



**LEADING TREASURY
PROFESSIONALS**



CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

**TREASURY'S
ROLE IN DRIVING
FINANCIAL
AND BUSINESS
STRATEGY**

BUSINESS BRIEFING



CHARTERED ACCOUNTANTS AUSTRALIA AND NEW ZEALAND

Chartered Accountants Australia and New Zealand is made up of over 100,000 diverse, talented and financially astute professionals who utilise their skills every day to make a difference for businesses the world over.

Members of Chartered Accountants Australia and New Zealand are known for professional integrity, principled judgement, financial discipline and a forward-looking approach to business.

We focus on the education and lifelong learning of members, and engage in advocacy and thought leadership in areas that impact the economy and domestic and international capital markets.

We are a member of the International Federation of Accountants, and are connected globally through the 800,000-strong Global Accounting Alliance and Chartered Accountants Worldwide which brings together leading Institutes in Australia, England and Wales, Ireland, New Zealand, Scotland and South Africa to support and promote over 320,000 Chartered Accountants in more than 180 countries.



THE ASSOCIATION OF CORPORATE TREASURERS (ACT)

The Association of Corporate Treasurers (ACT) sets the benchmark for international treasury excellence. As the chartered body for treasury, we lead the profession through our internationally recognised suite of treasury qualifications, by defining standards and championing continuous professional development.

We enable and support treasury professionals throughout their careers by:

- Providing clear treasury leadership and a trusted dynamic global network of experts
- Raising the profile of the profession, growing its influence and championing its success
- Delivering high level "real economy" influence among policy makers and regulators.

The ACT competency framework sets the global standard for treasury by defining the skills, knowledge and capabilities needed by treasury professionals to operate successfully in today's challenging business climate. Our qualifications have been mapped against this to offer a progressive learning pathway for those working in and with treasury, to build capability and support business talent.

As the world's leading professional body for treasury with members in over 100 countries, we facilitate networking and knowledge sharing in the treasury and business finance communities. We launched the Treasurer's Wiki as a free global resource. We provide informed and unbiased technical advice and best practice guidance through our briefing notes, technical updates, blogs and webinars. We seek the views of members and practitioners on key issues and contribute and respond to proposed policy, regulatory and market practice changes.

ACT is a member of the International Group of Treasury Associations (IGTA) and the European Association of Treasury Associations (EACT), and is an Affiliate of the International Federation of Accountants (IFAC). Treasury and accountancy go hand-in-hand. We work in partnership with leading accountancy bodies from around the world to offer a fast track route to becoming ACT-qualified and to raise awareness of the value qualified finance professionals bring to business.

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All information is current as at October 2015.

Chartered Accountants Australia and New Zealand ABN 50 084 642 571 (CA ANZ).

FOREWORD

CORPORATE TREASURY PLAYS A CRITICAL ROLE IN FINANCIAL AND BUSINESS STRATEGY. IT'S ESSENTIALLY THE LIFE-LINE OF AN ORGANISATION ENSURING STEADY CASH FLOW, SPEAR-HEADING INVESTMENT STRATEGIES, MANAGING LOANS AND BALANCING RISK AND REWARD.

Over the last few years, the treasury professional's role has become even more complex and challenging largely because of the volatile economic and political climate.

CAANZ and ACT have collaborated to produce this business briefing. It's designed to shed light on how the treasury function operates and sets out what to consider when performing treasury activities. The briefing covers the following key areas:

- Governance
- Corporate funding
- Cash management and liquidity
- Risk management.

Given the increasing significance of treasury for businesses right across the globe, This briefing will assist you in improving your understanding and management of treasury, and enhance your organisation's financial and business strategy.



Lee White FCA

Chief Executive Officer

Chartered Accountants Australia and New Zealand



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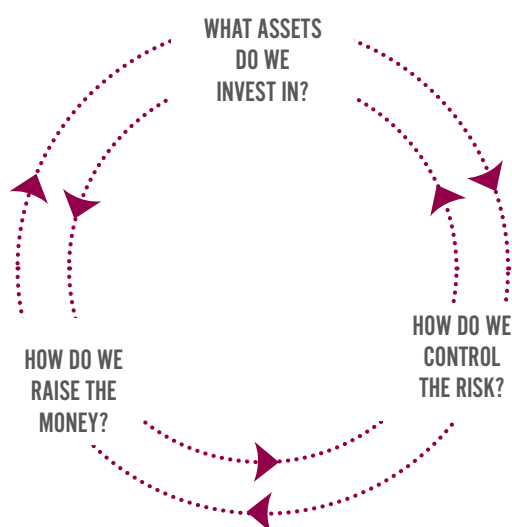
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CONTACT DETAILS

INTRODUCTION: A NEW BUSINESS LANDSCAPE

FINANCIAL STRATEGY AND BUSINESS STRATEGY TOGETHER FORM CORPORATE STRATEGY. FINANCIAL STRATEGY DEPENDS ON THE BUSINESS STRATEGY – BUT BUSINESS STRATEGY IS ENABLED OR CONSTRAINED BY THE FINANCIAL STRATEGIES AVAILABLE, AND BY THE CHOSEN FINANCIAL STRATEGY. THESE KEY STRATEGIC ISSUES ARE THE CONCERN OF AN ORGANISATION'S BOARD: DIRECTORS MUST BE COMFORTABLE WITH AND BUY INTO THE ORGANISATION'S FINANCIAL STRATEGY.

Treasury, the interface between the business and its financial providers, is a key element of financial strategy. Every organisation faces treasury issues, even if it does not have an identified treasury department. Where this paper refers to treasury, this may be a separate department or part of the responsibilities of the wider team. The treasurer referred to may be a separately identifiable role or part of the responsibilities of a broader role depending on the size and complexity of the organisation. At the strategic level, treasury is about advising on appropriate choices, the trade-offs and compromises involved when financial decisions are taken. There are three interrelated questions that are fundamental to treasury decision making:



Financing considerations for each organisation are different as there will be different answers to these three questions. For example, a utility company and a confectionery manufacturer will have very different responses. The time-horizons to be taken into account and the risks are different too – whether arising from the

nature of the business or from the financing chosen. Indeed, it is not possible to take sound decisions about any one of the key questions without influencing and taking account of the answers to the two other questions; they are interdependent.

Importantly, the answers to all three questions are also contingent on external factors. The interrelationship of those external factors and the three questions are usually too complex to be completely certain. Accordingly, we are in an area where judgment is required – from the outset and as conditions change.

WHAT ASSETS DO WE INVEST IN?

This question is central to the business strategy and to the financial criteria for investing. It boils down to whether the investment will earn enough and/or generate sufficient benefit to cover the cost of the funds and compensate for the risks involved.

“Investing” is any use of resources for future benefit. It covers not only acquiring property, plant and equipment and M&A or intangible property like patents and know-how and brands but R&D, staff training and marketing programmes.

HOW DO WE RAISE THE MONEY?

An organisation needs to know how much money it has available to invest and how much more it could raise, on what terms, at what cost and where from.

Raising the funds is the responsibility of the treasury department or those responsible for treasury, which needs to consider a number of questions, for example:

- Is additional finance raised as equity, debt, a hybrid or a combination?
- Does what is being invested in lend itself to asset-based finance?

(I.e. could it be rented or leased and at what cost?)

- Are there other existing assets that could be more easily financed, releasing funds for the new investment?
- To which providers of funds does your organisation have access?

HOW DO WE CONTROL RISK?

The organisation's risk management policy will cover providers of funds. Questions to be considered include:

- Is the cash flow impact of servicing and, except for equity, eventually repaying the funding and any other conditions of the funding (i.e. covenants and default wording) acceptable or manageable for the organisation and for the providers of the funds?
- Are the risks from the investment itself acceptable, when compared to the business to which it contributes?
- Is the overall business risk, including the total funding and cash flow risks, acceptable or manageable for the organisation and the providers of funds?

Identifying and managing some of those business risks, or enabling the business to adapt to make the risks manageable, is also a part of the treasury brief. In particular this applies to risks such as those arising from movements in interest rates, foreign exchange rates, commodity prices and inflation.

Some of these risks will be managed through structural decisions about the business, for example, the location of a new plant may affect currency exposures, access to finance or the security of supply for input commodities. Sourcing decisions and flexibility in sourcing of materials, components or finished goods will also affect how risk is managed.

Other risks will not be subject to such structural solutions but may be addressed through contract negotiation. For example, the pricing formulae in contracts may permit adjustments for interest rate, exchange rate or commodity price changes. Other risks will just be accepted and monitored.

Addressing these questions, and the day to day funding and investment of surpluses, makes up treasury operations.

Each section begins with a diagnostic questionnaire that highlights some of the key issues a senior business manager should consider. The questions are also consolidated into a treasury checklist at the back of the paper for quick reference. If the answer to a question is "no," then this is a prompt to ask further questions and/or take action. Very few questions, if any, should be not applicable.

GOVERNANCE

1.1 TREASURY'S ROLE AND OBJECTIVES

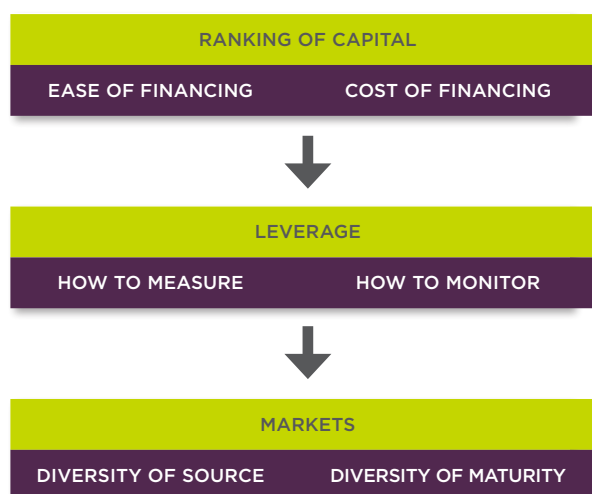
- Are treasury's role and objectives clearly defined and aligned with your organisation's objectives?
- Is the financial strategy articulated and integrated with your business strategy?
- Has the Board's risk appetite been quantified and clearly communicated to treasury?
- Do the CFO, Audit Committee and the Board of Directors as a whole understand the treasury issues and do they enjoy open lines of communication?

