ON POINT

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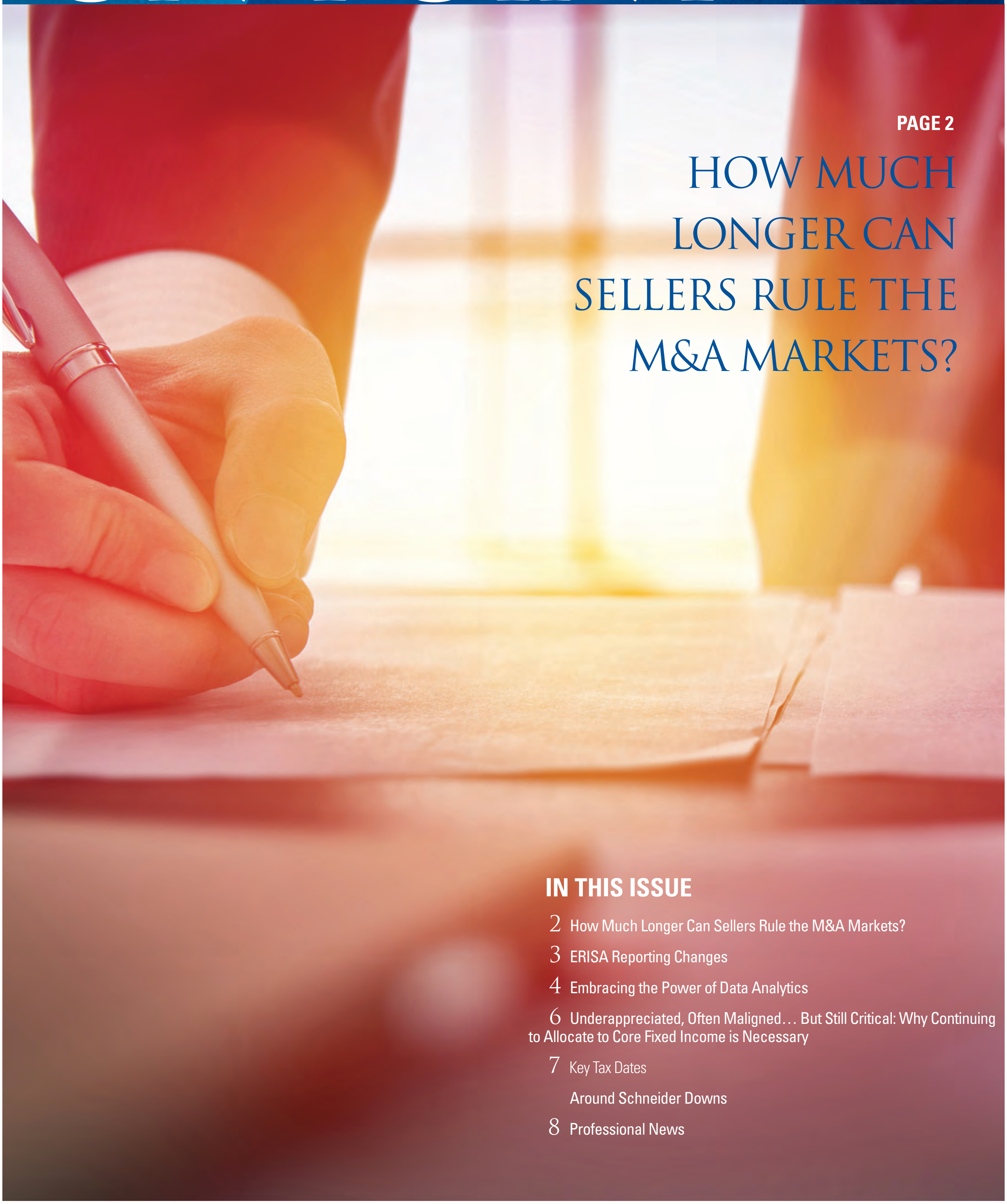

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HOW MUCH LONGER CAN SELLERS RULE THE M&A MARKETS?

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HOW MUCH LONGER CAN SELLERS RULE THE M&A MARKETS?

Sellers have ruled mergers and acquisitions markets for the better part of six years. The steady economic recovery from the 2008 recession and low interest rates have contributed mightily. But as the cycle matures, the factors driving M&A activity have evolved. Like all cycles, the market will eventually turn. What is driving the market now, what factors could change conditions and how should owners react?

