



# Business briefing series

20 issues on the increasing significance of  
corporate treasury



LEADING TREASURY  
PROFESSIONALS



The Institute of  
Chartered Accountants  
in Australia



The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. The ACT defines standards, promotes best practice and supports continuing professional development. As 'the voice of corporate treasury' representing the interests of its members, the ACT speaks for the treasury profession and influences relevant law, regulation and market practices.

The ACT is a member of the International Group of Treasury Associations (IGTA) and the European Association of Corporate Treasurers (EACT). ACT membership comprises over 4,300 individuals (including representation in 89% of the UK-FTSE 100) and over 2,100 students in 70 countries.

From its head office in London, the ACT provides a wide range of professional development and networking opportunities centred around:

- Professional qualifications and training courses delivered via distance learning and tuition centres
- Conferences, briefings and thought-leadership events
- Publications, technical updates, guidance and dialogue.

The ACT works in partnership with leading accountancy bodies from around the world to offer a fast-track programme for qualified accountants who wish to gain the AMCT Diploma in Treasury. In the UK, the ACT's partners include:

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Chartered Institute of Management Accountants (CIMA)  
Institute of Chartered Accountants in England and Wales (ICAEW)

Institute of Chartered Accountants of Scotland (ICAS)

The ACT is a not-for-profit organisation that encourages and facilitates collaborative networking and knowledge sharing in the world of treasury and business finance. For further information about the ACT, visit **[www.treasurers.org](http://www.treasurers.org)**

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**The Institute of  
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The Institute of Chartered Accountants in Australia (the Institute) is the professional body representing Chartered Accountants in Australia. Our reach extends to more than 67,000 of today's and tomorrow's business leaders, representing more than 55,000 Chartered Accountants and 12,000 of Australia's best accounting graduates currently enrolled in our world-class Chartered Accountants postgraduate program.

Our members work in diverse roles across commerce and industry, academia, government and public practice throughout Australia and in 109 countries around the world.

We aim to lead the profession by delivering visionary leadership projects, setting the benchmark for the highest ethical, professional and educational standards, and enhancing and promoting the Chartered Accountants brand. We also represent the interests of members to government, industry, academia and the general public by engaging our membership and local and international bodies on public policy, government legislation and regulatory issues.

The Institute can leverage advantages for its members as a founding member of the Global Accounting Alliance (GAA), an international accounting coalition formed by the world's premier accounting bodies. With a membership of over 800,000, the GAA promotes quality professional services, shares information, and collaborates on international accounting issues.

Established in 1928, the Institute is constituted by Royal Charter.

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# Business briefing series



## 20 issues on the increasing significance of corporate treasury

Corporate treasury plays a critical function in most businesses, though many are unaware of how broad a scope it covers. It can incorporate a number of different aspects relating to providing finances for an organisation. These could include cashflow management, investments and loans.

Over the last few years, treasurers' roles have become even more complex and challenging as they try to source and secure funds for their organisations in a volatile economic climate.

With this in mind, the Institute, together with the Association of Corporate Treasurers in the United Kingdom have compiled our latest Business Briefing, *20 issues on the increasing significance of corporate treasury*, designed to shed some light to members on how the treasury function operates and what to consider when performing it.

The publication discusses areas including:

- Governance
- Corporate funding
- Cash management and liquidity
- Risk management.

This Business Briefing is the seventh in our Business Briefing Series, which are designed to offer business leaders and financial professionals guidance in overcoming many of the challenges faced in the business world. Other publications in the series are available at [charteredaccountants.com.au/businessbriefing](http://charteredaccountants.com.au/businessbriefing).



**Craig Farrow FCA**

President  
Institute of Chartered Accountants in Australia



# The ACT in India



**Dr. Paritosh Basu** has served the corporate world for about thirty-four years. He was the Group Controller of Essar Group till June, 2013, preceded by the CFO of Reliance Communications Ltd. till August, 2008. Presently he is a full time Senior Professor of the School of Business Management, NMIMS University, Mumbai and engaged in many research and consulting activities.

He holds a Master degree and was awarded Ph. D. on 'Transfer Pricing' by the Calcutta University in 1999. He is a fellow member of both the Institute of Chartered Accountants of India and the Institute of Cost Accountants in India.

Dr. Basu's experience in MNCs spans over a wide spectrum of functional areas, across continents and countries.

- Corporate finance, treasury, strategic planning and controlling, accounting and reporting under IGAAP and IFRS, risk management, governance, management audit, etc. in MNC and conglomerate environment,

- Mergers and acquisitions, restructuring, IPO and listing in overseas and domestic stock exchanges, FCCBs and other overseas loan market transactions,

- Extensive IT enablement of operations, accounting, and reporting with multiple systems development and integration. One of his software is presently under the process of patent registration in India and the USA; and

- Mentoring, learning management, teaching and training.

Finance professionals in India are increasingly recognising corporate treasury and its core activities as a universal key enabler for successfully implementing business strategies and driving shareholders' value. They are very keen to bring in specialised professional knowledge completely focussed on cash and liquidity management, corporate financial management, funding, gainful investment of temporary surplus funds, currency exchange and treasury risks management, etc. Treasurers in India are fully convinced that professionally managed treasury operations and controls with the right skill sets can immensely contribute towards minimisation of value destruction and facilitate the process of innovative value creation.



Research activities, conducted by the Association of Corporate Treasurers (ACT), reveal that treasury professionals in India want to establish this function as a profit centre. It is their strong conviction that specialised knowledge and skill sets are absolutely imperative for them to acquire. This will help in meeting the challenges of governance, risks and compliance (GRC) oriented operations in contemporary business ecosystem, where clutches of regulatory oversights are increasing day by day and market volatilities and uncertainties will continue to be a part of the game. They are also completely conscious that treasury professionals need a distinguished identity in the crowd of finance professionals.

The worldwide financial crisis of 2008 and its aftermath have heightened the profile of the treasury function, increasing its influence and perceived value within organisations. More than ever, corporate treasurers and those engaged in treasury are relied upon by their CFOs, boards and other members of their organisation's management team to source efficient, innovative financial solutions to facilitate the business strategy and to manage its risks. Bankers, qualified in corporate treasury, are also increasingly being relied upon to understand and anticipate customers' needs, to efficiently sell such products and solutions with win-win strategies for both, and to minimise risks to the Bank. Organisations that take a progressive and distinguished functional approach to treasury operations see it not as a discrete finance function or just another link in the management chain, but as an end-to-end activity that is fully embedded in the business.

In an increasingly prominent and essential space within the domain of the CFO of large and medium-sized Indian enterprises, the corporate treasury function is day by day assuming a critical role. Such a trend is also being perceived in all emerging nations and developing countries. Let India lead them, particularly at this juncture when Indian MNCs are spreading their business wings all over the world.

The corporate treasury function has been described as the 'heartbeat of the business', and it can assist in various forms of improvements in the financial management of Indian enterprises. The quality of knowledge and skills of financial managers of different levels in delivering solutions to the financial and debt crisis has considerably increased in importance since 2007 and continues to grow.






The ACT, as the chartered body for the corporate treasury profession, in collaboration with the Australian Institute of Chartered Accountants, the ICAA, has issued this business briefing note, which examines 20 topics in the five core areas of corporate treasury, to highlight its growing importance.

The handbook will be useful to businesses across all sectors of the Indian economy, whether focused domestically or internationally. Its contents are particularly relevant at this time of heightened uncertainty, economic and business challenges, and accelerating pace of change.

For senior management the handbook can serve as a guide for benchmarking their own treasury and provide suggestions for how it can be better organized. It offers professionals in India the opportunity to compare their treasury organisation against benchmarked good practices around the world.

ACT has already conducted exploratory discussions with organisations such as Institute Chartered Accountants of India, Indian Institute of Banking and Finance, and large banks both in public and private sectors. ACT has also obtained considered views, comments and guidance from the CFOs of some large Indian Corporate Houses. The objective is to bring to India specific perspectives and focus to its distance learning programmes. Readers can learn more about ACT's four tier professional treasury education and certification programme at **[www.treasurers.org/qualifications](http://www.treasurers.org/qualifications)**.



We do hope that this will help and guide Indian business houses to better meet challenges, convert threats into opportunities and manage their finances, risks and all other treasury functions, to grow value for investors, employees, trading partners and the community at large. We welcome your thoughts and comments so please join the ACT's India LinkedIn Group, **[www.treasurers.org/linkedin/india](http://www.treasurers.org/linkedin/india)** and kindly give us your feedback and suggestions.

**Dr. Paritosh Basu**





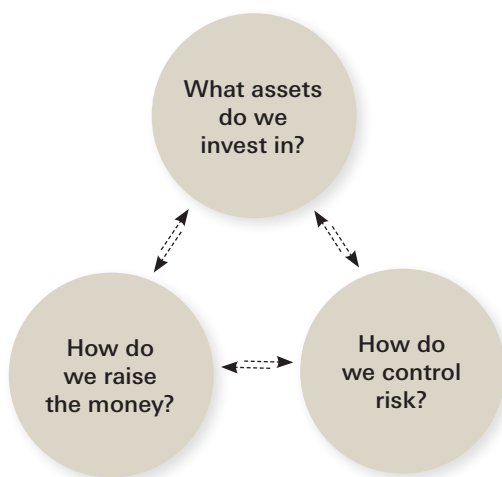
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# Introduction: A new business landscape

Every organisation faces treasury issues, even if it does not have an identified treasury department. Treasury issues are both strategic and operational. It is important to consider them in an integrated way. Financial strategy and business strategy together form corporate strategy. Financial strategy depends on the business strategy – but business strategy is enabled or constrained by the financial strategies available and by the chosen financial strategy.

There are three interrelated questions key to treasury decision making:



Financing possibilities for an organisation such as a utility are different from those for another organisation – for example, a confectionary manufacturer. The time-horizons to be taken into account and the risks are different too – both those from the businesses and those from the financing chosen. Indeed, it is not possible to take decisions about any one of the key questions without influencing and taking account of the answers to the two other questions; they are interdependent.

‘Investing’ is any use of resources for future benefit. It covers not only acquiring property, plant and equipment and M&A or intangible property like patents and know-how and brands but R&D, staff training and marketing programs.

Importantly, the answers to all three questions are also very contingent on external realities of countless kinds. The interrelationships of those contingencies and the three questions are usually too complex to be completely known or analysed. Accordingly, we are in an area where judgement is required – from the outset and as conditions change.

At the strategic level, treasury is about advising on appropriate choices, the trade-offs and compromises involved and when new decisions are needed. These key strategic issues are the concern of an organisation’s Board: directors must be comfortable with and buy in to what the organisation does.

What are the financial criteria for investing? It boils down to whether the investment will earn enough to cover the cost of funds and compensate for the risks involved.