Treasury plays a key role in determining the organisation's financial strategy, working out how to finance the business strategy and how to manage the risks that follow from this. Treasury therefore needs to contribute to the mix of business and financial strategy, namely the corporate strategy, by setting out what is possible financially, at what cost and with what risks as the business and the environment develop.

In order to do this, the treasurer needs to feed into the business plan process. If, for example, the growth plan cannot be funded, the treasurer needs to advise senior management and perhaps suggest plan modifications or phasing the plan in over a longer time period.



The financial strategy judges optimal financing based on the following three factors:



Overall financing and risk management guidelines are derived from the financial strategy and set the general approach to funding, managing currency and interest rate risks, investing surplus funds, setting counterparty limits etc., so enabling creation of treasury policies. From these, the approach to treasury is derived, such as degree of centralisation, services offered and whether it will be a cost, service, value-added or profit centre.

Quantification of risk appetite by the Board is not always easy. The potential impact on the financial statements, such as the Board's maximum acceptable fluctuation in earnings is one possible measure of risk appetite. To assist the Board in understanding its risk appetite, the treasurer will need to model various scenarios such as interest rate and foreign exchange rate movements, to calculate the potential earnings impacts but most importantly impacts on cash flows and (re-)financing capabilities. Stress testing outcomes should also be undertaken.

1.2 TREASURY POLICY

- Is treasury policy aligned with financial strategy (itself part of corporate strategy) and the approach to risk?
- Is treasury policy approved by the Board and reviewed at least annually?
- Does the treasury policy set limits for each financial risk?
- Is adherence to treasury policies reviewed by the Board and independently audited?

All well managed treasury functions have a written treasury policy with a process to manage regular updates. Treasury policy is a mechanism by which the Board and management can delegate fundamental financial decisions about the business in a controlled manner. It should give treasury staff written guidelines on what they are responsible for, how they should go about their responsibilities, what their boundaries are and how their performance will be measured. These can be developed in formal procedures.

As an example, the treasury policy document should explain:

- Risk management objectives which should reflect the organisation's goals, risk appetite and sources of risk for the specific business and the economic environment in which it operates
- The risk management framework to be adopted by the organisation (i.e. identify, assess, evaluate, respond, report)
- For each financial risk, what is the risk and why is it being managed, taking into account the organisation's risk appetite
- Risk measures which will be used to set target outcomes and model the likelihood of those outcomes. This may include sensitivity analysis with indicative probabilities attached.
- Procedures for the day to day management of risks, including:
 - The delegation of responsibility for managing risk
 - How treasury will relate to business operations where risks are identified and/or being managed
 - Risk targets and limits based on an acceptable level of risk, adapted as the organisation evolves
 - Performance reporting/feedback mechanisms.

The Board has ultimate responsibility for risk management and for approving risk policies. In larger organisations, risk management tasks may be delegated – but not abandoned – to a sub-committee of the Board, often called the Risk Management Committee (RMC). The contribution of the treasury function is to recommend

financial risk management (and potentially other) policies and to ensure that the approved policies are followed.

The Association of Corporate Treasurers was created to provide education and support to those involved with corporate treasury.

1.3 QUALIFIED PERSONNEL

- Is your treasury team adequately educated/qualified/trained and supported at each level?

Treasury differs from other finance roles, with an emphasis on cash, risk and markets. The complexity of instruments, systems and interactions with the business, both operationally and strategically, mean that some of the skills needed for treasury are specialised and demanding.

Many markets have become more difficult and expensive since the 2008 Global Financial Crisis (GFC). Greater risk awareness within organisations means more colleagues interacting with treasury, often wanting to take very long-term views in planning business development. Treasurers can, day to day, undertake transactions which have risks or consequences their Board and operational colleagues may not, initially, fully understand. The treasurer should be able to articulate these risks or consequences as and when required.

In smaller organisations, or where treasury is more decentralised, staff may carry out treasury activities on a part time basis. Emphasis may then be on training in specific treasury procedures rather than on wider education. Subsidiaries in a group will need help from the head office. In smaller organisations, some senior level familiarity with treasury issues is important to be able to recognise developing issues and be alert to the need to secure specialist treasury advice from time to time.

Organisations without specialist derivative product and financial risk knowledge are at greater risk of being mis-sold (or mis-purchasing) overly complicated or inappropriate derivatives by banks. Numerous case studies exist of organisations suffering multi-million dollar losses as a result of badly chosen derivatives, such as Procter & Gamble in interest rate derivatives and South African Airways and Greenpeace in foreign exchange derivatives.

CORPORATE FUNDING

2.1 CAPITAL STRUCTURE

- Has the Board agreed a target gearing or credit rating for your organisation?

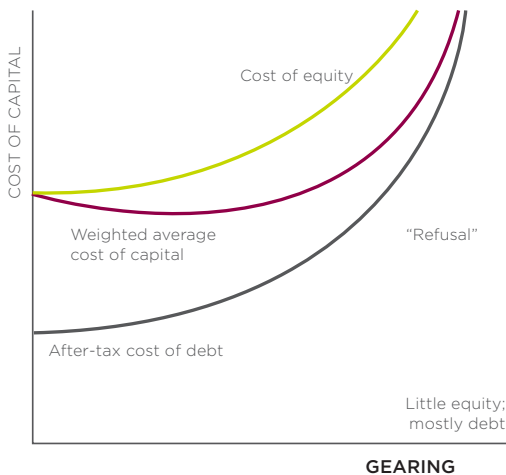
An organisation needs capital to fund its present assets, planned future development (and to allow for opportunistic investment) and to absorb the cash flow effects of responding to unexpected shocks (internal or external). Equity is the best shock-absorber as it places few demands on the cash flows of the organisation. Debt funding involves compulsory interest and eventual repayment of the amount borrowed – either from business cash flow or from new fund raising of debt or equity.

Organisations raise capital externally or generate it internally. Externally raised capital may be debt or equity, though there can also be hybrid structures. The proportion of total capital that is debt is called gearing or leverage and the

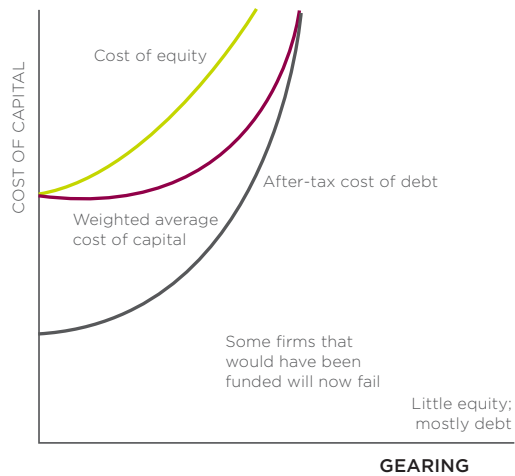
optimum level depends on the organisation's risk and return dynamics. The tax treatment of loan interest, equity dividends, and (under the G20 Base Erosion and Profit Shifting (BEPS) proposals) amounts and locations of debt may be a consideration for some organisations. Higher levels of debt increase the required return on equity i.e. the cost of equity to the organisation, which classically is offset by the increased amount of the relatively cheaper debt.

As shown in the diagram below, the overall cost of funding – the weighted average cost of capital – increases with higher gearing (as well as with the riskiness of the business strategy). At some point, investors become concerned about return **of** capital not return **on** capital: new funds are refused whatever the price offered. In squeezes and panics, refusal may arise at much lower gearing levels leaving some organisations that were previously financeable, now unfinanceable.

'OPTIMAL' DEBT/EQUITY (GEARING OR LEVERAGE)



'SQUEEZE' OR PANIC



Curves are intended to show the idea, not represent costs for any particular company.

THE EFFECTS OF GEARING/LEVERAGE



Corporate finance theory and market practice provide many techniques to help choose a target debt/equity ratio. This may be articulated as a targeted credit rating.

If the return on assets is unchanged, when moving from stronger credit (less debt) to weaker credit (more debt), we might find the effects shown above:

Riskier businesses or those with shorter-lived assets will tend to rely more on equity and only borrow short term if at all: perhaps for a season or a year. Organisations with more stable cash flows and longer-term assets will be more comfortable servicing debt and so borrow for proportionately longer periods. For example, a high rise building may be 65% debt financed, out to 30 years; the (supposedly) reliable rental income services both the debt and equity. Many businesses lie between these extremes.

A non-cash cost of debt is some loss of control by shareholders; covenants in lending contracts can cause constraints, and ultimately lenders can take control.

This loss of control may be too risky for some organisations, so they avoid debt. For example, those organisations with high real option values that are dependent on further development by scarce experts, such as high- or bio-tech start-ups.

Other organisations deliberately choose a high leverage strategy, e.g. using structured finance, hybrid instruments, project finance or private equity deals – often risky ventures for all parties.

(See 2.2 funding)

2.2 FUNDING

- What funding options does your organisation have?

- Over what time horizon does your organisation need to plan financing?
- Will your organisation be able to use the going concern assumption in your accounts as specified by IAS 1?
- Is there adequate headroom (size and maturity) relative to funding needs?
- Does senior management attach appropriate importance to negotiating the least restrictive covenants compared to the cost of funding?

