

# The key to corporate financial management

Dr. Hans-Bernd Menzel of Palm Tresckow & Partner argues that integration is a key factor as financial management develops beyond financial transactions.

Creating shareholder value is one of the predominant objectives of a company today. Companies typically search to achieve this through improving their competitive position via technical innovation, the application of new management methods and structures, or via mergers and acquisitions.

Professional financial management can also make an important contribution to shareholder value, via efficient management of all financial group risks, and by the systematic global use of internal and external financial resources. The cross-border transfer of liquidity between all group entities and the application of modern capital market instruments is one way of achieving this.

Meanwhile rating agencies and stock analysts have put similar questions on their agenda. Legal and para-legal requirements put an additional focus on these questions.

Not all corporates have yet discovered this, however, and of those which have, only a few have put world-wide and consistent financial management and controlling structures and processes into practice. The reason is simple: one of the keys to the solution is integration, but integration is extremely complex and the notion behind it is often vague and inconsistent. The objective of this article is to outline some key aspects of what may be called best practices in integration, and the prerequisites needed to achieve it.

## **Integrating operational business and financial management**

Financial risks, chances, tasks in general arise from the core operational business activities of companies, ie, production or trade of goods, services. Information about the operational business is the basis for exposure assessment. Financial controlling adds information about existing financial trans-

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actions and assesses cash and risk positions. So it has far-reaching economic implications for management decisions, and it controls the outcome of these decisions.

The instruments required to fulfil this ambitious task must be adequate. Nevertheless, experience shows that companies often recognise the fact, but continue to work with spreadsheets which require almost automatically double or triple data entry, come along with security problems in handling and, even worse, systematically misleading simplifications. Why is this the case?

The operational business of a company is long-term and rolling. Data on receivables and payables provided by accounting are not sufficient for correct exposure assessment. A solution can be achieved by an integrated planning procedure. In most companies planning is done on cash flow basis.

In these plans all cash flows are treated equally, but there is more to be considered, such as:

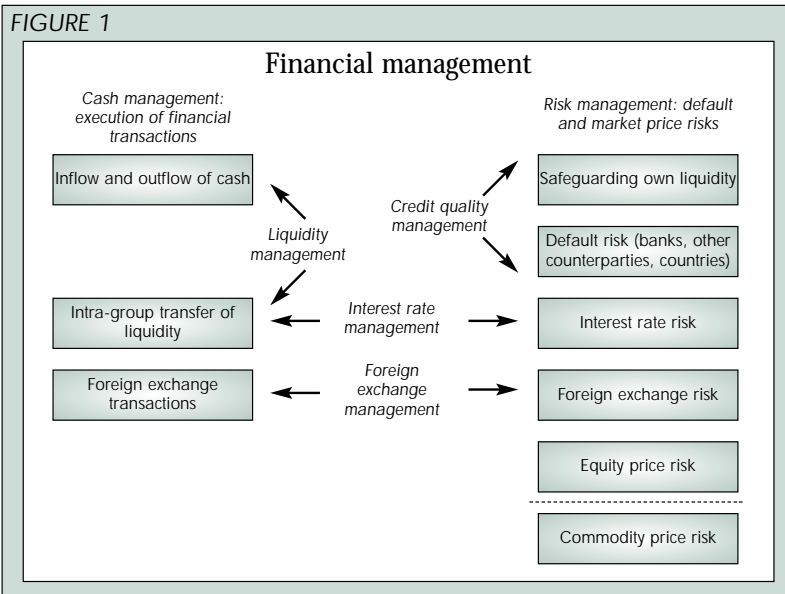
- the cash flows are planned in their currency of origin, but is the planning scheme complete? Financial controlling needs information about all cash flows, operational and financial, booked, contracted and planned, to and from third parties, and to and from group companies as well;
- perhaps a company has cash flows in foreign currencies which are not

exposed to foreign exchange risk, because of a price-adjustment clause, for example. These cash flows must be considered today for the liquidity position, but should automatically flow into the foreign currency exposure when the price-adjustment clause expires three months before payment;

- perhaps a company is buying products in its local currency but is nevertheless exposed to foreign exchange risk because the local price depends on a currency relation, as is the case with most commodities;
- cash flow-based planning is limited in its time horizon because of decreasing planning quality, and therefore often ends 12 to 18 months in the future. On the other hand companies sometimes have operational plans covering much longer time horizons – three, five years or even longer, which imply liquidity deficits or surpluses or interest bearing positions. Or they have loans or derivatives of up to 30 years beyond their planning horizon. In an integrated view, all of these must be taken into consideration and be a part of the exposure and hedging ratio assessment processes; and
- on the other hand, short- to medium-term liquidity planning (often done monthly initially, then daily) and very short-term planning for the disposition of bank accounts, should be interlinked because they refer to the same data.

