ESSENTIALS
of Managing Treasury

Karen A. Horcher

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For my dear friend Ashley—
you are greatly missed.

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Preface

The subject of treasury management is both broad and deep. Treasury is being revolutionized due to new services and technologies, some of which were only ideas a short time ago. However, technology does not change the nature of treasury. It is still a role that requires proactive risk management and due diligence in the collection and stewardship of organizational assets.

Although there are excellent information sources available on the subject of treasury, this book is designed to be a treasury primer. As a result, it focuses on the major issues and considerations within the evolving world of treasury.

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CHAPTER 1

Introduction

After reading this chapter, you should be able to:

- Appreciate the historical impact of past events that have shaped the form and function of today's treasury.
- Understand the component activities of treasury.
- Review the various functions of treasury and how they interact with other parts of an organization.

Background

Over the past several decades, the financial market environment has changed dramatically. Financial market volumes are larger, and news travels more quickly than at any time in history. Governments have always come and gone, crises have erupted, but today the information and implications are almost instant. Events that occur anywhere in the world can impact an organization within minutes.

As a result, significant energy and resources today are spent managing the financial implications of internally generated strategies and external events. The historical importance of past events has shaped many of today's treasury activities.

Changes in Financial Markets

Financial markets have changed over the past few decades. A number of factors have contributed, including long-term changes in inflation and interest rates, government debt and deficits, and the increasingly global markets where volatility in one market impacts others immediately.

Following World War I, volatility was a feature of financial markets. By the early 1930s, the financial markets faced some terrible problems, including suspension of the gold standard, massive unemployment, bank failures, and an unprecedented evaporation of wealth. World War II effectively ended the financial outlook of the 1930s as previously idle resources were deployed into war production.

The Bretton Woods Agreement of 1944 concluded the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire. The multilateral agreement was designed to foster postwar economic recovery and currency market stability among the nations of the world. Its accomplishments included the beginning of the International Monetary Fund and the International Bank for Reconstruction and Development (the World Bank).

The agreement included pegged exchange rates for the major currencies against the U.S. dollar and a gold price of $35 per ounce, to which the U.S. dollar itself was pegged. As a result, central banks could hold U.S. dollars and be guaranteed the convertibility of their dollars to gold.

The Bretton Woods Agreement would determine exchange rates for the next quarter century, bringing with it foreign exchange market stability.

Today, floating foreign exchange and interest rates provide additional challenges for business at home and abroad. Foreign exchange transactions provide the linkages for international flows of trade and capital. However, with estimated foreign exchange volumes at nearly $2 trillion daily, financial markets can adversely impact organizations transacting business. The impact of global capital flows can be significant, exceeding trade flows and in some cases the economic activity of small countries.

What Is Treasury?

The treasury department is the financial center of an organization. The key role of treasury is the safeguarding and stewardship of an organization's financial assets and the management of an organization's financial liabilities. Treasury's role is often focused on external issues: financial markets, investors, creditors, financial institutions, rating agencies, and debt issuers, for example.

Treasury is responsible for implementing various financial decisions made by management and the board. Its focus is on the financial assets and liabilities of an organization. Treasury also has an important role in risk reduction and mitigation.

In large organizations, a team of professionals might be responsible for various treasury activities. Although many of the functions are more complex within a large organization, smaller organizations may have similar functions domiciled within finance or accounting roles. In a smaller organization, the treasury function may be handled by one or two individuals. Treasury is an integral part of an organization, functioning as a service area to other parts of the organization. Although strategic decisions may be made at the executive level, treasury often plays a key role in advising on alternatives, assessing risk elements, and execution of decisions. The quality of an organization's treasury, therefore, impacts the success of the entire organization.

History of Treasury

The concept of treasury as a store of wealth of a company, a society, or a country is not new. Walter Bagehot, in his 1873 book *Lombard Street: A Description of the Money Market*, wrote about financial institutions and the "ultimate treasury, where the last shilling of the country is deposited and kept."[1]

The role of treasury has evolved significantly over the past 50 years, from a focus on cash management to a more strategic financial focus. Treasury is responsible for bringing a particularly expansive view of finance to an organization, which it gains through its contact with the various parts of an organization, with other financial market participants, and with financial institutions.

The introduction of technology, in particular, has changed the nature of treasury. The ability to electronically extract bank and transaction information, track real-time financial rates and prices, and automate many routine reporting requirements means individuals have an opportunity to add more strategic value. Yet the core of treasury remains the safeguarding and provision of financial assets to the rest of the organization.

The introduction of the Internet to treasury more than a decade ago was nothing short of revolutionary. Even small market participants now have the opportunity for pricing, news, and analytics that had previously been available only to larger participants. Communications

IN THE REAL WORLD

Notable Quote

Treasury is closely aligned with financial markets through the transactions that an organization undertakes. This quote from more than 100 years ago illustrates that the attributes of a good market have been around a long time:

"A perfect market is a district, small or large, in which there are many buyers and many sellers, all so keenly on the alert and so well acquainted in one another's affairs that the price of a commodity is always practically the same for the whole of the district."