An organisation needs to know how much money it has available to invest and how much more it could raise, on what terms and at what cost, and from where.

Raising the funds is the responsibility of treasury. Treasury needs to consider a number of questions, for example:

- Is additional finance raised as equity, debt, a hybrid or a combination?
- Does what is being invested in lend itself to asset-based finance? Could it be rented or leased and at what cost?
- Are there other existing assets that would be more easily financed, releasing funds for the new investment?
- To what providers of funds does your organisation have access?



Another question treasury needs to consider is about risks. The organisation's risk management will concern providers of funds. Questions include:

- Are the cash-flow impacts of servicing and, except for equity, eventually repaying the funding and any other conditions of the funding (e.g. covenants and default wording) acceptable or manageable for the organisation and for the providers of the funds?
- Are the risks from the investment itself acceptable, as compared to the business it contributes?
- Is the overall business risk, including the total funding and cash flow risks, as a whole acceptable or manageable for the organisation and the providers of funds?

A lot of judgement is involved. Getting it wrong may be sub-optimal or even existential for an organisation.

Identifying and managing some of those business risks, or arranging for the business to adapt to make the risks manageable, is also a part of the treasury brief. Particularly this applies to financial price risks or risks manageable in similar ways – interest rates, exchange rates, commodity prices, some catastrophe risks, as well as others such as inflation, in some businesses. Using financial contracts, both cash and derivative, provides time for business adjustment to changes if they persist.

Some of these risks will be managed through decisions about the business, for example, where a new plant is built will affect the currency exposures arising and, perhaps, the financeability of a project or the security of supply of input commodities. Sourcing decisions and flexibility in sourcing on materials or components or finished goods will also affect these issues.

Other risks will not be subject to such structural solutions but will require attention to contractual matters such as the pricing formulae in contracts: for example, are there adjustments for interest or exchange rate or commodity price changes?.

These activities, with the day-to-day funding and investment of surpluses, make up treasury operations.

Each of the 20 treasury issues begin with a diagnostic questionnaire that highlights some of the key issues a senior business leader should be thinking of. The questions are also consolidated into two pages at the back of the paper for quick reference and to enhance practicality. If the answer to a question is "no," then this is a prompt to ask further questions and/or take action. Very few questions, if any, should be not applicable.

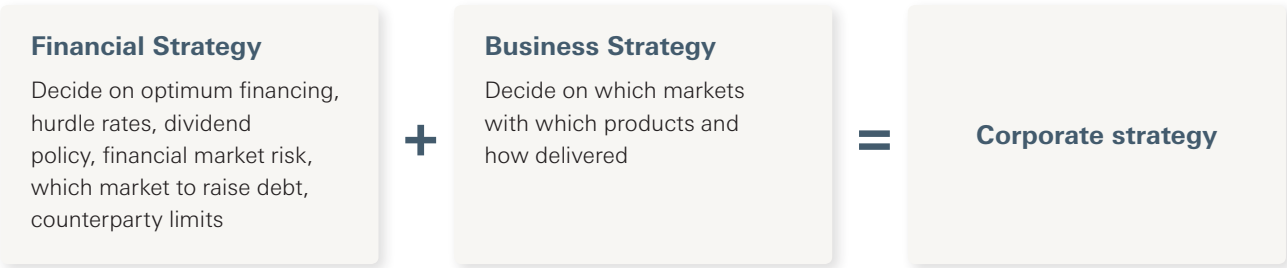
# Governance

## 1. Treasury’s role and objectives

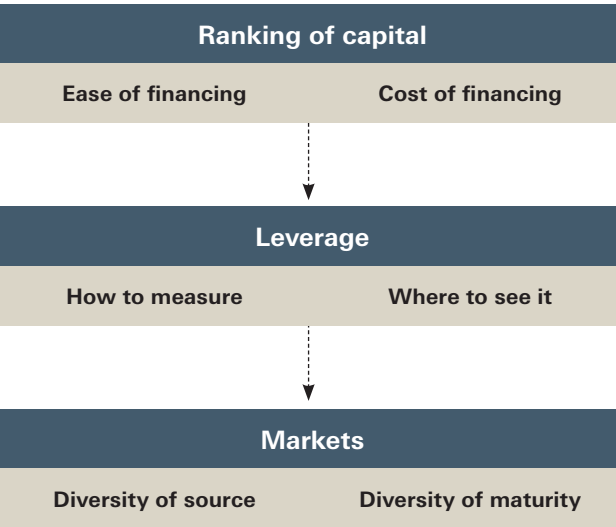
- ☐ Are treasury’s roles and objectives clearly defined and aligned with your organisation’s objectives?
- ☐ Is the financial strategy articulated and integrated with your business strategy?
- ☐ Has the Board’s risk appetite been quantified and clearly communicated to treasury?
- ☐ Do the Finance Director, Audit Committee and the Board of Directors as a whole understand the treasury issues and do they enjoy open lines of communication?

Treasury plays a key role in determining the organisation’s financial strategy, working out how to finance the business strategy and how to manage the risks that follow from this. Treasury therefore needs to contribute to the mix of business and financial strategy, namely the corporate strategy, by setting out what is possible financially, at what cost and with what risks as the business and the environment develop. In order to do this, the treasurer needs to feed into the business plan process. If, for example, the growth plan cannot be funded, the treasurer needs to advise senior management and perhaps suggest phasing the plan in over a longer time period.

## The inter-relationship between financial strategy and corporate strategy



## The financial strategy judges optimal financing based on the following three factors:



Operational aspects of treasury derive from the financial strategy. Overall financing and risk management guidelines deriving from the financial strategy set the general approach to funding, managing currency and interest rate risks, investing surplus funds, setting counterparty limits etc, enabling creation of treasury policies. From these derive the approach to treasury, such as degrees of centralisation, services offered and whether it will be cost/risk or profit centres.

Quantification of risk appetite by the Board is not always easy. The potential impact on the financial statements, such as the Board’s maximum acceptable profit and loss is one possible measure of risk appetite. To assist the Board in understanding its risk appetite, the treasurer will need to model various scenarios such as interest rate and foreign exchange rate movements, to calculate the potential profit and loss impacts. Stress testing outcomes should also be undertaken.

## 2. Treasury policy

- ☐ Is treasury policy aligned with financial strategy (itself part of corporate strategy) and the approach to risk?
- ☐ Is treasury policy approved by the Board and reviewed at least annually?
- ☐ Does the treasury policy set limits for each financial risk?
- ☐ Is adherence to treasury policies reviewed by the Board and independently audited?

All properly managed treasuries have a written treasury policy with a process to manage regular updates. Treasury policy is a mechanism by which the Board and management can delegate fundamental financial decisions about the business in a controlled manner. It should give treasury staff written guidelines on what they are responsible for, how they should go about their responsibilities, what their boundaries are and how their performance will be measured. These can be developed in formal procedures.

As an example, for each financial risk, the treasury policy document should explain:

- What is the risk and why is it being managed, taking into account the organisation's risk appetite
- Risk management objectives which should reflect the organisation's goals, risk appetite and sources of risk for the specific business and the economic environment in which it operates
- Risk measures which will be used to set target outcomes or ranges of outcomes and measure the likelihood of those outcomes (this may include sensitivity analysis with indicative probabilities attached)
- Procedures for the day-to-day management of risks, including:
  - The delegation of responsibility for managing risk
  - How treasury will relate to business operations where risks are being managed
  - Risk targets and limits based on an acceptable level of risk, adapted as the organisation grows
  - Performance reporting/feedback mechanisms.

The Board has ultimate responsibility for risk management and for approving risk policies. In many larger organisations, risk management tasks are delegated – but not abandoned – to a sub-committee of the Board, often called the Risk Management Committee (RMC). However it is the treasury function that proposes the policies and ensures the approved policies are followed.

## 3. Qualified personnel

- ☐ Is your treasury team adequately educated/qualified/trained and supported at each level?

Treasury differs from other finance roles, with an emphasis on cash, risks and markets. The complexity of instruments, systems and interactions with the business, both operationally and strategically mean some of the skills needed for treasury are specialised and demanding.

Many markets have become more difficult and expensive since the credit crisis. Wider risk awareness within organisations means more colleagues interacting with treasury, often wanting to take very long-term views in planning business development. Treasurers can, day-to-day, undertake transactions which have risks their Board and operational colleagues may not, initially, fully understand. The treasurer should be able to articulate these risks as and when required.

In smaller organisations, or where treasury is more decentralised, staff may carry out treasury functions on a part time basis. Emphasis may then be on training in treasury procedures rather than wider education. Subsidiaries in a group will need help from the group centre. In small organisations, some senior level familiarisation with treasury issues is important to be alert to the need to secure bought in or temporary advice from time to time.

Organisations without specialist derivative product and financial risk knowledge are at greater risk of being mis-sold overly complicated or inappropriate derivatives by banks. Numerous case studies exist of organisations suffering multi-million dollar losses as a result of badly chosen derivatives, such as Metallgesellschaft in oil futures and Procter & Gamble in interest rate derivatives.

The Association of Corporate Treasurers was created to provide education and support to those involved with corporate treasury.

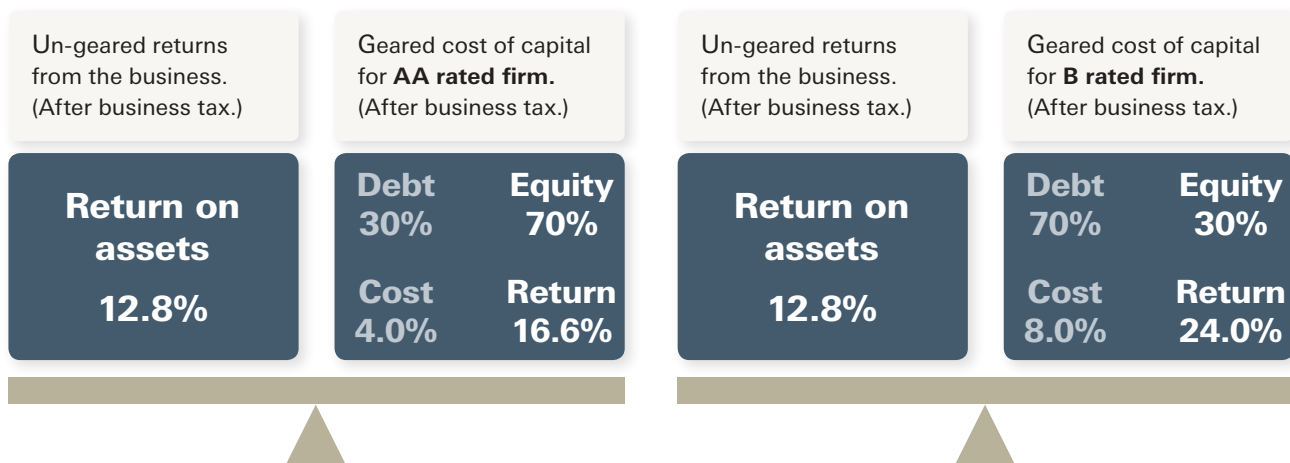
# Corporate funding

## 4. Capital structure

- ☐ Has the Board agreed a target gearing for your organisation?

