DELICATE OPERATIONS

WITH THE LATEST RAFT OF REGULATION, SUCH AS IAS 39, AFFECTING THE WAY ORGANISATIONS MANAGE THEIR TREASURY, A RECENT SURVEY BY ERNST & YOUNG ASKED CORPORATE TREASURERS HOW THEY WILL OPERATE IN THE NEW AGE OF STRICT COMPLIANCE. **JANE HURWORTH** LOOKS AT THE SURVEY'S FINDINGS.

In an increasingly complicated business environment it is important to get the basics right – this is particularly so in the treasury function. Providing the right framework, policies and procedures are an integral part of managing the treasury operation. Nevertheless, there is no one right way to structure and run it and consideration must be given to the particular needs of individual entities. What is important for all entities is that senior management are able to understand, identify, measure, monitor and control all the risks particular to their business. The treasury needs to be appropriately structured in order to do this.

The growing level of regulation impacting treasuries such as International Accounting Standards, the Sarbanes-Oxley Act (See *No shelter from the storm*, page 16) and, for regulated entities, the new capital adequacy standards means that it is not possible just to stand still. Treasurers must constantly keep up to date with developments in best practice for their type of entity.

Executive summary

- The most important risks faced by treasuries are cash and liquidity, funding, interest rate risk and foreign exchange risk, according to a recent survey.
- Most treasurers are "very cautious" or "cautious" in their approach.
- The chosen method of measuring risk must suit the level and type of risk. As a minimum treasurers must be aware of the mark to market value of their positions.
- Only 44% of treasurers currently measure and report on performance against the treasury policy.
- Most treasurers now rely on a specialist treasury system or the module of an enterprise-wide system.
- 44% of treasurers believe that IAS 39 will have an impact on their economic treasury policy. The majority expect to shift to more 'vanilla' hedging products.
- IAS 39 will necessitate a detailed review of treasury operations – at the very least.

RISK MANAGEMENT. A recent survey by Ernst & Young, in conjunction with the Association of Corporate Treasurers (ACT), into treasury operations, showed that treasuries manage a wide variety of risks. It revealed the most important risks to be managed as cash and liquidity, funding, interest rate and foreign exchange (FX).

The survey also showed that most treasuries are very cautious or cautious, although the percentage total was a slight decline on last year. This year no treasurers described their approach as aggressive or very aggressive (see *Figure 1*).

Of those that responded to the survey, only one respondent did not have a treasury policy document which covered all types of risks.

As well as documented policies, it is good practice for formal procedures manuals to be in place for all key treasury processes. Surprisingly, however, only 52% of the survey's respondents had procedures manuals in place, and only 65% of those had updated the manuals in the last year.

Policy documents should be regularly reviewed by the board as new risks do manifest themselves. For instance, as FRS17 brings defined benefit pension liabilities onto the balance sheet, companies may wish to consider the interest rate risk in their pension liabilities, which may be significantly bigger than their debt portfolios. Interestingly, only one respondent to the survey currently considers its pension liabilities interest rate risk.

MEASUREMENT AND LIMITS. It is imperative that organisations measure the treasury risks to which they are exposed. There are various ways of measuring risks, but the chosen method needs to be appropriate for the level and type of risk for each entity. For instance, it is not appropriate for an entity with a large debt book to measure interest rate risk purely on the level of outstanding floating rate debt. Treasurers should be looking at a sensitivity measure such as Value at Risk or the impact on net interest expense of a 100bps shift in the yield curve. As a minimum, treasurers should be regularly kept informed of the mark-to-market value of their positions. It is also good practice to have an independent treasury risk management function, although for many smaller treasuries this may not be possible.

Limits should be based on the risk measurement methodologies and the risk appetite of the board. It is important, however, that they are kept up-to-date. In particular, counterparty credit limits must be responsive to changes in a counterparty's credit status as well as general market conditions. A programme of regular credit reviews should be in place with the capacity to respond to changes outside the credit cycle. It is surprising, therefore, to note that of the survey respondents only a small proportion manage their credit risk from derivatives using a mark to market valuation of those derivatives.

The type of limit set does vary from entity to entity. However, regardless of an organisation's size, any limit breaches should be brought to management's attention and appropriate action taken.

REPORTING. Once policies have been communicated it is important that performance against the policy is measured and reported. Management should be kept informed of both the financial and the operational performance of the treasury against the policies. It is best practice to produce a monthly treasury report for the treasury committee. Amongst the survey respondents, however, only 44% currently measure their performance, although this was an improvement on the percentage reported in the previous year's survey.

