Treasury controls: New Year, same old mistakes?

Andrew Foulkes and Richard Raeburn of KPMG look at why control is so important in the treasury function.

Will you be responsible for the first corporate treasury disaster of the new millennium? Hopefully not. But it's a fair bet that at least one reader will witness a failure of internal controls that has the potential to lead to a disaster. Despite clearly established best practice we all see the same mistakes happen again and again. Unfortunately controls are so unglamorous and often so inconvenient that people flex them, circumvent them or even forget them altogether. For this reason we offer no apology for inviting you to take a fresh look at an old subject.

This article considers why control is so important in the treasury function, what could go wrong and what elements should be found in a 'best practice' control framework.

What can go wrong?

The treasurer's main concerns – funding, investment and financial exposures – are perhaps the most obvious source of risk. Ironically the increasingly complex strategies and instruments for managing these can merely change the risks, not eliminate them. At the operational level there are also risks in the form of high-value transactions individually material to the company or many smaller cash movements which are collectively significant; all such transactions carry risk of loss through fraud or (more likely) error.

Any one of these aspects of the treasurer's activities can lead to failures in control, some of which are illustrated in *Figure 1*.

To avoid such failures, a robust control framework is essential. But before considering what this might include, it should be comforting for the treasurer to remember that responsibility for control does not lie with him or her alone.

FIGURE 1 **Examples of failures in control**

- Exposures not identified – if policies do not specify how exposures are to be identified or measured or if procedures fail to ensure that accurate data is captured, substantial exposures may be left unhedged.
- Exposure not managed – if action on identified exposures is not taken (due, for example, to waiting until rates improve before hedging) the company's overall risk management approach may be compromised.
- Unauthorised deals – if dealing policies are not strictly defined, an individual may establish positions that are inappropriate to the company's requirements.
- Misappropriation of funds – when treasury transactions are settled there will be opportunities to defraud the company by redirecting funds.
- Procedural errors – if cash or borrowing positions are inaccurately recorded, or inadequately checked, incorrect payment instructions may be given and result in a loss of interest or misdirection of funds.
- Unauthorised systems access – unauthorised access to treasury management systems or electronic funds transfer systems may lead to loss of funds if payment details are changed or transaction records are deleted.

Responsibility for treasury control

Many parties have a role to play in ensuring that strong treasury controls are properly defined and applied. These include:

- the board – where the company's treasury activities must be understood and objectives, risk appetite and overall policies should be properly defined;
- the finance or treasury sub-committee – whose responsibilities may include approving detailed aspects of treasury policy and strategy in line with the board's approved objectives;
- the finance director – whose responsibility for both the strategic and tactical direction of treasury usually carries delegated authority to approve most of the actions of treasury (although the board should remain involved with the most significant treasury decisions);
- treasury – where responsibility for implementing treasury strategy will lie (and within which there will be further levels of responsibility); and
- internal audit – whose role is to test the effectiveness of the control framework.

Each responsible party should be assigned specific control processes, receive relevant reporting and be clear what control actions need to be taken. Unfortunately many treasury disasters can be traced to one or more parties not understanding or being ill-qualified to apply the control actions within their own area of responsibility.

Elements of the control framework

Each of the parties connected with treasury control will be concerned with some or all of eight key elements of the control framework: policies, procedures, limits, mandates, segregation of duties, documentation, management reporting and compliance monitoring.

Policies

The documentation of treasury policies serves a number of critical purposes, including defining the overall parameters within which treasury is to operate and the principles to be applied in controlling treasury. Policies should reflect:

- board approval for their content and a process to ensure that such approval is kept up-to-date;
- clear terms of reference for treasury, which include objectives and responsibilities;
- a description of treasury's role and the relationship that will apply between treasury and other parts of the organisation;
- clarity as to how treasury's performance is to be measured (for example as a cost, service or profit centre); and
- definition of the company's risk appetite.

The established treasury policies should be made available to all those involved and their existence and importance should be properly communicated within the company.

Procedures

Treasury procedures describe how policies are to be implemented. The most effective procedures are those that establish precisely how treasury policies are to be reflected in specific processes but remain sufficiently user-friendly to form a practical working document.

Procedures should define:

- the sequences of actions required to perform daily activities;
- where treasury's information is to be found;
- the limits and levels of authority for treasury activities;
- dealing, from deciding to deal through to completing a transaction;
- recording information in connection with transactions; and
- confirming, settling and reporting of transactions.

Procedures must also reflect all the elements of the control framework described here.

Limits

Limits set boundaries on the level of risk that will be borne by the company and allow for escalation of decision-making power when an individual's authority is insufficient for a particular action. There are three key types of treasury limits:

- counterparty limits – to protect the company from loss in the event that a counterparty defaults;
- position limits – to quantify the level at which identified exposures can remain unhedged; and
- authority limits – to define the types of transactions that can be undertaken by each member of staff.

Mandates

Mandates limit the authority of banks to act and define the banks' role in the company's own control framework. The two types of mandate in this context are:

- the dealing mandate – which establishes who is authorised to arrange transactions with the bank, the company's requirements for confirmation of deals, settlement procedures and the bank accounts to be used; and
- the transfer mandate – which defines who has the authority to initiate debit transactions on the company's bank accounts and how this may be done.

All mandates must be accepted by the bank in writing and always be kept up-to-date. Under no circumstances should the company undermine this control by asking a bank to operate outside the terms of its mandate.

Segregation of duties

Segregation seeks to ensure that one individual is not able to undertake dealing, confirmation and settlement without the control involvement of others. It is, however, not always easy to achieve. Typically, where resources are limited, responsibilities for review and authorisation are placed outside the treasury area. It is, however, most important that those involved in reviewing and authorising transactions can understand and challenge what is being undertaken.

Documentation

Whether in a manual or IT environment, documentation is there to create an audit trail to minimise the risk of a deal being overlooked or incorrectly recorded and to show that transactions have been checked and authorised in line with company policy.

Key areas of documentation associated with transactions include dealing diaries and deal tickets, but perhaps most important of all are confirmation letters. The process of producing, checking and signing confirmation letters is a key means of implementing segregation of duties and allowing management review to take place. Such letters should always be produced by the company and the bank unless electronic confirmation systems are in place.

Management reporting

Management reporting in treasury ensures that decision-taking, performance assessment and the recognition of control breaches is as timely as possible. Reporting should be risk-based (focusing on the key areas of risk for the company), hierarchical in content and fully supported by management commentary.

Key to effective reporting is keeping it as brief, clear and focused as possible, using benchmarks and exception reporting where appropriate.

Compliance monitoring

Routine treasury and accounting procedures should monitor the day-to-day application of controls, but for a more thorough review of the efficacy of policies and procedures, the treasury function should be subject to internal audit review at least once a year. Such a review must be undertaken by treasury-experienced individuals and be based on a programme tuned to the specialist needs of treasury, if it is not to be limited to a simple audit of transactions.

Did you pass the test?

If your control framework meets all the standards outlined above this is reassuring. Whilst achieving best practice in treasury control does not provide certainty that there will never be a major loss of funds, it is a significant step in avoiding being the next company in the headlines. ■

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(This article is based on material from the authors' recently published ACT book 'Introduction to Treasury Management' – see page 42 for further details).