Organisations raise capital externally or generate it internally. The choice is between debt and equity capital, though there can be hybrids. The proportion of debt is called gearing or leverage and the optimum level depends on risk and return. Tax may be a consideration for some organisations.

### The effects of gearing/leverage



Corporate finance theory and market practice provide many techniques to help choose a target debt/equity ratio. Few organisations actually choose to be of B rating, though AA rated organisations are few.

Riskier businesses or those with shorter-lived assets borrow shorter term if at all: perhaps a season or a year or five. Organisations with more stable flows and longer-term assets borrow proportionately more. For example, a high rise building may be 65% debt financed, out to 30 years: supposedly reliable rental income services debt and equity. Many businesses lie between these extremes.

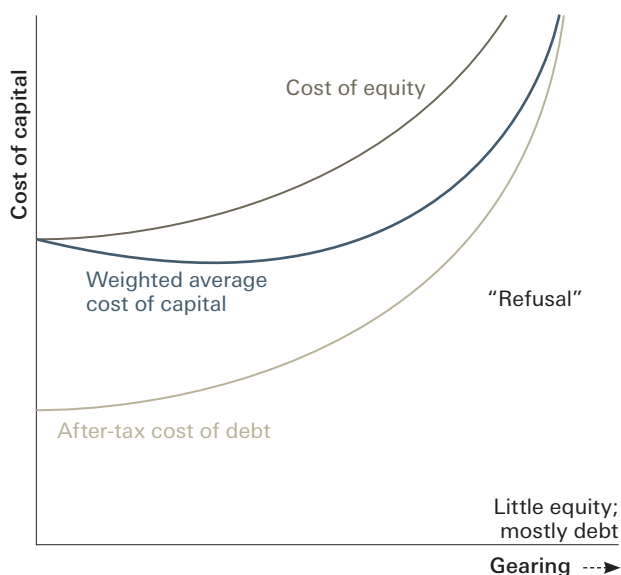
More debt increases return on equity i.e. the cost of equity to the organisation, which classically is offset by the increased amount of the relatively cheaper debt. If the return on assets is unchanged, when moving from AA rated (less debt) to B (more debt), we might find the effects shown below<sup>1</sup>:

A non-cash cost of debt is some loss of control by shareholders: covenants in lending contracts can cause constraints; ultimately, lenders can take control. This is too risky for organisations with high real option values dependant on further development by scarce experts, such as technology start-ups, so they avoid debt.

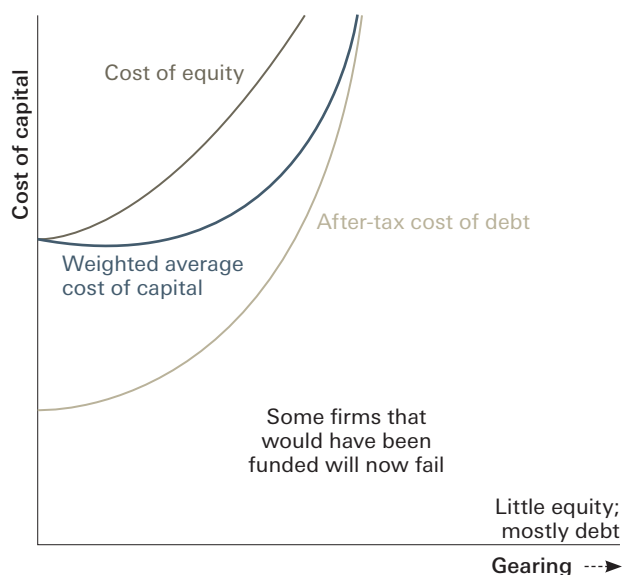
An organisation needs capital to fund its present assets and its planned future development and to absorb the cash flow effects of responding to unexpected shocks (internal or external). Equity is the best shock-absorber. Debt funding normally involves eventual repayment – from business cash flow or from new fund raising of debt or equity.

<sup>1</sup> Calculations based on Moody's 2006 (i.e. pre-financial crisis) median observed ratios for North American non-financial services firms at book values. Interest rates from Towers Perrin and ACT estimate.

**'Optimal' debt/equity levels ('gearing' or [US] leverage)**



**'Squeeze' or panic**



Curves are intended to show the idea, not represent the cost of any particular company

As shown in the diagram above, the cost of funding – weighted average cost of capital – increases with increasing gearing (as well as the riskiness of the business strategy). At some point, investors become concerned about return of capital not return on capital: new funds are refused whatever the price offered. In squeezes and panics, refusal is at much lower risks, i.e. gearing, leaving some organisations that were previously financeable, unfinanceable.

However some organisations choose high leverage: structured finance, project finance and private equity deals – often risky ventures for all parties. They might use hybrid instruments with features of debt and equity.

(See Issue 5 on Funding, overleaf.)

## 5. Funding

- ☐ What funding options does your organisation have?
- ☐ Over what time horizon does your organisation need to plan financing?
- ☐ Will your organisation be able to use the going concern assumption in your accounts as specified by IAS 1 (AASB 101)?
- ☐ Is there adequate headroom (size and maturity) relative to funding needs?
- ☐ Does senior management attach appropriate importance to negotiating the least restrictive covenants compared to the cost of funding?

The availability of funding when required cannot always be relied upon. Bond markets are more liquid and more reliably open for higher credit-standing organisations, while high yield bond markets come and go. Banks' risk appetite varies which can impact the industries, credit standings, and even geographical regions they are willing to lend to. Organisations need to plan new fund raisings ahead of need, to diversify sources of funding and to "warm up" potential investors and lenders in advance. Few organisations with choice would leave refinancing

significant outlays or debt maturities to the last eighteen months before the requirement matures. Indeed IAS1 (AASB 101) requires organisations to assess their access to adequate financial resources looking forward at least twelve months. Rather than relying on finding new finance at a particular time, investment grade organisations tend to hold liquidity in the form of cash and short-term investments.

Some assets lend themselves to dedicated finance, often called asset based finance, while some items can be leased instead of owned. Some assets are good security for a provider of acquisition funds – land and buildings, expensive equipment. On the working capital front, invoice discounting or factoring (sale of receivables) can be useful, but it must be noted that the more asset based finance an organisation uses, the less remaining asset value supports credit taken from other lenders, trade creditors and unpaid salaries, and this can change the attitude of those creditors.

An old saying, 'fund early and fund long' remains true. Organisations need to work harder than ever on their funding relationships – not just bank relationships, but all potential sources of funding such as private placement debt and asset based finance. Funding plans need to explore all options and think outside the box.

	Equity	Bonds	Bank debt
Return of funds	<ul style="list-style-type: none"> <li>No obligation to return funds</li> </ul>	<ul style="list-style-type: none"> <li>Bonds must be repaid upon maturity</li> </ul>	<ul style="list-style-type: none"> <li>Bank debt must be repaid upon maturity</li> </ul>
Relative cost	<ul style="list-style-type: none"> <li>High</li> </ul>	<ul style="list-style-type: none"> <li>Low</li> <li>Fixed interest rate</li> </ul>	<ul style="list-style-type: none"> <li>Low</li> <li>Almost always at a floating rate</li> </ul>
Information disclosure	<ul style="list-style-type: none"> <li>Quoted companies public, formal disclosure</li> </ul>	<ul style="list-style-type: none"> <li>More private, even for a public bond issue</li> <li>Private placements are more private still and suitable for smaller issues</li> </ul>	<ul style="list-style-type: none"> <li>More private than equity and bonds but amount of information high, even including business plans</li> </ul>
Covenant requirements	<ul style="list-style-type: none"> <li>None</li> </ul>	<ul style="list-style-type: none"> <li>Investment grade bonds have fewer conditions and generally no financial covenants</li> <li>Sub-investment grade bonds have more covenants</li> </ul>	<ul style="list-style-type: none"> <li>More covenants and more onerous even for investment grade borrowers</li> <li>Easier and cheaper to discuss amendments with banks than with possibly unknown bond holders</li> </ul>
Flexibility of usage	<ul style="list-style-type: none"> <li>Poor</li> </ul>	<ul style="list-style-type: none"> <li>Fairly poor</li> </ul>	<ul style="list-style-type: none"> <li>Good</li> <li>Amount can be drawn and repaid at will in revolving facilities as opposed to a term loan</li> </ul>

## 6. Own credit risk

- ☐ Have you presented your credit story accurately to stakeholders including investors, customers, suppliers, credit insurers and analysts?
- ☐ Do you have good cashflow projections, business plans plus stress tests for various downside scenarios, but showing the mitigating measures that would be deployed?
- ☐ Are your financial ratios running at an appropriate level and if not, can you adjust your capital structure or business risk profile?

Presenting and explaining your own organisation's credit standing to external parties will influence their willingness to do business with you and the terms they will demand. This applies to your suppliers, your lenders and lessors. Even your customers will want to assess the likelihood that you will still be in business to honour your commitments in the months and years ahead.

Larger organisations that issue publicly traded bonds may have a formal credit rating from international credit rating agencies, but almost all organisations will find they have been assessed by a credit reference agency. These latter organisations perform a fairly mechanised analysis of publicly available information such as annual accounts, invoice payment histories and court orders.

Credit analysis will start with an organisation's historical performance supplemented with forecasts and projections and perhaps an audit of assets. For those forecasts to have credibility the analysts will want to build up confidence in both senior management and strategy as well as the financial flexibility of the company.

The business plan and cash flow should be stress tested in a variety of scenarios to demonstrate compliance with loan covenants and other limiting factors. Credit analysts focus on how the potential downside risks are controlled and are less interested in outperformance on the upside, which are more the domain of the equity analysts.

Treasurers need to understand how their organisation looks to a lender, including not only their credit profile but also the economic business case where lending is part of a wider relationship.

# Cash management and liquidity

## 7. Liquidity and cash forecasts

- ☐ Does your organisation produce short-term, medium-term and long-term cash forecasts?
- ☐ Does treasury use all the forecasts?
- ☐ Do the forecasts coincide with the cash management structure so that the actual cash in bank can be easily tied back to the forecast?
- ☐ Is liquidity risk assessed by sensitivity or scenario analysis?

Liquidity management is the most fundamental element of treasury management — if it fails, the organisation cannot continue to function, and all other decisions, no matter how important, cannot proceed.