IAS1 requires organisations to assess their access to adequate financial resources looking forward at least twelve months from the end of the reporting period. The availability of funding when required cannot always be relied upon as banks' risk appetites vary depending on market conditions, and this can impact the industries, credit standings, and even geographical regions banks are willing to lend to. Organisations will need to plan new fund raising ahead of when they'll need it, to diversify their sources of funding and to "warm up" potential investors and lenders in advance. Few organisations with choice would leave the refinancing of significant committed outlays or debt maturities to the last eighteen months before the requirement crystallises.

Some assets lend themselves to dedicated finance, often called asset based finance, while some items can be leased instead of owned. Some assets are good security for a provider of acquisition funds – land and buildings, expensive equipment. On the working capital front, supplier-led invoice discounting or factoring (sale of receivables) and 'supply chain finance', where the buyer leads the process can each be useful. But it must be noted that the more asset based finance an organisation uses, the less asset value remains to support credit taken from other lenders, trade creditors and employees for unpaid salaries, and this can change the attitude of those creditors.

FACTOR	EQUITY	BONDS	LOANS / BANK DEBT
Return of funds	• No obligation to return funds	• Bonds must be repaid upon maturity	• Bank debt must be repaid upon maturity
Relative cost	• High	• Low • Fixed interest rate	• Low • Almost always at a floating rate
Information disclosure	• Quoted companies public, formal disclosure	• More private, even for a public bond issue • Private placements are more private still and suitable for smaller issues.	• More private than equity and bonds but amount of information high, often including business plans.
Covenant requirements	• None	• Investment grade bonds have fewer conditions and generally no financial covenants compared to loans/bank debt • Sub-investment grade ('high yield') bonds have more covenants.	• More covenants and more onerous even for investment grade borrowers • Easier and cheaper to discuss amendments with banks than with possibly unknown bond holders.
Flexibility of usage	• Poor	• Fairly poor	• Good • Amount can often be drawn and repaid at will in revolving facilities as opposed to a term loan.

An old saying, 'fund early and fund long' remains true. Organisations need to work harder than ever on their funding relationships – not just bank relationships, but all the increasingly diverse potential sources of funding such as private placement debt, direct lending and asset based finance. Funding plans need to explore all options and think outside the box. Alternatives such as crowdfunding (equity), peer-to-peer lending (debt) and specialist 'fintech' service providers are increasingly credible sources of financial solutions for businesses.

2.3 OWN CREDIT RISK

- Have you presented your credit story accurately to stakeholders including investors, customers, suppliers, credit insurers, and analysts?
- Do you have robust cash flow projections, business plans plus stress tests for various downside scenarios, and showing the mitigating measures that would be deployed?
- Are your financial ratios running at an appropriate level and if not, can you adjust your capital structure or business risk profile?

Presenting and explaining your own organisation's credit standing to external parties will influence their willingness to do business with you and the terms they will demand. This applies to your suppliers, your lenders and lessors. Even your customers will want to assess the likelihood that you will still be in business to honour your

commitments in the months and years ahead.

Larger organisations that issue publicly traded bonds may have a formal credit rating from international credit rating agencies, and almost all organisations will find they have been assessed by a credit reference agency. These latter organisations perform a fairly mechanised analysis of publicly available information such as annual accounts, invoice payment histories and court orders.

Credit analysis will start with an organisation's historical performance supplemented with forecasts and projections and perhaps an audit of assets. For those forecasts to have credibility the analysts will want to build up their confidence in both senior management and the business strategy as well as the financial flexibility of the company.

The business plan and cash flow should be stress tested in a variety of scenarios to demonstrate compliance with loan covenants, re-financing abilities and other limiting factors. Credit analysts focus on how the potential downside risks are controlled and are less interested in outperformance on the upside, which is more the domain of the equity analysts.

Treasurers need to understand how their organisation looks to a lender, including not only their credit profile but also the economic business case where lending is part of a wider relationship.

CASH MANAGEMENT AND LIQUIDITY

3.1 LIQUIDITY AND CASH FORECASTS

- Does your organisation produce short-term, medium-term and long-term cash forecasts?
- Does treasury use all the forecasts?
- Do the forecasts coincide with the cash management structure so that the actual cash in bank can be easily tied back to the forecast?
- Is liquidity risk assessed, for example by sensitivity or scenario analysis?

Liquidity is access to cash and its management is the most fundamental element of treasury management

— if it fails, the organisation cannot continue to function, and no other decision, no matter how important, can proceed.

Liquidity enables an organisation to pay its obligations where and when they fall due and to source additional funds to meet further obligations. Cash management is a tool of liquidity management - it being the physical day to day management of cash - so that those obligations can be met. An organisation with little cash can remain liquid as long as it has an ability to borrow. Cash forecasts are therefore a key component of a liquidity strategy, with the treasurer often looking forward over several timeframes to manage liquidity properly.

Key tools for managing liquidity are:

- **Cash management**, using cash generated by business operations, cash surpluses retained in the business and short-term liquid investments.
(See 3.2 Cash Management)
- **Working capital management**, by managing supplier payments, receivables and inventories to optimise the investment in working capital.
(See 3.4 Working Capital Management)
- **Organising and managing borrowing facilities** using cash flow forecasts, building in planned/required new funding and maturing funding that must be re-paid/re-financed.

Liquidity risk can be analysed by time frame:

- Operational liquidity risk focuses on the short term needs from day to day operations
- Strategic liquidity risk focuses on longer term risks, the need to ensure that the business can continue and can support

changing business plans in the future. (See 2.2 Funding).

Short term forecasts are usually driven by the receipts and payments data from accounts receivable and payable ledgers, interest and tax information, and net profit / performance reporting. They generally cover the period from the day they are created until approximately 30 days later. While those in highly geared or volatile businesses value them greatly, some treasurers in cash rich or cash generative businesses do not use short term forecasts. However, the need to optimise investment of surpluses means more companies require them today.

Medium term forecasts often extend to a 'rolling' year. These allow the planning of 'big ticket' items such as capital expenditure, tax and dividend payments and funding maturities, and feed in to some aspects of forecasting compliance with financial covenants.

Long term forecasts are an essential tool to identify trends and overall cash generation or consumption over time. They are usually driven from plan data prepared by management accountants and the timescale will typically extend from one year's time up to three, five or 10 or more years.

In many organisations, cash forecasting is not performed well. The forecasts are often too long, too short, not used or are consistently inaccurate. From a practical perspective, the treasurer should monitor their accuracy by comparing actual data to forecasts, and give feedback to material business units providing the source data.

3.2 CASH MANAGEMENT

- Do you have day-to-day visibility of bank account balances?
- Do you have an efficient bank account structure (such as inter-company netting, cash pooling)?
- Are surplus funds or short term borrowings being optimally invested or utilised?

Cash management is part of managing liquidity (See 3.1 Liquidity and Cash Forecasts.)

It is a treasurer's task to ensure that cash flows (receipts and payments) throughout the business are processed as efficiently and as securely as possible. Optimising bank charges and float (the time that a transfer is 'in transit') can save considerable amounts of money. One way of doing this is by organising bank accounts into cash concentration or notional pooling structures. Cash concentration, also referred to as zero balancing, is the physical netting of funding positions across bank accounts resulting in the offset of interest income and expense. Notional pooling has the same resultant offset of interest, however the bank creates a shadow or notional position from all participating accounts and there is no movement of funds involved.

CASH MANAGEMENT INCLUDES:

Day-to-day cash control
(including intra-day where necessary)

Having the information to monitor bank account balances and the tools to manage liquidity to ensure that the organisation has enough cash or near cash resources to meet its immediate obligations.

Money at the bank

Building an efficient bank account structure that minimises overall borrowing costs, maximises overall interest earned and facilitates liquidity management.

Receipts

Maintaining bank accounts optimised for collection streams and an efficient infrastructure for managing items in the course of collection.

Payments control

Maintaining bank accounts optimised for making payments, routine or urgent, together with appropriate systems support.

Short-term investments

Optimising the use of surplus funds with short term investments.

Short-term borrowings

Utilisation of borrowing facilities to cover immediate funding shortfalls.

Inter-company payments are another traditional source of lost liquidity and inefficiency, from bank processing time ('float') to foreign exchange costs and bank charges. In house netting systems can significantly reduce these inefficiencies, especially for cross-border transactions.

Aggregation of external payments and collections is another way for organisations to make best use of systems, expertise and economies of scale. Payment factories, collection factories, in-house banks and shared service centres are all tools using these and other techniques.

Since the GFC, interest rates have remained at minimal, even negative levels. As a result, cash holdings have been depreciating in real terms, and there is a substantial cost of holding cash. Organisations should regularly review the amount of cash they are holding in conjunction with a formal cost/benefit analysis, and adjust the level accordingly.

3.3 COUNTERPARTY RISK

- Have credit limits been set by counterparty?
- Have limits been set by rating bands or similar criteria?
- Have limits been set by instrument types?
- Is total exposure by counterparty reported regularly?
- Is there a procedure to react to changes in counterparty risk?

Credit risk arising from exposure to banks and other financial counterparties is often much larger than credit risk from an organisation's sales. Before the GFC, some organisations paid scant attention to this, regarding banks as safe. Times have changed: organisations are holding more cash, and banks' credit (from the corporate perspective) has become weaker.

