A possible Strategic Agenda for Corporate Treasury

By: Bas Rebel and Sebastian di Paola

"Never waste a good crisis". This quote of an anonymous seems a good motto for reflection at the start of a new budgeting season. The last few years have been a rollercoaster ride for many a corporate treasury professional. The 2008 Credit Crisis and its aftermath stress tested common practice and – occasionally - demonstrated how tangible "opportunity losses" can be. Given the recent past, what would the strategic focus of corporate treasury have to be for the next few years?

What kept you awake?

By the end of 2007 daily operations had become routine for most treasury professionals. There might still have been room for calibration, but in general many corporate treasuries have been content and tactical and strategic agendas often contained mostly "nice-to-haves". Even on the technology vendor front developments seemed stagnant.

The collapse of Lehmann Brothers in September 2008 marked an abrupt change. It sent a shockwave through the global economy far beyond the periphery of the financial industry. The world had to accept that we had lived on a volcano that could no longer be contained. The world had to come to terms with the fact that the financial industry had overstretched its lending capabilities and could by no means kick start the economy like it had done in the past decades. The failing of the financial industry triggered a domino effect that threatened business continuity of many companies on a scale not seen before. Companies were not only confronted with falling demand en increased inventory levels, but also with the real possibility of failing house banks, more than potential loss of principal investments, the necessity of renegotiation existing loans, major hikes in interest cost and last but by no means least; unavailable liquidity for paying bills. Overnight Treasury had to go in overdrive collecting the necessary cash and cash flow information for executive management. Even if the company was not itself at risk because of the turmoil on financial markets, management had to deal with the second order effects of business trading partners not being equally lucky. Last but not least the contracting economy also meant for quite a few companies that substantial amounts of cash were released from working capital with little solid or rewarding investment opportunity.

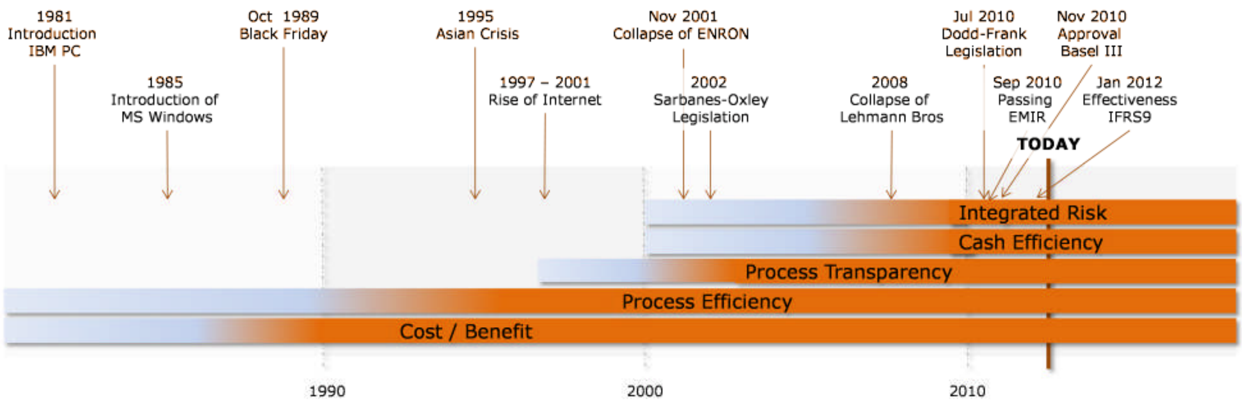

Figure 1: Shifting priorities for treasury at the background of major events

Ever since the collapse of Enron and the passing of the Sarbanes-Oxley legislation, compliance and transparency had been a major theme for treasury. Although it has always been acknowledged that regular (and fraudulent) decisions within treasury may have a major impact on profitability and corporate reputation, SOX was a first and successful attempt to regulate compliance. Its success seemed giving politicians worldwide the impression that regulation might be the solution to most evils: Basel III, Dodd-Frank, IFRS9 and EMIR only being the latest examples.

Taming your nightmares

One cannot avoid that the long hours and additional workload during the immediate aftermath of the Credit Crisis provides valuable input for the strategic agenda. If the 2008 Credit Crisis demonstrated but a few things, it would be that:

- External credit will never be abundant again and for many different reasons expensive for many years to come;
- Securing access to liquidity is a prerequisite for business continuity; and
- Labeling risk does not compartmentalize it, let alone quarantine it.

The events of 2008 gave textbook concepts like counterparty risk, trade credit risk, systemic risk and e.g. liquidity risk a face. By no means was this face a friendly one. Cash visibility and cash planning have become a daily obsession for many a corporate treasurer since monitoring liquidity and credit risk has become a matter of survival.

The logical consequence of the demand for instant, real-time management reporting is that Corporate Treasury has to become more effective about interfacing and integrating its departmental processes into the business across the enterprise. To phrase it differently; treasury has to become an enterprise wide process rather than a corporate department.