Liquidity is an organisation's ability to pay its obligations where and when they fall due and its ability to source additional funds to meet its obligations. Cash management is a tool of liquidity management – it being the physical day-to-day management of cash – so that those obligations can be met. An organisation with little cash can remain liquid as long as it has an ability to borrow. Cash forecasts are therefore a key component of a liquidity strategy, with the treasurer often looking forward over several timeframes to manage liquidity properly.

Key tools for managing liquidity are:

- **Cash management**, through cash generated by business operations, cash surpluses retained in the business and short-term liquid investments. (See Issue 8 on Cash Management)
- **Working capital management**, by managing supplier payments, receivables and inventories to optimise the investment in working capital. (See Issue 10 on Working Capital)
- **Organising and managing borrowing facilities** using cash flow forecasts, building in planned/required new funding.

Liquidity risk can be analysed by time frame:

- Operational liquidity risk focuses on the short term needs from day-to-day operations
- Strategic liquidity risk focuses on longer term risks, the need to ensure that the business can continue and can support changing business plans in the future. (See Issue 5 on Funding).

Short term forecasts are usually driven by the receipts and payments data from sales and purchase ledgers, interest and tax information, not by profit/performance reporting. They are generated from the day they are created until approximately 30 days later. While those in highly geared

or volatile businesses value them heavily, some treasurers in cash rich or cash generative businesses do not use short term forecasts. However, the need to optimise investment of surpluses means more companies require them today.

Medium term forecasts often extend to a 'rolling' year. These allow the planning of 'big ticket' items such as capital expenditure, tax and dividend payments, and feed in to some aspects of forecasting compliance with financial covenants.

Long term forecasts are an essential tool to identify trends and overall cash generation or consumption over time. They are usually driven from plan data prepared by management accounting and the timescale will typically extend from one year's time up to three, five or 10 or more years.

In many organisations, cash forecasts are not performed well. They are often too long, too short, not used or are consistently inaccurate. From a practical perspective, the treasurer should calculate the accuracy by comparing actual data to forecasts and providing feedback to material business units providing the source data.

## 8. Cash management

- ☐ Do you have day-to-day visibility of bank account balances?
- ☐ Do you have an efficient bank account structure (such as inter-company netting, cash pooling)?
- ☐ Are surplus funds or short-term borrowings being optimally invested or utilised?

Cash management is part of managing liquidity (See Issue 7 on Liquidity and Cash Forecasts above.)

It is a treasurer's task to ensure that cash flows (receipts and payments) throughout the business are processed as efficiently and as safely as possible. Optimising bank charges and float (the time that a transfer is 'in transit') can save considerable amounts of money. One way of doing this is through notional pooling or cash concentration structures. Cash concentration, also referred to as zero balancing, is the physical netting of fund positions across bank accounts resulting in the offset of interest income and expense. Notional pooling has the same resultant offset of interest, however the bank creates a shadow or notional position from all participating accounts and there is no movement of funds involved.



Cash management includes:

Day-to-day cash control (including intra-day where necessary)	Having the information to monitor bank account balances and the tools to manage liquidity to ensure that the organisation has enough cash or near cash resources to meet its immediate obligations.
Money at the bank	Having an efficient bank account structure that minimises borrowing costs, maximises interest earned and facilitates liquidity management.
Receipts	Having an efficient bank account structure for collections and an efficient infrastructure for managing items in the course of collection.
Payments control	Having an efficient bank account structure for making payments, routine or urgent, together with appropriate systems support.
Short-term investments	Optimising the use of surplus funds with short term investments.
Short-term borrowings	Optimising the use of short-term borrowing facilities.

Inter-company payments are a traditional source of lost liquidity and inefficiency, from float to foreign exchange costs and bank charges. Netting systems can significantly reduce these inefficiencies, especially for cross-border transactions.

Aggregation of external payments and collections is a way for organisations to make best use of systems, expertise and economies of scale. Payment factories, collection factories, in-house banks and shared service centres are all tools using these and other techniques.

## 9. Counterparty risk

- ☐ Have credit limits been set by counterparty?
- ☐ Have limits been set by rating bands?
- ☐ Have limits been set by instruments?
- ☐ Is total exposure by counterparty calculated regularly?
- ☐ Is there a procedure to react to changes in counterparty risk?

Credit risk arising from exposure to banks and other financial counterparties is often much larger than credit risk from an organisation's sales. Before 2008, some organisations paid scant attention to this, regarding banks as safe. Times have changed since the global financial crisis in 2007 and 2008: corporations have more cash and some banks have become weaker.

Credit risk with financial institutions does not just arise from deposits. It can be found in many places including:

- Cash on local deposit by particular group subsidiaries
- Cash in the process of collection through any medium such as cheques, wires, Automated Clearing Houses, or cards
- Cash in set off arrangements such as notional pooling and concentration systems prior to final concentration
- Derivative contracts in the money
- Letters of credit and bank guarantees receivable (and the risk of needing replacements for those out-bound in issue by a failed bank)
- Custodianship arrangements for investments
- Under general set-offs under contract or in local bank/ financial institution resolution (insolvency) practice.

When managing credit risk in investing, the treasurer's mantra is 'SLY': Security first, Liquidity second, Yield last. Yield can only be increased by taking on more credit risk or reducing liquidity. Diversification from single banks to other counterparties, such as governments, corporate commercial paper, or money market funds, improves an organisation's risk.

Counterparty analysis often starts with credit ratings. These can often be slow to change. In addition to reading ratings reports, (including outlooks,) the treasurer should look at stand alone domestic and foreign currency ratings, as well as those after assuming government support. Also important to consider is the ratings of governments' ability and willingness to support their banks. 'Market Implied Ratings' can be very useful, as can share and bond price movements (and equivalent credit default swap [CDS] pricing – though CDS prices reflect much more than a debtors' credit standing). Each of these can be used as triggers to suggest a change in credit limits: the treasurer must be able to reduce limits without further referral.

Credit Support Annexes (CSAs) can be used to manage the credit risk arising from International Swaps and Derivatives Association (ISDA) derivative contracts. A CSA collateralises the variation risk (in both directions) on derivatives, however there are still settlement risks.

10. Working capital management

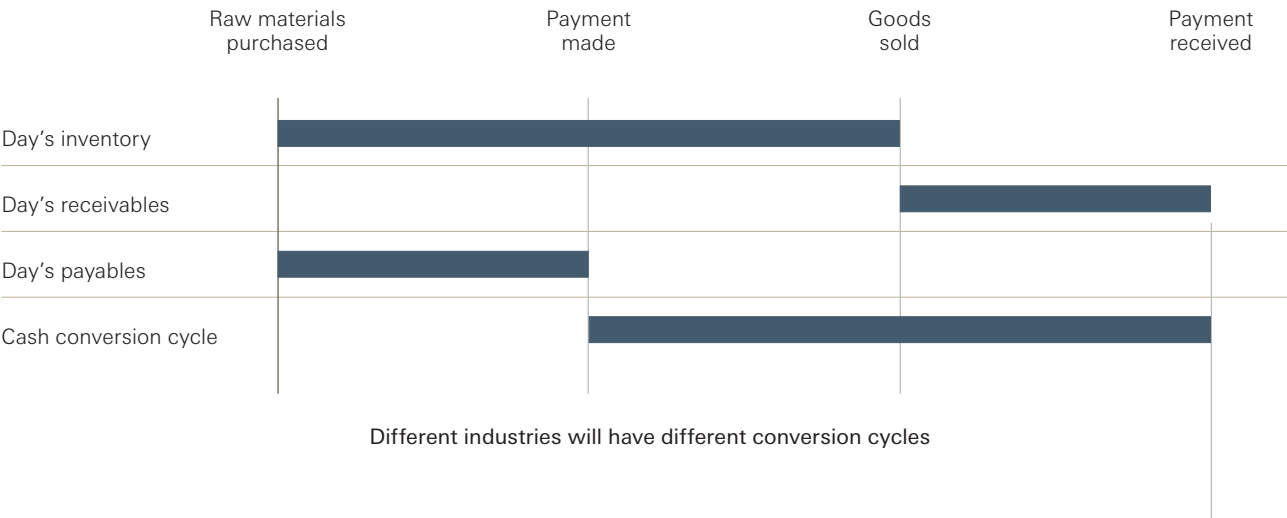
- ☐ Does your working capital management involve a multidisciplinary team from procurement, sales and treasury?
- ☐ Does your treasury have good oversight and have effective influence over working capital?

Working capital investment is part of doing business, which treasury needs to factor into its cash forecasts and funding plans. Higher working capital may ensure supply and boost sales and service levels, but at a cost. Lower working capital can reduce dependency on borrowing.

Working capital is, broadly, stock and work in progress plus debtors less creditors. It and the cash conversion cycle can be controlled by adjusting the levels of stockholding, creditor payment periods and the speed of collection of cash from debtors.

Cash conversion cycles differ. In a food supermarket, for example, buying stock for almost immediate cash sale, cash may inflow before suppliers have been paid. This is a negative cash conversion cycle. In other industries, where stock does not expire, supplier payments may occur long before cash from sales is received.

Cash conversion cycle



Targets and key performance indicators (KPIs) based on simple Days Payable Outstanding (DPO) and Days Sales Outstanding (DSO) tell only part of the story and are tricky to compare between organisations, each of which has its own unique characteristics. Optimal working capital levels balance: cost and availability of funding; credit risk in the supply chain; certainties of supply; the optimisation of stock; the appropriate sales finance; and competitors' positions.

Simply delaying supplier payments may make your organisation a lower priority customer, affect prices, or even push suppliers into financial difficulties, which could threaten supply chain security. At the receipts end of the cycle, the process for sales and credit terms is crucial in ensuring payments are made when required.

Optimising working capital needs a coordinated, multidisciplinary approach – a cooperative approach between business functions that involves finding solutions to shared problems or opportunities. Operational and funding issues will have different priorities at different points in the economic cycle or the life of an organisation. Treasurers essentially need to know about working capital for cash and financing planning. Their knowledge of the various ways of financing different elements of working capital mean they are able to play a positive role in this process.

