Governing treasury

IT IS NOW TIME TO BRING CONSISTENT BEST PRACTICE TO TREASURY PERFORMANCE MANAGEMENT AND CONTROL AT GOVERNANCE LEVEL. **AENGUS MURPHY** EXPLAINS WHY AND HOW.

Treasury performance management has been much debated but little, if anything, has been implemented. Attempts at implementation have been misdirected and off-target, and indeed, in many cases they have proved detrimental to a proper focus for treasury management in an organisation.

At an ACT conference in the early 1990s I put forward the principle that treasury objectives must dovetail precisely with the corporation's financial objectives. Treasury management was not a business area in its own right, isolated from the company's main business. Treasury practice in a company had to conform to this principle. At that time, many treasuries were not aligned with the financial objectives of their corporations. Now this principle is beginning to be accepted and adopted in corporate organisations.

Some companies have set up their treasuries to trade for profit. This type of treasury acts and is managed like a bank dealing room, or at least it should be. But the norm in corporate organisations is that the treasury is a service and support function, helping the company to achieve its financial and business objectives.

It is now time to bring consistent best practice to treasury performance management and control at governance level. In the past, many board directors had difficulty with financial information and financial decision-making; difficulty with understanding profit and loss accounts and balance sheets and other elements of the financial statements. Not so now, because continuous presentation of these financial statements in a fully consistent manner over time enabled non-specialist directors to become comfortable with them. The same need now exists for 'treasury statements'.

GOVERNANCE AND PERFORMANCE MANAGEMENT What does treasury performance management mean in a governance context? It means having the capability and effective process whereby those with responsibility for corporate performance manage the potential impact, especially negative, of treasury activities and risks in the business. This is a 'large statement' and difficult to deliver in the complex treasury area. Those with the responsibility are often not equipped to handle the task. So the process has to be made as easy to implement as possible, by having understandable information and informed decision-making. Key to this is a more consistent and routine methodology for presentation of treasury matters.

An effective process would require the following components for proper implementation:

- Clear identification and presentation of the material treasury activities and risks.

Executive summary

- **Treasury performance can have enormous potential for impacting overall corporate and financial performance and must be easily understood by those responsible for corporate governance.**
- **In order to manage treasury performance specific objectives must be set which dovetail with corporate objectives, and a strategy devised for achieving them.**
- **The treasury profession should now develop a best practice approach encompassing internal presentation and reporting to make treasury matters more easily understood by the corporate management team.**

- Board-approved comprehensive and valid policy for treasury management.
- Well developed governance, management and decision-making process.
- Well developed ongoing strategy formulation, approval and implementation for the business area, together with a monitoring system which establishes the ongoing status of strategy implementation – i.e. only the approved strategy is implemented.
- Proper reporting and management information (MI), including proper assessment of likely outcome and upside and downside potential arising from the strategy being implemented.

All of these elements should be made available to those with the governance role in a manner which is understandable for them.

WHY IS TREASURY PERFORMANCE MANAGEMENT IMPORTANT? Other than the business trading environment, treasury performance has the next greatest potential to impact on overall financial and corporate performance for most companies. Indeed in many cases, treasury performance has the single greatest potential for impact. It is very difficult for a company to influence the business trading environment; it is often outside its control. This is not the case with the treasury dimensions of the business – they can be effectively managed and that is the job of the treasury. There is enough risk in business, without treasury compounding the situation by adding its own potentially significant risks.

This is why the management of the treasury's performance is important. How well is the treasury managing its affairs, so that the impact of potential risks on the business is known and contained?

WHO IS TREASURY PERFORMANCE MEASUREMENT RELEVANT FOR? Those with governance responsibility, especially the board and its finance/treasury sub-committee, the executive management team, the finance director and the treasurer. These management levels must engage with the process of treasury performance management, where potential treasury impact is significant. And they must do so effectively. This means that they must insist that the 'capability and effective process' of the type outlined here must be in place to support them.

Over the last 12 months, during the period of 'dollar weakness', there has been a number of newspaper headlines in which dollar weakness was blamed for poor corporate results. The whimsical dollar is not the culprit, instead the newspapers should be looking at the corporate management and asking why the treasury had not performed, or had corporate management copped out of its governance role in a key risk area. Blaming the dollar is a treasury joke.

PERFORMANCE AGAINST WHAT? Performance measurement is the key starting point and relates to the dovetailing of treasury objectives and indeed practice with financial objectives. Nowadays, many companies will have a stated financial objective of stable Earnings Per Share (EPS) growth over a reasonably long timeframe, or some variant of this. In more specific terms, this will be interpreted by the company as aiming for x% per annum growth in EPS, with no more than y% downside volatility on this target, over a rolling [#] month period. The period selected is one that is relevant to the particular business or to the reporting timeframe, 18 months being probably the shortest.

Each word in this stated objective is important for treasury management. Stable means controlled treasury volatility; EPS means a profit focus for treasury; growth means that treasury must be profitability growth supportive; over time means that the treasury performance must deliver short term – next forecast result/this year's budget – and longer term, sometimes up to five years, in addition it is appropriate that some treasury risks are managed over a longer timeframe in any event.

WHAT NEEDS TO BE PERFORMANCE MANAGED? So now we need three elements:

- Identification of all of the treasury activities and risks that can significantly impact, especially negatively, on the stated financial objective.
- Implementation of a strategy for managing the potential impact.
- A means of establishing with reasonable confidence that the strategy will deliver the objective.

For most companies, the main treasury dimensions that can impact on financial performance are set out in *Table1* (page 34), together with the measurement and management focus. All of these may not be relevant to all companies, but some combination of them will.

It would require a further sizeable article to develop the detail behind this high level performance measurement and management matrix. However, the important point is that these are the key items and these are the elements which must be assessed.

