5.6.4 Control and Measurement of Treasury Self Test Questions

Unit:	Unit 1 – Treasury Strategy
Module:	Module 5 – Treasury structure
Date:	1 September 2016
Summary:	3 self-test questions on controls: Q1 looks at boilerplate, Q2 is a case study format, and Q3 looks at control in the context of risk.
Keywords:	internal control, environment, segregation, control procedures, profit centre, cost centre, benchmark

Question 1

Answer *briefly*:

a) What are the objectives of internal control in relation to a transaction?

b) The control environment in the treasury area must reflect the broader control environment that exists throughout the company. True or false? Why?

c) What is the distinction between a control procedure and an accounting system? Give an example.

d) When the segregation of duties principle is applied to a transaction, list the steps into which the transaction might typically be broken down.

Question 2

As part of a rationalisation programme, General Engineering plc intends to divest fully by public flotation its Plain Bearing Division, as Bearco Plc, with a turnover of nearly £200m. Plain bearings (cheaper and easier to manufacture than roller bearings) are used extensively in petrol and diesel engines and in many other types of industrial machinery with rotating parts. Proforma income statement and balance sheet for its most recent full year are shown below.

Bearco will be one of two major suppliers to the UK automotive market where it supplies original parts direct to the manufacturer and replacement parts via a distribution network. Bearco exports 40% of component production to mainland Europe, mostly to Italy, Germany and France, where it may decide to set up its own distribution network. Bearco also has a network of licensees to which it has supplied complete manufacturing plant and, in some cases, raw materials. Licensees already exist in Russia, Poland, Czechoslovakia, South Africa, Malaysia and Mexico. New licensing deals, involving the supply of complete plant, are under consideration in Hungary, Spain and South Korea.

You have been seconded from General Engineering to help set up Bearco Finance and Treasury Division. What areas would you consider a priority for control procedures?

Question 3

a) Profit centre treasuries are inherently riskier than cost centre treasuries. True or false? Why?

b) Characterise a cost centre treasury and a profit centre treasury.
c) Apart from having hedgeable risks to manage (and therefore available benchmarks) what other features are desirable before embarking on a profit centre approach?
d) Why might equity investors dislike a profit centre approach?

BEARCO PROFORMA INCOME STATEMENT: *most recent full year ended 31 December*

£m

© Association of Corporate Treasurers

Sales revenue	188.0
Cost of sales	141.2
Gross profit	46.8
Selling and distribution costs	(17.0)
Administrative expenses	(10.0)
Research and development costs	(3.9)
Other operating income	0.1
Operating profit	16.0
Finance costs	(2.3)
Profit before taxation	13.7
Taxation	(4.0)
Profit after taxation	9.7
Items marked as non recurring	(0.5)
Profit for the year	9.2
Dividends	(5.7)
Retained earnings	3.5

BEARCO PROFORMA BALANCE SHEET

	£m
Non-current assets	
Property, plant & equipment	64.4
Investments	2.4
	66.8
Current assets	
Inventory	42.6
Receivables	45.9
Short-term investments	0.3
Cash	7.0
	95.8
Current liabilities	
Borrowings	19.8
Other payables	47.1
Net current assets	**28.9**
Total assets less current liabilities	**95.7**
Non-current liabilities	
Borrowings	8.2
Other payables	2.9
	11.1
Provisions for liabilities and charges	**9.2**
Net assets	**75.4**
Capital and reserves	
Share capital	64.9
Retained earnings	10.5
Total equity	**75.4**

© Association of Corporate Treasurers

Answers

Answer 1

a) *What are the objectives of internal control?*

Key objectives of internal control are:

- *Authorisation* – to ensure that the transaction is within the guidelines established by management.
- *Validity* – to ensure that the transaction is factual.
- Completeness – to ensure that all transactions are recorded (i.e. neither missed out nor duplicated).
- *Accuracy* – to ensure that all relevant details of each transaction are noted in the appropriate records.
- *Safeguarding* – to ensure that access to assets, documents and associated equipment is limited to authorised personnel.
- *Reconciliation* – to ensure that records are matched with external records, related assets or that control accounts are reconciled with subsidiary records and that all differences found are investigated and remedied.
- *Measurement* – to ensure that key processes have a measure to allow judgement of success, failure and improvement. These can be in the form of KPIs.

b) *The control environment in the treasury area must reflect the broader control environment that exists throughout the company. True or false? Why?*

False. The treasury control environment must first of all reflect the requirements of the treasury function. It may, of course, turn out to be in line with the company control environment, but that will be a happy coincidence rather than a requirement.

c) *What is the distinction between a control procedure and an accounting system? Give an example.*

The accounting system records what has happened. The control procedure ensures that what has happened is authorised and that the record is accurate and complete.
Example: the sales ledger records sales to customers. The related control procedure would ensure that all sales are invoiced, that the invoices are accurate and that payment received is recorded.

d) *When the segregation of duties principle is applied to a transaction, list the steps into which the transaction might typically be broken down.*

Typical steps are:

- authorisation
- execution
- custody (settlement)
- recording
- checking
- arranging settlement.