Enterprise Treasury Management differs from traditional treasury in the sense that it owns exposures upon generation by the business rather than managing them based on an interpretation reported by local staff. An effective Enterprise Treasury Management requires a corporate wide mindset or culture of:

- Cash;
- Risk; and
- Compliance.

In the following paragraphs the possible role of treasury in the three cultures is discussed.

Corporate Cash Culture

A cash culture builds around “cash efficiency.” Cash efficiency is not just about managing the cash within the treasury chest. It is characterized as cash flow management with the objective of “just-in-time” cash management securing the company’s ability to pay its bills in time. A successful cash culture will typically acknowledge that:

- Cash is a corporate resource. Cash is more than a bank balance and the affiliate that legally owns a bank account has no ultimate title to the cash in the account; and
- A sale is completed only after the cash is collected from the customer.

A cash culture puts collection from customers at par with revenue recognition and evangelizes the time-value-of-money. It brainwashes the organization with facts like:

- Every 3.5 days sales outstanding represents a funding requirement of 10 million per 1 billion sales; or
- At a weighted average cost of capital of 8% each 45.6 days sales outstanding equals 1% gross margin.

The implementation of a cash culture brings treasury in orbit of core business operations. It will make treasury a business consultant and partner of managers for strategizing on trade terms and conditions, working capital management and payment execution. A cash culture will most certainly make a payment factory and in-house banking readily accepted and no longer a corporate intrusion in local affairs.

A focus on corporate cash expands treasury's role and responsibilities to working capital management. With credit lines under pressure for some and mounting cash for other companies, flexible trade credit terms and vendor financing can be an alternative source of funding and tools for (strategic) supplier relationship management.

Yet another reason for implementing a cash culture and having treasury involved in day-to-day working capital management of the enterprise is that it might proof to be instrumental for managing the balance sheet and other financial ratios more effectively. Such balance sheet and ration management is key for maintaining a credit rating and consequently also for managing profitability, cost of funding and access to credit.

Figure 2 summarizes the potential contribution of treasury to a cash culture.

Sequence	Cash Theme	Treasury Focus	Project Scope
4	Controlling Cash Generation	Unlocking trapped cash Managing financial ratios	Working Capital Management Vendor Financing Balance Sheet Ratios / Financial Ratios
3	Understanding Cash Generation	Anticipating cash	Cash flow Forecasting Internal Cash flow Consultancy Financial Ratios
2	Grip on Cash	When mutate cash balances?	Payment / Collection Factory Infrastructure In-house Banking SEPA A/P and DPO Internal cash advisor to business Standardizing efficient Payment Methods Used by business
1	Full Cash Visibility	Where is the cash?	Bank Statement Hub Reported cash

Figure 2: Action Plan for Corporate Cash Culture

A cash culture almost naturally extends treasury departmental roles to enterprise wide roles and responsibilities. For instance the themes "full cash visibility" and "grip on cash" expands corporate treasury's responsibility for bank relationship management to include also responsibility day-to-day bank connectivity, irrespective of a bank account is controlled by treasury, is stand-alone or is only indirectly linked to corporate cash pools. This because by definition full visibility implies accurate and (near) real-time consolidated reporting on all balances, including those of stand-alone accounts. Consequently, a project aiming for full cash visibility has to consider:

- The creation of a bank statement hub and central repository that is linked to both TMS and (local) ERP;
- Automation of bank statement upload and auto-matching; and
- Integration of bank balance reporting and cash forecasting.

The themes "understanding cash" and "controlling cash" bring treasury in even closer connection with businesses across the enterprise. These themes insert treasury in daily processes of local units and entail the transfer of decision power and/or control over timing of payment execution and business terms and conditions like trade credit terms, trade credit limits and business partner approval.

Corporate Risk Culture

A risk culture builds on the principle that risk:

- Is inherent to doing business;
- Drives the quality of the cash flow and the company's business continuity in the best interest of all stakeholders; and
- Managing the volatility of projected cash flows adds value for all stakeholders.

A risk culture zooms in on the concept of "risk adjusted return" and has to be developed hand in hand with the cash culture. The liaising topics between cash and risk are cash flow and working capital management. There are two key aspects for treasury's contribution to a risk culture :

- Business Operations faced Risk; and
- Financial Markets faced Risk.

The business operations facing aspect of a risk culture concerns trading partner acceptance, enforcing trading limits and credit management in general. It also concerns the risk adjusted provisions booked for overdue outstanding trade balances. I risk culture should make sales and procurement sensitive to financial viability of customers and vendors and gives incentives for negotiating risk adjusted trade terms with business partners. An ultimate consequence of a risk culture might be that corporate price lists and trade terms and conditions differentiate by the (implied) credit rating of business partners similar to the pricing strategies in the financial sector.

