Survival of the fittest

David Harrison and Louisa Hodgetts of Arthur Andersen outline the main themes of a recent survey on leading European companies on performance measurement.

Shareholder value-based management is receiving increased attention in companies in all countries and industry sectors. This has led to a focus on the contribution of all parts of the company to the creation of additional shareholder value. The treasurer is a strong proponent of the need to protect and grow shareholder value, but how does the treasury function demonstrate how it is contributing to the enhancement of shareholder value? Performance measurement is crucial to this.

Recognising this, Andersen's corporate treasury group conducted a survey among leading European companies which was designed to identify the current position and future trends in the area of performance measurement for treasury. In this article, we will outline the main themes of the survey and highlight some of the key actions we feel all treasurers need to take.

Mastering market risk?

Central to the study was consideration of the role of treasurer as risk manager, building on our previous research on enterprise wide risk management (EWRM). Among the conclusions of this was that companies should "embrace risk, as opportunities are limited". Managing risk through the use of appropriate risk management techniques can help a company add value for shareholders.

In applying this to the treasury area we are not advocating that the treasurer should actively seek to take additional risk positions. Rather we suggest that there may be scope to add value by:

- using knowledge of the company to identify and disaggregate the risks that exist in the core business operations;
- using knowledge of the markets to identify ways in which these risks can be managed. As risk management techniques evolve a broader range of risks are becoming capable of management, at least in part by the use of market instruments – power, credit, weather are all examples of this; and
- applying a judgemental approach in deciding which risks to accept and which to cover off in the market.

But the justification for a risk management approach must be in the demonstration that it has added value, hence the need for appropriate performance measures.

What would it be like in practice?

When it comes to risk, we found treasurers concentrate on the traditional areas of interest rate and foreign exchange – the concept of the treasurer as a more broadly focused risk manager is yet to be fully embraced. Few see other risks as within their remit – however, they envisage their increasing importance in three years' time. Within these areas the treasurer's objectives are typically:

- to manage foreign exchange risk by ensuring that there is a minimum level of cover in place; and
- to manage interest rate risk to ensure a target ratio of floating/fixed debt.

These high-level objectives are far more commonly used than more sophisticated measures such as value-at-risk calculations.

In terms of performance, the emphasis is on measuring the result against internal benchmarks. For example, the majority of firms use a budget number against which to measure performance in interest rate risk management. Equally, achievement of the budget rate is regarded as the benchmark for performance in managing foreign exchange risk. Treasurers need to consider whether these represent a valid assessment of their value-added contribution. *Table 1* sets out some questions and actions all treasurers should consider.

TABLE 1

Market risk

ISSUES	*ACTIONS TO CONSIDER*
Is the Board aware of the magnitude of the financial risks facing the group?	Set performance measures based on actual market variables rather than forecast rates drawn up when the budget is prepared
How closely are your treasury objectives aligned to the organisation's corporate risk management objectives?	Provide regular management reports to the CFO, outlining key financial risks and steps to mitigate these. Quantify the potential financial exposure of inaction.
When did you last review your treasury risk management measures? Are they still appropriate?	Assess treasury goals and performance measures to ensure that they are in line with corporate objectives. Assess the gap between current approaches and best practice and identify achievable actions to close gaps.
Is treasury performance measured against a budget number or a market-oriented number?	Use sensitivity or value-at-risk calculations to indicate the importance of risk management activity and the scope for adding or losing value.
If so, is the budget number adjusted through the year?	Flex the budget to reflect market movements and changing company circumstances.
Do you modify your objectives, strategies or information systems to meet changing circumstances?	Implement a regular assessment of the risk management approach and performance measures. Encourage a culture of continuous improvement.

Funding and investment

The other key area considered was the treasurer's responsibility for funding and investments. Here, treasurers usually have a range of objectives, including diversification, return and liquidity. Despite this, performance measures are primarily financially based – relating to interest costs/receipts – and benchmarked against budgets. As with risk management, there is a tendency to look inward rather than to external market forces.

Moreover, the simplicity of the performance measures, while in some ways admirable, does not necessarily reflect the richness of the objectives. This may lead to an inconsistency between objectives and performance measures. The clear message from respondents is that achieving the maximum return is not the most important objective for the investment of surplus funds since it would compromise liquidity and credit risk. However, the most common performance measures related to returns (see *Table* 2).

TABLE 2 Funding and investment

ISSUES	*ACTIONS TO CONSIDER*
Are your objectives purely financial?	Review your objectives. If purely financially focused, set broader business objectives that are more closely linked with the corporate strategy. When objectives have a non-financial component, set appropriate performance measures for this.
Do you measure financial performance against an absolute amount (ie interest paid/received) or a percentage?	Set a rate-based measure and compare your performance to market rates over time.
Do you monitor your borrowing costs against a peer group?	Compare your loan margin/bond spread to that of companies with a similar rating in similar industries.

Banking relationships

In the areas of cash management and banking, performance measures are also inconsistent with the stated objectives. For example, with banking relationships, the main objectives are to establish the appropriate quality of service and to manage the relationships to deliver maximum benefits. However, the most popular performance measure involved monitoring the split of business given to each bank and a focus on costs (see *Table* 3).

TABLE 3 Banking relationships

ISSUES	*ACTIONS TO CONSIDER*
Do you know how dependent you are on your key banks? Or how important you are to them? Do you use this information in regular performance evaluation meetings with your main banks?	Prepare a database of business with your main banks. Create a formal policy for reviewing your current banking relationships. Set key performance indicators to assess the quality of service you are receiving.
How is your forward planning for cash and banking management structured?	Assess how banking relationships could be streamlined through rationalising and simplifying your dealings with fewer providers.

Overcoming the obstacles

What are the obstacles to introducing timely and relevant performance measures? A number of barriers to change were cited, including:

- **IT systems weaknesses.** This comment must reflect problems with the existing systems of the respondents rather than what is available in the market. Competition among treasury management system (TMS) suppliers is driving functionality up and cost down;
- **reliability and frequency of data.** This could represent a number of problems. There may be difficulty in linking the TMS with the mainstream accounting systems to ensure data integrity and efficiency of operations. Alternatively, it may be that the TMS is capable of generating such a mass of data that it is difficult to identify the appropriate measures. One particular aspect of data-deficiency mentioned was the poverty of cashflow forecasts. This is one of the treasurers' key tools and, in its absence, the effectiveness of treasury operations are inhibited;
- **lack of resources and time.** The treasurer's role is one which is a combination of day-to-day treasury management and time-critical transaction activity. Around this various projects have to be fitted in, for example, improving cash management arrangements or reviewing banking relationships. It is therefore not surprising that time and resources can be a constraint in improving performance measures; and
- **lack of cash control over the performance variables.** We would argue that this obstacle is really a consequence of having inappropriate performance measures or benchmarks. Whether the variables are internal (for example, differences from forecast cashflow) or external (such as interest or exchange rates), a more sophisticated approach to performance measurement should be able to adjust to these and provide an an independent way to measure the performance of the treasury function.

Rising to the challenge

No one would claim that devising the right performance measures and setting the right benchmarks is easy. Establishing the systems and information flows to generate the information represents a further challenge. But it is a pre-requisite if the board is to have confidence that its treasury is a significant contributor to the organisation. ■

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The survey was conducted among 112 leading companies from seven different European countries. The respondents were generally multi-national corporates with material operations – more than 65% of respondents were from firms with an annual turnover exceeding ¤ 1,000m. A full report analysing the responses is now available from david.a.harrison@uk.arthurandersen.com.