Credit risk with financial institutions does not just arise from deposits. It can be found in many places including:

- Cash on local deposit by particular group subsidiaries
- Cash in the process of collection through any medium such as cheques, wires, Automated Clearing Houses or payment cards
- Cash in set off arrangements such as notional pooling and concentration systems prior to final concentration
- Derivative contracts that are 'in the money' i.e. that are worth more than their replacement value in the market.
- Letters of credit, bank payment orders and bank guarantees (specifically the replacement risk in the event of a bank failure)
- Custodianship arrangements for investments
- General set-offs under contract or in local bank/financial institution resolution (insolvency) practice or in internationally agreed bail-in actions.

Counterparty credit analysis must be done by legal entity (in some cases by branch). In addition to using overall ratings reports, including ratings outlooks, the treasurer should look at standalone domestic and foreign counterparty credit ratings, as well as those after any assumed government support. It is also important to consider an assessment of governments' ability and willingness to support their banks. However, ratings can be slow to change and may effectively lag market events so should not be relied upon exclusively.

'Market Implied Ratings' can be very useful, as can share and bond price movements (and equivalent Credit Default Swap [CDS] pricing – though CDS prices reflect much more than a debtor's credit standing).

Each of these indicators can be used as triggers to suggest a change in credit limits. Due to the speed of change in financial markets, the treasurer must be able to reduce such limits and if need be the exposure, immediately without further referral.

When managing credit risk in investing, the treasurer's mantra is 'SLY': Security first, Liquidity second, Yield last. Yield can only be increased by taking on more credit risk or reducing liquidity. Diversification from single banks to other counterparties, such as governments, corporate commercial paper and money market funds, reduces an organisation's risk. Larger corporates may use repurchase agreements ('Repos'), where collateral is received in exchange for funds invested, to reduce credit risk and to supplement money market fund utilisation.

Credit Support Annexes (CSAs) can be used to help manage the credit risk arising from International Swaps and Derivatives Association (ISDA) derivative contracts. A CSA collateralises the risk from changes in value (in both directions) on derivatives, however there are still settlement risks.

3.4 WORKING CAPITAL MANAGEMENT

- Does your working capital management involve a multidisciplinary team from procurement, sales and treasury?
- Does your treasury have good oversight of and effective influence over working capital?

Investment in working capital is part of doing business, which treasury needs to factor into its cash forecasts and funding plans. Higher working capital may ensure supply and boost sales and service levels, but at a cost. Lower working capital can reduce dependency on borrowing.

Working capital is broadly, inventory and work in progress plus receivables less payables. It and the cash conversion cycle can be controlled by adjusting the levels of inventory, supplier payment periods and the speed of collection of cash from customers.

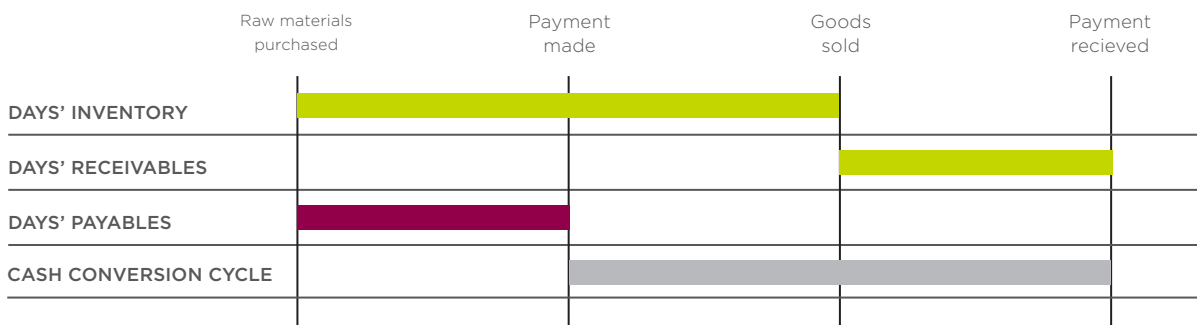
Cash conversion cycles differ. In a food supermarket, for example, which buys inventory for almost immediate cash sale, cash may flow in before suppliers have been paid. This is a negative cash conversion cycle. In other industries, where inventory is held for some time, supplier payments may occur long before cash from sales is received.

Targets and key performance indicators (KPIs) based on simple Days Payable Outstanding (DPO) and Days Sales Outstanding (DSO) tell only part of the story and are tricky to compare between organisations, each of which has its own unique characteristics. Optimal working capital levels balance: cost and availability of funding; credit risk in the supply chain; certainty of supply; the optimisation of inventory; the appropriate sales finance; and competitors' positions.

Simply delaying supplier payments may make your organisation a lower priority customer, affect prices, or even push suppliers into financial difficulties, which could threaten supply chain security. At the receipts end of the cycle, the process for sales and credit terms is crucial in ensuring payments are received when required.

Optimising working capital needs a coordinated, multidisciplinary approach - a cooperative approach between business functions that involves finding solutions to shared problems or opportunities. Operational and funding issues will have different priorities at different points in the economic cycle or the life of an organisation. Treasurers essentially need to know about working capital for cash management and financing planning. Their knowledge of the various ways of financing different elements of working capital mean they are able to play a positive role in this process.

CASH CONVERSION CYCLE



Different industries will have different conversion cycles

RISK MANAGEMENT

4.1 RISK MANAGEMENT FRAMEWORK

- Is risk management effectively integrated with the overall management of the business, and appropriately aligned with business objectives?
- Are there policies and procedures in place to consider the risk capacity, tolerance and appetite for risk in the organisation and has this been communicated widely?
- Is there a proper risk management framework in place to address the financial risks faced by the organisation?

ISO Standard 31000-2009 defines risk as the “effect of uncertainty on objectives”.

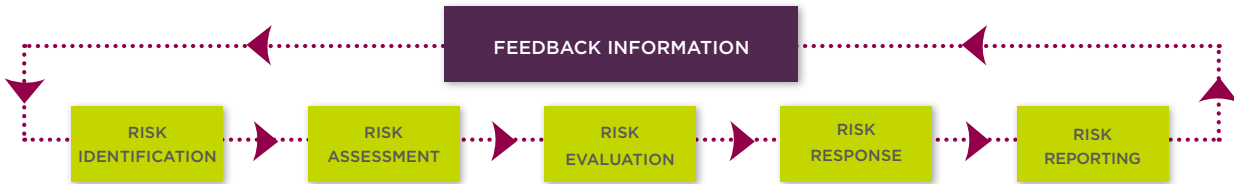
Risk can present opportunities for or threats to objectives.

An uncertainty that does not affect objectives cannot be a risk to those objectives.

The treasurer must be aware of the overall approach of the organisation to risk management, and be able to answer:

- Has the organisation properly articulated its management approach to both threats and opportunities?
- Hence is there **capacity** to take certain risks?
- If so, is there an **appetite**?
- How much of this appetite can be taken in treasury?

Having established a budgetary approach to treasury, a risk management framework will provide a mechanism to develop an overall approach to financial risks across the entire group by creating the means to discuss, compare, evaluate and respond to these risks. It can be seen as a series of successive phases. A useful framework is shown below:



Risk identification	Identification and classification of an organisation’s risk exposures and their sources to its objectives.
Risk assessment	An initial assessment of the likelihood of each risk occurring and of its potential impact on objectives together with the prioritisation of those significant risks for further analysis, evaluation and management. A useful way of assessing risks systematically is with a risk map or probability/impact matrix.
Risk evaluation	The evaluation or quantification in more depth in priority order to establish the probability and extent of potential loss (or gain) both for single risks, and groups of risks combined and consideration of non-calculable risks (events). Evaluation techniques include scenario analysis, sensitivity analysis, Value at Risk, statistics, and maximum loss. For some risks, for instance political risk, there can be no statistical approach. In these cases, non-statistical evaluation such as scenario analysis or stress testing is key.
Risk response	<p>After risk evaluation, risk responses can be planned and implemented. Each organisation’s corporate objectives, risk appetite and risk sources are unique and will lead to a different risk set and risk responses for each company. Risk responses can be categorised into four classes:</p> <ul style="list-style-type: none"> • Avoid or transfer the risk if investors do not expect the organisation to take it • Accept (retain) and monitor the risk if the threat is immaterial or the opportunity attractive • Reduce threats (their probability or impact) by internal action such as internal controls, diversification or by contingency plans • Transfer threats to a third party via insurance, derivatives, or the use of subcontractors. <p>Risk policy statements are used to document risk responses. (See 1.2 Treasury Policy)</p>
Risk reporting	Reporting helps ensure that risks are being managed as agreed and information is fed back in to the risk management process. (See 4.2 Risk Reporting)

APPROACH TO RISK MANAGEMENT IN TREASURY

Remember that if you hedge a risk you don't have, that is speculation.

Corporate finance theory suggests that the value of an organisation can be increased if its risk, i.e. the uncertainty of returns, is reduced.

Speculation is the act of deliberately taking on risk, or hedging a risk that you don't have. Opportunities consistent with the business strategy, commonly within strict limits (such as credit risk or liquidity risk in investing surplus funds) are acceptable. Anything else (inconsistent with the business strategy) is speculation and should be prohibited in corporate treasury as elsewhere. Inaction, deliberate or inadvertent, when policy would call for action is also considered speculation and should also be prohibited or strictly controlled within limits. For example, treasury operations might disregard foreign exchange positions passed to them if they are accepted as small and not of market size.

This approach does not prohibit the taking of financial risk: for example, increasing levels of debt (leverage), thus making the financial structure riskier, is a widely accepted approach to increase shareholder returns. But such leverage should be decreased if either the business or its financing becomes more risky (we have seen this happen widely since the GFC).

APPROACH TO RISK



Each of these requires a way to measure risk

4.2 RISK REPORTING

- Does treasury regularly report all significant risks, hedges in place and quantify outstanding exposures to senior management?
- Is the information fit for purpose – does it focus on achieving the financial objectives?
- Is action taken as a result of the information received? Is the information challenged?
- What assurance is there as to the timeliness, accuracy and completeness of the information?
- Are public disclosures adequate to demonstrate proficient risk management?

