biosimilar medications, as potential cost-savings outlets.

To review, in a self-funded prescription benefits arrangement, an employer assumes the responsibility associated with covering the costs of prescriptions for all employees after employee copays or co-insurance. For this reason, stop loss coverage is often purchased to shield against any excessive expense liabilities, which can occur with Tier 4 specialty medications. Some of these medications – for diseases such as cancer, rheumatoid arthritis, multiple sclerosis and liver disease – cost six figures or more per year. Stop loss coverage isn't an impermeable shield, and certain exceptions could still leave an employer with a major expense.

One such exception to stop loss coverage is "lasers," which identifies high-risk employees (e.g., those with diseases and illnesses that require expensive medications and create a higher deductible specific to those individual employees). Employers will accept a laser to keep stop loss coverage costs lower for the entire plan. However, these higher prescription costs are then placed back in the employer's responsibility, which cannot be directly passed on to the high-risk employees.

Another factor to consider is the employer cash flow if prescription claims border a claim year. Depending on the terms of a claims contract, there could be a lag in submitting and paying claims near the end of a claim year, which increases an employer's liability risk, especially if drugs cost $10,000 or more per month as with many biologic medications.

Biosimilar medications are providing benefits managers and consumers some hope of reduced costs in the near future. Biosimilars are drugs that are similar to but not exactly the same as their originator biologic medications. They are and have been the subject of a rigorous FDA approval process in recent years. Concerns about biosimilars include toxicity and overall efficacy, though they have been used in Europe for nearly a decade.

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Insurance Audit: Peace of Mind & Potential Savings

BY **GREG CRYAN**

Running and growing a business require many talents, not the least of which is engaging professional service providers with specialized expertise to support your operations, management responsibilities and leadership decisions. Here's the key: Whether you are building a new relationship or have received many successful years of service, you need to ensure your advisors continue to match your company's evolving needs regarding industry and service area regulatory changes, best practices and pricing models.

This is particularly true with risk management. Regardless of the size of your enterprise, successfully managing risk is an ongoing and dynamic process that is much more than purchasing a policy and filing away a pile of paper once a year.

Your insurance broker and risk management advisors should be proactively working with you to reduce, eliminate and transfer as much risk as possible, while minimizing the total annual impact to your budget, inclusive of insurance premiums, applicable deductibles, self-insured retentions and self-insured exposures. Conducting an insurance audit is the best way to ensure this outcome.

Features & Benefits of an Insurance Audit

An insurance audit takes a fresh look at your current insurance policies coverage, identifying any gaps and noting limitations, exclusions and warranties, conflicting terms, and unscheduled underlying policies. This process should take no more than a couple hours of your time. Even if third parties, including lenders, deem that your coverage is adequate, other exposures outside of their interest may be uninsured or under insured. The audit process will provide you with additional peace of mind and potential for savings; it will be time well spent.

Here's what to expect from a comprehensive insurance audit:

- Review of Standard Contract(s)/Lease Agreement(s); Schedule of Values/Locations
- Review Completeness and Accuracy of Named Insureds
- Review Coverage Observations by Policy Type
  - ☐ Adequacy of coverage (scope/depth matching their business)
  - ☐ Sufficiency of limits
  - ☐ Levels of deductibles and retentions
  - ☐ Territory of coverage
  - ☐ Concurrency of coverage
  - ☐ Coordination of coverage limits
  - ☐ Suitability of coverage forms (especially when existing forms are non-ISO)
  - ☐ Material coverage problems (exclusions, limitations, conditions, warranties, subjectives)
- Additional Coverage Recommendations
  - ☐ Missing coverage(s)/policy(ies)
  - ☐ Added-value services provided by the agent of record
- Portfolio or a Master Program vs. Individual Policies (provides great leverage)
- Comparison of Current Pricing vs. Market Competition (resulting in reduced premiums)

Depending on your risk tolerance, you may consider self-insuring part of your risk. Risk sharing through the purchase of insurance is often advisable, but an audit will provide the cost benefit. Standard placement of insurance is both experience and market driven. A complete analysis of all factors typically provides great coverage protection and financial benefit.

Bottom Line

As your business expands, your risk increases. Additionally, industry regulations may change over time and insurance products and pricing respond to regulatory and market changes. Your risk advisor and insurance brokerage experts specialize in protecting assets. Take the time to meet with them to identify creative insurance and risk management opportunities on a regular basis.