This is the big picture, although for some companies, liquidity and funding sources may also fall into the big picture, and for some specific companies with large surplus cash funds, return on these funds will be in the big picture. There are a few other peripheral measures which should be covered for good order, such as operational efficiency, and internal controls.

Note that there is no reference to dealing performance here, and this is not an oversight. Because of the minuscule potential impact of a basis point here or there on overall financial performance, it does not feature in the big picture. The amount of effort, resource and cost which corporate treasuries put into chasing the last basis point on transactions never ceases to amaze, worse still is performing the three simultaneous quotes sham where auditors foist on treasury staff the requirement to obtain quotations from three banks when doing a transaction. It would be much better if the effort were directed into good strategy development where the greatest potential impact lies. In reality, we should just expect those involved in transaction execution to do so professionally as a matter of course. Auditors, please take note.

At the next level of detail, which is also outside the scope of this article, performance management needs to be translated into information (the actual outcome of the task, action or transaction); benchmarks (a target outcome or preset criteria for targeted performance); and metrics (a standard of measurement, being the difference between the actual and the benchmark).

EFFECTIVE STRATEGY The next important requirement is the development of comprehensive specific strategies for each significant impact item which will within reason secure the targets set. These strategies should be board approved and the board should get regular updates, at least quarterly, on the progress of implementation and what is being achieved in terms of targets set. The board is also responsible for ensuring that strategies presented to it for approval align with the treasury policy which it has also approved. Any non-implementation of, or deviation from, approved strategy needs to be properly explained. Anything other than what has been approved is in effect unauthorised position-taking by treasury, the source of all of the infamous treasury scandals.

In playing the governance role, those involved must focus on this

Table 1 Performance Management Parameters

Treasury Dimension	Impact	Management Short-term	Target Long-term
Interest Rates: ▪ Existing Portfolio ▪ Future Portfolio	Cost of Financing (COF)	Current Year COF	COF over 5 years
Exchange Rates: ▪ Transaction Exposure ▪ Profit Translation Exposure	Revenue & Costs Profitability	Budget Rates Next Profit Forecast	% Hedged % Hedged #
Commodity Price	Revenue &/or Costs	Budget Rates	% Hedged

(# Subject to IAS 39 considerations)

whole strategy aspect of treasury management, since this is the mechanism whereby they can ensure that treasury activities and risks are properly controlled in governance terms.

WILL THE STRATEGY DELIVER? The nature of corporate treasury and the financial and commodity markets makes it difficult to be certain that a particular strategy will deliver a definite result, that is unless all treasury risk is hedged out of the business, if that can really be done. However, it is necessary to undertake a robust exercise to establish the performance parameters.

Many companies now utilise corporate financial models to support business management. Such models have the capability to run the treasury strategy scenario or scenarios and to clearly assess to impact on future corporate and financial results. The analysis should present the likely outcome, together with the residual potential positive and negative boundaries. This is what governance should focus on – delivery to these assessments – and treasury performance should be measured in particular against this overall deliverable as well as the individual elements above.

THE CURRENT GAME Unfortunately, at present treasury performance measurement is not in the ballpark set out here. Rather the focus is still on irrelevant 'dealing performance' and on operational efficiencies and use of technology, etc. This is probably because the treasury profession has not itself dealt with the matter properly and other players on the sidelines are influencing whatever developments have taken place. More often than not, though, companies have merely ignored the treasury performance management area, because it is too complex or too difficult to administer.

BEST PRACTICE This situation cannot prevail. The profession should advance this aspect of treasury management in a comprehensive way, by developing a best practice approach. If not, other interests will begin to set best practice for the profession, not a welcome development.

The Guide to Treasury Best Practice & Terminology (www.treasurybestpractice.com.) proposes a best practice methodology for treasury management, with a focus on governance aspects. I am not trying to just promote this book, most of which I authored. Rather I do wish to promote the propositions in it, which in the main deal with the issues covered here.

Boards of directors in particular should demand that this standard be adopted by their companies. The proposed methodology has the support of a number of treasury professional bodies including ACT.

The Guide is regarded as an initial initiative in developing best practice, and it is recognised that more needs to be done. After all the P&L and balance sheet also had to start somewhere.

INTERNAL PRESENTATION AND REPORTING A main contribution from the *Treasury Best Practice Guide* is in the internal company presentation and reporting aspects of treasury, with these two main features:

- A proposed reporting suite for all governance levels in the company, setting out format, content and frequency appropriate to each level
- A proposed consistent methodology for presenting the treasury positions of the company.

These two features will do more than anything else to enable those involved in treasury governance to understand and make decisions in treasury management matters presented to them. This represents a major contribution to competence and capability building in the corporate management team, which has responsibility for treasury governance.

ALERT TO THE BOARD, AUDIT COMMITTEE AND INTERNAL AUDIT Those elements of corporate management which are probably most exposed under governance requirements are the board, and (if it has one) its finance/treasury sub-committee, the audit committee and the company's internal audit function. This is because they have a key role in governance of the treasury aspects of business. Yet they tend to have limited capability in the treasury management area. By comparison, the managing director and the finance director will be reasonably well versed, or at least should be.

There is an onus on all of those involved to endeavour to have arrangements in place in the company which will facilitate the fulfilment of their governance role. Too many things can go wrong too often in the sensitive treasury area, as we have seen so often in the past. No excuse of complexity, lack of understanding or inadequate process will be listened to if something does go wrong. Adopting best practice, such as it is, is the best step.

Aengus Murphy Chairman, FTI.
amurphy@fti.ie.
www.fti.ie

Aengus Murphy is facilitating a roundtable discussion at The Treasurers' Conference 11-13 May 2005 on performance measurement and internal treasury reporting.