# Risk management

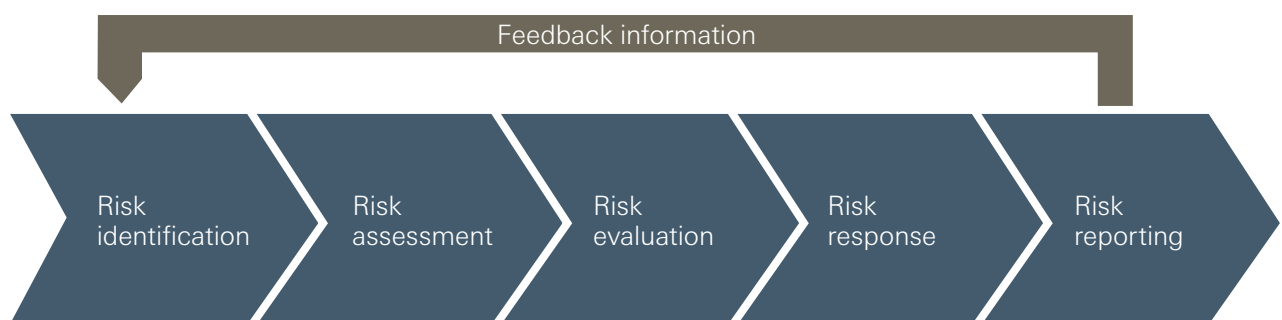
## 11. Risk management framework

- ☐ Are there policies and procedures in place to consider the risk capacity, tolerance and appetite for risk in the organisation and has this been communicated widely?
- ☐ Is there a proper risk management framework in place to address the financial risks faced by the organisation?

Having established a budgetary approach to treasury, a risk management framework will provide a mechanism to develop an overall approach to financial risks across the entire group by creating the means to discuss, compare, evaluate and respond to these risks. It can be seen as a series of successive phases. A useful framework is shown below:

The treasurer must be aware of the overall approach of the organisation to risk management, and be able to answer:

- Is there capacity to take certain risks?
- If so, is there an appetite?
- How much of this appetite can be taken in treasury?



Risk Identification	Identification and classification of an organisation's risk exposures and their sources.
Risk Assessment	An initial assessment of the likelihood of each risk occurring and of its potential impact together with the prioritisation of those significant risks for further analysis, evaluation and management. A useful way of assessing risks systematically is with a risk map or probability/impact matrix.
Risk Evaluation	The evaluation or quantification in more depth in priority order to establish the probability and extent of potential loss both for single risks, and groups of risks combined and consideration of non-calculable risks (uncertainties). Evaluation techniques include scenario analysis, sensitivity analysis, Value at Risk, statistics, and maximum loss. For some risks, often called uncertainty, there can be no statistical approach, for example, liquidity risk. In these cases, non-statistical evaluation is key.
Risk Response	<p>After risk evaluation, risk response can be planned and implemented. Each organisation's corporate goals, risk appetite and risk sources are unique and will lead to a different risk response for each company. Risk responses can be categorised into four classes:</p> <ul style="list-style-type: none"> <li>• Avoid the risk if the organisation is not expected to take it</li> <li>• Accept the risk and retain it (if it is immaterial or investors expect the organisation to take the risk or it is unavoidable)</li> <li>• Reduce the risk (probability or its impact) by internal action such as internal controls or diversification and by contingency plans</li> <li>• Transfer the risk to a third party via insurance, derivatives, or the use of subcontractors.</li> </ul> <p>Risk policy statements are used to document the risk response. (See Issue 2 on Treasury Policy)</p>
Risk Reporting	Reporting helps ensure that risks are being managed as agreed and information is fed back in to the risk management process. (See Issue 12 on Risk Reporting)

### Approach to risk management in treasury

Corporate finance theory suggests that the value of an organisation can be increased if its risk is low.

Speculation is the act of deliberately taking on risk, or hedging a risk that you don't have. Risks arising within the organisation to enable part of the business, or within strict limits (such as credit risk or liquidity in investing surplus funds) are acceptable. Anything else is speculation and should be prohibited in corporate treasury. Inaction, deliberate or inadvertent, is also considered speculation. This should also be prohibited or strictly controlled within limits. For example, treasury operations might disregard foreign exchange positions passed to them if they are accepted as small and not of market size. This approach does not prohibit the taking of financial risk: for example, value is created with risky financing structures, such as in early stage project finance, but from that starting position, risk reduction and refinancing as project risk declines is usually a good approach.

### Approach to risk



## 12. Risk reporting

- ☐ Does treasury regularly report all significant risks, hedges in place and quantify outstanding exposures to senior management?
- ☐ Is the information fit for purpose? i.e. Does it focus on achieving the financial objectives?
- ☐ Is action taken as a result of the information received? Is the information challenged?
- ☐ Is there assurance as to the timeliness, accuracy and completeness of the information?
- ☐ Are public disclosures adequate to demonstrate proficient risk management?

A treasurer's role is partly as a risk manager with delegated authority. Treasury must report on its management of those, usually financial, risks. The treasurer also contributes to external reporting where both policy and performance are communicated to investors.

For each financial risk, there should be some measure of the risk and risk-reduction. Regular reports should:

- Inform management of financial exposures outstanding both pre and post any hedging
- Demonstrate that treasury activity is within the policy authorised by the Board
- Promote the concept of analysis and performance measurement in treasury
- Create a feedback mechanism, leading to improvements in efficiency and control.

Examples of typical treasury risk management reports:

Policy/risk area	Typical Risk Management Report(s)
Liquidity management	Liquidity and debt report, ideally with history and cash flow forecast added. Often weekly out to 30 days and monthly out to one year
Bank relationship management	Facilities provided by bank with usage history and any issues including concentration risk and attitude to renewals. Often quarterly with longer term annual review
Credit risk	Credit exposure against limits, significant issues or downgrades, etc. Often monthly with longer term annual review and also special report following on any major event affecting a relationship bank.
FX (and commodity) risk	<div> <div> Transaction exposure report  Translation exposure report  Economic exposure report </div> <div> </div> <div> All often monthly with annual review focusing on longer term economic exposure </div> </div>
Funding and debt portfolio management	Funding review and outlook, debt maturity profiles, possible proposals for refinancing/new funding/equity raising. Often monthly but more frequently in run up to issue of new debt/equity and with a major annual review.
Covenant compliance	Performance against covenants (if any) on historical and forecast basis. Often monthly but weekly or daily or intra-day at times of stress
Interest rate risk	Interest rate risk report. Often monthly with annual review
Investments	Security, liquidity and return. Often monthly with annual review.
Treasury operations	Daily reports to the treasurer on controls

Another tool for the treasurer is dashboarding, an internal report which summarises, in one page, the key risks/positions with brief commentary on any deviations/issues along with selected market rates. In the treasury context items on the dashboard may include:

- Foreign exchange (FX) exposures (pre and post hedging)
- FX volatilities
- FX rates
- Interest rates
- Headroom
- Cash positions
- CDS prices
- Funding developments.

Best practice reporting should focus on accuracy, completeness, timeliness, materiality and be fit for purpose.

For more information on dashboard reporting, see the Institute's Business Guidance Note 15, available at [charteredaccountants.com.au/guidancenotes](https://www.charteredaccountants.com.au/guidancenotes).

### 13. Currency/commodity transaction risk

- ☐ Does your organisation have a mechanism to capture its explicit exposures to currency/commodity transaction risks?
- ☐ Does your organisation's policy on hedging and the instruments allowed provide adequate risk mitigation and over suitable timescales?
- ☐ Are internal hedges created and used as far as possible? Has the hedging behaviour of key competitors been considered?

The following has been written from the context of foreign exchange (FX) but equally applies to commodity risk.

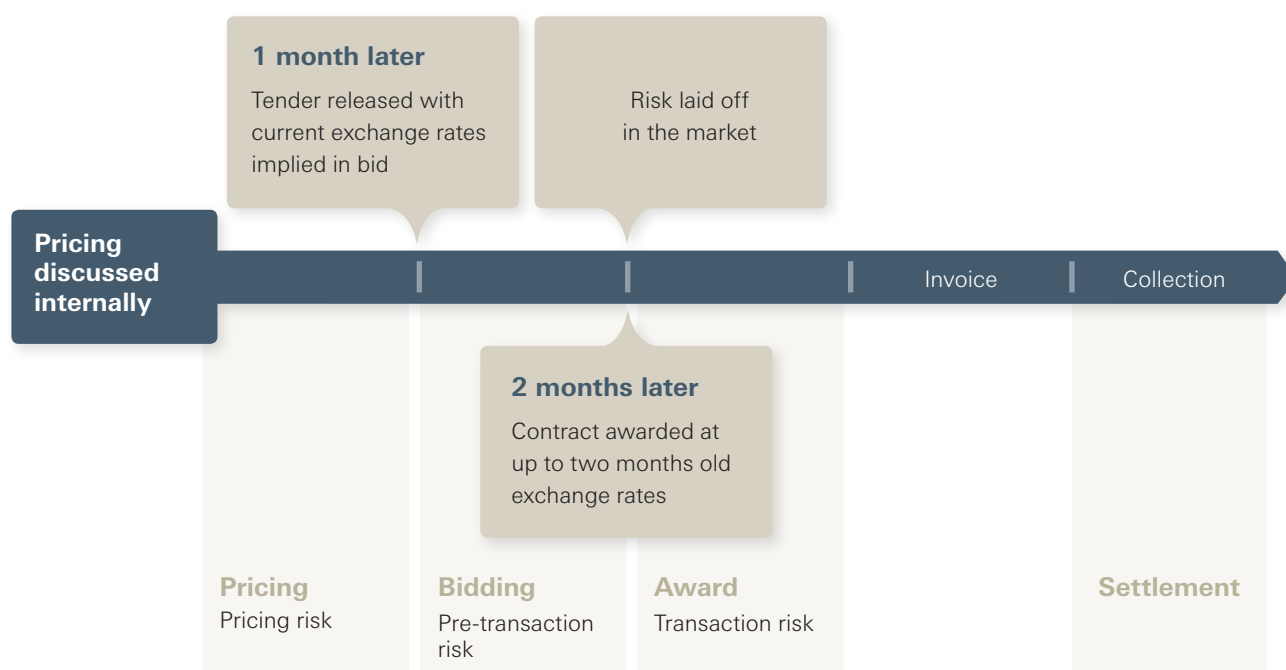
Transaction risk is the risk that committed cash flows in a foreign currency are worth less or cost more than expected, due to changes in FX rates. It arises from, for example, sales or purchases made or contracts entered into in a foreign currency.

An appropriate response to transaction risk is to hedge it, transfer it, or eliminate it. Some exposures can be internally hedged by netting against opposite exposures within the organisation or another group subsidiary. The relevant financial hedge is often a forward contract, usually used in foreign exchange, or a future, usually used for commodity risk.

Hedging with forwards and futures provides a degree of certainty for periods, depending on the organisation policy, out to several years. Hedging can smooth out some of the market volatility in rates/prices but if there is a permanent and significant change to market rates, the hedging only buys time before the impact is felt. In the long run, the organisation may have to adjust its business model by changing its geographic sales patterns, or by changing the currency of its input costs, which might even mean relocating its manufacturing location,

#### Leaving an FX exposure un-hedged can be seen as speculation.

Using an example of a simple contract where an organisation supplies a product on a one off basis with income in a foreign currency and costs in the domestic currency, the following diagram shows that after winning the contract, foreign exchange transaction risk exists until the risk is hedged in the market.