A treasurer's role is partly that of risk manager with delegated authority. Treasury must report on the management of its delegated, usually financial, risks. The treasurer also contributes to external reporting where both policy and performance are communicated to investors.

For each financial risk, there should be some measure of the risk and risk reduction. Regular reports should:

- Inform management of financial exposures outstanding both pre- and post- any hedging
- Demonstrate that treasury activity is within the policy authorised by the Board
- Promote the concept of analysis and performance measurement in treasury
- Create a feedback mechanism, leading to improvements in efficiency and control.

Best practice reporting should focus on accuracy, completeness, timeliness and materiality.

EXAMPLES OF TYPICAL TREASURY RISK MANAGEMENT REPORTS:

POLICY/RISK AREA	TYPICAL RISK MANAGEMENT REPORT(S)	FREQUENCY AND/OR PERIOD OF REPORT
Liquidity management	Liquidity and debt report, ideally with history and cash flow forecast added	Weekly out to 30 days and monthly out to one year (not just to the current year end).
Bank relationship management	Facilities provided by bank with usage history and any issues including concentration risk and attitude to renewals.	Quarterly with longer term annual review.
Credit risk	Credit exposure against limits, significant issues or downgrades, etc.	Monthly with longer term annual review and also special report following on any major event affecting a relationship bank.
FX (and commodity) risk	Transaction exposure report Translation exposure report Economic exposure report	Monthly with annual review focusing on longer term economic exposure
Funding and debt portfolio management	Funding review and outlook, debt maturity profiles, possible proposals for refinancing/new funding/equity raising.	Monthly but more frequently in run up to issue of new debt/equity and with a major annual review.
Covenant compliance	Performance against covenants (if any) on historical and forecast basis.	Monthly but weekly or daily or intra-day at times of stress.
Interest rate risk	Interest rate risk report.	Monthly with annual review.
Investments	Security, liquidity and return.	Monthly with annual review.
Treasury operations	Reports to the treasurer on controls.	Daily

Another tool for the treasurer is dashboard reporting, an internal report which summarises, in one page, the key risks/positions with brief commentary on any deviations/issues along with selected market rates.

This is a particularly valuable tool for reporting to senior management. In the treasury context, items on the dashboard may include:

- Foreign exchange (FX) exposures (pre- and post-hedging)
- FX volatilities
- FX rates
- Interest rates
- Headroom
- Cash positions
- CDS prices
- Funding developments

4.3 CURRENCY/COMMODITY TRANSACTION RISK

- Does your organisation have a mechanism to capture its explicit exposures to currency/commodity transaction risks?
- Does your organisation's policy on hedging and the instruments allowed provide adequate risk mitigation and over suitable timescales?
- Are internal hedges created and used as far as possible? Has the hedging behaviour of key competitors been considered?

The following has been written from the context of FX but equally applies to commodity risk.

Transaction risk is the risk that committed cash flows in a foreign currency are worth less or cost more than expected, due to changes in FX rates. It arises from, for example, sales or purchases made or contracts entered into in a foreign currency.

Like other risks, transaction risk can be avoided (for instance by only buying or selling goods and services in local currency), or accepted, reduced or transferred. Some exposures can be reduced or avoided by netting against opposite exposures within the organisation or another group subsidiary. Others can be transferred to a third party. The relevant external hedge is often a forward contract, usually used in foreign exchange, or a future, usually used for commodity risk, which transfers the risk to the hedge counterparty.

External hedging with forwards and futures provides a degree of certainty for periods, depending on the organisation policy, out to several years. Hedging can smooth out some of the market volatility in rates/prices but if there is a permanent and significant change to market rates, the hedging only buys time before the impact is felt. In the long run, the organisation may have to adjust its business model by changing its geographic sales patterns, or by changing the currency of its input costs, which might even mean relocating its manufacturing location.

Leaving a non-trivial FX exposure un-hedged can itself be seen as speculation.

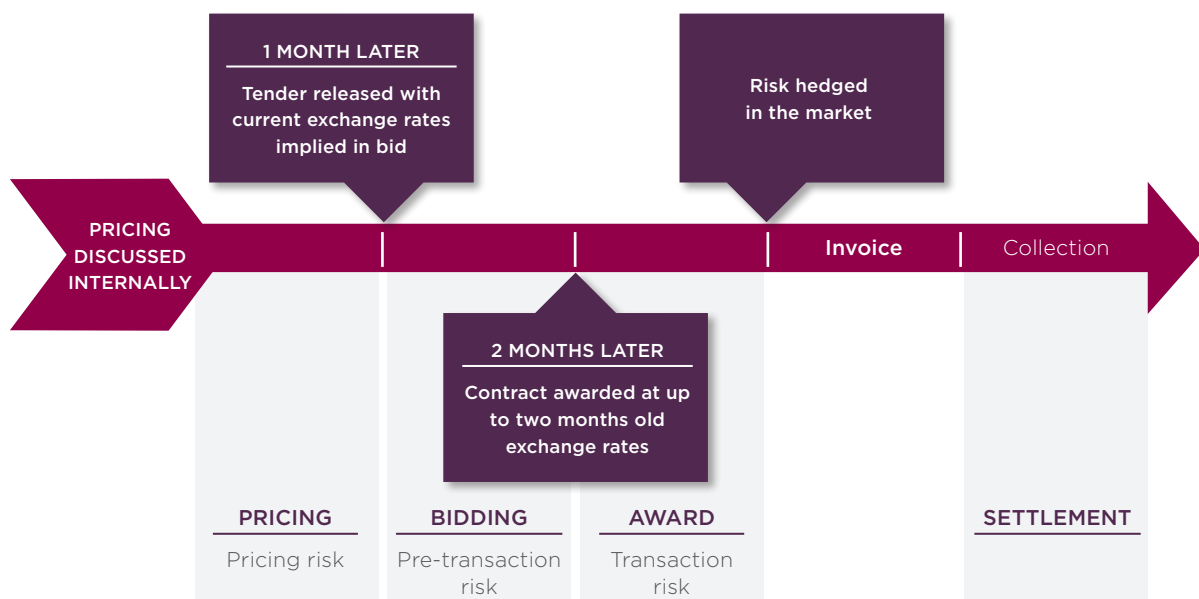
Using an example of a simple contract where an organisation supplies a product on a one off basis with income in a foreign currency and costs in the domestic currency, the following diagram shows that after winning the contract, foreign exchange transaction risk exists until the risk is hedged in the market.

Companies often adopt a policy to hedge all "certain" foreign cash flows at the time each becomes a firm commitment, for example when the purchase order is placed or a sales order is received and accepted. Leaving it until the invoice date is too late as the organisation has been exposed to exchange rate movements for the period from placing or receiving the order. In addition organisations may adopt a rolling programme, adjusted each month, to ensure that, for example 50% of sales forecast 12 months ahead and 20% of the 12 to 24 month predicted sales are hedged.

Organisations should watch out for hidden exposures.

A purchase denominated in your own local currency but from a foreign supplier could mean they are carrying an FX risk and so may increase their prices if exchange rates change.

FX RISK LIFETIME



4.4 ECONOMIC AND PRE-TRANSACTION FOREIGN EXCHANGE RISK

- Have strategic/economic foreign exchange risks implicit in your organisation's business model been adequately assessed?
- Can prices be changed as currency changes occur?
- Does your organisation tender for foreign currency denominated contracts and can contract margins withstand potential foreign currency movements?
- Is your organisation hedging uncertain risks with options rather than outright contracts?

ECONOMIC EXCHANGE RISK

Economic foreign exchange risk is the risk of a change in the value of an organisation arising from varying exchange rates. It is the aggregate of the present values of all types of foreign exchange risks. The largest component is sometimes called strategic foreign exchange risk and arises from the consequential changes in the organisation's competitive position. Factors affecting economic exchange risk include the organisation's market position and its ability to control sales and cost prices; markets such as aerospace which are effectively denominated in a particular currency in this case USD; and business concentration in particular geographies compared to truly global businesses.

The specifics of the individual organisation mean that economic exchange risk usually differs materially between organisations.

HEDGING ECONOMIC RISK

Economic risk goes to the heart of a business strategy and the underlying competitiveness of the organisation. The response to economic risk is therefore based around the business strategy itself, and the risk can rarely if ever be avoided. The risk to the organisation needs to be properly measured, considered and responded to with a view to retaining or reducing that risk e.g. by facilitating contingency plans for business operations. In principle, the contingent nature of the risk might properly be responded to with contingent instruments like financial options (discussed below) but given the very long term and large sums involved costs are usually prohibitive.

PRE-TRANSACTION RISK

Pre-transaction risk arises when an organisation has to commit to a price before actually entering into transactions or commercial agreements or where the volumes to be shipped are uncertain, for example, under call-off contracts or contracts

with cancellation or partial cancellation clauses, or when tendering for a construction contract.

This contingent risk is ultimately best managed with a contingent risk transfer product, such as an option, although companies may hedge proportions of forecast cost or revenue using FX forwards. For example, when the German auto industry cancelled call-off orders at the start of the recent European financial crisis, it left central European suppliers with outstanding outright currency contracts that were cripplingly expensive to cancel, whereas options could have been exercised if in the money or allowed to expire if out of the money. Companies commonly use a proportion of options partially to hedge, or transfer such risks.

Options have certain important characteristics:

- They provide the option buyer (holder) with the right, but not the obligation, to exercise the option if the price of the underlying asset meets or exceeds a certain price – the strike price
- Purchased, they provide protection against adverse price movements while allowing the holder to benefit from favourable movements
- Purchased options can never be a liability for the holder
- Options have an up-front cost to buy (the premium) and can seem expensive
- They can be seen as speculative if used for cash flows that really are certain
- For most organisations, selling options is speculation, as they place potentially unlimited liability on the seller.

