Beyond narrow boundaries

MARTIN O'DONOVAN EXAMINES THE ROLE OF THE TREASURER IN CASH MANAGEMENT

Executive summary

Cash management may lack the glamour of mergers and acquisition deal making, it may be very much taken for granted in your organisation, but if cash management or its closely related discipline of liquidity management goes wrong, it spells disaster for the company.

The UK bank Northern Rock is the most recent high-profile example of a company brought down not by lack of financial strength but by lack of available cash and liquidity sources. There must be countless definitions and descriptions of cash management but irrespective of where you draw the boundaries it forms a core and important element in all treasury departments. Interestingly, if cash management is to be undertaken effectively it goes well beyond the narrow boundaries of treasury and will involve the treasurer in understanding the cash dynamics of all his group businesses. On the back of cash management the treasurer could be taking on a wider role understanding and influencing operations across the group.

It is fair to say that cash management traditionally includes an amount of operational administration but it does include a number of key strategic elements too, so any diligent treasurer and his senior management must take a keen interest in it.

CASH MANAGEMENT'S RISE Ignoring the full history of cash back in ancient times, we can trace the rise of the importance of cash management back to the 1950s in the US when inefficiencies in the banking systems meant that companies invented various workarounds such as lockboxes. Since then there have been many external triggers which raised the profile of cash management such as the ultra-high inflation and interest rates of the 1970s. In that environment letting working capital spiral out of control was an expensive option well worth avoiding. This was followed by increasing globalisation of banking services and dismantling of exchange controls which opened up far more possibilities for looking at cash management on an international scale. Then in recent years new and cheaper technology has been expanding the cash management possibilities so that treasurers will want to ensure they are making the most of any relevant opportunities. Maybe in a few years time we will look back at the current credit and liquidity crisis as the trigger for an increased focus on diversified and committed funding and a reassessment of credit risks.

In this new series of Treasurer Cash Management Supplements we plan to explain many of the new initiatives that are taking place in this field so as to keep you up to date and aware of the possibilities – at the detailed level and at the strategic level. We will also be revisiting many of the more established techniques and topics that fall within the umbrella of cash management in its widest definitions.

PRIVATE EQUITY If any evidence were needed that cash management has a key strategic relevance one need look no further than the typical private equity model. Simplifying, to a perhaps excessive extent, private equity managers aim to deliver outstanding returns by stretching the financial structures to the limit with high gearing and at the same time pushing the business performance by strong and

focused management. Part of that tight management involves submitting to rigorous financial covenants from the lenders with frequent monitoring and testing of financial ratios. Cashflow measures and constraints on debt levels form part of this package so that treasurers operating in businesses owned by private equity investors report an all pervading focus on cash, forecasting and working capital control. Tight constraints in well managed private equity companies, or at the other extreme of financially stressed companies operating near their covenant default levels, demonstrate that cash management is important. If it is obviously important for these sorts of circumstances it is equally important for all organisations wanting to operate efficiently and cost effectively.

CAPITAL STRUCTURE AND WORKING CAPITAL Treasurers and finance directors seeking to enhance shareholder value can target headcount reductions or other cost savings, and these may be beneficial, but more often than not far more shareholder value can be added by getting the financial strategy and bigger picture right. Capital structure is part of that. In theory debt levels should be increased to the optimal level that the income (or cash) generation of the business can safely support. If the net working capital asset that the business has to finance can be reduced the gearing can be increased or some more productive investment made. This is a roundabout way of saying that carrying excess working capital is sub-optimal.

Unilaterally delaying payments to suppliers or getting heavy with late paying customers will improve working capital but may not preserve good relationships, indeed it may even send out negative signals that the company is in trouble. A far better plan would be to start a multi-functional review of working capital taking in the totality of supplier and customer terms – quality, delivery times, pricing and discounts not just credit terms and payment methods, not forgetting the production and stock side of the equation. Any degree of credit given on sales means the company is exposed to credit risk and something to be taken seriously and managed and controlled in a professional way. Treasurers can help here too since they are familiar with credit insurance, collateral or other hedging methods. In other words understanding and controlling working capital is potentially a high-profile multi-discipline project that can deliver a re-engineering of internal processes over and above any simple cashflow benefits. So, efficient working capital management needs senior management involvement and commitment across the organisation.

PAYMENTS Virtually every transaction by a company generates a payment. Handling company payments is a volume business and as such it should be streamlined, efficient and low profile and for most organisations this probably is the case. However should a payment go wrong or some unusual payment be required suddenly this very mundane function becomes ultra high profile and its true importance is revealed. I am sure we can all think of the likely circumstances: we are late approving a large invoice to an important supplier which is now threatening to stop deliveries unless paid by 12.00 today; the Business Development Director is renting a new office in Columbia and needs immediate cash to place a deposit; a major acquisition is completing and for tax reasons cash must be seen to flow down through several financing vehicles to a strict timetable of events.

Even ignoring such rather extreme situations all payments to suppliers are a very visible interface with them and misdirected payments, late payments, or ones with inadequate remittance information attached would damage reputations. By definition they are external and must therefore be right first time – there is no scope for some sort of internal fudge.