Treasury reporting must be clear, reliable, relevant and timely. It is important that, as well as showing compliance with the treasury policy, it should enable senior management to assess the appropriateness and consequences of their policy.

Monthly treasury reporting could include: an economic update including how potential scenarios would impact performance; an FX update including the valuation of all open positions and the FX rates achieved against budget, a funding update including facility head room and debt maturity concentrations; and an interest rate update including the organisation's sensitivity to interest rate movements and its fixed:floating debt mix.

As well as formal monthly reporting, operational exception reports form an integral part of the treasury control environment. Exception reports such as breached trading or counterparty limits, off-market trades, outstanding confirmations, aged items in suspense, changes to standard settlement instructions and funding concentrations are key indicators of non-compliance with approved policies or procedures.

IT SYSTEMS. The survey results showed that over 80% of respondents use a specialist treasury system or the treasury module of an enterprise-wide system, with the remainder relying on spreadsheets. As with other aspects of any control environment, it is important that controls around the IT systems are appropriate for the particular risks faced and processes used by the organisation. However there are certain controls that should be in place regardless of size or sophistication. As a minimum, systems and spreadsheets should be fully documented with change controls in place to ensure models and calculations are working as documented. It is usual for entities to have a spreadsheet policy to ensure spreadsheets are used appropriately. Access to treasury systems should be restricted by means of user passwords, combined with time-out periods for inactivity where possible.

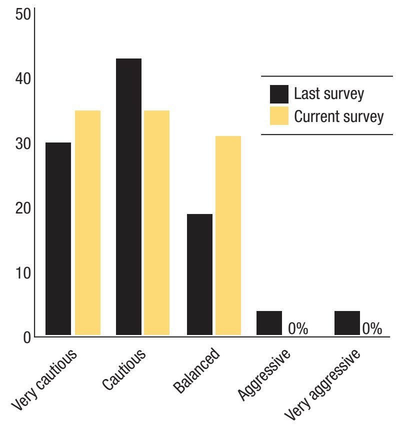
Other operational risk management functions such as internal audit are vital to the overall control framework. Internal audit should be able to provide an independent risk assessment of the treasury function, but this is a specialist area and should be staffed by auditors with specialist knowledge. The survey results indicated that where outsourcing occurs, internal audit is a frequently-outsourced function, probably due to the requirement for specialist skills.

IAS 39. HIGH-LEVEL IMPACT. The implementation of International Accounting Standards (IAS) for all EU-listed groups in 2005 is one of the biggest accounting shake-ups in recent history and is much more than just an accounting issue. The organisations surveyed were at varying stages in their IAS conversion programmes, despite the fact that time is running out for those that are required to comply.

IAS 39 is the standard causing the most problems for treasurers as, should it go ahead in its current format, it will require a very different treatment for derivatives to that required by current UK Generally Accepted Accounting Principles. IAS 39 is likely to bring derivative transactions onto corporate balance sheets at fair value with all changes in fair value going through the profit and loss (P&L) account. This will bring increased P&L volatility to organisations' financial statements unless efforts are made to achieve hedge accounting. Treasurers will be required to explain any volatility.

As a result of IAS 39 hedging rules, some existing economic hedges may not qualify for hedge accounting. Decisions will need to be made

Figure 1. Description of treasury operations



Source: Treasury Operations Survey (2004)

Responsibilities, structure and staffing

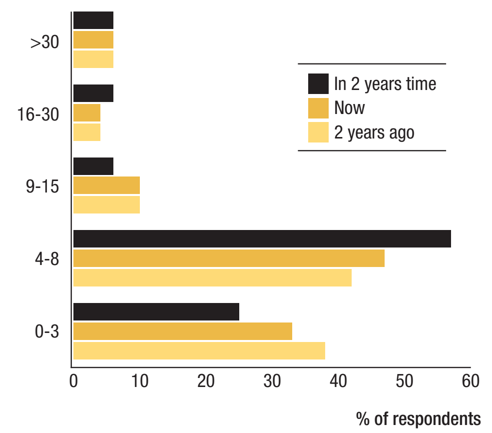
RESPONSIBILITIES. The treasury function usually obtains its delegated authority from the treasury policy document. As well as being clear on the role of the treasury department, individuals also need to understand the parameters of their own responsibility and authority. It is common for dealers to have individual limits, but the role and responsibility of all treasury staff should be unambiguous to all persons. Job descriptions are a good means of achieving this aim.

Typically, a treasury function would have responsibility for the management of the following risks: liquidity risk, interest rate risk, FX risk, commodity price risk, credit risk and operational risk.