Current Conditions

Since 2011, when M&A markets started to recover from the Great Recession, several common factors have remained in place to create conditions that are extremely seller-friendly: (1) an enormous surplus of capital; (2) evolving M&A deal practices that speed execution and improve seller proceeds; and (3) a relatively fixed number of companies available for sale. For quite some time now, there has been a lot of money looking for a limited number of deals.

Surplus of Capital

Buyers fund deals from: (1) borrowings from banks and non-bank lenders; (2) third-party equity investors; and (3) their own (and sometimes the sellers') pockets.

Banks and other institutional lenders are currently funding M&A deals at levels approaching the market peaks in 2006 and 2007, priced at historically low levels. In the first half of 2017, the median debt component of large leveraged buyouts was 5.9x the target's cashflow (EBITDA), according to Pitchbook. In 2007, large LBO leverage peaked at 6.5x cashflow.

Equity investor funds seeking M&A exposure also continue to flow into the markets. Global public equity markets remain strong, and the U.S. markets are at all-time highs. Private equity fundraising is on track to exceed $200 billion in new commitments in 2017 for the second year in a row.

At the same time, corporate profits have surged. Improved global economic performance and continued strong conditions in the U.S. drove nearly 80% of the S&P 500 to exceeded earnings expectations in the third quarter. The cash generated from those profits needs to be invested.

Efficient M&A Markets

As the supply of money seeking M&A has ballooned, technological and financial innovation has made it easier to put more dollars in the hands of owners. Negotiation of confidentiality agreements, distribution of marketing materials and delivery of due diligence documents is executed online, speeding closing and facilitating extensive competition among buyers. Representation and warranty insurance is now market standard in deals above $50 million in value, dramatically reducing post-closing escrows – meaning more money for sellers at the close, with less at-risk afterwards.

BY PETER J. LIEBERMAN
SCHNEIDER DOWNS CORPORATE FINANCE, LP
PARTNER

Stable Volume of Companies for Sale

While the smartest minds in finance have found ways to make it easier for buyers to pay more for companies, they haven't been as successful in convincing more owners to sell. U.S. M&A transaction volume has stagnated after growing more than 64% in 2015. Private equity has historically driven transaction volume, but the long recovery has meant that many PE-owned firms have already traded more than once in the cycle. Meanwhile, in the low-interest environment that has prevailed for the last 15 years, many baby-boomer owners have delayed sales and retirement, often on the logic that investment options aren't competitive with just keeping their businesses and collecting distributions.

Impact on Market

Predictably, the impact of excess capital and limited targets has been higher prices. In 2017, nearly three-fourths of deals with disclosed values have traded in excess of eight times cash flow, according to Capital IQ. Companies worth $100 million or more have seen cashflow multiples increase by two turns from 2014. Sellers have also asserted their leverage by demanding and receiving more liberal terms and conditions with respect to liability for post-closing issues.

Potential Risk Factors

While the current environment has created the perfect storm for sellers, risk factors are accumulating. Over the last 40 years, M&A cycles have lasted about five years. While GDP growth has accelerated over the last two quarters, the current cycle is pushing seven years. Interest rates are rising. Significant geopolitical risks, such as North Korea, have heightened.

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TOP STORY

ERISA REPORTING CHANGES

Audit quality and consistency of employee benefit plans (EBP) serve significant roles for participants of retirement plans. Currently, the Department of Labor (DOL) and Internal Revenue Service (IRS) have the authority to issue regulations on the administration of EBPs for which plan sponsors and administrators have a fiduciary responsibility. Part of the reporting and disclosure requirements include the annual filing with the DOL (Form 5500); however, the DOL has not established a financial reporting framework for EBP financial statements, nor does it set professional standards for auditing those financial statements, leading to concerns over audit quality and consistency.

As a result, the DOL had requested the American Institute of Certified Public Accountants (AICPA) Auditing Standards Board (ASB) to explore different reporting models. The DOL has expressed concerns that the wording of the current limited scope auditor's report and resulting disclaimer of opinion typically issued may be a contributing factor to audit quality deficiencies because of potential confusion regarding the auditor's responsibilities in performing engagements. In response to that request, the ASB formed a special task force to improve the quality of EBP audits by strengthening the EBP auditor's report.

