TREASURY VALUE ADDED

DEREK ROSS OF DELOITTE & TOUCHE DISCUSSES REMUNERATION – HOW IT IS EVALUATED AND THE THEORY BEHIND IT. NEEDLESS TO SAY, GOOD PERFORMANCE DOES PAY.

The trend in executive remuneration towards a greater proportion in bonus – and therefore performance related, often partly the out-turn of the whole business, but in many cases individual performance – inevitably focuses attention on evaluation. The theory about how to measure the treasurer's added value is often markedly different to the practice, however.

WHY MEASURE PERFORMANCE? This is the first question to be answered. The reader will doubtless be disappointed that the requirement to measure performance is not primarily to enable the computation of his or her bonus. Appraising the treasurer is usually last in the list of reasons. The primary one is to control treasury. A rational performance measurement structure, quite apart from being best practice corporate governance, is an important aspect of the control environment. An equally important reason is that management – and in the case of treasury this usually means the Board – should not only approve policy but should monitor the effectiveness of that policy. Measuring performance will inevitably assist the process of feedback, whereby the policy and its execution can be improved.

THE THEORY. The theory starts with the concept that the performance measurement system should be consistent with the organisational model in place. The historic categorisation is between profit and cost centre. Management is often wary of setting up treasury departments as profit centres because of the perception that this will inevitably lead to speculation. In the author's opinion, this is more perception than reality and, in practice, even if a treasury is not set up explicitly as a profit centre, it is a rare treasurer who would not wish to capture every bit of profit going and report this up the management chain, thereby demonstrating his skills. Naturally, everyone wishes to show their personal contribution in the best light.

Financial managers, and treasurers more than most, understand the fear, particularly on the part of the non-executives and audit committees, that a heavily bonused treasurer operating in a profit centre is an inflammable combination. In practice, this is a rare circumstance in companies, even in the biggest treasuries, and is much more of an issue in banks. The history of high profile losses speaks for itself. To this traditional binary characterisation maybe a third should be added. This is the value added centre. It simply recognises that there is little point having a central treasury unless it adds value to the business. It inevitably follows that the value added ought to be measured. Most would regard the distinction between measuring added value and having a profit centre as rather semantic, and to some extent it is. But terminology is important because it guides perception. Few finance directors would take issue with the concept of measuring value. What then are the types of measures that are employed, and how do they relate to these organisation models?

MEASURING VALUE. For a value-added or profit-centred treasury, meeting a treasury value-added target is a simple and, in most cases, accurate measure. It can be called TVA if consistency with shareholder value concepts is helpful. A bottom line measure, being the net earnings in the treasury management accounts, will often simply reflect the difference between out-turn and what the position would have been if treasury did not exist. This follows if the treasury acts as a sort of in-house bank giving arms' length prices to operating units. These are defined as at least as good as the rate the department would have got if they had gone to the financial markets independently. All of the benefits, that treasurers do not need to be listed in this article, from having the central function will then be manifest in the treasury management accounts in one way or another as gross income, against which the costs can be set.

At the other end of the spectrum, for a pure cost centre treasury, which may not even be doing transactions in its own name, but as agent for the operating units, a simple process of not exceeding a budgeted cost and outperformance against benchmarks is the normally preferred route.

BEDEVILLED BY BENCHMARKS. Benchmarks often present problems. One of the big advantages of a value-added treasury centre is that extensive use of benchmarks becomes unnecessary. Benchmarking is an area which regularly produces contentious and protracted debate of a most unproductive nature. It is an issue

where the devil is in the detail and it is easy to get carried away with a design that becomes so complicated that it becomes no longer market related. I have seen some strange combinations of instruments, rates, periods, markets and the like that could never be replicated in the open market. Equally, treasurers usually have a headstart on their bosses when it comes to the implications of benchmark design. Of course, treasurers would never wish to design a benchmark with the flattering of personal performance in mind, but, if one wished to be unscrupulous, it is child's play to design a benchmark where outperformance is inevitable. The choice of a different instrument type, credit rating, maturity or liquidity characteristics in the benchmark compared with what treasury is actually expecting to access, with respect to either deposits or debt portfolios, are the obvious mechanisms.

In addition to such issues, benchmarking can become demanding of resource. In particular it usually requires shadow portfolios (of FX exposures, debt, investments and the like) to be maintained. Also the computation must be carefully controlled. For rapidly moving portfolios, the method by which yields are calculated in itself can produce big differences and the calculation is not always straightforward.

Whether management accounts or benchmarks, or some combination are used, the key weakness is that no methodology has yet been devised fairly to present opportunity gains and losses. Reports can only present actual results and potentially what the results might have been under different scenarios. Attempts to use such scenario analysis to highlight opportunity gains and losses can easily create scepticism that items have been cherry-picked.

QUALITATIVE MEASURES. The next area of measurement is the qualitative measures. The most obvious being simply whether the department has achieved its objectives and whether both the department and the treasurer has developed in the expected manner.

Relationships, both third-party relationships and within the group, can be assessed in terms of the impact the treasurer has had, such as on the quality of advice and communication. Managing expectations and talking a good book are issues that finance directors will always be on their guard against because they know that these qualitative measures are highly subjective and easily manipulated. Treasurers will feel that sometimes the evaluation is inappropriate and there are certain aspects of the treasury function where there is only downside for the treasurer. For example, if poor quality advice is given to subsidiaries, or if control weaknesses arise, these are bound to be highlighted and represent key career damaging negatives for the treasurer. Conversely, consistently giving good quality advice and running an efficient and well-controlled treasury are rarely attributes which in themselves are judged worthy of special reward. They are usually regarded as basic pre-requirements.

IN PRACTICE. Performance evaluation is an area where over-complication easily creeps in. Finance directors are wary of spending too much time and money measuring things. I will even admit that consultants are tempted to get carried away with theoretical perfection. In practice, most of the evaluation will depend on a mixture of simple performance measures, achievement against objective reviews, and the personal knowledge and relationship that the finance director has of and with the treasurer.

Not many wise FDs will paint themselves into a corner by agreeing detailed performance measures and linking these explicitly to remuneration. When it comes to bonuses, the FD will either have a view that the treasurer is worth rewarding or is not. Attempting to exploit the quantitative measures to try to justify a large bonus when the FD does not believe it is deserved is doomed to failure. Conversely, even the best treasurer will from time to time suffer a bad year. Nothwithstanding the underachievement of benchmarks, if the FD is clearly of the view that he or she is employing a brilliant treasurer then a bonus is unlikely to be cut.

FDs know the limitations of performance measurement and can generally recognise a good treasurer when they see one. While some treasurers may find a scientific link between performance measurement, personal evaluation and pay a compelling theory, in practice the organisation will behave in a less complex and much more pragmatic manner.

Derek A Ross is the Partner responsible for Treasury and Financial Markets at Deloitte & Touche. He is a past Chairman of the Association.
dross@deloitte.co.uk
www.deloitte.co.uk