Companies often adopt a policy to have hedged all certain foreign cash flows at the time the purchase order is placed or a sales order is received. Leaving it to the invoice time is too late. In addition there may be a rolling program, adjusted each month, to ensure that, for example, 50% of sales forecast 12 months ahead are hedged and 20% of the 12 to 24 month predicted sales.

Organisations should watch out for hidden exposures. A purchase denominated in your own local currency but from a foreign supplier could mean they are carrying an FX risk and so may up their prices if exchange rates change.

#### **14. Economic and pre-transaction foreign exchange risk**

- ☐ Have strategic/economic foreign exchange risks implicit in your organisation's business model been adequately assessed?
- ☐ Can the price list be changed as currency changes occur?
- ☐ Does your organisation tender for foreign denominated contracts and can the contract margin withstand potential foreign currency movements?
- ☐ Is your organisation hedging uncertain risks with options and not using outright contracts?

#### **Economic risk**

Economic foreign exchange risk is the change in the value of an organisation with varying exchange rates. It comprises the sum of the present values of all types of foreign exchange risks. The largest component is sometimes called strategic foreign exchange risk and arises from the consequential changes in the organisation's competitive position. The contingencies of the individual organisation mean that these exposures usually differ materially between organisations.

#### **Economic risk from market position**

The effect depends on the organisation's market. High end luxury goods manufacturers may be relatively indifferent to FX rates as they have very high margins and low or inverse price elasticity of demand. But suppliers of relatively cheap or discretionary goods such as some automobiles or electronics can be affected materially and immediately as exchange rates move with or against them. It is worth thinking here about the place in the supply chain where pricing power is held and who it is held by. An organisation with price leadership has less economic exchange risk than a price follower.

#### **Economic risk from market sector or geography**

The magnitude of the effect differs between sectors. Transactions in the global aerospace and oil industries are, for example, effectively denominated in US Dollars (USD). So movements in USD versus other currencies are hugely important for all players. Some organisations such as global automotive manufacturers, regard themselves as truly global with an even spread of activity across countries and currencies. They may be substantially indifferent to economic risk on the basis that an adverse effect due to one currency will be compensated for by a favourable move elsewhere and they can adapt to long-run rate movements.

#### **Hedging economic risk**

Economic risk goes to the heart of a business strategy and the underlying competitiveness of the organisation. Because no amount of hedging lasts forever, and long-term hedging eventually becomes speculative, the future cash flows of the business beyond any hedging horizon will be subject to exchange rate or commodity risk. Ultimately there is therefore no risk transfer solution to economic risk. What can be done is some form of risk reduction which will buy time for the locations of production/sourcing or sales or the business strategy to be changed to suit the new circumstances, or for the organisation to exit the business model and avoid the risk.

Even if selling entirely in your home market, your organisation can be exposed to a devaluation in your foreign competitor's currency, making their product much cheaper. Hedging this with financial instruments would rarely be appropriate. Rather, your organisation might look to productivity improvements, sourcing materials from your competitor's country or improving quality to differentiate yourself.

The response to economic risk is therefore based around the business strategy itself. The risk to the organisation needs to be properly measured, considered and responded to with a view to reducing that risk or facilitating contingency plans for business operations if risks occur. In principal, the contingent nature of the risk might properly be responded to with contingent instruments like financial options (discussed below) but given the very long term and large sums involved costs are usually prohibitive.

### **Pre-transaction risk**

Pre-transaction risk arises when an organisation has to commit to a price before actually entering into transactions or commercial agreements or where the volumes to be shipped are uncertain, for example, under call-off contracts or contracts with cancellation or partial cancellation clauses, or when tendering for a construction contract.

The contingent risks are ultimately best managed with a contingent risk transfer product, such as an option. For example, when the German auto industry cancelled call-off orders at the start of the European financial crisis, it left central European suppliers with major outstanding outright currency contracts that were crippling expensive to cancel, whereas options could have been exercised if in the money or allowed to expire if out of the money. Companies commonly use a proportion of options to hedge, or transfer these risks.

Options have certain important characteristics:

- They provide the option buyer (holder) with the right, but not the obligation, to exercise the option if the price of the underlying asset meets or exceeds a certain price – the strike price
- Purchased, they provide protection against adverse price movements while allowing the holder to benefit from favourable movements
- They have an up-front cost to buy and can seem expensive
- They can be seen as speculative if used for cash flows that really are certain
- For most organisations, selling currency options is speculation.

Structured bank products, such as range forwards, cylinder options, knock-outs or -ins, increase risk in the hope of excess returns and this should not be normal practice for non-financial organisations.

## **15. Foreign exchange translation risk**

- ☐ Has your treasury given the Board analysis and advice whether translation risk is significant for the group?
- ☐ Could the impact of translation risk materially affect credit ratios or leverage measurements leading to a threat to credit ratings or loan covenants?

Foreign exchange translation risk arises from exchange differences arising on consolidating foreign assets and liabilities into the group accounts. The traditional view is that this is a non-cash exposure, but an accounting issue, and is often not hedged by the organisation. It is a characteristic that shareholders expect from investing in an international group.

Accounting standards, however, tend to point managers towards 'net investment hedges' where an organisation borrows or enters into a derivative to hedge against movements in the value of the accounting net assets of an overseas entity. However, this is a hedge of accounting net worth that bears little relation to the economic risks/ value in such investments. The hedge may actually have increased risks by introducing a cashflow from the hedge that is not balanced by an offsetting cashflow from the foreign investment.

Translation exposure can nevertheless have important real positive or negative effects because of the way that it can affect credit ratios and cash flow measurements that may be



relevant to debt covenants. The measures and ratios that can be affected by movements in exchange rates include:

- Net worth or enterprise value
- Gearing
- Net debt/EBITDA
- Interest cover
- Cash flow (and measures involving cashflow).

This example shows the impact of a weakening Australian dollar on the above ratios for an Australian holding company with a subsidiary in the United Kingdom. While debt has increased from \$135 to \$180 and some may think the organisation has lost \$45, what is not often apparent is the impact of currency movements on EBITDA and net worth which have both increased.

The risk of covenant default is often the measure adopted in the management of foreign exchange translation risk and can be assessed by modelling various 'what if' scenarios applied to the business plan. The response to such a risk is usually to adjust the amount of debt by currency so that the debt is more evenly balanced against earnings or net worth by currency.

	<b>Subsidiary GBP</b>	<b>Holding co. AUD</b>	<b>Consolidate AUD @ 1.5</b>	<b>Consolidate AUD @ 2.0</b>	<b>Change % (33.3%)</b>
Assets net	100.00	90.00	240.00	290.00	20.8%
Debt	(90.00)	0.00	(135.00)	(180.00)	33.3%
Equity	10.00	90.00	105.00	110.00	4.8%
EBITDA	15.00	10.00	32.50	40.00	23.1%
Interest 7%	(6.30)	0.00	(9.45)	(12.60)	33.3%
Net worth			105.00	110.00	4.8%
Gearing (debt/ equity)			1.29	1.64	27.3%
Net debt/EBITDA			4.15	4.50	8.3%
Interest cover			3.44	3.17	(7.7%)

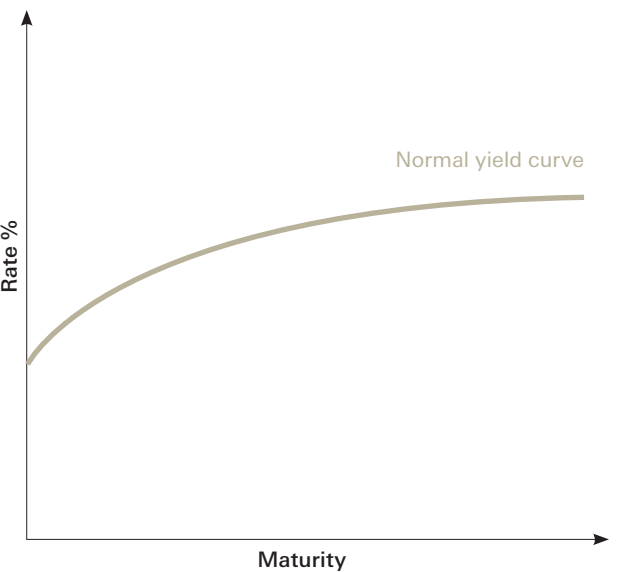
16. Interest rate risk

- What interest rate risk does the organisation have in its cost of capital?
- How is the organisation’s performance affected by a movement in interest rates?

If interest rates rise, borrowers will pay more interest. If they fall, depositors will earn less. However, there are many more facets to interest rate risk, as described below:

Risk type	Description
Risk over future interest payments or receipts	Borrowers will pay more and investors will receive more if interest rates rise.
Economic risks – linkage between business performance and interest rates	If a business does well in a high interest rate environment, its risk to rising interest rate is lower and may be inverse if that dominates the effect on the organisation’s debt costs.
Organisations with high leverage	For organisations with high leverage (e.g. many property companies), there is a very high exposure to the risk which could swamp the organisation and must be managed.

Normally market interest rates fixed for longer periods are higher than for shorter periods (the yield curve).



There is also room for opportunity loss with no way to eliminate it. Borrowers who fix interest rates will lose if rates fall and borrowers who float will lose if rates rise. Interest rate options are generally short term and can be expensive. As opportunity loss on debt cost is minimised when an organisation is around half fixed and half floating, this is a common response to the risk unless interest rate effects on the underlying business dominate.

If an economy slows, government or central banks may reduce the interest rate to stimulate activity. Accordingly, a business may be somewhat protected. There are, however, issues over how this effect is timed and there are also regional variations inside large economies.

Organisations with a naturally high debt structure, such as property companies and those financed by private equity, will usually have a very high proportion of fixed rate debt. Generally their revenue streams are reasonably fixed, such as rental income. This matching reduces their interest rate exposure.

Many studies show that a fully floating rate approach for a borrower with steady amounts of debt will, in the long run, be cheaper, mainly because longer term (fixed) rates have inflation, a liquidity premium and, arguably, a maturity premium. Many organisations can generally raise prices with moderate inflation and so paying a material premium by fixing seems wasted expense.

For some organisations, the objective may be to minimise the chance of a financial covenant breach, interest cost being a secondary issue. This is achieved by managing the fixed/floating ratio of debt. Since bond finance is usually at fixed rates and bank finance is usually at floating rates, to reach the chosen ratio it is possible to enter into interest rate swaps.

# Treasury operations and control

## 17. Internal controls

- ☐ Does treasury have adequate internal controls and are they audited annually?
- ☐ Are KPIs used to measure treasury operational controls?