Source: Alfred Marshal, quoted in *The Foreign Exchange Market in the United States*, Federal Reserve Bank of New York, 1998.

networks mean that information can be shared easily between disparate organizations around the world. Treasury technology is discussed in more detail in Chapter 7.

Not so long ago, the business of treasury was synonymous with the activities around cash management, primarily collecting and disbursing cash. Today's treasury is often involved with liquidity management, foreign exchange, and risk management. However, cash and its management remains a central role for treasury.

The changing role of treasury can be seen by its increasing importance as a strategic financial center. Increasingly, treasury functions as a consulting and advisory group to other parts of the organization for activities related to treasury and cash management. Its importance as a liaison with accounting, reporting, and compliance add to its strategic role. In addition, there is more emphasis today on the importance of accurate cash forecasts and management of working capital resources.

Role of Key Participants

The role of treasury is primarily a financial management role. The treasurer's responsibility encompasses cash management, funding, risk management, and relationships with key market participants. In most organizations, the treasurer reports to the chief financial officer (CFO).

A related role is that of controller, who typically also reports to the CFO. However, unlike the treasurer, the controller's role is more focused on accounting and reporting, budgeting, credit, and the audit process. Together, the roles of treasurer and controller provide critical financial support to the business of the organization.

The role of the treasurer and the treasury team has evolved considerably in recent years. Traditionally, the most visible role of treasury was cash management. However, recent events and regulatory changes have focused significantly more responsibility on the CFO, putting more pressure on treasurers.

At the same time, the use of technology to support financial data and reporting has increased dramatically. Reports often are received in near real-time, even from geographically disparate locations. The globalization of commerce has also accelerated dramatically, making it more difficult to view events or situations in isolation. As a result, the treasurer is increasingly seen as a key member of the strategic management team, the global hub focusing on the interrelationship between financial markets and the operations of an organization.

Why Manage Treasury?

Organizations today have much more financial accountability than perhaps ever before in history. Strategy has shifted to support improvements in competitiveness. Without adequate financial management, companies compete in increasingly aggressive global environments without the necessary proficiencies.

Changes have occurred for several reasons. First, management of corporations has become increasingly transparent, and shareholders and stakeholders are aggressive in their demands for adequate financial accountability. Consider, for example, the implications of companies complying with legislation such as Sarbanes-Oxley in the United States.

Second, companies are much more global in their activities. Competitors may be international with a different set of economic circumstances at their disposal. Although organizations can control risk factors internal to the organization, it is not possible to control the many external factors that affect international business activities.

Third, financial markets are arguably more volatile than they were 30 years ago. Changes in exchange rates, interest rates, and commodity prices can quickly and adversely impact a profitable company.

As a result, it is more important than ever to manage treasury and the inherent risks and opportunities appropriately.

Functions of Treasury

Treasury deals with many of the financial risks of an organization. After all, treasury is where major decisions (and mistakes) can be made. In addition, treasury advises on and executes the various strategic decisions of the organization. This responsibility includes obtaining and managing financing and the effective control of funds once financing is obtained, as well as the timely execution of financial decisions made by senior management and the board on behalf of stakeholders.

Treasury encompasses the major functions of cash and liquidity management and financial risk management. Within these two broad categories are several functions.

Traditional treasury functions include cash management, cash forecasting, hedging of financial market exposures, investing, and debt issuance. The management of relationships with financial institutions, such as banks and investment dealers, assessment of acquisitions and divestitures, and other related types of transactions may also be handled by treasury. Treasury may also play an important role in liaison with both the board of directors and senior management.

Organization

The financial function falls into the area of responsibility managed by the CFO. Reporting roles may include vice president of finance, sometimes with a subordinate director or manager of treasury. In large organizations, treasury functions may be handled by several individuals, each with an area of expertise.

Treasury functions vary by industry and organization but typically include cash management, cash forecasting, investing and financing, foreign exchange, information management, reporting, financial institution relationship management, and risk management. In a large organization, these functions may be handled by different groups within treasury. In a smaller organization, individuals may manage treasury with other functions.

Treasury functions on information, and data and system requirements are critical from a strategic perspective. The technology infrastructure permits an organization to have adequate information and reporting to make key financial decisions.

Cash Management

Cash management plays an important role in an organization, and it is the central role for treasury. Most other treasury functions develop as a result of cash management. Cash management includes cash flow forecasting, control of cash receipts, and disbursements. The investment of excess cash and funding or debt issuance to cover cash shortages are also considered to be under the broad label of cash management, as are the analysis and control of cash balances.