Sequence	Risk Theme	Treasury Focus	Project Scope
1	Business Operations • Customer viability • Supplier viability • Operational risk	Trade Credit Outstanding Risk Adjustment Provisions	Model for business Trading Partner Rating
1	Financial Markets • Liquidity risk • Interest & FX risk • Counterparty risk • Systemic risk	Optimizing Financial Ratios WACC (Implied) Company Credit Rating Use of derivatives	Working Capital Management External Funding Structure IC Funding Structure

Figure 3: Action Plan for Corporate Risk Culture

The financial markets facing aspect of a corporate risk culture centers on balance sheet management and optimizing key financial ratios. The focus on financial ratios and weighted average cost of capital (WACC) is important for the company's ability to assure access to external funding from shareholders, banks and where applicable other (in)formal investors. Following the introduction of Basel III financial markets will be more differentiated as well as highly sensitive to risk and credit ratings. Consequently, companies have an interest in managing key input variables for (implied) rating models as these define their access to financial markets and the cost of funding.

Corporate Compliance Culture

Operational efficiency and transparency and process tooling define a compliance culture. Key objective is protecting the corporate reputation and minimizing operational risk. A compliance culture will focus on:

- Process standardization and automation; and
- Global applications with strong workflow management functionality.

The scope of potential treasury projects related to the compliance culture dovetail nicely with the scope of projects already mentioned above as part of implementing cash and risk cultures. Almost naturally, it drives the deployment of centralized and integrated systems for the support of business processes irrespective of the physical location of operating staff. It is no wonder that internal and external auditors welcome payment factory / in-house banking and bank connectivity hub projects as they make the sensitive payment process more standard and transparent and are typically compatible with the key control framework.

Sequence	Compliance Theme	Treasury Focus	Project Scope
1	Operational Risk	Workflow Support Payment Collections	Key Controls End User acceptance / User Profiles Standardization & Centralization Secure Automation Payment Factory / In-house Banking Trade Credit Limit Management Business Trading Partner Acceptance Process Bank Account Management (BAM)
1	Transparency	Invoice Approval Payment Release	Key Controls Bank Connectivity Hub Internal and Multibank EB tooling
1	Reporting	Monitoring KPIs related to Cash and Risk Culture	Treasury Data Repository Reporting Dashboard

Figure 4: Action Plan for Corporate Compliance Culture

Responsibilities, KPIs & Incentives and Reporting

We labeled the different elements of the strategic agenda as "cultures" for a good reason. It is important that cash, risk and compliance are part of the corporate mindset similar to sales and results are already. Successful implementation of a (new) culture requires cross-functional collaboration, endurance and executive sponsorship.

Executive sponsorship is necessary because key to success is the roll out of a new, consistent set of SMART KPI's and related incentive schemes for most business and corporate departments. Treasury has to play an important role at the definitions on the new incentives because the underlying KPIs will have to gear towards liquidity and risk.

New KPIs do not necessarily entirely obsolete existing ones. Sales incentives for instance will continue to be important. Pay out of these sales bonuses might be (partially) tied to collection from the customer within the agreed timeframe. In addition, a sales bonus might be made dependent on the (implied) credit rating of the customer.

As responsibilities are shifted incentives could be transferred between departments. In case a full payment factory is in scope, it does no longer make sense keeping local businesses responsible to DPO. Instead, the PF-shared service center should be responsible for DPO whereas local business should be monitored on the period between invoice receipt and acceptance.

Traditional ratio's might not adequately support the full scope of cash and risk cultures. Periodic DSO for instance does not properly reflect the actual trade credit given to customers. Instead companies might consider as working capital KPI an amount weighed actual trade credit term and standard deviation from the average.

Under a new incentive scheme treasury will be allotted responsibility for cash balances on all bank account and the obligation funding accounts on time / just-in-time. Management of account balances held in open economies can be included in SLAs or can be part of in-house banking agreements, whereas the management of account balance in restricted economies could be incorporated in agency treasury agreements.

Tracking and reporting the underlying KPIs is pivotal when redesigning incentive schemes. If local managers will become responsible for swiftly approving supplier invoice such that they can be discounted under a vendor financing scheme, a report dashboard has to report on the lapse time between invoice and approval date at individual invoice level. Consequently, the implementation project for a cash and risk culture will include a data mining project stream. The data mining team might - on the back of its dash boarding work related to the new cultures - contribute to a more scientific and more reliable approach to cash forecasting.[1]

Rewarding

Embarking on the implementation of the above sketched agenda for treasury may seem radical, and for sure is complex and will require a substantial investment in effort and resources. Often the overall benefit of a cash and risk culture by far outweigh the project effort. Making cash and risk part of the corporate DNA improves the quality of the cash flow and financial ratios as it aligns the interest of diverse business functions. It also improves information on daily liquidity. Consequently it contributes positively to the dialogue with stakeholders and most certainly also to the cost of funding / return on assets. Furthermore an improved control over the cash flow and more effective working capital management can expand funding options for the company and its vendors and thereby securing supplies and business continuity. On a personal interest level and from a career development perspective there is a lot to gain for treasury professionals as the agenda implies expanding roles responsibilities for treasury and a closer alignment to the businesses.

[1] See also B. Rebel, "A New Approach to Reliable Cash Flow Forecasting", gtnews.com Jan 2010

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