In carrying out its function, treasury is exposed to particular risks around its operations, relating to issues such as fraud, errors, market and systems failures. Treasury is particularly susceptible to these issues because of the large numbers in money terms, its ability to make payments and the potential complexity surrounding its necessary activities.

Individual treasuries differ so much in make-up and scope and how tasks are allocated in an organisation, that when considering operational controls we emphasise the underlying principles rather than the detail of specific control and reporting systems.

Control procedures in treasury generally cover the following areas:

- Prior authorisation and approval of financial transactions via delegated authorities
- Segregation of duties (see below)
- Adequacy of documents so that no transaction is omitted or is recorded more than once
- Safeguards for access to systems or documents
- Reconciliation/checking of records
- Measurement, including the use of KPIs
- Reporting
- Internal audit.

Segregation of duties is designed to prevent fraud and detect errors. It is an essential approach so that no transaction or payment, internal or external, is carried out without at least one other person knowing about it. In a treasury function, this becomes a general principle so that those executing and recording transactions, must not confirm or settle these transactions. The diagram below shows segregation of duties in the dealing process. In a small treasury, the lack of staff means that some functions may have to be performed outside the treasury.

## Segregation of duties



Businesses are acutely aware of counterparty risk so that dealing limits should be rigorously enforced. Breach of limits should be a disciplinary matter and may even lead to dismissal.

Measuring treasury operations encourages excellent control features and targeting. KPIs, as simple measures, can be used in the control and efficiency measurement of treasury operations. While there are many possibilities, some of the more important ones could be as follows:

## Key performance indicators

KPI	Target
Number of items un-reconciled in bank accounts	Nil
Time for exchange of confirmations	1 hour
Number of confirmations sent/received that are not agreed	Nil
Trades made in error (e.g. wrong way round)	Nil
Bank and dealing mandates up to date	100%
Passwords changed every month	100%

Treasury operations should report the above to the treasurer daily, as any movement here can conceal big problems.

## 18. Business operations

- ☐ Does the treasurer have a good understanding of the business and industry knowledge?
- ☐ Does the treasury team interact with and understand business operations and individual subsidiaries?
- ☐ Has group treasury clearly documented and communicated delegated authorities to local treasury centres/businesses?

In managing capital structure, funding and liquidity, and financial price risks, crucial considerations are the level and nature of business risks, and their impact on cash flows. It is important that the treasurer has a good understanding of the business and the industry sector within which it operates, and that treasury supports and enables the business operations and strategy of the organisation.

Organisations with high business risk are less likely to take financial risks. Stable organisations with high quality earnings may take more financial risks.

The treasurer and his team must make efforts to get close to operational management. There are natural barriers between head office and operations. The treasurer must show they can understand the view of operations and demonstrate that the organisation will be better off for the application of the treasurer's deep knowledge of financial risk into those operations.

For example, whenever an organisation issues a tender or price list with foreign currency content and/or with foreign currency costs in the supply chain, the treasurer should understand the risks involved. By working closely with procurement, the treasurer can aid the debate on procuring from one country over another.

When a new project or investment is being considered, the treasurer can give guidance on financing rates and discount rates and perhaps on any country risk premium required.

Equally, when the treasurer talks to lenders in the capital markets, they should understand the sector and know how their organisation compares to others in it as well as the wider market for risk and return.

## 19. Systems

- ☐ What reliance is placed on internal and external systems?
- ☐ Are the systems used reliable, secure and well backed up?
- ☐ Is there an effective, up to date and practical disaster recovery plan?
- ☐ Are treasury transactions efficiently managed through the use of straight-through-processing (STP)? If not, does the cost of STP outweigh the benefits of STP?

### Straight-through-processing (STP)

The effectiveness of transaction processing is usually determined by the degree to which it facilitates STP. STP is the efficient, secure and instantaneous flow of information:

- Within a system
- Within systems in the treasury department, such as the electronic confirmation matching system automatically updating the deal confirmation status in the treasury management system (TMS)
- With other internal systems, such as automatic posting of journal entries created in the TMS into the general ledger system
- With other parts of the business such as the capture of FX transactional risk by forecast FX transactions reported from subsidiaries
- With external parties, such as cash balances reported from banks.

For treasury, technology in areas such as automating processes, performing sophisticated calculations, communicating with internal and external partners and monitoring risk is of growing importance. Extending automation in all countries where an organisation operates is probably the biggest challenge, but automation everywhere in the financial supply chain is still a major focus.

All treasury transactions should be recorded and managed within the TMS, the heart of most corporate treasury technology infrastructures. A TMS can be a major investment for a treasury both financially and in the time required to implement and continuously manage the system, including keeping it up to date as market practices develop. However, a TMS of different scales, costs and complexity or the treasury module of an enterprise resource

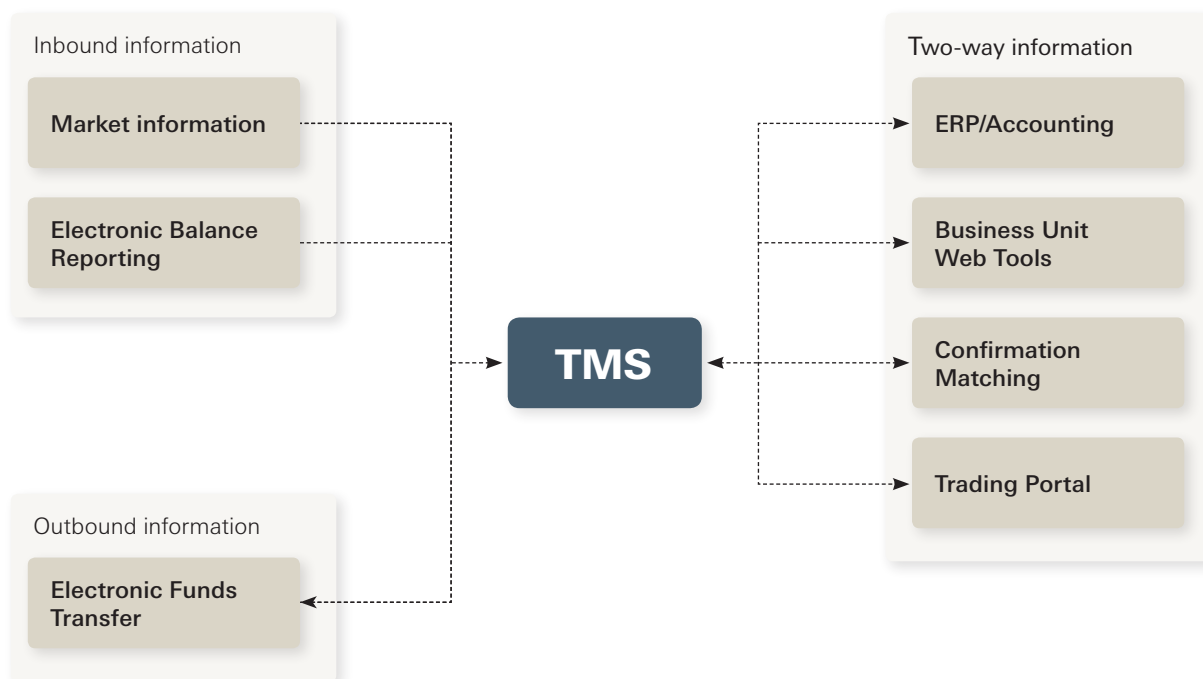
planning system is essential to virtually every treasury. A TMS facilitates the processing and management of information that is specialist in nature, provides secure information through workflow controls, defines user rights ensuring segregation of duties, a key treasury control, and provides an audit trail. It produces sophisticated treasury reports and accounts for treasury transactions which under International Financial Reporting Standards (IFRS) and the equivalent Australian standards has become highly complicated. These issues are important for a number of reasons:

- The amounts of money handled by treasuries are always large relative to the size of the organisation. The potential cost of even a relatively minor incident of error or fraud can be material

- Treasury needs reliable information to help make decisions on risk management, liquidity and funding, the financing of investment and acquisitions, structuring debt, etc.
- Corporate governance is on the agenda of every CFO and treasurer and may be externally imposed to some extent. For example, Sarbanes-Oxley (US legislation) requires rigorous operational controls, only available with specialist technology.

While spreadsheets are commonly used for broad forecasting roles, proper risk management techniques are universally available in the more sophisticated systems. TMS will often need to be supplemented by, or connected to additional systems covering payments, market information or other specialist tools, as presented in the diagram below.

#### Typical systems used in treasury



As with any system, the maximum benefits are achieved by avoiding multiple entries. Ideally, a single entry after executing a deal will generate the confirmation, match it against an inward confirmation, schedule any payments, create the accounting entries and interface to the accounting system and generate any reporting needed. Systems can be multi centre with remote data inputs to cater for global treasury centres with regional access.

## 20. Treasury accounting

- ☐ How are hedging decisions made?
- ☐ Are the economics, including tax effects, considered as well as the accounting rules?
- ☐ Is there a process in place to manage all the disclosure requirements?
- ☐ Does your organisation ensure that accounting changes do not risk loan covenant breach?

A feature of accounting standards is how quickly they change, and in almost no other area as quickly as in the treasury arena. IFRSs are being increasingly adopted as the global standards. There are three major International Standards which particularly affect treasury:

- IAS 32 (AASB 132) covers financial instrument presentation and disclosure
- IAS 39 (AASB 139) covers accounting for derivatives and for hedging decisions
- IFRS 7 (AASB 107) covers financial instrument presentation and disclosure.

IAS 39 (AASB 139) and its successor IFRS 9 (AASB 9) are the standards which are considered to be the most demanding, as they cover the rules for accounting for derivatives and for when they might be treated as hedges. In broad terms all derivatives must be recognised on the balance sheet and carried at fair value which can create significant P&L volatility. If the transaction qualifies for hedge accounting this volatility can be removed or deferred. The ability to utilise hedge accounting is very demanding in IAS 39 (AASB 139) but is expected to become somewhat more user friendly through the hedge accounting amendments being incorporated into IFRS 9 (AASB 9), currently at exposure draft stage. Due to the demands of the standards, CFOs have developed several different approaches to their use.

Changing standards can have a major effect on covenants in loan agreements. A change might alter how some ratios are calculated, possibly causing a loan default merely because of these changes. For this reason most loans

define these standards as at the date of the loan agreement, but this can mean that two (or multiple) sets of accounts are required, one to meet IFRS and the others to comply with various loan agreements.