© Association of Corporate Treasurers

Answer 2

Bearco - What areas would you consider a priority for control procedures?

Based on the description of the company and review of the proforma accounts, the following areas suggest themselves.

- It will be a new public company. Therefore, controls will be needed in two areas:
  - compliance, governance and reporting (potentially under IFRS)
  - financial market relationships e.g. investors.

- The company is a major supplier of original equipment to car manufacturers. Therefore, controls will be required for:
  - the financial aspects of contractual arrangements with major customers
  - safety and quality standards on product, including product liability risk.

- Licensing deals involving the implementation of multi-million pound capital projects are a feature of the business. Controls will be needed for:
  - financial aspects of capital projects, both tender and execution, including FX and where appropriate commodity risk
  - financial aspects of licensing agreements.

- The income statement shows PBIT of 8.5%. There is a lot of international business in the turnover, so profitability will be very sensitive to currency movements. Therefore, controls will be required for:
  - the recognition and management of foreign exchange exposures
  - sourcing inputs such as power and steel – contract terms and possible hedging.

- The income statement shows significant R&D expenditure, so controls will be needed for:
  - authorisation and implementation of R&D, and its accounting treatment.

- The balance sheet shows high fixed capital intensity, so controls will be needed for:
  - authorisation and implementation of capital expenditure.

- The balance sheet also shows high working capital intensity, with payables a very significant source of funding, so controls will be needed for:
  - stock control
  - financial aspects of contracts with suppliers
  - credit and collection control of customers.

- The balance sheet shows significant cash balances, so controls will be needed for:
  - bank mandates (irrespective of balances held)
  - investment of surplus funds.

- The balance sheet shows substantial borrowings. Therefore, controls will be needed for:
  - loan documentation
  - monitoring of covenants and warranties
  - management of loan accounts.

© Association of Corporate Treasurers

Bearco seems set to maintain a reasonably sophisticated treasury operation. Areas for treasury control would include (this is not exhaustive):

- Control over overall cash flow, including forecasting procedures
- Control over bank accounts – mandates (mentioned above) but consider centralised administration, signatories, authorities
- Controls over dealing – authorisation, execution, recording, confirmation matching and settlement
- Controls over range, term, amounts of instruments to be used
- Controls over the setting up of new facilities
- Setting up of effective communication with operating units
- Setting up treasury reporting to and from operating units and the Board
- Setting up delegated authorities or committees of the Board to decide and where necessary execute treasury matters
- Controls over recruitment
- Controls over systems – payments, accounting, treasury management system
- Controls over bank relationship management

Answer 3

a) *Profit centre treasuries are inherently riskier than cost centre treasuries. True or false? Why?*

False. Profit centre treasuries are more likely to have hedgeable risks to manage and more likely to have the skills and systems to manage them. A cost centre treasury, assuming the underlying risk of the firm, on the other hand, may have large underlying natural risks which are very difficult to hedge.

b) *Characterise a cost centre treasury and a profit centre treasury.*

A cost centre treasury is risk averse; confines its activities to eliminating or minimising risk; if ‘passive’, will hedge where practical and let hedges run to maturity; if ‘active’, will selectively hedge within tight guidelines in order to minimise cost and meet/exceed whatever benchmarks may exist; if the organisational structure allows, will try to minimise overall treasury costs by improving system efficiency e.g. pooling, netting.

Profit centre treasury is risk tolerant; as well as actively managing natural risk, will trade in financial markets to create risk for profit; will actively seek ways to minimise costs by reorganising and by improving systems.

c) *Apart from having hedgeable risks to manage (and therefore available benchmarks) what other features are desirable before embarking on a profit centre approach?*

The scale of treasury operations must be large enough to justify employment of skilled staff and investment in sophisticated systems. Corporate policy, organisation structure and corporate culture need to be in tune.

d) *Why might equity investors dislike a profit centre approach?*

Because it can significantly alter the riskiness of the business in a way that cannot easily be evaluated, and because they may be concerned about control adequacy. This is less true of companies whose underlying natural riskiness already demands extensive hedging and risk management e.g. an EU manufacturer using dollar-priced commodities as a major factor of production and where some measure of speculation is necessary to compete.

© Association of Corporate Treasurers