In April 2017, the AICPA issued an exposure draft for public comment related to the auditor's opinion and reporting on financial statements of employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA). Comments related to the proposed reporting model are available on the AICPA's website.

Under the proposed model, the section related to management's responsibilities would be expanded to clarify that management has a responsibility over maintaining and administering the plan in accordance with the plan document. A new section of the auditor's report has been proposed to incorporate elements similar to the reporting required by generally accepted government auditing standards (GAGAS), also known as Yellow Book. The proposed reporting model would state that the auditor performed procedures regarding participant eligibility, benefit payments, participant vesting provisions, employer contributions, disclosure of prohibited transactions, Internal Revenue Code compliance tests, and use of forfeitures, which isn't a change to the audit requirements. However, to the extent there are findings as defined by the proposed statement of auditing standard (SAS), the auditor would need disclose those finding(s) in the auditor's report. An example provided in the proposed SAS relates to the plan administrator not calculating vesting in accordance with the plan document and resulting in in the plan not paying appropriate benefits. The financial statements are a public document that are available on the DOL's website, making these finding(s) public knowledge.

For ERISA-permitted audit scope limitation engagements, the new form of the auditor's report would incorporate a section titled "Basis for Limitation on the Scope of the Audit." The opinion of the auditor's report would explicitly state that the auditor's opinion is based on information certified by a trustee or custodian, which the auditor was instructed not to audit.

The proposed form of report would result in a significant change in reporting audits of EBP financial statements and would be effective for audits of financial statements for period ending after December 15, 2018.

FEATURE

Picture it…internal auditors with unfettered access to data across all departments and business lines within the organization, further enabling Internal Audit to serve as a trusted strategic partner to executive management. Many organizations might not be leveraging data to its fullest extent to enable business decisions. But that could become reality, thanks to the power of data analytics.

Today, data is being collected, created and stored at a never-before-seen pace. With the sheer volume of available structured data (derived from software applications) and unstructured data (gleaned from social media), how do organizations respond? An organized, systematic approach can enable organizations to effectively and efficiently analyze data, identify anomalies and patterns, and summarize the results in a manner optimized for decision-making. That's where Internal Audit can help.

For many years, internal auditors have used computer-assisted audit techniques (CAATs) and data analytics to mine data and interpret and communicate the results. Data analytics used by auditors tend to be more risk-focused (e.g., control effectiveness, fraud identification, policy/regulatory noncompliance, exception reporting) instead of performance-focused (e.g., decreased costs, improved profitability, increased revenue), but the process of analyzing the data is the same regardless of the intended outcome.

BY
HEATHER A. HAEMER
SCHNEIDER DOWNS RISK ADVISORY
SENIOR MANAGER

BY
ROSEMARY MAZZEO
SCHNEIDER DOWNS RISK ADVISORY
MANAGER

EMBRACING THE POWER OF DATA ANALYTICS

Whether looking at risk or performance metrics, it is a matter of applying data analytics to group and isolate data sets from raw data and communicate meaningful results to management.

In this data-driven world, Internal Audit's ability to quickly analyze data is a business necessity, not an option. Many organizations' internal audit departments do not fully integrate data analytics into their audit procedures, and unfortunately, organizations miss the opportunity to maximize the value of audits, broaden risk coverage, create efficiencies in the audit process, test an entire population (rather than selecting a sample) and identify trends. So why aren't more internal auditors integrating data analytics into their day-to-day procedures? One of the biggest challenges internal auditors face is access to raw data - including, but not limited to, identifying where the data is stored and understanding the system constraints to obtaining the data.

While the idea of data analytics may be somewhat overwhelming for novices, first-time users or even seasoned users, the opportunities to integrate data analytics into audits can result in great benefits achieved by following the steps highlighted below:

- Develop a vision and do not lose sight of the big picture – understand the data created by the analytics and how that data may be used to drive business decisions
- Evaluate current capabilities:
  - » Understand what data is available and the data requirements
  - » Partner with the IT department to understand what data is available as well as data requirements and the data acquisition process
- Implement analytics:
  - » Identify all manually performed audit tests – assess each manual test to determine if the test can be replaced by meaningful data analytics
  - » Plan and develop audit tests that achieve the audit objectives based on the data available and understanding of that data
  - » Execute the newly established data analytics techniques/test steps using a preferred software solution

  - » Interpret and document the results of the tests
  - » Assess the effectiveness of the data analytics procedures
  - » Identify uses for data analytics to achieve your organization's continuous auditing efforts
- Evolve – look for opportunities to use data analytics elsewhere in the audit process (and perhaps even in the business)

Through experience, the Schneider Downs Risk Advisory Services team has incorporated value-added data analytics in a variety of circumstances—and has found that the results and efficiencies gained can provide meaningful insight and give us a competitive advantage.