Payments and money transmission are volume businesses so small cost efficiencies will be magnified and can become significant. For high volume transactions technology can normally deliver efficiencies and this is certainly the case for payments. Submission of payment instructions via the internet is now commonplace for both one offs or bulk file transfers and other techniques and systems are moving forward at a rapid pace.

This series of cash management supplements will recap on getting the most out of established payment mechanisms but there several new ideas coming through. The use of mobiles, wave and pay systems, SEPA, corporate access to SWIFT or CLS, bank proprietary systems and in the UK the Faster Payments Scheme and the trend away from cheques that is a core part of the National Payments Plan.

Thinking along the theme of technology soon gets you into an even more significant area of change if electronic payments can be linked into a wider e-business process. The next goal for strategically minded managers could be to achieve straight-through processing (STP) and to embrace e-business right across the financial supply chain – the processes of ordering goods, recording delivery, invoicing, paying and checking and reconciling throughout. Once this process becomes more automated the use of reliable information on payables and receivables can facilitate possibilities for supply chain finance, and this too will be fully covered in the supplements.

Payments may appear at first glance to be a mundane administrative function but there is a good deal more to it. Getting the right set up working well is crucial.

SECURITY AND CONTROLS Once a payment has been made it can be exceedingly difficult to reverse the transaction without a good deal of honesty and co-operation from the parties involved. Mistakes and fraud are ever present risks which is why companies will institute rigorous internal procedures and controls. They will insist on top-quality security features from their banks. And even the external authorities impose their own overarching controls and rules. We have to contend with anti-money laundering legislation, know your customer rules, in the US the Patriot Act and Office of Foreign Assets Controls and the all pervading Sarbanes Oxley Act.

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INTERNATIONAL CASH POOLING AND NETTING For groups operating through many subsidiaries, either in the UK or abroad, keeping an eye on cash balances or deficits across the patch can be a full-time job. Irrespective of size of organisation, holding large balances in some companies or countries whilst borrowing elsewhere is intrinsically inefficient. There is inevitably a spread between borrowing costs and deposit rates and what is more, grossing up both sides of the balance sheet increases the credit risk from investing while forcing the company to use its credit capacity on more and more overdrafts or short-term borrowing facilities. To address this the international banks have come up with various balance reporting, pooling or offset systems with all manner of features to save interest even across different currency pools, and specialist suppliers can offer sophisticated technical support for this.

Centralisation of cash management can go even further with centralisation of payments themselves perhaps, through a process of netting intra-group payables and receivables or through a payments factory catering for all cross-border payables. And now as SEPA begins to be rolled out we will be watching to see if within the euro zone the idea of handling all your euro payments from one centre catches on. If SEPA makes all cross-border payments as simple as domestic payments this is theoretically very straightforward.

However, as with all new products from washing powder to cars, those selling them always maintain that newer must mean better. I remember the Citroen 2CV advert extolling the car's central window operation – you can reach them all from the driver's seat – so there is the counter argument that we should keep it simple. An over-sophisticated solution can be expensive to create and maintain so that a full-cost benefit assessment should be done on any large-scale new cash management set up. Maybe a once a week central funding of local bank accounts is as good as a daily sweep; maybe if cheap overdrafts are available simply running with a small overdraft to absorb unexpected inflows is sufficiently effective? And let us not forget that taking too many responsibilities away from individual management can mean that they fail to focus sufficiently on the importance of getting cash in from their operations. The principle of retaining local control and transparency is cited as one of the prime reasons for using a notional pooling system.

RUNNING OUT OF CASH MUST BE THE ULTIMATE FAILURE FOR A TREASURY DEPARTMENT AND ITS CASH MANAGEMENT.

CASH FORECASTING Running out of cash must be the ultimate failure for a treasury department and its cash management. In the worst cases of business failure it may be unavoidable, but to run out of cash through carelessness or failing to forecast properly is surely unforgivable. Good short and longer-term cash forecasts are an essential part of cash management, but do they get the attention they deserve? Often I suspect they do not, for the simple reason that they are not easy and are notoriously inaccurate. One technique to minimise this inaccuracy is to compile your forecasts from several different sources, be they statistical trends, direct methods looking at actual expected cash movements or the more common indirect approach using management accounting data.

It may be possible to absorb inaccuracy in the near-term forecasts through use of overdrafts or very liquid cash balances but a recent survey would have you believe that companies that forecast their cash position out at least 30 days had average portfolio returns 30 basis points higher. This sounds high but either way with good information the routine investing and borrowing must be more efficient. The longer-term forecasts however are where the major benefits come in, allowing proper business planning and getting the right level of standby facilities and longer-term debt in place.

A CRITICAL FUNCTION So cash and liquidity management takes in all manner of topics but it can be a critical function in your company and deserves proper attention. The list of work to be done and objectives to be achieved may mean there is an awkward mix of skills required to cover the administrative and volume processing aspects but without losing sight of its strategic importance. Through this series of quarterly Treasurer Cash Management Supplements you will be reminded of its importance. You will be able to keep up to date on the latest initiatives and build up a comprehensive body of knowledge as we explore the intricacies of cash management in its widest senses.

Martin O'Donovan, Assistant Director – Policy and Technical, ACT.
modonovan@treasurers.org
www.treasurers.org