Maximising business performance

Michael Turner-Samuels of Pearce Management Consultants (PMC) asks: if company treasuries add so much value, why aren't they run as profit centres?

Treasurers have enjoyed an increasing – and fully justified – recognition of their status and value over the past 15 years or so, encouraged by the sterling work of The Association of Corporate Treasurers. We have developed into a sophisticated profession with strong influence at a senior level in companies throughout Europe and I believe our breadth of experience and skill is the envy of our US cousins.

As we enter the new millennium, the argument for the effectiveness of treasury skills could not be stronger. But if we add so much value to a business, why aren't treasury departments structured as profit centres?

Definitions

It always helps when trying to analyse a question to get your definitions straight – so here are some we will use in this discussion:

Profit centre – a business operation in which the managers of that business have accounts that show, through deduction of associated expenses from income, the extent to which their actions have generated a profit. Frequently, the managers' remuneration is linked to the level of profit generation to ensure they are focused on the accepted task of making money for the company and its shareholders.

Speculation – engagement in a risky commercial venture – that is, opening up the company to the possibility of losing its shareholders' money in pursuing a perceived opportunity to create a profit.

A treasury context

Let's take the area of speculation first. In the treasury context we are talking about the risks of exposure of the business to the rises and falls in the financial markets. For example, if the business borrows it is exposed to fluctuations in interest rates, if it invests in overseas assets it is exposed to changes in exchange rates (see *Figure 1*).

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There are two ways that a company might take on such an exposure:

- as a result of its agreed business activities; and
- as a result of a specific action to expose the company to such a financial risk which is beyond any such market risk that the other business activities have created.

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The latter point is, for the purposes of this article at least, considered speculation. The former – dealing with the existing exposures of the business – is considered 'risk management'. But note that both involve making judgements.

Speculation

So how might treasuries add value? Clearly, one way in which they might be able to do so would be to speculate.

Obviously, a board that decides on this course of action is seeking a profit from its actions and would want to set up the treasury as a profit centre in this case. The board should also want to undertake the most careful measurement and examination of the treasury's progress in making or losing money, and might want to place severe stop–loss and other restrictions on exposure levels on treasury members. This should all be tied down with total segregation of duties and scrupulous bookkeeping.

But, crucially, the board should make the creation of this potential source of income and loss known to the shareholders – in advance. After all, the shareholders have certain justified anticipations as to how their money is going to be exposed when investing in any company and in selecting its board.

Many reported cases over the years – such as Allied Lyons, Metallgesellschaft, Volkswagen, Electrolux and many banks – have identified losses in the tens or hundreds of millions and have shown the potential for disaster through the undertaking of (often unauthorised) financial market speculation. One wonders how many times other perhaps smaller losses resulting from what was essentially financial market speculation have gone unreported. Let's be fair, no doubt sometimes profits may have been made (although if this is consistently better than 50% the individuals concerned could be in the wrong business!).

However, the crucial question here is – what is the purpose of the company? What are the expectations of the shareholders regarding the commercial and financial risks to which their investment is exposed? And what are the skills of their chosen board as a result of these expectations?

It is always salutary to remember that if we want to make a play as a result of a particularly strong conviction regarding a certain financial market, there are respectable firms advertising in the *Financial Times* that will take on your gamble as a bet. The good news is that all your winnings are, as a bet, tax-free. Unfortunately, so are your losses, but at least no-one need be deprived of acting on their own hunches with their own money.

Risk management

As a treasury consultant, PMC is sometimes asked for advice on where interest rates or exchange rates will be going next. Even though as individuals we may each have our own ideas on this, as professionals we are sure that our true skill lies in knowing what to do once it is accepted that no-one knows how the markets will move next. We think that this should be the true skill of all treasury professionals.

Clearly then, we are now talking about engaging in risk management and not in speculation. Yet there is still plenty of fun to be had in deciding what to do. After all, the business has created certain financial market exposures and risk management involves deciding by how much to reduce those exposures, from 0% to 100%.

Invariably there is a price for reducing risk – sometimes (but not always) it involves swapping an indefinite exposure for a known cost. However, in setting up treasury activities as risk management activities it becomes much harder to produce a set of accounts that show whether the operation has made a profit or not. Hence it is difficult to set up a treasury with risk management objectives as a profit centre. Indeed, many would see the profit centre concept as contrary to the motivation that the board

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wants to set on the treasurer. However, the debate should not stop here.

The importance of benchmarking

Let's go back to our premise. Since we treasurers believe we add so much value to our companies, why can't we measure that value?

The answer is that we can or rather that we should. It's just not always obvious how. And the answer is invariably different for each company and each exposure being managed, though there are certain key principles that generally can be applied:

- first, it's back to being clear about your own definitions. Be certain what the risk is that you are managing and what your objectives are for success;
- second, look at measuring the result of not doing anything (0% cover) and of doing everything (100% cover). Then look at measuring your board's parameters for cover (you do have some board parameters, don't you?). If there is flexibility in the parameters then measure the impact of being at one limit or the other. It is sometimes possible to track the different results of different ways of covering (for example, caps versus fixed for interest rates); and
- third, try measuring the result of what you do and comparing it to the other results.

But always be clear in each case on the criteria for success.

Adding value in other areas

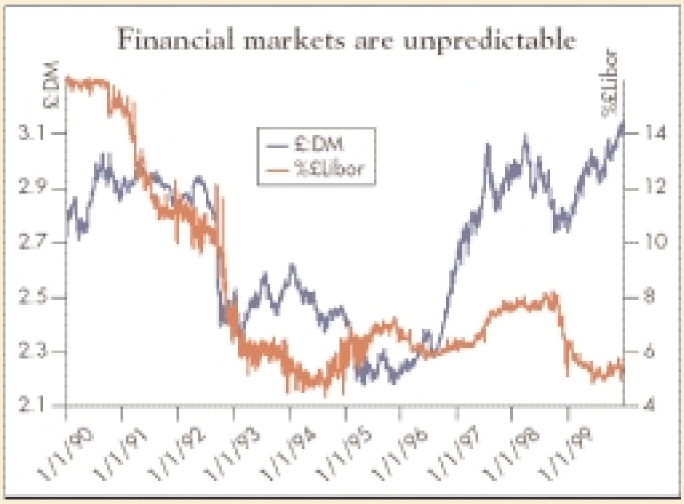
Of course treasurers do more than just cover the financial market exposures their businesses have created. We add value in negotiating finer rates for borrowings and in minimising restrictive covenants which limit the board's flexibility of action. We minimise transaction charges from the company's banks and we maximise interest income/minimise interest expense through efficient cash management practices.

All these benefits are difficult to quantify because you rarely know what the company would have suffered without the treasurer. However, intelligent estimates can sometimes be made.

Illustrating value

While it is general practice – and, we believe, rightly so – that most treasuries are not set up as profit centres, it nevertheless behoves us all to think of how we can best illustrate the value we add to our companies. In providing a measure of that, where possible, we will also sharpen our own skills at doing what we do. And not least, we will continue to support the proper recognition of the value (way beyond our cost) that our employers enjoy. ■

FIGURE 1



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