STRUCTURE. It is best practice for the treasury back and front office to have separate reporting lines. Moreover, in order to maintain a good control environment different people should ideally perform the following operations: dealing, authorisation, confirmation, authorisation of settlement, release of settlement and accounting. For smaller organisations this is not always possible. However, a minimum level of segregation of duties must be achieved, regardless of size. For instance it is important that the same person cannot undertake any two sequential steps in the lifecycle of a treasury transaction. Most companies in the recent survey did have separate back and front offices, and over half of those back offices had reporting lines outside of the treasury function, mainly through finance.

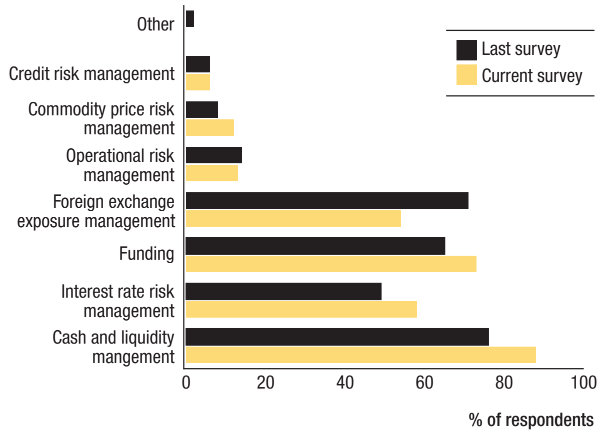
As well as proper segregation of duties, the organisation of the treasury function should include a treasury committee, appointed by

Figure 2. Number of staff



Source: Treasury Operations Survey (2004)

Figure 3. Most important financial risk management function



Source: Treasury Operations Survey (2004)

the board to independently oversee the activities of the treasury. This ensures its activities are conducted in accordance with its delegated authority and that the delegated authority continues to be appropriate.

STAFFING. It is important for the treasury function to be appropriately staffed in terms of both the number of people and their skill sets.

Treasury risk management is a complex area where expensive mistakes can be made if treasury risks are not fully understood. This is further exacerbated by the fast moving nature of the treasury market where new products and techniques are constantly being developed. A suitable training programme for all treasury staff should be in place to meet the demands being placed upon them.

The culture within a treasury operation can have a major impact on the performance of a function. For example, a culture that is ambivalent in its attitude to control lapses is likely to suffer from a serious breakdown in the control environment as staff will not consider it important to carry out controls, no matter how sophisticated the controls are. Equally, the means of incentivising treasury staff will also drive behaviour. For example, if dealer incentives are based on deal volumes rather than, say, funding cost versus Libor, then unnecessary and costly deals may be transacted. Similarly, if back-office staff incentives are based on completion of reconciliations alone, rather than including the age of outstanding items, then this too could encourage the wrong behaviour.

as to whether it is preferable to accept the resultant P&L volatility, knowing that risks have been economically hedged, or to change the hedge. In order to make such decisions, senior management is likely to require significant analysis from treasurers. In the survey, 44% of respondents indicated that IAS 39 would have an impact on their economic treasury policy, with the majority of those expecting a shift to more 'vanilla' hedging products. At the very least, IAS 39 is likely to necessitate a detailed review of treasury policies.

OPERATIONAL ISSUES. IAS 39 is likely to have a major influence on treasury operations, not least the additional processes necessitated by the hedge accounting requirements. Treasury management may need to think about current treasury staffing levels in light of this additional workload. Management will need to decide whether to centralise the additional workflows or push them down to the business units.

Treasury management information will need to be reviewed. Potential amendments will include an indication of the success of hedging relationships, including the impact of various scenarios, and in particular any hedge ineffectiveness, i.e. where hedge relationships have failed and why.

A management decision will need to be made as to where any ineffectiveness should be reflected, either within the business units or centrally within the treasury. Many business units will assume they have locked in a particular rate and will be very surprised to be presented with swings in their P&L due to the disqualification of hedging transactions or recognition of ineffectiveness. It is imperative that treasuries engage early with business units to ensure a smooth transition to IAS.

The P&L accounts and balance sheets of organisations will look very different in an IAS world. Many loan covenants are written on 'frozen GAAP' and so in theory may not be impacted by a move to IAS. However, as more entities move to IAS for their financial statements, it may be preferable to renegotiate loan covenants on an IAS basis to avoid the requirement to maintain UK GAAP accounts purely for loan covenant monitoring.

As noted previously, IAS 39 may influence products transacted by treasurers. As part of every new product approval process, the IAS 39 implications of a product should be considered before it is signed off.

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The full results of the survey are available on the Ernst & Young (www.ey.com/uk) and ACT (www.treasurers.org) websites. Hard copies can be obtained from Sally Spooner of Ernst & Young on 020 7951 5139.