## Conclusion

The global financial crisis has had a considerable impact on business, increasing the significance of treasury. Financial markets are now more volatile, many financial risks have increased and many traditional funding sources are changing. Additionally, regulatory changes since the crisis have added and will continue to add to the cost both of funding and of derivative hedging. And, as if life wasn't challenging enough, proposed regulatory changes, such as clearing Over-the-Counter (OTC) derivatives through Central Clearing Houses, could have a detrimental impact on an organisation's liquidity risk and change the ability of the firm to use derivatives as hedging instruments.

Whilst these all present challenges to the treasurer, they have also resulted in the discipline of treasury being more prominent in the boardroom. Compared to accountancy, treasury is a relatively young profession, less widely known or understood. It could be said that since the financial crisis treasury has 'come of age'.

Not all Boards and senior management fully understand what their treasurer is or should be up to. It is hoped that this publication has gone some way to explaining the role of treasury and its increasing significance in organisations today.

# 20 issues checklist

Governance		Yes	No
1. Treasury's role and objectives	• Are treasury's role and objectives clearly defined and aligned with your organisation's objectives?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is the financial strategy articulated and integrated with your business strategy?	<input type="checkbox"/>	<input type="checkbox"/>
	• Has the Board's risk appetite been quantified and clearly communicated to treasury?	<input type="checkbox"/>	<input type="checkbox"/>
	• Do the Finance Director, Audit Committee and the Board of Directors as a whole understand the treasury issues and do they enjoy open lines of communication?	<input type="checkbox"/>	<input type="checkbox"/>
2. Treasury policy	• Is treasury policy aligned with financial strategy (itself part of corporate strategy) and the approach to risk?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is treasury policy approved by the Board and reviewed at least annually?	<input type="checkbox"/>	<input type="checkbox"/>
	• Does the treasury policy set limits for each financial risk?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is adherence to treasury policies reviewed by the Board and independently audited?	<input type="checkbox"/>	<input type="checkbox"/>
3. Qualified personnel	• Is your treasury team adequately educated/qualified/trained and supported at each level?	<input type="checkbox"/>	<input type="checkbox"/>
Corporate funding		Yes	No
4. Capital structure	• Has the Board agreed a target gearing for your organisation?	<input type="checkbox"/>	<input type="checkbox"/>
5. Funding	• What funding options does your organisation have?	<input type="text"/>	
	• Over what time horizon does your organisation need to plan financing?	<input type="text"/>	
	• Will your organisation be able to use the going concern assumption in your accounts as specified by IAS 1 (AASB 101)?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there adequate headroom (size and maturity) relative to funding needs?	<input type="checkbox"/>	<input type="checkbox"/>
	• Does senior management attach appropriate importance to negotiating the least restrictive covenants compared to the cost of funding?	<input type="checkbox"/>	<input type="checkbox"/>
6. Own credit risk	• Have you presented your credit story accurately to stakeholders including investors, customers, suppliers, credit insurers and analysts?	<input type="checkbox"/>	<input type="checkbox"/>
	• Do you have good cashflow projections, business plans plus stress tests for various downside scenarios, but showing the mitigating measures that would be deployed?	<input type="checkbox"/>	<input type="checkbox"/>
	• Are your financial ratios running at an appropriate level and if not, can you adjust your capital structure or business risk profile?	<input type="checkbox"/>	<input type="checkbox"/>
Cash management and liquidity		Yes	No
7. Liquidity and cash forecasts	• Does your organisation produce short-term, medium-term and long-term cash forecasts?	<input type="checkbox"/>	<input type="checkbox"/>
	• Does treasury use all the forecasts?	<input type="checkbox"/>	<input type="checkbox"/>
	• Do the forecasts coincide with the cash management structure so that the actual cash in bank can be easily tied back to the forecast?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is liquidity risk assessed, by sensitivity or scenario analysis?	<input type="checkbox"/>	<input type="checkbox"/>
8. Cash management	• Do you have day-to-day visibility of bank account balances?	<input type="checkbox"/>	<input type="checkbox"/>
	• Do you have an efficient bank account structure (such as inter-company netting, cash pooling)?	<input type="checkbox"/>	<input type="checkbox"/>
	• Are surplus funds or short-term borrowings being optimally invested or utilised?	<input type="checkbox"/>	<input type="checkbox"/>
9. Counterparty risk	• Have credit limits been set by counterparty?	<input type="checkbox"/>	<input type="checkbox"/>
	• Have limits been set by rating bands?	<input type="checkbox"/>	<input type="checkbox"/>
	• Have limits been set by instruments?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is total exposure by counterparty calculated regularly?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there a procedure to react to changes in counterparty risk?	<input type="checkbox"/>	<input type="checkbox"/>
10. Working capital management	• Does your working capital management involve a multidisciplinary team from procurement, sales and treasury?	<input type="checkbox"/>	<input type="checkbox"/>
	• Does your treasury have good oversight and have effective influence over working capital?	<input type="checkbox"/>	<input type="checkbox"/>

## Top 20 issues (continued)

Risk management		Yes	No
11. Risk management framework	• Are there policies and procedures in place to consider the risk capacity, tolerance and appetite for risk in the organisation and has this been communicated widely?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there a proper risk management framework in place to address the financial risks faced by the organisation?	<input type="checkbox"/>	<input type="checkbox"/>
12. Risk reporting	• Does treasury regularly report all significant risks, hedges in place and quantify outstanding exposures to senior management?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is the information fit for purpose? i.e. Does it focus on achieving the financial objectives?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is action taken as a result of the information received? Is the information challenged?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there assurance as to the timeliness, accuracy and completeness of the information?	<input type="checkbox"/>	<input type="checkbox"/>
	• Are public disclosures adequate to demonstrate proficient risk management?	<input type="checkbox"/>	<input type="checkbox"/>
13. Currency/commodity transaction risk	• Does your organisation have a mechanism to capture its explicit exposures to currency/commodity transaction risks?	<input type="checkbox"/>	<input type="checkbox"/>
	• Does your organisation's policy on hedging and the instruments allowed provide adequate risk mitigation and over suitable timescales?	<input type="checkbox"/>	<input type="checkbox"/>
	• Are internal hedges created and used as far as possible? Has the hedging behaviour of key competitors been considered?	<input type="checkbox"/>	<input type="checkbox"/>
14. Economic and pre-transaction foreign exchange risk	• Have strategic/economic foreign exchange risks implicit in your organisation's business model been adequately assessed?	<input type="checkbox"/>	<input type="checkbox"/>
	• Can the price list be changed as currency changes occur?	<input type="checkbox"/>	<input type="checkbox"/>
	• Does your organisation tender for foreign denominated contracts and can the contract margin withstand potential foreign currency movements?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is your organisation hedging uncertain risks with options and not using outright contracts?	<input type="checkbox"/>	<input type="checkbox"/>
15. Foreign exchange translation risk	• Has your treasury given the Board analysis and advice whether translation risk is significant for the group?	<input type="checkbox"/>	<input type="checkbox"/>
	• Could the impact of translation risk materially affect credit ratios or leverage measurements leading to a threat to credit ratings or loan covenants?	<input type="checkbox"/>	<input type="checkbox"/>
16. Interest rate risk	• What interest rate risk does the organisation have in its cost of capital?	<input type="text"/>	
	• How is the organisation's performance affected by a movement in interest rates?	<input type="text"/>	
Treasury operations and control		Yes	No
17. Internal controls	• Does treasury have adequate internal controls and are they audited annually?	<input type="checkbox"/>	<input type="checkbox"/>
	• Are KPIs used to measure treasury operational controls?	<input type="checkbox"/>	<input type="checkbox"/>
18. Business operations	• Does the treasurer have a good understanding of the business and industry knowledge?	<input type="checkbox"/>	<input type="checkbox"/>
	• Do the treasury team interact with and understand business operations and individual subsidiaries?	<input type="checkbox"/>	<input type="checkbox"/>
	• Has group treasury clearly documented and communicated delegated authorities to local treasury centres/businesses?	<input type="checkbox"/>	<input type="checkbox"/>
19. Systems	• What reliance is placed on internal and external systems?	<input type="text"/>	
	• Are the systems used reliable, secure and well backed up?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there an effective, up to date and practical disaster recovery plan?	<input type="checkbox"/>	<input type="checkbox"/>
	• Are treasury transactions efficiently managed through the use of straight-through-processing (STP)? If not, does the cost of STP outweigh the benefits of STP?	<input type="checkbox"/>	<input type="checkbox"/>
20. Treasury accounting	• How are hedging decisions made?	<input type="text"/>	
	• Are the economics, including tax effects, considered as well as the accounting rules?	<input type="checkbox"/>	<input type="checkbox"/>
	• Is there a process in place to manage all the disclosure requirements?	<input type="checkbox"/>	<input type="checkbox"/>
	• Does your organisation ensure that accounting changes do not risk loan covenant breach?	<input type="checkbox"/>	<input type="checkbox"/>



# Glossary

**ACH:** Automated Clearing House System. A domestic electronic clearing system in which payment orders are exchanged among financial institutions, primarily via magnetic media or telecommunication networks, and handled by a data-processing centre.

**CDS:** Credit Default Swap. A variety of swap agreement that enables the effective transfer of credit risk from one party to the other.

**Covenant:** In loan documentation, a promise given by the borrower to take, or not to take, relevant actions. For example, a financial covenant to maintain a minimum ratio of net worth to debt.

**Credit rating:** An assessment of creditworthiness. Although the general term can apply to individuals, in treasury it is usually used with reference to public debt issued by corporations or public bodies.

**CSA:** Credit Support Annex. An agreement allowing the parties to an ISDA Master Agreement to mitigate their counterparty credit risk by requiring the “losing” counterparty to post collateral for the amount by which the related derivative instrument is currently out of the money for the losing counterparty.

**Derivative:** A derivative instrument or contract is one whose value and other characteristics are derived from those of another asset or instrument (sometimes known as the Underlying Asset).

**EBITDA:** Earnings Before Interest, Tax, Depreciation and Amortisation.

**Financial covenant:** A clause in a loan agreement that commits the borrower to operate within predefined financial constraints. For example, an interest cover covenant might state that interest cover will be no less than three times; the borrower promises that the ratio will always exceed the set figure.

**Float:** Time interval, or delay, between the start and completion of a specific phase or process that occurs along the cash flow timeline.

**Interest cover:** From a whole-firm perspective, interest cover is the ratio of Profit before interest and tax divided by interest payable. Interest cover measures the safety or sustainability of the future debt servicing flows, from the perspective of the lenders. Commonly ‘fixed charge cover’ replaces interest cover. Fixed charge cover takes account of the interest equivalent arising from lease costs.

**ISDA:** International Swaps and Derivatives Association. The industry body responsible, among other things, for standardising swap documentation.

**Net worth:** Broadly, Net worth is the value of equity, based on book values, which a borrower covenants to maintain at a minimum absolute or relative level (for the protection of the position of the lender).

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