Structured option products, such as range forwards, cylinders or collars involve offsetting the cost of a purchased option with the proceeds from selling an option. Such instruments should be entered into only after a thorough evaluation of the possible outcomes for the corporate customer. The potentially unlimited pay out under the sold option may negate the effectiveness of such a hedge.

4.5 FOREIGN EXCHANGE TRANSLATION RISK

- Has your treasury given the Board analysis and advice whether translation risk is significant for the group?
- Could the impact of translation risk materially affect credit ratios or leverage measurements leading to a threat to credit ratings or loan covenants?

Foreign exchange translation risk results from exchange differences arising on consolidating foreign currency assets and liabilities into the group financial statements. The traditional view is that this is not a cash exposure, but an accounting issue, and it is often not hedged by the organisation. This is the approach that shareholders generally expect from investing in an international group.

Accounting standards, however, tend to point managers towards 'net investment hedges' where an organisation borrows or enters into a derivative to hedge against movements in the value of the accounting net assets of an overseas entity. However, this hedge of accounting net worth may bear little relation to the economic risks/value in such investments. The hedge may actually increase risk by introducing a cash flow from the hedge that is not balanced by an offsetting cash flow from the foreign investment.

Translation exposure can nevertheless affect credit ratios and cash flow measurements that may be relevant to debt covenants.

The measures and ratios that can be affected by movements in exchange rates include:

- Net worth or enterprise value
- Gearing
- Net debt / EBITDA
- Interest cover
- Cash flow (and measures involving cash flow).

The risk of covenant default is often the measure adopted in the management of foreign exchange translation risk and can be assessed by modelling various 'what if' scenarios applied to the business plan.

The response to such a risk is usually to adjust the amount of debt by currency so that the debt is more evenly balanced against earnings or net worth by currency.

The example below shows the impact of a weakening local currency "CCY" on the above ratios for a local holding company with a subsidiary in the United States. While debt has increased from CCY135 to CCY180, EBITDA and net worth have also both increased.

For simplicity, the example uses a single exchange rate to translate balance sheet, income statement and equity in each scenario; the exact treatment will depend on the reporting jurisdiction. The point remains however, that changes to ratios are unlikely to be linear nor necessarily intuitive.

	SUBSIDIARY USD	HOLDING CO. CCY	CONSOLIDATE CCY @ 1.5	CONSOLIDATE CCY @ 2.0	CHANGE % (33.3%)
Total Assets	100.00	90.00	240.00	290.00	20.8%
Borrowings	90.00	0.00	135.00	180.00	33.3%
Equity	10.00	90.00	105.00	110.00	4.8%
EBITDA	15.00	10.00	32.50	40.00	23.1%
Interest 5%	4.50	0.00	6.75	9.00	33.3%
	Net Worth		105.00	110.00	4.8%
	Gearing (Debt / Equity)		1.29	1.64	27.1%
Covenant measures:	Net Debt / EBITDA		4.15	4.50	8.4%
	Interest Cover		4.81	4.44	(7.7%)

4.6 INTEREST RATE RISK

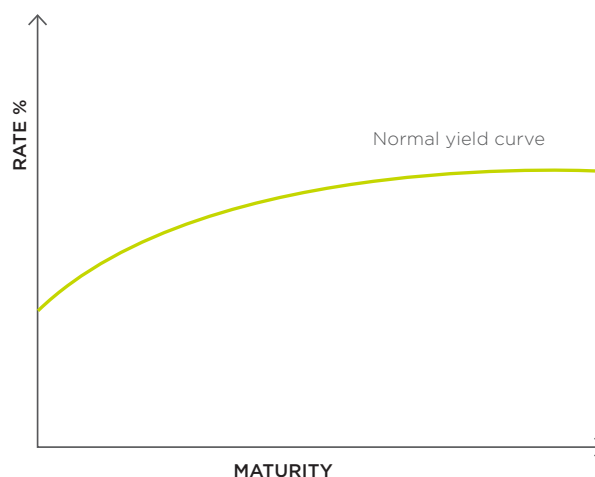
- What interest rate risk does the organisation have in its cost of capital?
- How is the organisation's performance affected by a movement in interest rates?

If interest rates rise, borrowers will pay more interest. If they fall, depositors will earn less. However, there are more facets to interest rate risk, as described below:

TABLE 1: THE ASPECTS OF INTEREST RATE RISK

RISK TYPE	DESCRIPTION
Risk over future interest payments or receipts	Borrowers will pay more and investors will receive more if interest rates rise.
Economic risks - linkage between business performance and interest rates	If a business does well in a high interest rate environment, its risk to rising interest rates is lower. Such a rise may be beneficial for the business overall, if the commercial improvement dominates the effect on the organisation's debt costs.
Organisations with high leverage	For organisations with high leverage, there is a very high exposure to interest rate risk which could swamp the organisation and must be managed.

Normally market interest rates fixed for longer periods are higher than for shorter periods (the yield curve).



If an economy slows, government or the central bank may reduce the interest rate to stimulate activity. Accordingly, a business may be somewhat protected from the economic downturn. There are, however, issues over how this effect is timed and there are also regional variations inside large economies.

Organisations with a naturally high leverage structure, such as property companies and those financed by private equity, will usually have a high proportion of fixed rate debt. Generally their revenue streams are also reasonably fixed, such as rental income. This matching reduces their interest rate exposure.

Many studies show that adopting a fully floating interest rate approach for a borrower with steady amounts of debt will, in the long run, be cheaper, mainly because longer term (fixed) rates include inflation, a liquidity premium and arguably, a maturity premium. Many organisations can generally raise prices with moderate inflation and so paying a premium by fixing seems wasted expense.

For some organisations, the objective may be to minimise the chance of a financial covenant breach, interest cost being a secondary issue. This is achieved by managing the fixed/floating ratio of debt. Since bond finance is usually at fixed rates and bank finance is usually at floating rates, to reach the chosen ratio, it is possible to enter into interest rate swaps.

TREASURY OPERATIONS AND CONTROL

5.1 INTERNAL CONTROLS

- Does treasury have adequate internal controls and are they audited annually?
- Are KPIs used to measure treasury operational controls?

In carrying out its function, treasury is exposed to particular risks around its operations, relating to issues such as fraud, error, market and systems failures. Treasury is particularly susceptible because of the large money amounts involved, its ability to make payments and the potential complexity surrounding its activities.

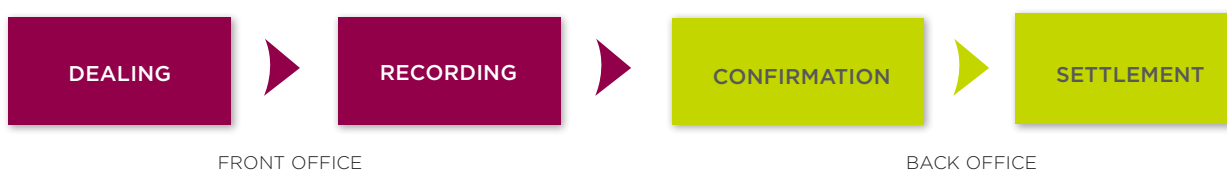
Individual treasuries differ so much in make-up, scope and how tasks are allocated in an organisation, that when considering operational controls we emphasise the underlying principles rather than the detail of specific control and reporting systems.

Control procedures in treasury generally cover the following areas:

- Prior authorisation and approval of financial transactions via delegated authorities
- Segregation of duties (see below)
- Recording procedures so that no transaction is omitted or is recorded more than once
- Safeguards for access to systems and documents
- Reconciliation/checking of records
- Measurement, including the use of KPIs
- Reporting
- Internal audit.

Segregation of duties is designed to prevent fraud and detect errors. It is an essential approach so that no transaction or payment, internal or external, is carried out without at least one other person knowing about it. In a treasury function, this becomes a general principle so that those executing and recording transactions (the "Front Office") must not confirm or settle these transactions (the "Back Office"). The diagram below shows segregation of duties in the dealing process. In a small treasury, the lack of staff means that some functions may have to be performed outside the treasury.

SEGREGATION OF DUTIES



Businesses must be aware of counterparty risk and dealing limits should be rigorously enforced. Breach of limits should be a disciplinary matter and may even lead to dismissal.

Measuring treasury operations encourages focus on key targets. KPIs can be used in the measurement of treasury operations. While there are many possibilities, some of the more important ones could be as follows:

KEY PERFORMANCE INDICATORS

KPI	TARGET
Number of items un-reconciled in bank accounts	Nil
Time for exchange of confirmations	1 hour
Number of confirmations sent/received that are not agreed	Nil
Trades made in error (e.g. wrong way round)	Nil
Bank and dealing mandates up to date	100%
Passwords changed every week/month	100%

Treasury operations should report the above to the treasurer daily, as a missed target could indicate an issue.

5.2 BUSINESS OPERATIONS

- Does the treasurer have a thorough understanding of the business and industry?
- Does the treasury team interact with and understand business operations and individual subsidiaries?
- Has group treasury clearly documented and communicated delegated authorities to local treasury centres/businesses?

The level and nature of business risks and their impact on cash flows have a material impact on managing capital structure, funding and liquidity, and financial risks – key treasury activities.

Therefore it is important that the treasurer has a thorough understanding of the business and the industry sector within which the organisation operates, and that treasury supports and enables the business operations and strategy of the organisation.

The treasurer and their team must get as close to operational management as possible. The treasurer must show they can understand the view of operations and demonstrate that the organisation will be better off for the application of the treasurer's deep knowledge of financial solutions into those operations.