## **Functional integration**

Financial management is commonly divided into different functions, but most financial management activities and instruments affect various of these functions at once; for example, simple intercompany loans in foreign currencies affect cash management, liquidity management, foreign exchange



management and so on, some of which can be derived from *Figure 1*.

This leads to two tasks. On the one hand each management function must be defined separately from the others; and on the other cross-over effects resulting from one activity and affecting another must be made transparent and attributed correctly to their origin. And the overall result of financial management must nevertheless be the sum of the results of the individual functions. Not all companies have addressed this question, and there are even fewer which have found a concrete solution.

**Integration of corporate controlling and sub-ledger**

And there are more steps in functional integration: the links between financial management on the one hand, and corporate controlling and sub-ledger for financial instruments on the other. Corporates tend to create new benchmarks for operational results beyond profit and loss statements. Few of them have been defined in co-operation with the finance or financial controlling departments. In an integrated view, effects from exchange rate developments, financing costs etc must also nevertheless be considered, if a company wants to find out the 'real' performance.

Similar aspects are true for the link to accounting: financial management will probably be measured by on-going economic benchmarks, but its' activities will have an impact on p&l accounting.

Be it IAS or US-GAAP this impact will probably not be identical to the benchmark results today. Perhaps the board has defined limits for this impact, just to avoid surprises. In an integrated view, financial controlling will measure it on a daily basis. And it will apply the same input, algorithms and tools to calculate this as the accounting department does. Ideally, it will apply an integrated sub-ledger function, which is under the responsibility of the accounting department.

If this can be achieved, the financial controlling information can be generated automatically and in time, and the monthly or quarterly discussions between financial controlling and accounting about the sources of their different p&l results can be replaced by more forward-looking activities.

**Group-wide integration of group entities**

Today, at least at group level, most managers are convinced that a centralisation of financial management activities improves efficiency by the

concentration of know-how, and the reduction of bank margins, etc. And more efficiency would lead to more shareholder value. Nevertheless, corporates often still focus on financial management activities by company or by region or country. Approaches are often based on case-by-case decisions and ignore side-effects.

What is going to be centralised to increase shareholder value? Discussions on this point often quickly turn out to be emotional, but one aspect is certain: complete and consistent information must be available in time on every management level where decisions are made. Transparency is the key word.

Compared to information the centralisation of decision-making is often a more political question (see *Figure 2*). If the responsibility of subsidiaries includes their financial result, they must be allowed to decide on its determinants. Even if from a group's point of view it may not be efficient that dozens of people are spending time on financial markets' forecasts, it may be acceptable for other reasons as long as the subsidiaries conclude their transactions with the group treasury.

**Conceptual and technical integration**

Imagine that the concept is clear and the board has given its consent, so implementation will require an efficient software support. The integrated concept must be mirrored by this integrated software solution.

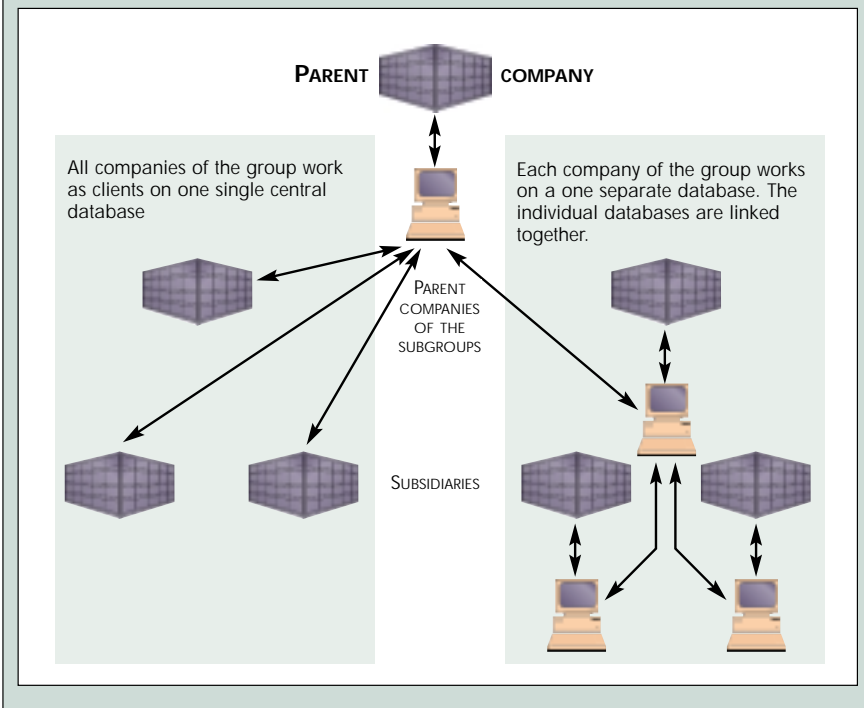
**Integration of operational business and financial management.** State-of-the-art software solutions include a three-step planning function:

- short-term for the disposition of bank accounts;
- short to medium term for the assessment of foreign exchange exposures; and of short to medium term liquidity and interest rate exposures; and

**FIGURE 2**

to be...	information	decision-making	transactions
...centralised	necessarily	definition according to management system	centralisation where possible and economical
...decentralised			

FIGURE 3



- medium to long term for the assessment of medium to long term liquidity and interest rate exposures. These elements will be linked, and the software will avoid contradictory figures in overlapping periods.

**Functional integration.** Treasury software today is typically bought by front office people who keep in mind that some back office functions would be helpful, too. So, the number of handled exotic instruments and fancy graphics capabilities often dominate middle office, ie the controlling and security questions. As a consequence, the importance and complexity of mathematically correct result calculations, on-line limit checks, etc are generally underestimated, in the hope that 'some report writer capacity' will do it. An integrated software solution will respect the necessary degree of security, even if, for example, the data entry scheme will require more compulsory fields such as data on accounting assignments than pure front office tools.

**Group-wide integration of group entities.** Even under more centralised management systems parts of the transactions will probably remain decentralised for practical (such as certain foreign exchange spot transactions) or

legal reasons (such as transactions in countries with currency restrictions or control of capital movements). The resulting data must nevertheless be available on group level: the settlement risk resulting from a foreign exchange spot transaction done by a Japanese subsidiary is part of the group's settlement risk.

Real integration means that all data is entered only once. There are two basic ways to implement this, as shown in Figure 3. In the first approach, all entities work as clients on the same database using the same programs. In the second approach, the subsidiaries have their own treasury software package for handling their management activities. The installations are, at least, connected to the group treasury's installation so that the data appear automatically, ideally on-line, at least through an overnight routine. In both cases the software must be fully client-safe: it must be possible to handle the internal and external exposures and transactions of all group entities in their respective names. If other levels or portfolios of responsibility exist beyond legal entity and group level (eg, country, regional, currency-related, business field or business unit, or sub-group level) the software should allow for the calculations for these areas, too. Ideally, this can be

freely defined. A second major problem to be solved is the correct handling of majority, but not fully owned affiliates. An integrated software solution should consider this in the calculation of group exposures as well as in the consideration of internal and external hedging transactions, whereas from the company's viewpoint everything must remain at 100%.

**Integration in a data warehouse.** Even the most integrated software solution will not be self-sufficient, but be part of a larger structure: it will, for example, have interfaces to banking software for cash management and confirmation purposes or to accounting software for the import of receivables and payables and the export of sub-ledger balances.

Experience shows that one kind of interface is still particularly difficult to realise: efficient and stable real-time on-line access to market data in all

modules of an integrated software. Cut and paste is only progress if market data had to be entered manually before. DDE-links are better and easy to develop, but the most efficient and stable is the direct access to the provider's data base.

#### **It's a people issue**

If you don't have it yet, the degree of integration outlined above can only be achieved via strong and on-going efforts throughout the whole group of companies. Experience shows that the hardest work is to be done where links to units and functions beyond the finance and financial controlling departments of the headquarters must be established. Long-lasting habits are questioned when financial controlling starts to implement group-wide consistent and state-of-the-art planning procedures, or when it takes influence on operational benchmarking. But new ideas always encounter resistance. It is worth trying, and avoid compromising. Compromising dilutes shareholder value. ■

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