There is not a set path to ensure that organizations and internal auditors are using the benefits of data analytics, but that also means that there is no wrong way to get started.

There is a learning curve risk associated with integrating data analytics into the audit process. However, the even-bigger risk is not using data analytics at all. Auditors who fail to incorporate data analytics into their procedures will fall behind and perhaps make themselves obsolete. James Yard, Risk Advisory Services Practice Leader at Schneider Downs, states that "data analytics is the present-day opportunity for risk management professionals to partner with executive decision-makers to better evaluate performance against defined objectives." In short, the rewards far outweigh the risks.

NEWS YOU NEED

HOW MUCH LONGER CAN SELLERS CONTROL THE M&A MARKETS?

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And certain industries may be affected disproportionately, in the near-term, by policy choices designed to benefit markets overall. For example, increased trade barriers could affect agriculture and automotive manufacturing industries, and tax reform proposals have the potential to affect housing markets by modifying the mortgage interest deduction.

How to React

We continue to view the current environment as one that is extremely receptive to potential sellers of well-managed companies and that is at its peak. We believe that valuation multiples have plateaued for the near term. Buyers should recognize the risks inherent in buying at a cyclical peak – there is little room for error.

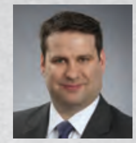
For sellers, the current conditions reflect limited upside to waiting for further market improvements. Owners contemplating a sale should recognize the unique opportunity that current market conditions represent. The time to begin planning for a sale, even if your intended window is a year or more out, is now.

Material discussed is meant for general illustration and/or informational purposes only and it is not to be construed as investment, tax or legal advice. Although the information has been gathered from sources believed to be reliable, please note that individual situations can vary. Therefore, the information should be relied upon when coordinated with individual professional advice.

SCHNEIDER DOWNS WEALTH MANAGEMENT ADVISORS, LP

QUARTERLY COLUMN

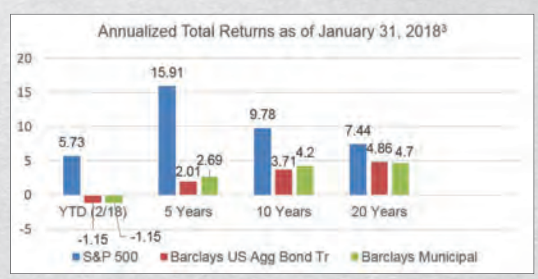
UNDERAPPRECIATED, OFTEN MALIGNED… BUT STILL CRITICAL: WHY CONTINUING TO ALLOCATE TO CORE FIXED INCOME IS NECESSARY



BY
JASON R. STALEY, CFA®
INVESTMENT RELATIONSHIP MANAGER, WEALTH MANAGEMENT ADVISORS

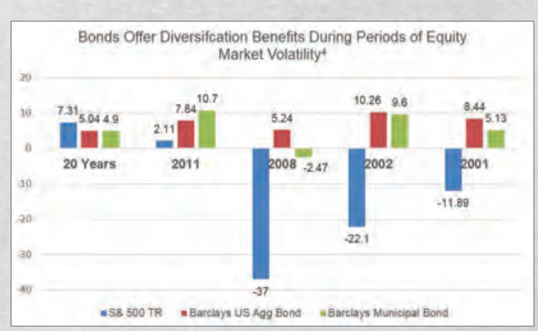
Over the past 12 to18 months, we have alternatively described our outlook on fixed income as "less sanguine," "not constructive," "challenging," and "unattractive," among other less than optimistic portrayal. One phrase you have not heard from our team, however, despite our concerns about the fixed income asset class, is "abandon." This is incredibly important because despite the challenges facing core fixed income — historically low bond yields and a U.S. Federal Reserve intent on rising interest rates, albeit in a deliberate and telegraphed policy — the asset class still offers investor portfolios two valuable characteristics: diversification and current income (lower than we would like, but cash flows nonetheless).