For example, whenever an organisation issues a tender or price list with foreign currency content and/or with foreign currency costs in the supply chain, the treasurer should understand the risks involved. By working closely with procurement, the treasurer can aid the debate on procuring from one country over another.

When a new project or investment is being considered, the treasurer can give guidance on financing rates, discount rates, entity structuring, cash investment and repatriation, sources and structuring of finance and the impact on the company's credit rating.

Equally, when the treasurer talks to lenders in the capital markets, they should understand both their own sector and their lenders', and know how each organisation compares to its peers as well as to the wider market for risk and return. For example, organisations with high business risk are less likely to take significant financial risks. Stable organisations with high quality earnings may take more financial risks.

5.3 SYSTEMS

- What reliance is placed on internal and external systems?
- Are the systems used reliable, secure and effectively backed up?
- Is there an effective, up to date and practical disaster recovery plan?
- Are treasury transactions efficiently managed through the use of straight-through-processing (STP)? If not, might the benefits of STP outweigh the costs of its implementation?
- Are mandatory regulatory derivative reporting and reconciliation requirements met?

STRAIGHT-THROUGH-PROCESSING (STP)

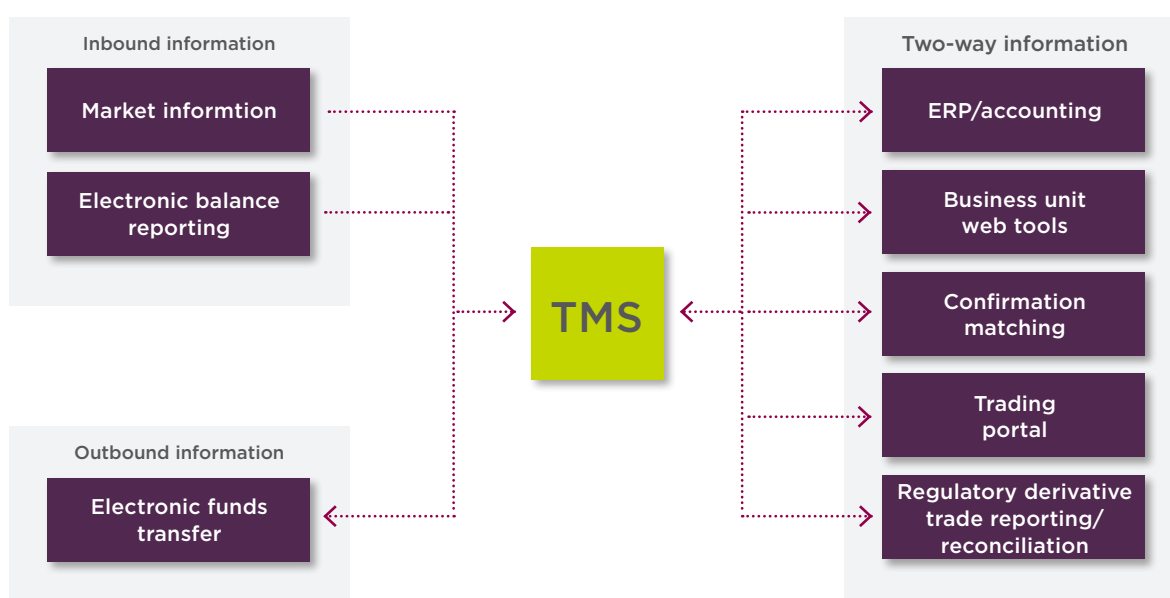
The effectiveness of transaction processing is usually determined by the degree to which it facilitates STP. STP is the efficient, secure and instantaneous flow of information:

- Within systems in the treasury department, such as the electronic confirmation matching system automatically updating the deal confirmation status in the Treasury Management System (TMS)
- With other internal systems, such as automatic posting of journal entries created in the TMS into the general ledger system
- With other parts of the business such as the capture of FX transactional risk by forecast FX transactions reported from subsidiaries
- With external parties, such as cash balances reported from banks or mandatory derivative trade reporting / reconciliation.

For treasury, technology used for automating processes, performing sophisticated calculations, communicating with internal and external partners, monitoring risk and generating compliance reports is of growing importance. All treasury transactions should be recorded and managed within a Treasury Management System (TMS), the heart of most corporate treasury technology infrastructures.

While spreadsheets are commonly used for broad forecasting roles, proper risk management techniques are universally available in the more sophisticated systems. The TMS will often need to be supplemented by, or connected to additional systems covering payments, market information or other specialist tools, as presented in the diagram below.

TYPICAL SYSTEMS USED IN TREASURY



A TMS facilitates the processing and management of specialist information; provides secure information through workflow controls, defines user rights ensuring segregation of duties, is a key treasury control, and provides an audit trail. It produces sophisticated treasury reports and accounts for treasury transactions, which under International Financial Reporting Standards (IFRS) and equivalent local standards may be highly complex. These issues are important for a number of reasons:

- The amounts of money handled by treasuries are always large relative to the size of the organisation. The potential cost of even a relatively minor incident of error or fraud can be material, even fatal, for the business.
- Treasury needs reliable information to help make decisions on risk management, liquidity and funding, the financing of investment and acquisitions, structuring debt, etc.
- Corporate governance is on the agenda

of every CFO and treasurer, and may be externally imposed to some extent. For example, Sarbanes-Oxley (US legislation) requires rigorous operational controls, only available with specialist technology.

A TMS can be a major investment for a treasury both financially and in the time required to implement and maintain the system as market practices develop. However, a TMS of appropriate scale, cost and complexity or the treasury module of an enterprise resource planning (ERP) system is essential to virtually every treasury.

As with any system, the maximum benefits are achieved by avoiding multiple entries (STP). Ideally, a single entry after executing a deal will generate the confirmation, match it against an inward confirmation, schedule any payments, create the accounting entries and interface to the accounting system, and generate any reporting needed.

Systems can be multi centre with remote data inputs to cater for global treasury centres with regional access and to allow segregation of duties and review. Extending automation to all countries where an organisation operates is probably the biggest challenge, but automation throughout the financial supply chain remains a major focus.

Disaster recovery should cover all angles, ranging from the mundane (sickness, holiday, maintenance) to the catastrophic (loss of power, communications, service availability, natural disasters, cyber-attack and terrorism). With an absolute reliance on data and its processing, the treasurer must have detailed plans and fall-backs to ensure data and systems integrity at all times. The treasurer must plan for the effects of cyber-attacks not only on treasury systems, but also on the company's other data and systems, and those of funders, cash management counterparties and so on.

5.4 TREASURY ACCOUNTING

- How are hedging decisions made?
- Are the economics, including tax effects, considered as well as the accounting rules?
- Is there a process in place to manage all the disclosure requirements?
- Does your organisation ensure that accounting changes do not risk loan covenant breach?

A feature of accounting standards is how quickly they change, and in almost no other area as quickly as in the treasury arena. IFRSs are being increasingly adopted as the global standards. There are five major international standards which particularly affect treasury:

- **IAS 39** covers accounting for derivatives and for hedging decisions
- **IFRS 9** replaces IAS 39 (effective 1 January 2018)
- **IFRS 7** covers financial instrument presentation and disclosure
- **IAS 17** covers leases
- **IAS 21** sets out how reporting entities should include foreign currency transactions and foreign operations in their financial statements

IAS 39 and its successor IFRS 9 are the standards which are considered to be the most demanding, as they cover the rules for hedge accounting for derivatives. In broad terms all derivatives must be recognised on the balance sheet and carried at fair value which can create significant income statement volatility. If the transaction qualifies

for hedge accounting some or all of this volatility can be removed or deferred if the company chooses to hedge account. The ability to utilise hedge accounting is subject to very demanding criteria and the introduction of a new general hedge accounting model in IFRS 9 is generally perceived as a positive change. Compared to IAS 39, IFRS 9 allows more hedging instruments and hedged items to qualify for hedge accounting and overall is trying to more closely align hedge accounting with the corporate's risk management strategies (i.e. the underlying economic rationale for hedging). Early adoption of IFRS9 is allowed in many jurisdictions, including Australia and New Zealand. The European Union is expected to endorse the standard in H2 2015.

Leases provide a source of financing for lessees however under current accounting (IAS 17) most leases are not reported on a lessee's balance sheet and are instead only disclosed in the notes to the financial statements. Since 2009 the IASB has been consulting on changes to lease accounting and has tentatively decided (as at the time of writing - August 2015) that a lessee would be required to recognise assets and liabilities arising from all leases with the exception of leases of 12 months or less and small asset leases. The IASB expects to issue a new lease accounting standard by the end of 2015.

The objective of IAS 21 is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements. IAS 21 does not apply to hedge accounting for foreign currency items, including the hedging of a net investment in a foreign operation as IAS 39 applies to hedge accounting.

Changing standards can have a major effect on covenants in loan agreements. A change might alter how some ratios are calculated, possibly causing a loan default merely because of these changes. For this reason most loans define these standards as at the date of the loan agreement and covenants are calculated under 'frozen GAAP', but this could mean that multiple sets of accounts may be required, one to meet IFRS and the other(s) to comply with various loan agreements.

CONCLUSION

THE GLOBAL FINANCIAL CRISIS HAD A CONSIDERABLE IMPACT ON BUSINESS, INCREASING THE SIGNIFICANCE AND VISIBILITY OF TREASURY. FINANCIAL MARKETS ARE NOW MORE VOLATILE, AS RISKS, SUCH AS FINANCIAL COUNTERPARTY RISK, HAVE INCREASED, AND TRADITIONAL FUNDING SOURCES ARE CHANGING.

