Exchequered history

John Ogilvie

The author of the CIMA Study System on Finance explains the role and management of the treasury function

The treasury function exists in every business, although in small firms it may be part of a department that's responsible for other functions, such as accounting or company secretarial work. In larger organisations it is likely to be a separate department reporting to the chief financial officer, but it needs to communicate well with the rest of the organisation if it's to provide an effective service.

Treasury represents one of the two main aspects of financial management, the other being financial control. The former is concerned with the relationship between the entity and its financial stakeholders, who include shareholders, fund lenders and tax authorities. The latter, on the other hand, is concerned with the relationship between the entity and stakeholders such as customers, suppliers and employees.

The practice of establishing a specialist treasury function in the finance department can be traced back to the late 1960s. Technological developments, the breakdown of exchange controls and increasingly volatile interest rates and exchange rates, combined with the globalisation of business, have all created greater opportunities and risks for businesses over the past three decades. To survive in today's complex financial environment, businesses must be able to manage both their ability to take these opportunities and their exposure to the risks they create.

Businesses have had to become more aware of the growing range of hybrid capital instruments (for instance, convertible preference shares issued in the name of a subsidiary registered in the Dutch Antilles) and financial instruments (forward markets and the various derivatives markets). They must be able to choose from these the ones that are most appropriate to the business's needs.

A separate treasury function is more likely to develop the right skills for such roles. In larger firms, treasury is usually centralised at head office and provides a service to all parts of the business. This allows it to achieve economies of scale – for example, by obtaining better borrowing rates. The financial control function is often delegated to individual units, where it can respond more easily to customers and suppliers and relate more specifically to the units' competitors. As a result, treasury and financial control tend to be separated by location as well as responsibility.

The main functions of the treasurer can be classified as follows:

- **Banking**. The treasurer is responsible for managing the business's relationships with banks. This is an integral part of the three other functions identified below.
- **Liquidity management**. This involves working capital and money management. The treasurer will need to ensure that the business has the liquid funds it needs, and that it invests surplus money.
- **Funding management**. This is concerned with identifying suitable sources of funds. It requires knowledge of the sources that are available, the cost of those sources, whether any security is required and how to manage interest rate risks.
- **Currency management**. The treasurer is responsible for providing the business with forecasts of exchange rate movements, which in turn determines the procedures that will be used to manage exchange rate risks.

The treasurer's main tasks can also be categorised according to the three levels of management:

- **Strategic** – eg, matters concerning the capital structure of the business and distribution/retention policies, the raising of capital (including share issues), the assessment of likely returns from each source, dividend levels and alternative forms of finance.
- **Tactical** – eg, the management of cash/investments and decisions concerning the hedging of currency or interest rate risk.
- **Operational** – eg, the transmission of cash, the placing of "surplus" money and other dealings with banks.

Treasurers require specialist skills to be able to handle an ever-growing range of capital instruments – for instance, convertible preference shares issued in the name of an offshore subsidiary – and to determine the most suitable way to protect their firm from foreign exchange risk, which demands a good knowledge of forward markets and the ability to choose the most appropriate methods of hedging and foreign exchange cover.

They also need a knowledge of taxation in all areas in which their group operates and, following on from that, the ability to advise effectively on policies such as transfer pricing in permissible ways to minimise the business's overall tax liability.

The capacity to achieve big gains or sustain big losses is enormous – in the space of a few hours a treasurer can wipe out all the profits their organisation has made over several months. It is therefore important that the authority and responsibility associated with the treasury function are carefully defined and monitored. This becomes even more important as the range of derivatives increases.

Senior managers need to be aware of which risks are being carried, which are being laid off and, where appropriate, which are being taken on. There is also increasing pressure on companies to disclose in their annual reports more information about their treasury policies and their "positions" on the balance sheet date.

Both the treasurer and the financial controller will usually report to the financial director, whose concern will be to harmonise their activities in the most efficient way possible. Here are two examples comparing their relationships:

- The treasurer is best able to assess cost of capital and quantify the business's aversion to risk, while the financial controller relates these factors to group strategy.
- The financial controller identifies the business's currency risks, while the treasurer advises on the best means to hedge the risks.