Applied Quantitative Research deconstructs the return of fixed income to its most rudimentary form: Total Return= Risk Free Rate + Excess Return.[1] This formula essentially states that the return an investor can expect from fixed income is the interest rate on the 10-year U.S. Treasury Bond[2], plus any risk premium associated with a bond (term, liquidity, and credit, among others) that could potentially deliver a return in "excess" of the risk free rate. Taking the simple construct just laid out, an investor could reasonably make the judgment that they simply aren't being "compensated" enough to own fixed income, and allocate capital normally reserved for fixed income to other riskier assets that can "compensate" them for their investment. In a vacuum, we wouldn't blame investors for coming to this conclusion, but basing investment decisions made in a vacuum against a backdrop of an increasingly complicated and integrated global economy and marketplace can lead to ill-timed asset allocation decisions. Take the chart to the right, for example. In a vacuum an investor could say, "Why not put all your money into the S&P 500? Look at the returns you could earn, especially the year-to-date and five-year returns."



While the chart paints an attractive picture of recent historical performance in the S&P 500, it doesn't tell the entire story. Compare the above chart with the below chart that illustrates that equity markets don't move in a straight line and are prone to drawdowns of varying magnitudes.

As the chart to the right illustrates, equity markets can have several years of low to sharply negative performance within an overall attractive time period. To look at bonds from only a "total return" perspective ignores the diversification benefits investors achieve by having assets included in a portfolio that generates price movement by different data points and risk sentiments. Specifically, bonds have low correlation[5] (please see the above chart) over long time periods, but in times of equity market, volatility bonds typically exhibit negative correlation. This negative correlation is



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UNDERAPRECIATED, OFTEN MALIGNED

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important in investor portfolios because as the "Equity" allocation is experiencing a drawdown, the "Bond" allocation is often able to balance the negative performance out by having flat to positive returns (demonstrated in the chart above).

Time Period [6]	Barclays US Aggregate Bond Correlation to S&P 500	Barclays Municipal Bond Correlation to S&P 500
20 Years (1/31)	-0.09	-0.05
2011	-0.35	-0.36
2008	+0.35	+0.47
2002	-0.72	-0.84
2001	-0.40	-0.39

It's often easy to eschew fixed income in favor of equities. It's even easier to do so when equity markets continually appreciate, seemingly year-over-year, and the experience of the great financial crisis fades deeper into the recesses of our memories. But failing to account for the historical volatility and variability of equity returns in lieu of recent favorable conditions in asset allocations would be a disservice to our clients. We do not believe it's possible to forecast when the next large drawdown in the global equity markets will occur, though we do know that another drawdown will happen at some point in the future. When that drawdown does occur, we expect the ballast of our portfolio, our core fixed income allocation, to steady the ship until it returns to calmer waters. Despite a challenging investment environment that lies in its face, core fixed income will remain a critical part of client portfolios.

Investors should be aware that there are risks inherent in all investments, such as fluctuations in investment principal and with any investment vehicle, past performance is not a guarantee of future results. Indexes shown are unmanaged and investors cannot invest into them directly. The information discussed is meant for general illustration and/or informational purposes only and it is not to be construed as investment, tax or legal advice. Individual situations can vary, and the information should be relied upon when coordinated with individual professional advice.

[1] Asset Allocation in a Low Yield Environment. John Huss, Thomas Maloney, Zachary Mess, Michael Mendelson, August 2017.
[2] The 10-Year U.S. Treasury Bond is assumed to be the "Risk Free Rate" in this illustration
[3] Returns from Morningstar Direct; annualized total returns as of 1/31/2017.
[4] Return source Morningstar Direct. Returns represented are total returns and are one year time period.
[5] Correlation defined as degree to which two securities move in relation to one another
[6] Correlations sources Morningstar Direct

AROUND SCHNEIDER DOWNS

Schneider Downs Class of 2017

United Way Games for Good

United Way Hoodies for the Holidays

Wesley Family Services holiday gift drive

New Hires

Welcome aboard! In October, we welcomed more than 30 recent college graduates…our Class of 2017. We're excited to have these new, friendly faces in our Pittsburgh and Columbus offices.