Globally governments, throughout the G20, have placed more risks on the non-financial sector and moved them away from the financial sector. New regulatory regimes discourage maturity transformation (e.g. banks investing in assets like medium term loans using short-term liabilities such as deposits), liquidity transformation (i.e. investment funds investing in long term bonds but willing to realise assets to return money to investors at short notice), and credit transformation (e.g. stronger banks guaranteeing the payment obligations of weaker customers). Non-financial firms are now exposed to being “bailed in” in bank rescues – instead of the failed bank being bailed-out by tax payers.

The banking landscape is changing dramatically; individual banks’ capabilities are shrinking, and both banks’ balance sheets and corporate credit have become finite, valuable, resources which have to be used as cost-effectively as possible.

Other regulatory changes since the GFC will continue to add to the cost both of funding and of hedging.

And, as if life wasn’t challenging enough, proposed regulatory changes worldwide, such as clearing Over-the-Counter (OTC) derivatives through Central Clearing Houses could have a detrimental impact on an organisation’s liquidity risk management and change the ability of the firm to use derivatives as hedging instruments.

And treasurers, their organisations and their Boards in many jurisdictions will have to get used to being part of the regulated financial sector in regard to their use of financial derivatives – and to the exposure to civil and criminal penalties that brings. The requirement to report all OTC derivative transactions to a trade repository is an example of this.

Whilst these all present strategic and operational challenges to the treasurer, they have also resulted in professional treasury being more prominent in the boardroom. Compared to accountancy, treasury is a relatively young profession, less widely known or understood. It could be said that in the last decade treasury has started to ‘come of age’.

Not all Boards and senior management fully understand what their treasurer (or those that carry out the treasurer’s role) is or should be doing. This publication highlights the role of treasury in organisations today and how having skilled and qualified treasury professionals can significantly add value.

TREASURY CHECKLIST

GOVERNANCE		YES	NO
1.1 Treasury's role and objectives	<ul style="list-style-type: none"> Are treasury's role and objectives clearly defined and aligned with your organisation's objectives? Is the financial strategy articulated and integrated with your business strategy? Has the Board's risk appetite been quantified and clearly communicated to treasury? Do the CFO, Audit Committee and the Board of Directors as a whole understand the treasury issues and do they enjoy open lines of communication? 		
1.2 Treasury policy	<ul style="list-style-type: none"> Is treasury policy aligned with financial strategy (itself part of corporate strategy) and the approach to risk? Is treasury policy approved by the Board and reviewed at least annually? Does the treasury policy set limits for each financial risk? Is adherence to treasury policies reviewed by the Board and independently audited? 		
1.3 Qualified personnel	<ul style="list-style-type: none"> Is your treasury team adequately educated/qualified/trained and supported at each level? 		

CORPORATE FUNDING		YES	NO
2.1 Capital structure	<ul style="list-style-type: none"> Has the Board agreed a target gearing or credit rating for your organisation? 		
2.2 Funding	<ul style="list-style-type: none"> What funding options does your organisation have? Over what time horizon does your organisation need to plan financing? Will your organisation be able to use the going concern assumption in your accounts as specified by IAS 1? Is there adequate headroom (size and maturity) relative to funding needs? Does senior management attach appropriate importance to negotiating the least restrictive covenants compared to the cost of funding? 		
2.3 Own credit risk	<ul style="list-style-type: none"> Have you presented your credit story accurately to stakeholders including investors, customers, suppliers, credit insurers, and analysts? Do you have robust cash flow projections, business plans plus stress tests for various downside scenarios, and showing the mitigating measures that would be deployed? Are your financial ratios running at an appropriate level and if not can you adjust your capital structure or business risk profile? 		

CASH MANAGEMENT AND LIQUIDITY		YES	NO
3.1 Liquidity and cash forecasts	<ul style="list-style-type: none"> Does your organisation produce short-term, medium-term and long-term cash forecasts? Does treasury use all the forecasts? Do the forecasts coincide with the cash management structure so that the actual cash in bank can be easily tied back to the forecast? Is liquidity risk assessed, i.e. by sensitivity or scenario analysis? 		
3.2 Cash management	<ul style="list-style-type: none"> Do you have day-to-day visibility of bank account balances? Do you have an efficient bank account structure (such as inter-company netting, cash pooling)? Are surplus funds or short term borrowings being optimally invested or utilised? 		
3.3 Counterparty risk	<ul style="list-style-type: none"> Have credit limits been set by counterparty? Have limits been set by rating bands or similar criteria? Have limits been set by instrument types? Is total exposure by counterparty reported regularly? Is there a procedure to react to changes in counterparty risk? 		
3.4 Working capital management	<ul style="list-style-type: none"> Does your working capital management involve a multidisciplinary team from procurement, sales and treasury? Does your treasury have good oversight of and effective influence over working capital? 		

RISK MANAGEMENT		YES	NO
4.1 Risk management framework	<ul style="list-style-type: none"> Is risk management effectively integrated with the overall management of the business, and appropriately aligned with business objectives? Are there policies and procedures in place to consider the risk capacity, tolerance and appetite for risk in the organisation and has this been communicated widely? Is there a proper risk management framework in place to address the financial risks faced by the organisation? 		
4.2 Risk reporting	<ul style="list-style-type: none"> Does treasury regularly report all significant risks, hedges in place and quantify outstanding exposures to senior management? Is the information fit for purpose - does it focus on achieving the financial objectives? Is action taken as a result of the information received? Is the information challenged? What assurance is there as to the timeliness, accuracy and completeness of the information? Are public disclosures adequate to demonstrate proficient risk management? 		
4.3 Currency/commodity transaction risk	<ul style="list-style-type: none"> Does your organisation have a mechanism to capture its explicit exposures to currency/commodity transaction risks? Does your organisation's policy on hedging and the instruments allowed provide adequate risk mitigation and over suitable timescales? Are internal hedges created and used as far as possible? Has the hedging behaviour of key competitors been considered? 		
4.4 Economic and pre-transaction foreign exchange risk	<ul style="list-style-type: none"> Have strategic/economic foreign exchange risks implicit in your organisation's business model been adequately assessed? Can prices be changed as currency changes occur? Does your organisation tender for foreign currency denominated contracts and can the contract margin withstand potential foreign currency movements? Is your organisation hedging uncertain risks with options rather than outright contracts? 		
4.5 Foreign exchange translation risk	<ul style="list-style-type: none"> Has your treasury given the Board analysis and advice whether translation risk is significant for the group? Could the impact of translation risk materially affect credit ratios or leverage measurements leading to a threat to credit ratings or loan covenants? 		
4.6 Interest rate risk	<ul style="list-style-type: none"> What interest rate risk does the organisation have in its cost of capital? How is the organisation's performance affected by a movement in interest rates? 		

TREASURY OPERATIONS AND CONTROL		YES	NO
5.1 Internal controls	<ul style="list-style-type: none"> Does treasury have adequate internal controls and are they audited annually? Are KPIs used to measure treasury operational controls? 		
5.2 Business operations	<ul style="list-style-type: none"> Does the treasurer have a thorough understanding of the business and industry? Does the treasury team interact with and understand business operations and individual subsidiaries? Has group treasury clearly documented and communicated delegated authorities to local treasury centres/businesses? 		
5.3 Systems	<ul style="list-style-type: none"> What reliance is placed on internal and external systems? Are the systems used reliable, secure and effectively backed up? Is there an effective, up to date and practical disaster recovery plan? Are treasury transactions efficiently managed through the use of straight-through-processing (STP)? If not, might the benefits of STP outweigh the costs of its implementation? Are mandatory regulatory derivative reporting and reconciliation requirements met? 		
5.4 Treasury accounting	<ul style="list-style-type: none"> How are hedging decisions made? Are the economics, including tax effects, considered as well as the accounting rules? Is there a process in place to manage all the disclosure requirements? Does your organisation ensure that accounting changes do not risk loan covenant breach? 		

GLOSSARY

CDS	Credit Default Swap. A variety of swap agreement that enables the effective transfer of credit risk from one party to the other.
COVENANT	In loan documentation, a promise given by the borrower to take, or not to take, specified actions relevant to the borrower's creditworthiness. For example, a borrower may agree to maintain appropriate and sufficient insurance in respect of its business and assets.
CREDIT RATING	An assessment of creditworthiness. Although the general term can apply to individuals, in treasury it is usually used with reference to public debt issued by corporations or public bodies.
CSA	Credit Support Annex. An agreement designed to reduce counterparty credit risk in derivative transactions. Collateral is posted for the amount by which the related derivative instrument is out of the money for the losing counterparty.
DERIVATIVE	A derivative instrument or contract is one whose value and other characteristics are derived from those of another asset or instrument (sometimes known as the Underlying Asset).
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation.
FINANCIAL COVENANT	A clause in a loan agreement that commits the borrower to operate within predefined financial constraints. For example, an interest cover covenant might state that interest cover will be no less than 3 times; the borrower promises that the ratio will always exceed the set figure.
FLOAT	Time interval, or delay, between the start and completion of a specific phase or process that occurs along the cash flow timeline.
INTEREST COVER	From a whole-firm perspective, interest cover is the ratio of Profit before interest and tax ÷ Interest payable. Interest cover measures the safety or sustainability of the future debt servicing flows, from the perspective of the lenders.
ISDA	International Swaps and Derivatives Association. The industry body responsible, among other things, for standardising swap documentation.
NET WORTH	Broadly, net worth is the value of equity, based on book values, which a borrower covenants to maintain at a minimum absolute or relative level (for the protection of the position of the lender).

The definitions above are taken from The Treasurer's Wiki that aims to share knowledge across the treasury community (<http://wiki.treasurers.org/wiki/>)

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