Cash flow forecasting, in particular, is an important aspect of treasury. There are many benefits to an accurate cash flow forecast, both short term and long term. Many senior executives consider an accurate cash flow forecast and the availability of adequate liquidity to be the most valuable contributions that treasury makes to an organization.

Risk Management

Financial risk management is the process of dealing with the uncertainties that arise from financial markets. Although the process of financial risk management incorporates aspects that are unique to specific industries and organizations, there are some universal components. These include:

- Identification of key risks, including risks that arise from financial markets, extension of credit, and the ability to obtain financing
- Procedures for risk measurement
- Development of alternative risk management strategies
- Determination of risk appetite or tolerance
- Formation of, and contribution to, financial risk management policy

- Implementation of risk management strategies
- Development of infrastructure to monitor risks and report on compliance with policies and performance reporting

Treasury provides a valuable role in the process of risk management, advising senior management and the board on whether to hedge, what to hedge, how to hedge, and the implications of hedging decisions. The most common risk management activities in treasury include foreign exchange, interest rates, credit, operational issues, and commodity prices. Treasury risks are discussed in more detail in Chapter 6.

Other Treasury Roles

Other treasury roles include bank and counterparty management, and technology, services, and infrastructure support. Treasury also acts as a strategic advisor to management, providing information about financing opportunities, cash flow forecasts, and financial asset valuation.

Because many treasury professionals have financial market expertise, it is not surprising that treasury often provides market intelligence, both locally and globally. Analysis and performance benchmarking and reporting are other areas in which treasury contributes to the long-term benefit of an organization.

Treasury Community

An organization's treasury depends on a number of key and ancillary community members, including:

- Financial institutions, including banks and dealers
- Investment community

- Regulatory environment that dictates reporting and accounting requirements
- Accounting, audit, and legal experts
- Vendors of information or infrastructure, including payments, data, and software
- Credit rating agencies

Externally, treasury relies on organizations such as accounting and legal professionals, as well as financial institutions. Many of treasury's most important relationships are with financial institutions.

The management of key relationships is a role that naturally falls to treasury due to its extensive contact with many of these organizations. Treasury manages the relationships with financial institutions and the investment community, as well as the rating agencies that facilitate the reports that ease the debt issuance process.

Financial Institutions

Financial institutions function as financial intermediaries, delivering various financial services and facilitating nonfinancial activities. Financial institutions may act as principals, buying or selling currencies, debt, or investments for or from their own account. They may also act as brokers, in which case a commission for buying or selling may be payable. Services provided by financial institutions include:

- Processing receipts and disbursements
- Debt issuance
- Investments

- Foreign exchange products and services
- Hedging products, including derivatives
- Custodial and trustee services

Financial institutions provide varied services through in-house experts, whose skills and relationships are managed by the account manager or relationship manager assigned to an organization. The need for a new type of service—to discuss interest rate swaps, for example—should be prefaced by a call to the relationship manager, who can direct treasury to the appropriate person and follow up to ensure all documentation is in place to transact business.

Although financial institutions often provide informal advice to treasury, their main area of expertise is their own portfolio of products and services. As a result, their understanding of each organization and its unique attributes may be limited. Financial institutions are discussed in more detail in Chapter 8.

Investment Community

The external investment community is an important one for many treasuries, particularly if the organization issues marketable debt to investors, either through an investment dealer or directly to the marketplace. The investment community includes rating agencies, which are important components of the investment mechanism.

Credit rating agencies provide credit assessments of borrowers, financial institutions, governments, and debt issuers. Prominent credit rating agencies include Dominion Bond Rating Service, Fitch, Moody's Investors Service, A. M. Best, and Standard & Poor's Ratings Services.[2] Credit risk is discussed in more detail in Chapter 6.

Service Providers

Other participants that provide key or important products and services to treasury include consultants, who may work on specific projects or provide ongoing advisory services, real-time information providers, payment facilitators, and vendors and developers of treasury and related software. These are discussed in more detail in Chapters 7 and 8.

Treasury and the Organization

Treasury operates a financial clearinghouse for all other parts of an organization. In large companies, an international or regional treasury may provide specific services to companies within the corporate group anywhere in the world.

Just as all parts of an organization typically impact treasury, either directly or indirectly, the efficient and effective functioning of treasury provides implicit benefits throughout an organization. As a result, the organization may benefit from lower cost of funds, debt reduction, control of risk, increased liquidity, and the benefit of strategic financial planning expertise.

Sales transactions with customers and clients affect treasury through the collection of funds, normally accounts receivable. Purchases of raw materials, services, and goods for resale also affect treasury through payments and accounts payable.

Other departments that affect treasury include human resources, through salaries and wages, benefits, and bonuses. The legal department may provide information about claims that have been made or are being settled or significant financial settlements, such as the purchase or sale of real estate. The tax department will have to submit