Giving Back

Volunteers from Schneider Downs continue to hit the streets. The United Way Games for Good were held at Highmark Stadium in Pittsburgh in September. A group from Schneider Downs helped lead the program, which encouraged children to practice healthy habits through exercise and engaging with others. Schneider Downs was also proud to be part of the United Way's Hoodies for the Holidays in November. That annual event collects college hoodies to distribute to middle school students. In December, employees collected gifts for Wesley Family Services this past holiday season.

Annual CPE and Networking Events

It wouldn't have been December without our annual CPE and Networking events held in Pittsburgh and Columbus. Collectively, we hosted more than 500 guests through both events, and provided 12 combined hours of CPE credits. As you can imagine, tax reform was a hot topic. Special thanks to our Pittsburgh guest speakers, John McIlvaine (The Web Law Firm), Bill Strickland (Manchester Bidwell Corporation) and John Dick (Civic Science). In Columbus, we would like to thank Bill Lafayette from Regionomics® LLC for sharing his update on the Central Ohio Economy.

Pittsburgh event at Westin Hotel

Columbus event at Hilton Easton

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SCHNEIDER DOWNS
Big Thinking. Personal Focus.

One PPG Place, Suite 1700
Pittsburgh, PA 15222

P: 412.261.3644
F: 412.261.4876

65 E. State Street, Suite 2000
Columbus, OH 43215

P: 614.621.4060
F: 614.621.4062

www.schneiderdowns.com

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PROFESSIONAL NEWS

THEODORE M. PETTKO, Audit Shareholder, **LOGAN KOWCHECK**, Audit Manager, and **AARON MCFADDEN**, Audit Manager, attended Pennsylvania Independent Oil and Gas Association's Cigar Dinner at Mallorca Restaurant in November.

MARY D. RICHTER, Tax Shareholder, was a speaker at the German American Chamber of Commerce EU Data Privacy Event in October. Mary also presented at the PrimeGlobal World Conference on Networking and Expanding Services through PrimeGlobal. She also joined the Go Red for Women Luncheon Executive Leadership Team. Mary was also named to the Western Pennsylvania District Export Council (DEC).

MELANIE M. LASOTA, Director of Estates and Trusts, has been reelected as President of the Pittsburgh Youth Symphony Orchestra Board of Directors for the 2017-2018 year. Melanie also attended the Pennsylvania Bar Association 24th Estate Planning Institute in Philadelphia in November. Melanie also spoke at the PICPA Western Pennsylvania Tax Conference in Pittsburgh in January.

CHRISTOPHER S. MCELROY, Tax Shareholder, and **MARY D. RICHTER,** Tax Shareholder, presented to the Pittsburgh Institute of Management Accountants on the topic of Brexit and GDPR in September.

JOEL M. ROSENTHAL, Business Advisory Shareholder, joined the Boards of the Pittsburgh Public Theater and JDRF of Western PA.

KIMBERLY P. GRIFFITH, Audit Shareholder, was appointed to the Boards and their associated Finance Committees for Contemporary Craft and Clarion University Alumni Association.

BRIAN F. WEBSTER, Business Advisors Director, attended the AICPA Forensic and Valuation Services Conference in Las Vegas in November.

CHRISTOPHER S. MCELROY, Tax Shareholder, and **STACI L. BROGAN,** Audit Shareholder, were speakers at the Duquesne University A&A Update. Chris presented on "U.S. Tax Reform" and Staci was part of a panel discussion on "Audit 2.0 - The Audit of the Future."

MARIA D. STROMPLE, Director of Private Client Tax Advisory Services, joined the Allegheny Tax Society.

SARAH R. PIOT, Tax Senior Manager, and **PATRICK F. KERNS,** Audit Senior Manager, attended the PrimeGlobal Leadership Development Conference in Denver in January.

JOSEPH A. BRUCE, Audit Shareholder, **THEODORE M. PETTKO**, Audit Shareholder, **EUGENE M. DEFRANK**, Audit Shareholder, and **NICHOLAS D. LOMBARDO**, Audit Senior Manager, attended the AICPA Construction and Real Estate Conference in Las Vegas in November.

JENNIFER L. ZATCHEY, Audit Senior Manager, was appointed to the Board at the Lighthouse Foundation and elected Treasurer.