GREG CRYAN
CBIZ Insurance Services, Inc.
Alpharetta, GA
470.282.2537 • gcryan@cbiz.com

The 5 Cs of Credit

BY **MICHAEL CARON**

Many business owners do not fully grasp the challenge facing lenders. Virtually no lender, banker, salesperson, business development officer, relationship manager or the person a business owner would work with to begin the loan process can make a decision on your credit request.

Back in the day, it was possible in some cases for a banker to make a lending decision. Today, the person you meet with to apply for the loan, your lender, will be the one to demonstrate your creditworthiness to a credit officer (the decision maker) who has not and probably will not ever meet you. The only thing the credit officer will have to base a decision on will be the paperwork evidence you've presented to the lender.

Ensuring your paperwork meets the minimum standards established by the credit officer will help demonstrate your creditworthiness. These standards can be broken down into the five Cs of credit.

Character

Character generally is measured by a number of readily available reports that bankers pull. Within the reports, the lender looks for trends in payment history, as well as any derogatory information relating to the business and/or owner. Borrowers who do not demonstrate integrity in their past financial dealings will have a very difficult time getting reputable lenders to provide a loan on any terms. Keep in mind that personal and business credit issues, including bankruptcy, may be explainable.

Collateral

Banks are not in business to take risk. When banks make loans, they generally look for collateral to help mitigate any perceived risk. Assets include accounts receivable and inventory, as well as real estate. In addition to the collateral securing the loan, personal guarantees are a usual and customary requirement for loans to privately held companies. Banks make unsecured and unguaranteed loans; however, borrowers who qualify for these loans are very strong financially and have a long history of financial success.

Conditions

Economic- and company-specific factors that may influence the ultimate success or failure of the business are conditions. For example, evidence of pending sales, generally in the form of purchase orders or contracts, demonstrate to the lender that your claim of increasing sales in a down sales environment can be realized. Concentration risk is also a condition to consider. Many may contemplate the effects of a major customer decreasing sales or not paying invoices, but what if that customer increases its sales exponentially?

Capital

Capital includes retained earnings and money you or others have invested in (capital stock or paid-in-capital) or loaned to (subordinated debt) the business. Leverage, the ratio of debt to equity, is a key measurement taken by banks to assess the perceived level of risk inherent in a business. If you have too much debt relative to your overall equity and something goes wrong in the business, the highly leveraged business has less of a cushion to fall back on.

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Employee Benefits *(Continued from page 5)*

In the U.S., biosimilars have been released for Enbrel, Humira, Neupogen and Remicade. In the next 24 months, 156 more biosimilars are expected to be released and are estimated to provide cost savings of approximately 30 percent. Biosimilars used in combination with step therapy should provide additional opportunities for greater cost savings to plan sponsors. One might also assume stop loss premiums will decrease or not increase as much given a reduction in some medication costs.

It can be logically argued that costs are costs and insurers and reinsurers will price medications accordingly as more biosimilars are approved. As employers look ahead, it is important for HR and benefits professionals to review all contract language and reinsurance protection to hedge against surprise excessive costs. A thorough review of stop loss attachment points, contractual language and PBM arrangements can make all the difference in the risk an employer assumes in a self-funded plan.

NEIL MODEL
CBIZ Employee Services Organization
Plymouth Meeting, PA
610.862.2460 • nmodel@cbizmodel.com

Expanding Your Business *(Continued from page 7)*

Capacity

Capacity is the demonstrated ability to service the loan you are requesting. Insufficient cash flow is the fastest way to be declined for a loan. Lenders typically require coverage ratios of at least 1.10 times the loan's minimum payment requirement. The higher the coverage ratio, the easier it is to qualify for a loan. Profit alone may not be adequate to demonstrate the ability to pay back a loan. Lenders look at a combination of numbers reported on your financial statements, including interest expense, taxes, depreciation, amortization and other non-cash items expensed.

Consider the Five Cs

Armed with the knowledge that lenders base their credit decisions on your character, the collateral, the conditions, your capital position and your capacity, you have a better understanding of the rationale they will use in approving or declining your request for credit.

MICHAEL CARON
CBIZ MHM, LLC
Philadelphia, PA • 610.862.2335
mcaron@cbiz.com