An interesting topic for debate is whether treasury should be accounted for simply as a cost centre or as a business in its own right, seeking to make a profit from its activities – for example, by charging other business units in the enterprise for its services (and giving those business units the choice of whether they use it or a bank). The main advantages of operating the treasury as a profit centre rather than as a cost centre are as follows:

- Individual business units can be charged a market rate for the service provided, thereby making their operating costs more realistic.
- The treasurer is motivated to provide services as effectively and economically as possible to ensure that a profit is made at the market rate – eg, in managing hedging activities for a subsidiary – thereby benefiting the group as a whole.

The main disadvantages are as follows:

- The profit concept is a temptation to speculate – eg, by swapping funds from currencies expected to depreciate into ones expected to appreciate.
- Management time is wasted in arguments with business units over charges for services, even though market rates may have been impartially checked by the internal audit department.
- The extra administrative costs may prove to be excessive.

The decision on whether to operate treasury as a profit centre may well depend on the particular "style" of your company and the extent to which its activities are centralised or decentralised.

Taking treasury management at Sainsbury's as an example: its annual report for 1999 states that "treasury policy and significant treasury transactions are reviewed and approved by the board, while the finance management subcommittee of the board is responsible for monitoring treasury activity and performance.

"The group's major treasury activities, with the exception of the operations of Sainsbury's Bank, are centralised in the group treasury function. Group treasury operates as a cost centre with group-wide responsibilities for cash management, funding and interest rate and currency risk management. In this context, group policy allows the use of derivative instruments, but they may be used only to reduce exposure arising from underlying business activities, and not for speculative purposes." ■

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Consuming passions

Sue Brear

The second of two articles on identifying your business's most profitable customers

The role of the management accountant has changed considerably over the past decade. It has moved beyond number crunching and into business and financial strategy. A management accountant with a broad knowledge and understanding of their organisation's business can now play a significant part in designing segmentation strategies and measuring their success.

If an organisation is to develop the most effective segmentation strategy, it needs to understand what motivates different types of consumers in different areas to purchase goods and services. Management accountants can play their part in the collection and analysis of the substantial amount of data that's needed to predict consumer behaviour. Such information needs to combine geography and demographics (geodemographics) with the consumers' underlying characteristics, so that significant factors such as age, sex, marital status, occupation, economic position, education and location are included.

Neighbourhood classifications based on demographics tend to be better indicators than those based solely on behavioural information, because consumers generally live where they do on account of their age, household and socio-economic circumstances. Such factors generally influence their buying habits.

The level and source of the information captured does depend on the nature of the industry. So, for example, to predict consumer behaviour when purchasing durables, UK census information may be enough. In contrast, entertainment and leisure companies are based on the premise that people have more disposable income to spend on entertainment and leisure

Segmentation in brief

Customer segmentation can serve as the foundation stone for sustainable competitive advantage because it identifies the most profitable opportunities to be exploited. But the development of an effective customer segmentation model demands a big investment of both time and money.

In planning its strategic direction, a company needs to decide the most appropriate allocation of its marketing efforts and investments across the segments. For example:

- A financial institution's marketing strategy may be to target wealthy consumers.
- Catering businesses may wish to target consumers with busy lifestyles, or those living in bedsits, flats and student accommodation, who tend to be most likely to eat out or buy takeaway meals.
- Organisations can develop their segmentation information internally or use the services of specialist organisations.
- Cluster analysis links behaviour to geography. The results produce a set of clusters that are different from each other and, within each cluster, sets of postcodes that are similar as possible across the variables. This information is arguably more sophisticated than that derived using demographic measures such as age, sex, income and so on.

Management accountants can play an important part in a business's segmentation activities. They can provide support in:

- grouping consumers into segments;
- grouping the products into categories;
- constructing the market;
- identifying most profitable segments and products;
- selecting target segments;
- designing performance yardsticks to enable the chosen segments to be measured effectively.